Chapter 3

Status of Ongoing Projects

The IMF's Approach to Capital Account Liberalization[14]

Capital account liberalization and related issues re-emerged as a topic of intense debate among policymakers and economists in the early 1990s. Although the IMF does not have clear jurisdiction over capital account transactions, the increasing importance of international capital flows for macroeconomic and exchange rate management in many countries has caused the IMF to give considerable attention to capital account issues in recent years. Thus, an independent assessment of how the IMF has addressed these issues, particularly those related to capital account liberalization, seems warranted.

The evaluation seeks to (i) contribute to transparency by documenting the IMF's approach to capital account issues and capital account liberalization in particular; and (ii) identify areas, if any, where the IMF's instruments and procedures, including surveillance and TA, might be improved, in order to deal better with capital account issues.

Issues for evaluation

The evaluation, covering roughly the 1990s and early 2000s, poses the following two main questions:

- What was the IMF's advice on capital account liberalization and other capital account issues, and how did it change over time?
- Did the IMF's advice on capital account issues in specific instances sufficiently take into account the trade-offs involved in various alternatives in the light of the state of knowledge existing at the time?

These questions may be addressed by asking more specific questions about aspects of the IMF's two related areas of activity, namely (i) its specific advice on capital account liberalization and (ii) its analysis and surveillance of broader capital account issues.

For example, specific questions might include:

- Is there evidence that, in more recent years, the IMF has changed its approach toward encouraging member countries to liberalize the capital account?
- In countries that opened their capital accounts during this period, what was the role of the IMF in terms of policy advice and TA?
- Was the IMF's approach consistent across countries, as well as across departments or between the staff, management, and the Executive Board within the IMF?
- What was the IMF's position on policy choices available to member countries facing a sudden—and presumably temporary—surge of capital inflows?
- How did the IMF take into account the context within which a country seeking advice was placed? In this context, did the IMF take a consistent position on the role of temporary capital controls as part of crisis response and prevention?
- Did the IMF give sufficient attention to the consistency of policy toward the capital account with macroeconomic and exchange rate policies?

Scope and methodology of evaluation

The evaluation is designed to assess the IMF's approach to capital account liberalization, as it relates to the broader question of how to manage capital flows. The focus of the evaluation therefore will be primarily on emerging market economies, for which private capital flows have been important. Particular attention will be paid to country experiences with liberalization (in terms of speed, sequencing, and preconditions) and policy responses to capital flows, including temporary use of capital controls, and the IMF's role and advice in these areas.

[14]A detailed issues paper/terms of reference for the evaluation is available on the IEO website at www.imf.org/external/np/ieo/2004/cal/091504.pdf.

The evaluation will utilize three layers of analysis:

- Analysis of cross-sectional issues, including multilateral surveillance.
- A study of internal documents for about 15 countries.
- A more detailed analysis of country experience in about five countries.

The *first layer* uses public and internal documents to consider how the IMF viewed capital account issues, including its own mandate in this area. It will also examine how the IMF communicated its views to the international community through formal and informal channels.

The *second layer* is a cross-country analysis of about 15 countries, which are being selected on the basis of the size of portfolio capital flows during 1991–2003 and the changes introduced in capital account openness during the 1990s. The sample includes: (i) countries that significantly liberalized the capital account; (ii) countries that still maintain significant controls on capital account transactions; and (iii) countries that introduced measures to restrict capital account transactions.

Finally, the *third layer* is a more detailed analysis of about five countries with varied experiences with, and at different stages of, capital account liberalization. The purpose is to have a better understanding of the role of the IMF in countries that substantially eased restrictions on capital transactions during the early 1990s, the nature of IMF advice for countries that are in the process of liberalizing their capital account, and specific country experiences with capital controls and capital account liberalization. The countries will be selected from among those included in the second layer of analysis.

The work of the evaluation is based primarily on a study of internal documents, supplemented by interviews with IMF staff and a review of academic literature. In addition, brief field visits are being made to some of the countries selected for the evaluation, including all of the case study countries. It is expected that the evaluation report will be circulated to the IMF Executive Board in the first quarter of 2005.

Financial Sector Assessment Program and Financial Sector Stability Assessment[15]

The Financial Sector Assessment Program was introduced in May 1999 in response to the financial crises of the late 1990s, which had led to a call for the IMF and the World Bank to find jointly an effective way to provide policy advice to strengthen the financial systems of member countries. It was meant to fill an identified gap in the international financial architecture in support of crisis prevention, based on a judgment that existing approaches at the IMF under Article IV consultations were not sufficient for effective financial sector surveillance.

The FSAP was designed to strengthen the surveillance of member countries, facilitating early detection of financial sector vulnerabilities and identification of development needs in the financial sector. The recognition of the close relationship between financial stability and financial development issues led to the decision to adopt a joint IMF–World Bank approach. The FSAP has become a principal platform for financial sector diagnosis at the IMF. Over 80 country assessments have been completed or are under way. Drawing on the FSAP, the IMF staff also prepares a Financial Sector Stability Assessment (FSSA), which summarizes the FSAP findings of relevance to IMF surveillance, based on discussions with the country authorities as part of the regular Article IV consultations.

The instruments to achieve the FSAP initiative's objectives include: (i) identifying financial sector risks and vulnerabilities by a team of IMF and Bank staff and outside experts using a variety of tools and methodologies; (ii) articulating findings and prioritizing recommendations; and (iii) follow-up activities to assess implementation of recommended measures. In addition, the initiative contemplates reassessments to identify new sources of vulnerabilities (Figure 3.1).

Issues for evaluation

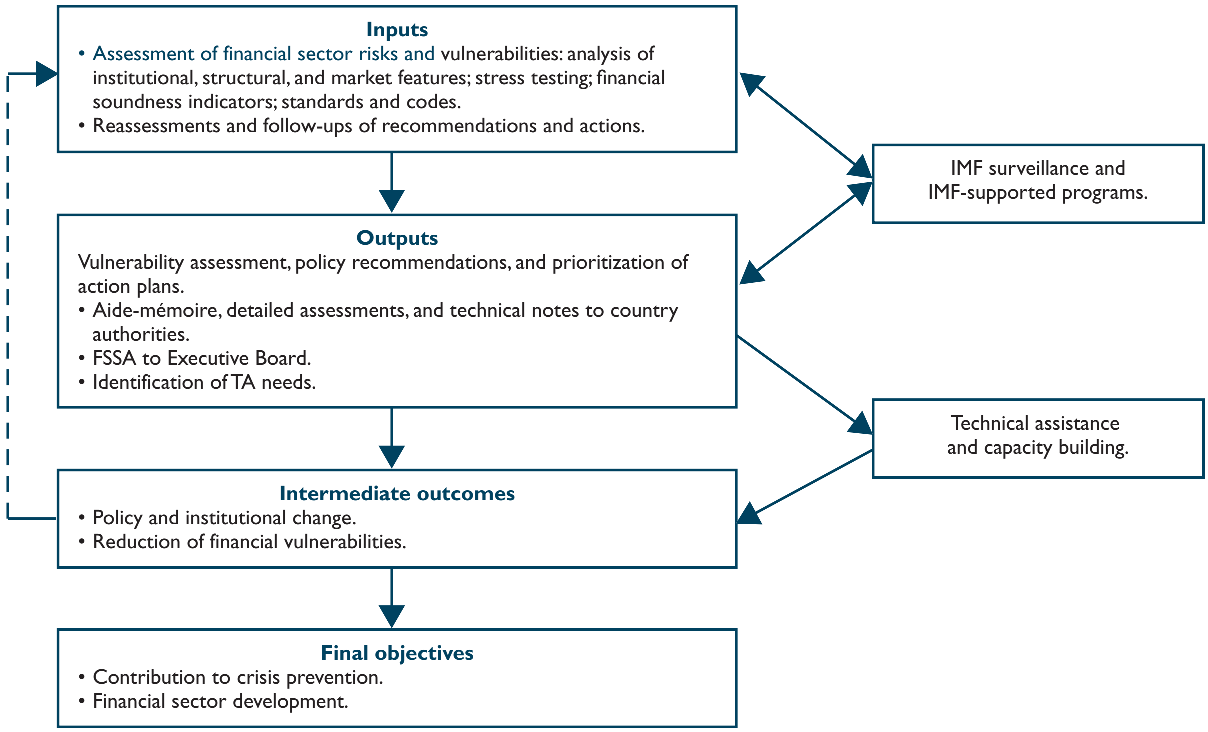
The IEO evaluation will focus mainly on those aspects of the FSAP for which the IMF has primary responsibility, in particular, on financial sector stability. Development issues will be considered inasmuch as they have direct influence on these aspects. A parallel evaluation by the World Bank's OED will assess the Bank's role in the FSAP initiative.

The ultimate objective of the FSAP initiative is to help countries reduce their financial sector vulnerabilities, thereby enhancing crisis prevention, with due consideration of the implications for financial sector efficiency. Consequently, a major question for the evaluation is how effectively the FSAP has achieved this objective.

Addressing this central issue involves evaluating four broad questions related to the architecture of the initiative and different parts of the results chain—its inputs, outputs, outcomes, and integration with the IMF's core activities (especially surveillance):

[15]A detailed issues paper/terms of reference for the evaluation is available on the IEO website at www.imf.org/external/np/ieo/2004/fsap/082504.pdf.

Figure 3.1. The FSAP Framework



(i) *Inputs.* Has the assessment of financial vulnerabilities been effective and cost-efficient in terms of identifying the principal sources of risks?

(ii) *Outputs.* Have findings and recommendations been clearly articulated and prioritized?

(iii) *Outcomes.* Has the FSAP process, as well as supporting IMF instruments, led to policy and institutional changes that significantly reduced financial vulnerabilities? Have follow-ups provided effective encouragement to this process?

(iv) *Integration with surveillance.* Has the overall surveillance function of the IMF with regard to the financial sector been improved by the integration of the FSAP/FSSA into Article IV surveillance? Have the arrangements for follow-ups and reassessments resulted in effective support for ongoing financial sector surveillance?

Methodology and time frame

The evaluation will use various types of evidence to address the above questions. Cross-country analysis will address such issues as how FSAP priorities were implemented, coverage of Reports on the Observance of Standards and Codes (ROSCs), characteristics of stress testing performed, and use of financial soundness indicators. Desk reviews will be employed systematically to collect evidence contained in FSAP documents and assess the main evaluation issues across a broad group of countries (that is, assessment effectiveness, articulation of recommendations, and overall surveillance integration under diverse country circumstances). More in-depth reviews, including country visits, will examine in greater detail how the FSAPs have been conducted, their interaction with IMF surveillance, and their policy impact. The evaluation will also make use of interviews and surveys to gather the views of diverse groups of stakeholders, including IMF and World Bank staff, financial market participants, regulators, and country authorities. Coordination with the OED will include cooperation on various joint inputs, including on the in-depth country reviews and survey exercises, but the two units will produce separate reports covering the roles of their respective institutions. The final IEO report is expected to be presented to the Board in the fall of 2005.

IMF Assistance to Jordan[16]

Jordan has been selected to be the subject of the single country case study in the IEO's work program for FY2004–05.[17] The evaluation will assess how effectively IMF assistance helped the country tackle major macroeconomic challenges since the late 1980s, including the shocks related to political and economic developments in the Middle East. The evaluation provides an opportunity to revisit—in a specific country context—some issues discussed in earlier IEO evaluations of program design and interactions between program, surveillance, and TA activities of the IMF. As indicated in the work program, the evaluation is intended to illustrate the scope for learning from a systematic ex post assessment of IMF activities in a country, and also to investigate in some detail what the case suggests about the IMF's recent approach to program design, including the structure and focus of conditionality.

After almost 15 continuous years under IMF arrangements, the Jordanian authorities indicated that the expiration of a Stand-By Arrangement (SBA) in July 2004 marked the country's "graduation" from reliance on IMF financial assistance. Altogether, since 1989, Jordan had IMF-supported programs under three SBAs and three Extended Fund Facility arrangements. Against a backdrop of marked slowdown in economic activity, double-digit inflation, and growing fiscal and external current account deficits, the program supported by the first arrangement sought to lower the country's macroeconomic imbalances while setting the stage for recovery in export-led economic growth. By contrast, the last arrangement was designed to consolidate macroeconomic stability. The arrangement was then converted into a precautionary one after the first program review because of significantly strengthened balance of payments and international reserves positions. The choice of Jordan allows for assessments of typical features of relations between the IMF and its borrowing members, while at the same time broadening the scope of members that have been the subject of case studies in IEO evaluations.

Issues for evaluation

The evaluation seeks to answer three principal questions:

- How effective were the programs—strategies and policies, as well as conditionality—in achieving their objectives, and what were the major factors that contributed to their success or lack thereof?
- To what extent did IMF surveillance contribute to identifying and tackling deep-rooted macroeconomic problems?
- What were the main considerations that drove the provision of TA, and how effectively did the assistance contribute to the country's capacity to formulate, implement, and monitor macroeconomic polices and performance?

While the focus of the evaluation is on the role of the IMF, including the extent to which internal policies and procedures permitted effective learning, implementation issues (which depend largely on government actions) and collaboration with Jordan's other international development partners will also be reviewed. Of particular interest will be collaboration between the authorities, the IMF, and the World Bank on issues related to growth strategies, structural reforms, quality of fiscal adjustment, and social safety nets.

Methodology of evaluation

The evaluation will include extensive desk reviews and interviews with a wide range of stakeholders. The desk reviews will cover internal IMF documents and reports as well as papers and publications from outside the IMF that address issues relevant to IMF-Jordan relations, including the rationale for IMF policy advice and program design. Interviewees will include current and former government officials, other stakeholders (for example, representatives of the business community, civil society groups, and academia), current and former IMF and World Bank staff, and representatives of Jordan's other development partners. A staff visit to Jordan took place in late 2004.

The evaluation report is expected to be completed by April 2005.

Structural Conditionality in IMF-Supported Programs

Largely responding to outside criticism of the increasing size and widening scope of structural conditionality in IMF-supported programs, IMF management appointed a Working Group on Streamlining Structural Conditionality in mid-2000. Following consultation with the Executive Board, new Conditionality Guidelines were approved in 2002. These guidelines stress the need for parsimony and a test of *criticality for the achievement of program goals* for the selection of any variable subject to conditionality.

[16]A detailed issues paper/terms of reference for the evaluation is available on the IEO website at www.imf.org/external/np/ieo/2004/jor/ip.pdf.

[17]For details on the selection criteria, see the issues paper.

They also encourage cooperation with other IFIs, especially in areas outside the IMF's expertise.

The evaluation is designed to (i) review how structural conditionality has been used in recent years, (ii) assess its effectiveness, and (iii) draw lessons for improving the design of structural conditionality in future programs. In pursuing these objectives, the evaluation aims to go beyond a simple analysis of compliance with conditions. Instead, it attempts to examine how conditionality has affected economic outcomes, including through IMF conditionality's impact on local ownership of reforms and on domestic policy processes more generally.

Because observed conditionality is largely the product of a negotiation process, a proper assessment of the effectiveness of structural conditionality must account for the various factors that play a role in that process. Without such information, little can be inferred from a simple measure of compliance.[18] The evaluation will also examine the channels through which conditionality can affect economic outcomes, either positively or negatively. To address these issues, it will examine the economic, social, and political factors at play over the lifetime of a typical IMF-supported program. The evaluation will examine various arguments advanced in academia, civil society, and policy circles regarding the pros and cons of structural conditionality.

Issues for evaluation

Key issues to be addressed will include:

- Has structural conditionality in specific instances contributed to improvements in policymaking processes or long-term economic performance?
- How has the test of macro-criticality been applied in practice? Have there been instances in which the streamlining initiative has led to the failure of a program to address areas deemed critical for the achievement of program objectives? Are there instances in which structural conditionality is still excessive or insufficiently focused?
- Are there areas in which structural conditionality is used despite the lack of a clear link with program objectives?
- Has the streamlining effort led to meaningful changes in interactions between IMF staff and national authorities, and has the IMF's internal review process been conducive to streamlining?
- Have certain types of conditionality (for example, conditionality focused on processes rather than on specific policy actions or on outcomes) worked better than others?
- Has the envisioned degree of cooperation with the World Bank in structural reform areas been achieved in practice?

The specific methodologies and time frame of the evaluation are being spelled out in the issues paper, which will be posted on the IEO website. The evaluation report is expected to be completed in the first quarter of 2006.

Multilateral Surveillance

It is generally understood within the IMF that multilateral surveillance is conducted mainly through *World Economic Outlook* (WEO) and *Global Financial Stability Report* (GFSR)[19] exercises, in which the Research Department and International Capital Markets Department, respectively, play the leading role. Complementing bilateral surveillance, these exercises are aimed at analyzing the forces driving the world economy, identifying global vulnerabilities, and advising on appropriate policies, especially in the most systemically important countries.

This evaluation is intended to assess the effectiveness and impact of multilateral surveillance in the IMF and to draw lessons that may help improve the content, process, and organization of multilateral surveillance in the future. Focus will necessarily be placed on major industrial countries whose policies have greater impact on the rest of the world economy. Some Executive Directors have expressed the view that the evaluation should also address issues related to regional surveillance.[20]

Potential issues to be addressed include the following:

- What has been the effectiveness of multilateral surveillance in giving "early warning" of potential global vulnerabilities, such as cross-country asset booms and sharp fluctuations in capital

[18]For example, an IMF-supported program may include a condition that reflects the country authorities' desire to send a positive signal to the markets. The effectiveness of conditionality in this case would then have to be assessed in terms of whether the intended effect on capital inflows materializes, rather than exclusively in terms of compliance with that particular condition.

[19]Previously called the *International Capital Markets Report*.

[20]While several regions are of interest for this evaluation, the IMF has formally applied an explicitly regional approach to only four regions in its surveillance work: the European Union, the Eastern Caribbean Currency Union, the West African Economic and Monetary Union, and the Central African Economic and Monetary Union.

flows to emerging markets? Does the staff produce sufficiently pointed analysis and recommendations on these issues; how effectively does the IMF follow up on them; and what has been the actual impact of IMF policy advice on the policy debate and on member country policies?

- Has interaction between multilateral surveillance and bilateral surveillance, particularly in major industrial countries, been effective? How could this cross-fertilization be improved?[21] How has the interaction of multilateral and bilateral surveillance dealt with the increasing "globalization" of some vulnerabilities, and does this suggest that changes in the way such surveillance is conducted are needed?
- In this context, has the IMF's bilateral surveillance work sufficiently considered increasingly important regional linkages? Has bilateral surveillance been consistent across countries that are part of a formal regional monetary arrangement? Should there be a greater formalization of regional surveillance in these countries?
- What has been the role of WEO and GFSR exercises in forecasting prospects for the global economy and identifying global vulnerabilities? How well are these exercises integrated into the IMF's other operational work, including the design of IMF-supported programs and advice to nonprogram countries?
- How effective a role has the International Capital Markets Department played in enhancing the coverage and integration of financial market issues into multilateral surveillance and in identifying systemic weaknesses originating in the financial sector?
- What has been the impact of the increased emphasis on capital market issues in multilateral surveillance and the enhanced interactions with private financial market participants? Has it led to a clearer focus on areas where action is needed on the supply side to mitigate volatility?
- What has been the effectiveness of the IMF's inputs into the deliberations of various international or regional groups, such as the G-7 and the Asia-Pacific Economic Cooperation?
- How does the product of multilateral surveillance (including economic forecasts) compare with similar assessments produced by other public and private institutions? What has been the value added to different parts of the international community, including member country authorities and the private sector?

The evaluation is at an early stage of preparation. The issues paper, detailing the methodologies and issues to be addressed, will be prepared and posted on the IEO website in the spring of 2005. It is expected that the evaluation report will be completed and discussed by the Executive Board toward the end of 2005.

[21]The December 1999 "External Evaluation of IMF Surveillance" identified inadequate cross-fertilization between multilateral and bilateral surveillance as a problem and made a number of recommendations (www.imf.org/external/pubs/ft/extev/surv/eval.pdf). The IEO evaluation may also assess the impact of those recommendations endorsed by the Executive Board in this area.