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IMPLEMENTATION PLAN IN RESPONSE TO BOARD- ENDORSED RECOMMENDATIONS FOR THE IEO EVALUATION OF INTERNATIONAL RESERVES—IMF CONCERNS AND COUNTRY PERSPECTIVES

EXECUTIVE SUMMARY

This paper proposes Management's response to the IEO's *Evaluation of International Reserves—IMF Concerns and Country Perspectives*. The proposed implementation plan focuses on those recommendations that are not already being addressed by other recent Fund initiatives, and include: (i) a successor paper on reserve adequacy, which will review the work contained in the Fund's 2011 *Assessing Reserve Adequacy* paper and develop additional and updated guidance where needed; (ii) the preparation of a staff guidance note for assessing adequacy; and (iii) additional engagement on reserve issues with members, the private sector, and academics.

Approved By

Prepared the Strategy, Policy and Review Department

Siddharth Tiwari

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INTRODUCTION

1. This paper presents a forward-looking management implementation plan for the IEO evaluation on international reserves. The proposals set out in this paper seek to address the outstanding recommendations on which there was broad support from the Executive Directors. It also highlights a number of cross-cutting Fund policies and practices which are in place which help address some of the issues presented in the IEO's evaluation. Progress on the implementation of this plan will be monitored through future Periodic Monitoring Reports, which provide updates on IEO evaluations, and followed up in subsequent broader reviews of surveillance.

IEO RECOMMENDATIONS AND BOARD REACTIONS

2. The IEO's recommendations addressed the Fund's approach to the analysis of reserves in both multilateral and bilateral contexts as well as its policy advice. The IEO report focused on analysis and advice on reserves in the context of the IMF's overarching objectives to promote the stability of the international monetary system and external stability in its member countries. The evaluation's recommendation centered on (Annex 1):

- **The analysis of reserves.** In the *multilateral context* the IEO recommended that the discussion of reserve accumulation be embedded in a comprehensive treatment of threats to global financial stability and reflect developments in global liquidity and financial markets. In the *bilateral context* the IEO recommended that assessments of reserve adequacy reflect country-specific characteristics, and that clearer advice be given on reserve adequacy considerations for advanced economies.
- **Reserve policies and their spillovers.** The IEO recommended that policies should be designed to target the underlying distortions rather than just symptoms, such as excessive reserves, as well as account for each country's relative contribution to the systemic externality which may result from excessive reserve accumulation. At the country level, the IEO sought greater recognition for the multiple policy tradeoffs that reserve accumulation decisions can involve.

3. During the Board discussion, Executive Directors broadly supported the general recommendations presented in the evaluation, while recognizing that the Fund had already made progress in many of the areas the evaluation highlighted. Specifically, Directors welcomed the evaluation's findings that Fund research on reserve adequacy has been at the forefront of the field, and that surveillance of systemically important countries had struck the right balance in deploying analytical tools and taking account of other factors that affect the external conditions facing these countries. There was also a general recognition that "the Fund has already made

progress in many of the areas highlighted in the [IEO] report.” Even so, Directors called for follow-up in a few areas:

- More thorough and complete reserve adequacy assessments in bilateral surveillance and specific guidance tailored to certain types of economies, including advanced economies; and
- Improved communication of the Fund’s views, and guidance, on assessing reserve adequacy for precautionary purposes to reduce misunderstandings regarding the Fund’s work, role, and interest in this area.

IMPLEMENTATION PLAN

4. The management implementation plan developed in this paper focuses on the specific areas where additional work is needed. The following two subsections lay out proposals to: (i) ensure robust coverage of reserve adequacy in Fund surveillance, and develop advice on adequacy to reflect certain characteristics of economic structures; and (ii) improve the communication and external understanding of the Fund's advice on issues related to reserve adequacy. The final subsection discusses other recent Fund initiatives which also address the IEO’s recommendations.

A. Ensure robust coverage of reserve adequacy in Fund surveillance, and specific guidance tailored to certain types of economies

5. Management and staff will continue to promote implementation of the guidance on surveillance in Article IV consultations, including assessment of reserve adequacy. It will be essential to ensure that the recently revised guidance on bilateral surveillance is flexibly implemented, and reflected in the spectrum of Fund surveillance products. This flexibility will aim to ensure a consistent assessment of reserve adequacy across countries with similar features. While the relative importance of reserve adequacy will vary across members, staff should make an assessment as part of the consultation process. This will be supported by ongoing efforts to enhance attention to surveillance priorities in the review process.

6. Further work is proposed to review recent experience of use of the reserve adequacy metric and propose possible areas for new development. This work would build on staff’s initial thinking in the *Assessing Reserve Adequacy* paper. A follow-up paper is planned for later in 2013 and would consider how the reserve adequacy metric designed for emerging markets performed during the most recent crisis relative to other metrics. The paper will also assess whether alternative external risk factors may also provide informative guidance on reserve adequacy, as well as investigate which factors dollarized and advanced economies should consider when thinking about reserve adequacy. Specifically, the paper would, inter alia, investigate the following areas:

- a. Are there alternate variables or metrics which are important drains on the balance of payments during times of stress which should be used more widely when assessing reserve adequacy?
- b. To what extent can the metric developed for emerging markets be projected forward to make adequacy assessments more forward looking?
- c. Does the existing emerging market metric adequately cover commodity importers?
- d. How can the opportunity cost of holding reserves be better integrated into adequacy assessments?
- e. How should the impact of volatility in financial markets and flows be reflected in assessing the adequacy of reserve levels?

7. Together with existing work, this new analysis will form the basis for a Board paper and staff guidance note on reserve adequacy. Following a Board paper, staff would prepare a guidance note on reserve adequacy (planned for early 2014) to help ensure new and existing analysis is applied in a flexible and consistent manner both inside and outside the Fund. The note would draw together existing analysis, provide good examples of reserve adequacy assessments in current surveillance, and include new insights from the successor Board paper. The aim would be to contribute to a more comprehensive discussion with member countries and other interested observers on the topic of reserve adequacy.

B. Improved communication of the Fund's views, and guidance, on reserve adequacy

8. The second External Sector Report (ESR) provides a key opportunity to present a multilaterally consistent assessment of external developments and policy recommendations. The pilot ESR report provided a significant contribution to addressing the evaluation's recommendations. The second report, expected to be discussed by the Board in late June, will benefit from feedback and comments received on the pilot through consultation with officials, academics, the private sector and civil society among others. As this approach to surveillance of the external sector is further refined the Fund will ensure that the discussion in the ESR responds adequately to the IEO's call for an integrated multilateral discussion of external sector risks and policies.

9. The Fund will step-up engagement on reserve adequacy through dedicated missions, and as part of the regular surveillance cycle. Enhanced engagement would be focused on countries where discussion of reserve adequacy is central to the policy mix, and where there is an opportunity to share analysis and hear views on these issues. This will help advance the analytical underpinnings of Fund assessments. In particular, a follow-up Board paper on reserve adequacy would benefit significantly from country views on the extent to which the

Fund's past work on reserve adequacy—including the Fund's reserve adequacy metric for emerging markets—has contributed to policy decisions on reserves, and where there is room for improvement. Separately, the enhanced reserve adequacy toolkit, including the metric, could then be made available on the external IMF website to broaden its usage as well as stimulate further development by policy makers and academics.

C. Recent Fund initiatives which also address the IEO's recommendations

10. Several recent surveillance and policy initiatives in support of the IEO's recommendations are underway. The IEO's recommendations cut across a number of areas in which the Fund has taken steps in recent years to strengthen both multilateral and bilateral surveillance. The surveillance products and policy initiatives set out below, some of which are in response to previous IEO evaluations and the 2011 Triennial Surveillance Review (TSR), contribute towards addressing some of the IEO's recommendations. Specifically:

- *Bilateral Surveillance Guidance.* Guidance on bilateral surveillance was updated in July 2012 to incorporate recommendations from the TSR and was again revised in October 2012 to reflect the implications of the Integrated Surveillance Decision. A key element of this guidance is the focus on balance of payments stability as an operational priority for surveillance. The goal is to ensure comprehensive coverage of external sector issues including an analysis of exchange rates, the current and capital and financial accounts, balance sheet mismatches, and reserve and intervention policies where relevant. As part of this, guidance on reserves adequacy stresses that staff should consider a range of approaches, while taking account of country-specific characteristics and vulnerabilities. Staff have been encouraged to use the IMF's reserve adequacy metric where it is appropriate, while taking into account country-specific considerations when assessing the adequacy of reserves. Where relevant and feasible, guidance has also encouraged the use of other approaches.¹
- *External Sector Report.* The pilot External Sector Report in 2012 provided a multilaterally consistent snapshot of global external imbalances, and pointed to potential policy responses in a multilateral context. The analysis considerably broadened the Fund's external sector surveillance by systematically assessing developments in exchange rates, current accounts, balance sheet positions, reserves adequacy, capital flows and capital flow measures. It used the newly developed pilot External Balance Assessment approach, together with judgment, to assess external imbalances, and was designed to complement bilateral surveillance by taking a detailed multilaterally consistent approach to the

¹ See [Guidance Note for Surveillance under Article IV Consultations](#), October 10, 2012, Paragraph 40.

external sector. Given the pilot nature of this work, the methodology will evolve over successor reports based on the lessons learned.

- *Spillover reports and other multilateral surveillance products.* A key motivation for the Spillover reports, the first of which was published in 2011, is to focus on countries of systemic importance and provide specific policy recommendations. Importantly, this work takes account of the relative size of countries' contributions and the size of spillovers, while also taking a comprehensive view of country policies. The 2013 Spillovers Report is expected to investigate the impact of policies followed by advanced economies on emerging markets. More generally, the Fund has a wide set of surveillance initiatives that integrate advice on reserve accumulation with related policy areas. For example the Global Financial Stability Report (GFSR), Vulnerability and Early Warning Exercises all consider threats to global stability, of which reserves are just one aspect of the assessment.
- *Integration of policy analysis and advice.* Recently, the Fund has proposed an institutional view on the liberalization and management of capital flows. This work resulted in a comprehensive, flexible, and balanced approach for the management of capital flows so that the Fund is in a position to provide clear and consistent advice, which also takes reserve adequacy considerations into account. Specifically, the policy advice for responding to capital inflow surges proposes combining the appropriate mix of monetary and fiscal policies consistent with inflation and growth objectives, allowing the currency to strengthen if it is not overvalued, and building foreign reserves if these are not more than adequate. A supporting staff guidance note is being produced to set out the operational implications of this advice.

RESOURCE IMPLICATIONS

11. Resource implications are expected to be relatively modest. Many of the initiatives are ongoing and already accounted for in the existing budget envelop. Wherever possible, opportunities to coordinate with other outreach missions, for example on capital flows or the ESR, will be sought. Outreach activities are also expected to be drawn from reallocating travel budgets. The main additional resource implication will be in relation to a follow-up Board paper on assessing reserve adequacy where costs are expected to be modest and can be accommodated for in existing budgets.

**ANNEX. IEO EVALUATION OF INTERNATIONAL RESERVES—IMF CONCERNS
AND COUNTRY PERSPECTIVES: RECOMMENDATIONS, BOARD RESPONSE,
AND PROPOSED FOLLOW-UP**

IEO Recommendations	Executive Directors' Responses	Follow-Up Plan
<p><i>1. Target perceived policy distortions directly.</i></p>	<p>Many Directors shared the IEO's view that excessive reserve accumulation is only a symptom of underlying distortions, and stressed the importance of other factors like developments in global liquidity and capital flows.</p> <p>A number of other Directors agreed with staff that it is justified to highlight that, in addition to being a symptom, reserve accumulation can be a potential cause of instability for the IMS, given the limited availability of reserve assets.</p>	<p>Thorough implementation of revised bilateral surveillance guidance and addressed in the second External Sector Report.</p>
<p><i>2. Embed the discussion of reserve accumulation in the multilateral context in a more comprehensive treatment of threats to global financial stability that is informed by developments in global liquidity and financial markets</i></p>	<p>Directors noted with satisfaction the broad congruence between the IEO's recommendations and current Fund policies and practices. In particular, the latest <i>Triennial Surveillance Review</i> calls for widening the scope of external stability assessments in bilateral surveillance, and the recently launched <i>External Sector Report</i> lays out, in a multilaterally-consistent manner, the evolution of external imbalances across the largest economies.</p>	<p>Thorough implementation of revised bilateral surveillance guidance and addressed in the second External Sector Report.</p>

IEO Recommendations	Executive Directors' Responses	Follow-Up Plan
<p>3. Policy initiatives that are meant to deal with systemic externalities must take into account the relative size of countries' contributions to the externality.</p>	<p>Directors noted that Fund surveillance of systemically important countries has struck the right balance in deploying those tools, taking into account other factors that affect external conditions for these countries.</p> <p>As regards global spillovers from excessive reserve accumulation, a number of Directors supported the IEO's recommendation that the relative contribution of a country to such externality be taken into account, without prejudice to the principle that all Fund members should be treated evenhandedly. This approach is already being applied in the Fund's multilateral surveillance products, including the <i>Spillover Reports</i>.</p>	<p>Implementation of Spillover Reports and other multilateral surveillance products.</p>
<p>4. Reserve adequacy indicators should be applied flexibly and reflect country-specific circumstances.</p>	<p>Directors welcomed the IEO's findings that the Fund staff's research on the adequacy of official reserves is at the forefront of the field. They noted that this research has provided a rich set of tools to inform reserve assessments at the country level.</p> <p>Directors agreed on the desirability of a comprehensive assessment of reserve adequacy, including for advanced economies, and urged staff to build on their earlier work in the <i>Assessing Reserve Adequacy</i> paper.</p> <p>Most Directors saw room for making Fund guidance on reserve adequacy more alert to country-specific conditions, but in a consistent manner across countries with similar features.</p>	<p>Follow-up Board paper on Assessing Reserve Adequacy (by end-2013) and new Staff Guidance Note (March 2014).</p> <p>Implementation of the guidance on bilateral surveillance, including the flexible implementation of exiting guidance reserve adequacy, with the flexibility ensuring consistent assessment of reserve adequacy across countries with similar features.</p>

IEO Recommendations	Executive Directors' Responses	Follow-Up Plan
<p><i>5. Recognize the multiple tradeoffs involved in decisions on reserve accumulation and reserve adequacy at the country level, and integrate advice on reserves with advice on related policy areas.</i></p>	<p>Directors saw the need for additional work on more thorough and complete reserve adequacy assessments in Article IV consultations.</p> <p>Directors noted... widening the scope of external stability assessments in bilateral surveillance the recently launched <i>External Sector Report</i> ... integrating advice on reserve adequacy with that on related policy areas.</p>	<p>Implementation of revised bilateral surveillance guidance and addressed in the second External Sector Report.</p> <p>As noted above, new Staff Guidance Note on reserve adequacy.</p>
<p><i>6. Advice should also not be directed only to emerging markets but, when necessary, take into account the concerns in advanced economies that have arisen after the crisis.</i></p>	<p>Directors saw the need for additional work on directing advice on reserve adequacy to all member countries, including advanced and dollarized economies.</p>	<p>Further work on advanced economies in Board paper on Assessing Reserve Adequacy (noted above).</p>