The Acting Chair's Summing Up
Evaluation of the Role of the Fund in Recent Capital Account Crises

Report by the Independent Evaluation Office

Executive Board Meeting 03/69
July 16, 2003

General Remarks

Executive Directors welcomed the second report of the Independent Evaluation Office (IEO report), which offers a comprehensive and thoughtful analysis of the Fund's role in capital account crises in three important country cases—Brazil, Indonesia, and Korea—and of the lessons to be learned from these experiences. They considered the report a useful complement to previous studies undertaken both within and outside the Fund. Directors broadly agreed with the report's analysis and conclusions, which they found to be generally consistent with those of earlier studies.

Directors stressed that several caveats need to be borne in mind regarding the findings and conclusions of the report. First, the report focuses mainly on the Fund's involvement in the early stages of crises. Many Directors considered that the report would have been more useful if it had also examined the later successes and challenges in restoring confidence, stemming capital outflows, and putting in place structural reforms that have reduced vulnerabilities. For example, in Indonesia progress was made in tackling the fundamental problems in the financial and corporate sectors as early as the second half of 1998 and, as the policies under the Fund-supported program took hold, the economy's performance improved markedly. It was recognized, however, that, in some cases, the IEO's mandate not to interfere in ongoing operations constrained the extent to which the report could examine longer-term developments.

Second, the Fund has already taken steps in recent years to address many of the concerns raised in the report, in areas such as transparency, conditionality, standards and codes, financial sector surveillance, vulnerability assessments, and Fund-Bank collaboration. While the report acknowledges these changes and seeks to identify additional areas for improvement, some Directors felt that its usefulness might have been enhanced if it had spent more time assessing the adequacy of the changes that have already been made. However, Directors acknowledged that assessing how these changes might have affected the earlier crises would have been a complicated task.

Third, the report confirms that every capital account crisis is unique. Thus, anticipating crises will always require difficult judgments in the context of great uncertainty, and distilling lessons from past crises is no guarantee of future success. Directors stressed that there is no standard solution to capital account crises; the nature and adequacy of the policy advice will need to take into account the causes and specific circumstances of each crisis, and the capacity to prevent crises will depend to a large extent on the actions of member countries.

With these caveats in mind, Directors noted that most of the Fund's efforts to anticipate or deal with the three crises went in the right direction. Nevertheless, they shared the report's view that the Fund made some mistakes, and that the crises highlighted the need for improvements in the Fund's policies and procedures. Directors considered that the report has provided useful recommendations on how to further improve Fund surveillance and program design, and on how to enhance the catalytic role of Fund financing and the role of the Fund in coordinating crisis management and resolution.

Directors noted that the Board will have the opportunity to return to many of the issues discussed in the report during the forthcoming discussions on transparency, surveillance, financial soundness indicators, the balance sheet approach, information reporting requirements under Article VIII, data standards, and sustainability assessments. They encouraged management to address some of the issues related to personnel policies.

Recommendation 1. To increase the effectiveness of Fund surveillance, Article IV consultations should take a stress-testing approach to the analysis of a country's exposure to a potential capital account crisis.

Directors agreed that it is essential to strengthen the focus and effectiveness of Fund surveillance by extending and systematizing assessments of crisis vulnerabilities. Surveillance discussions should identify major shocks that the economy could face in the near future, explore the real and financial consequences of these shocks—including balance sheet effects—and discuss the authorities' plans for dealing with these shocks should they materialize. Directors emphasized that, within the general framework that has been endorsed by the Board, vulnerability assessments—and, in particular, stress testing—should not be over-generalized and exhaustive, but should focus on the key risks and economic realities facing the member in question. Furthermore, the assumptions underlying such assessments should be set out clearly to allow a proper interpretation of the results and to help inform the prioritization of reforms by authorities.

Most Directors agreed that the Fund should try to develop a greater understanding of the political constraints that may affect program implementation in a crisis, while cautioning that this should not lead to interference in domestic affairs. Some Directors stressed that this policy should be applied uniformly to all countries facing capital account crises. A number of Directors cautioned that a political economy focus could be counter-productive if it causes staff to lose focus and press for policies and reforms that are not macro-critical.

Given that restoring market confidence is essential to successful crisis resolution, Directors stressed the need for Fund staff to heighten their awareness of market perspectives on economic policies. They saw great value in systematic discussions with the domestic and international financial and business communities, including through the International Capital Markets Department, to better understand their concerns—but emphasized that the staff would need to assess private sector views critically.

Recommendation 2. Management and the Executive Board should take additional steps to increase the impact of surveillance, including through making staff assessments more candid and more accessible to the public, and providing appropriate institutional incentives to staff.

Directors strongly supported greater candor in the assessment of country risks and vulnerabilities in staff reports, building on the increase in candor that has already occurred. The provision of institutional incentives to the staff to facilitate such candor also was encouraged. Nevertheless, Directors expressed a range of views regarding the potential conflict between candor and transparency, and the implications of the proposed shift from voluntary to presumed publication of staff reports. Many Directors warned that greater candor could adversely affect both the Fund's dialogue with countries and market confidence in the context of the publication of staff reports. Some of these Directors felt that what really matters is candor in face-to-face consultations with the key decision-makers in a country, rather than in the staff report. Many other Directors strongly supported presumed publication. These believed that concerns about candor are overstated, and that surveillance would be more effective in building ownership and influencing policy if Fund analyses and recommendations are made public. It was agreed that the Board would return to the issue of presumed publication of staff reports during the discussion on transparency.

Many Directors considered that escalated signaling—a procedure the report recommends to be used when key vulnerabilities identified over several rounds of surveillance are not addressed—might be an idea worth pursuing. A number of these Directors reserved judgment on the suggestion until they had more information about how it would work. A few Directors felt that escalated signaling would undermine the Fund's role as confidential advisor, and doubted that it would help in preventing crises or designing more effective programs.

Many Directors were not in favor of inviting second opinions from outside the Fund when the authorities disagree with the staff's assessment on key policy issues. Whereas some Directors considered that a second opinion would bring a fresh perspective that could help resolve differences of opinions with the authorities, many were concerned that it could encroach on the role of the Board, and undermine the work of the staff. Furthermore, if extended to program cases, it would slow the process of designing Fund-supported programs and impair the ability of Fund-supported programs to resolve financial crises. A few Directors also noted that this approach has been tried and has failed.

Recommendation 3. A comprehensive review of the IMF's approach to program design in capital account crises should be undertaken.

Directors recognized that program design plays a critical role in the determination of program success. They looked forward to the forthcoming staff papers on program design and the balance sheet approach, which they hoped would give due attention to the issues raised in the report.

Directors agreed that the primary objective of a crisis management program should be to help restore confidence by implementing a comprehensive set of policies that effectively address the root causes of the crisis. Directors noted that the Fund's increased attention to financial sector surveillance has reduced the risk that vulnerabilities in the financial sector will be neglected in program design. At the same time, many Directors also concurred that much greater attention needs to be paid to the interaction of balance-sheet weaknesses and key macroeconomic variables, including the implications for aggregate demand, especially in capital account crises where the possibility of multiple equilibria exists—although it was acknowledged that the estimation difficulties may be formidable. Several Directors reiterated that the balance sheet approach should be closely linked to debt sustainability analysis and, in particular, to the implications of the currency and maturity structure for the debt dynamics. Directors called for more analytical work to design a framework for dealing with "twin" (exchange rate and banking) crises, including the implications for the sovereign's policies and financial position.

Directors agreed that program design should allow for a flexible response in case unfavorable outcomes materialize; that conditionality should be reviewed to see how it can be adapted to the rapidly evolving circumstances of capital account crises; and that, at a minimum, the broad outlines of the program should be communicated to the public and the markets. This is crucial to strengthening ownership, the Fund's credibility, and market confidence. Program documents should fully set out the assumptions underlying the central projections, identify and explain as far as possible the risks to the program, discuss alternative scenarios, and spell out explicitly how macroeconomic policies will respond in the event that known program risks materialize. Directors noted the critical importance of country ownership in ensuring successful program implementation, and saw continued value in a formal mechanism to trigger consultation on monetary and fiscal policies. They also stressed the importance of designing programs to fit the particular circumstances of individual countries. Nevertheless, a few Directors cautioned against excessive emphasis on risks and alternative scenarios in program documents, since it would be difficult to know all risks upfront and since such emphasis could erode the program's effectiveness in building confidence in the chosen action plan.

Directors supported the recommendation that a crisis should not be used as an opportunity to force long-standing reforms, however desirable they may be, in areas that are not critical to the resolution of the crisis or addressing vulnerability to future crises. They agreed that parsimony and focus should be the principles to guide the design of structural conditionality in a program whose objective is to restore confidence quickly. Directors noted that this recommendation is in line with recent initiatives by the Fund to streamline conditionality, and looked forward to reviewing the experience with the implementation of the conditionality guidelines.

Recommendation 4. Since restoration of confidence is the central goal, the IMF should ensure that the financing package, including all components, should be sufficient to generate confidence and also of credible quality.

Directors agreed that, to the extent that financing packages supporting the member's program rely on parallel financing from official or multilateral sources, it is essential that the terms of such support be clear and the amount be adequate. However, they noted that there are limits to the Fund's influence over the conditions for parallel financing, which reflect the structure and organization of partner institutions. Directors fully supported the idea of moving toward more explicit procedures for collaboration with regional development banks and others and clear delineation of responsibilities, while noting that such procedures do not by themselves guarantee effective coordination.

Directors observed that experience with capital account crises raises important issues relating to Fund liquidity, exceptional access, and private sector involvement. They stressed that the policy on access to Fund resources in capital account crises agreed in September 2002 has to be observed. More fundamentally, Directors stressed that the high quality and credibility of a program, together with adequate financing, should be at the heart of successful Fund involvement.

Recommendation 5. The IMF should be proactive in its role as crisis coordinator.

Directors emphasized the importance of all members' working together constructively during the period when a program is being negotiated. They noted that, for the Fund to play an effective role in coordinating efforts of other members, management should provide the Executive Board and member countries with candid assessments of the probability of success of a proposed strategy, including frank feedback when parts of a strategy favored by some members lower this probability; and they should protect the technical judgment of the staff from excessive political interference. While Directors were in favor of early involvement of the Board in program discussions, a number of them observed that the Board and major members should not seek to micro-manage the operational details of programs or influence Fund missions in the field.

Many Directors attached particular importance to the early involvement of the private sector in crisis resolution. They emphasized that the authorities, not the Fund, should play the leading role in negotiations with the private sector. However, they noted that the Fund has a responsibility to identify circumstances in which a more concerted effort is needed to involve the private sector, recognizing that decisions on the nature of such involvement will have to be made on a case-by-case basis.

Recommendation 6. Human resource management procedures should be adapted further to promote the development and effective utilization of country expertise within the staff, including political economy *skills, and to ensure that "centers of expertise" on crisis management issues allow for a rapid application of relevant expertise to emerging crises.*

Directors generally agreed on the need to ensure that the Fund is in a position to respond rapidly with relevant expertise to member countries facing crises. While recognizing that proposals related to organizational and human resource activities are among management's responsibilities, Directors expressed several views on these issues. Some Directors supported the creation of "centers of expertise" in crisis management, whereas others put greater emphasis on mechanisms for drawing upon available expertise and experience in the event of a crisis. A number of Directors favored longer country desk assignments to ensure that sufficient country experience is maintained within the staff, while others noted the importance of staff mobility in broadening the experience and perspectives of the staff and maintaining its impartiality. Most Directors favored a greater role for resident representatives in surveillance and program design, in countries with resident representative offices, with a few noting that only relatively senior resident representatives would be sufficiently acceptable to the authorities to play such a role. Directors also favored modifying internal guidelines and human resource procedures to create incentives for greater candor. They noted that management is already moving to improve the Fund's crisis management capability—for example, through the reorganization of the Monetary and Financial Systems Department and the review of the area departments.