EXECUTIVE BOARD MEETING

SM/19/104
Supplement 3

May 15, 2019

To: Members of the Executive Board

From: The Secretary

Subject: **Independent Evaluation Office—IMF Advice on Unconventional Monetary Policies—IMF Advice on Unconventional Monetary Policies to Selected Asian Economies**

Board Action:	Executive Directors' **consideration** (Formal)
Tentative Board Date:	**Wednesday, June 5, 2019**
Additional Information:	This paper is unchanged from the version previously circulated to the Evaluation Committee and other Executive Directors on Thursday, April 25, 2019 (EB/EVC/19/9, Sup. 3).
Publication:	The IEO proposes that, after the Executive Board completes its discussion, the evaluation report be posted on the external IEO website, together with management comments, any IEO response, and the summing up of the Board discussion. The Board would be notified of any corrections made in the published version.
Questions:	Mr. Collyns, IEO (ext. 38383) Mr. Loungani, IEO (ext. 37043)

BACKGROUND PAPER

BP/19-01/03

IMF Advice on Unconventional Monetary Policies to Selected Asian Economies

China and India:

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Korea and Selected ASEAN Economies:

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 BP/19-01/03

IEO Background Paper
Independent Evaluation Office
of the International Monetary Fund

IMF Advice on Unconventional Monetary Policies to Selected Asian Economies

May 14, 2019

Contents Page

Abbreviations iv

Executive Summary v

Chapter 1—China and India 1

I. Introduction 2

II. China 2

A. Economic Developments Since the GFC 2

B. Consultations with the IMF 4

C. Assessment 7

III. India 9

A. Economic Developments Since the GFC 9

B. IMF Engagement 12

C. Assessment of IMF Advice 15

IV. Conclusions 17

Figures

1. China: Selected Economic Indicators 3
2. China: Real House Price Index and Total Debt 5
3. India: Selected Economic Indicators 10
4. India: Capital Inflows, Stock Market, Exchange Rate, and International Reserves 11

References 18

Chapter 2—Korea and Selected ASEAN Economies 19

I. Introduction 20

II. Economic Developments Since the GFC 20

III. IMF Engagement 23

IV. Assessment 26

V. Conclusions 28

Figures

1. Net Capital Flows, Including Errors and Omissions 21
2. Use of MPP and CFM, by Region 22

Annex 1. Korea and ASEAN: External Developments 29

References 33

ABBREVIATIONS

AE	advanced economy
ASEAN5	Indonesia, Malaysia, the Philippines, Singapore and Thailand
CFM	capital flow management
EM	emerging market
FCL	flexible credit line
Fed	Federal Reserve (United States)
FDI	foreign direct investment
FSAP	Financial Sector Assessment Program
FX	foreign exchange
GDP	gross domestic product
GFC	Global Financial Crisis
IV	Institutional View
LDR	loan-to-deposit ratio
LTV	loan-to-value
MAE	major advanced economy
MPP	macroprudential policies
NEER	nominal effective exchange rate
PBOC	People's Bank of China
QE	quantitative easing
RBI	Reserve Bank of India
SARB	South African Reserve Bank
SARTTAC	South Asia Regional Training and Technical Assistance Center
SDR	Special Drawing Rights
UMP	unconventional monetary policies

EXECUTIVE SUMMARY

This paper assesses IMF advice to Asian economies (China, India, Korea, and the ASEAN5—Indonesia, Malaysia, the Philippines, Singapore, and Thailand) on dealing with the spillovers from unconventional monetary policies in the major advanced economies. It also describes how authorities in the region viewed IMF efforts to promote international policy cooperation.

IMF advice: At the start of the Global Financial Crisis (GFC), the IMF endorsed the monetary and fiscal stimulus provided by these economies and the use in some countries of foreign exchange intervention to offset capital outflows. As these economies recovered quickly, the IMF advocated rolling back the stimulus and turned its focus to advice on managing capital inflows. Staff were generally sympathetic to the use of capital flow management (CFM) measures to deal with capital flow volatility, and particularly so after the 2012 adoption of the Institutional View (IV) on such measures, and also provided advice on the use of macroprudential policies.

Assessment: Authorities in Asia felt that the Fund had provided valuable advice and had acted on many fronts to help Asian emerging markets cope with the effects of the GFC and adoption of UMP by the major advanced economies. The Fund's increased openness to CFM measures was appreciated by the authorities and seen as a validation of policy frameworks they had put in place before the GFC. Its work to support China's market reforms in the face of a challenging external environment was also greatly valued. The Asian authorities recognized the efforts that went into the spillover reports and the launch of the FCL, even though these countries had not in the end used the FCL option.

Officials and outside observers also noted several ways in which IMF advice could be improved:

- First, to be of greater value added to central banks, Article IV consultations and other engagements with the Fund should bring greater depth in monetary policy issues. They would also benefit from greater discussion and sharing of cross-country experience. High turnover of mission chiefs and staff on country teams was flagged as hampering the development of deep expertise and strong relationships, so that the Fund was not the first port of call when officials sought outside advice.
- Second, officials—particularly in the ASEAN5—felt that the IV did not truly expand the choice set of policies that could be used with the Fund's blessing as the restrictions placed on the use of CFMs were very limiting; officials preferred an approach that recognized the preemptive role that CFMs could play as part of a broad toolkit of measures. Moreover, the labeling by the Fund of certain measures that the authorities view as taken for financial stability considerations or for social objectives as CFMs proved to be an irritant in the Fund's dialogue with these countries.
- Third, it was felt that the IMF's spillover work had not fully succeeded in capturing the challenges for policymakers arising from volatile capital flows and that it needed to delve deeper into the impact on emerging markets through financial channels to be of greater policy relevance.
- Fourth, officials observed that design issues and stigma concerns continued to limit Asian interest in IMF contingent financing instruments.

Chapter 1—China and India

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I. INTRODUCTION

1. This chapter evaluates IMF advice to China and India on how to deal with the consequences of the unconventional monetary policies (UMP) adopted in the major advanced economies (MAEs) over the past decade, especially volatile capital flows. Emerging markets (EMs) were facing large capital flows already prior to the Global Financial Crisis (GFC), amid declining interest rates in AEs, particularly in the United States after the dot-com crash of 2000–02. During the subsequent years up to mid-2008, many EMs, including China and India, took measures to manage these flows, including capital flow management (CFM) measures and significant foreign exchange intervention. Their responses to the GFC involved deploying policies with which they already had some experience. Nevertheless, the developments of the past decade proved more challenging than expected, given that the crisis was much more serious than anticipated and the global economic recovery weaker. As a result, UMP, initially perceived to be temporary, have persisted for many years.

2. In assessing how IMF staff helped China and India navigate these challenges, this chapter evaluates the advice provided on policy options including on CFM; whether the technical expertise of IMF staff was useful to central banks in these countries; how IMF staff tailored advice to the circumstances of each country; and the extent to which the IMF played the role of a trusted advisor to these countries.

3. The assessment is based on desk review of the annual Article IV reports conducted by IMF staff for China and India between 2008 and 2017 and related documents, such as transcripts of press conferences by IMF mission chiefs; spillover reports; speeches and statements by IMF management; and internal Fund documents. The desk review was complemented by interviews with many IMF staff on the country teams for China and India (including nearly all mission chiefs over the past decade); with current and former officials at the central banks and other agencies; and with experts in academia and at think tanks.

II. CHINA

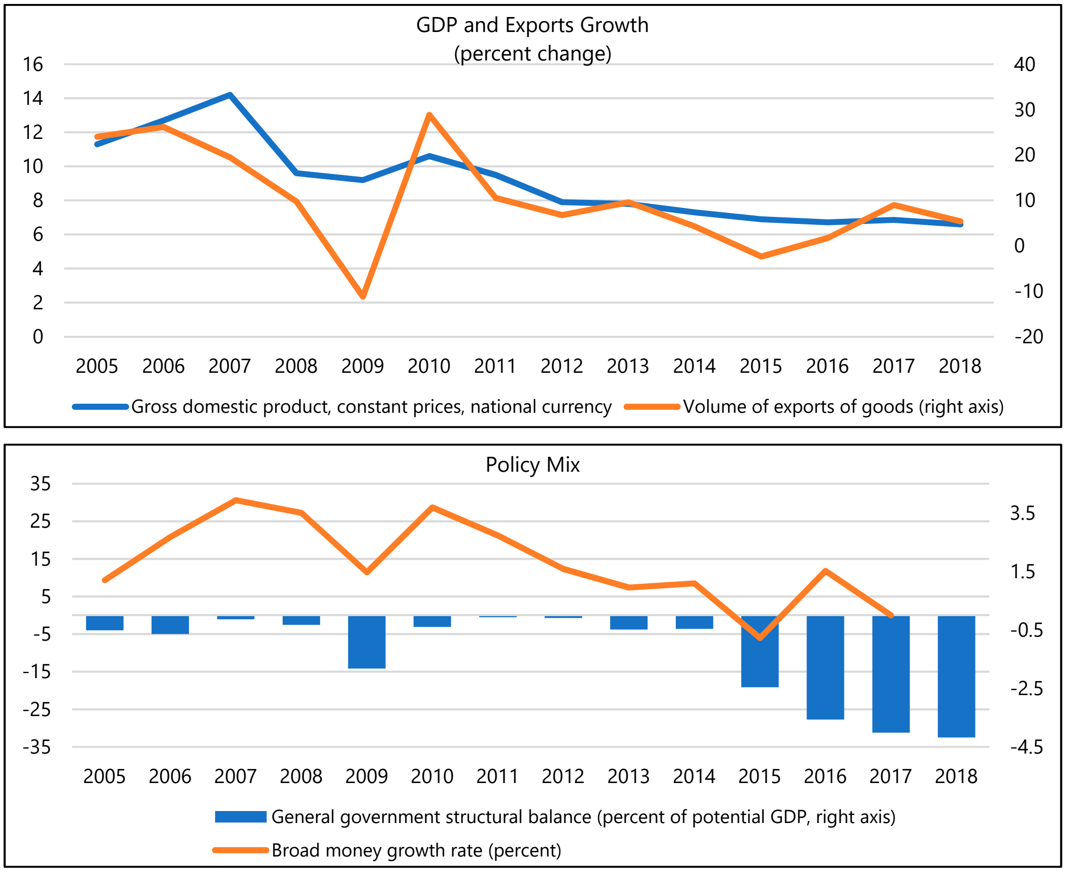
A. Economic Developments Since the GFC

4. China's macroeconomic performance prior to the GFC was very strong. Its annual growth rate exceeded 10 percent in the five years preceding 2008; its current account surplus increased from less than 3 percent of GDP before 2003 to almost 10 percent by 2007; and its foreign exchange reserves rose from around USD 400 billion in 2003 to more than USD 2 trillion in 2008, when it also had a healthy fiscal balance.

5. The Chinese economy was significantly affected by the GFC (Figure 1). In response, China eased monetary policy through lower interest rates and quantitative measures to increase credit, initiated a large fiscal stimulus to finance infrastructure investment and support individual industries, and introduced some consumption subsidies. The earlier move toward greater

flexibility in exchange rate management was halted. The policy stimuli succeeded in maintaining GDP growth at about 9 percent in 2009.

Figure 1. China: Selected Economic Indicators



Sources: IMF, *International Financial Statistics* (2018); *World Economic Outlook* (2018); Yahoo Finance (2018).

6. With the economy returning to strong growth, monetary policy accommodation began to be withdrawn through both interest rate and quantitative credit measures and the fiscal stimulus was removed gradually starting from 2010. The exchange rate was returned to a managed float in June 2010.

7. Capital flows to China recovered after 2009, boosted by heavy corporate borrowing overseas, and were not much affected by the 2013 taper tantrum. GDP growth remained robust albeit trending down to just below 8 percent in 2013. The global trade slowdown, however, resulted in a substantial reduction in annual export growth from more than 20 percent in the period prior to 2008 to single digits by 2012, which helped reduce current account surpluses to around 2 percent of GDP.

8. The subsequent years from 2013 to 2015 were characterized by an attempt to rebalance the economy from investment towards consumption. On the monetary policy front, there were

gradual and measured moves to liberalize interest rates, exchange markets were made more open and market determined, and cautious financial sector liberalization continued. By 2015, interest rate liberalization was largely complete, the monetary policy framework was adjusted with an interest rate corridor centered on a seven-day repo rate, and the internationalization of the renminbi led to its inclusion in the IMF's Special Drawing Rights (SDR) basket.

9. Despite the care it exercised to maintain economic stability, China faced a challenge to market confidence in the summer of 2015, when the exchange rate and equity markets took a tumble, sending ripple effects across the global markets. Some observers blamed unclear policy communication about exchange rate policy adjustment and the deflation of a stock market bubble for the unsettled market conditions. There were significant capital outflows in both 2015 and 2016, leading to greater attention being paid to the management of the capital account and the re-imposition of some capital controls as well as the adoption of a "macroprudential framework for managing cross-border flows." Foreign exchange market intervention was also deployed to resist substantial downward pressure on the renminbi.

10. The attempt to rebalance the economy from exports towards domestic consumption has continued in recent years, while credit growth was contained after a period of rapidly rising indebtedness. GDP growth has continued its downward trend since 2011 from double digits to 6.6 percent in 2018, as investment slowed. Notwithstanding overall economic stability, the high level of debt, now more than 250 percent of GDP, and the rapid increase in housing prices since 2015, have caused concerns (Figure 2).

B. Consultations with the IMF

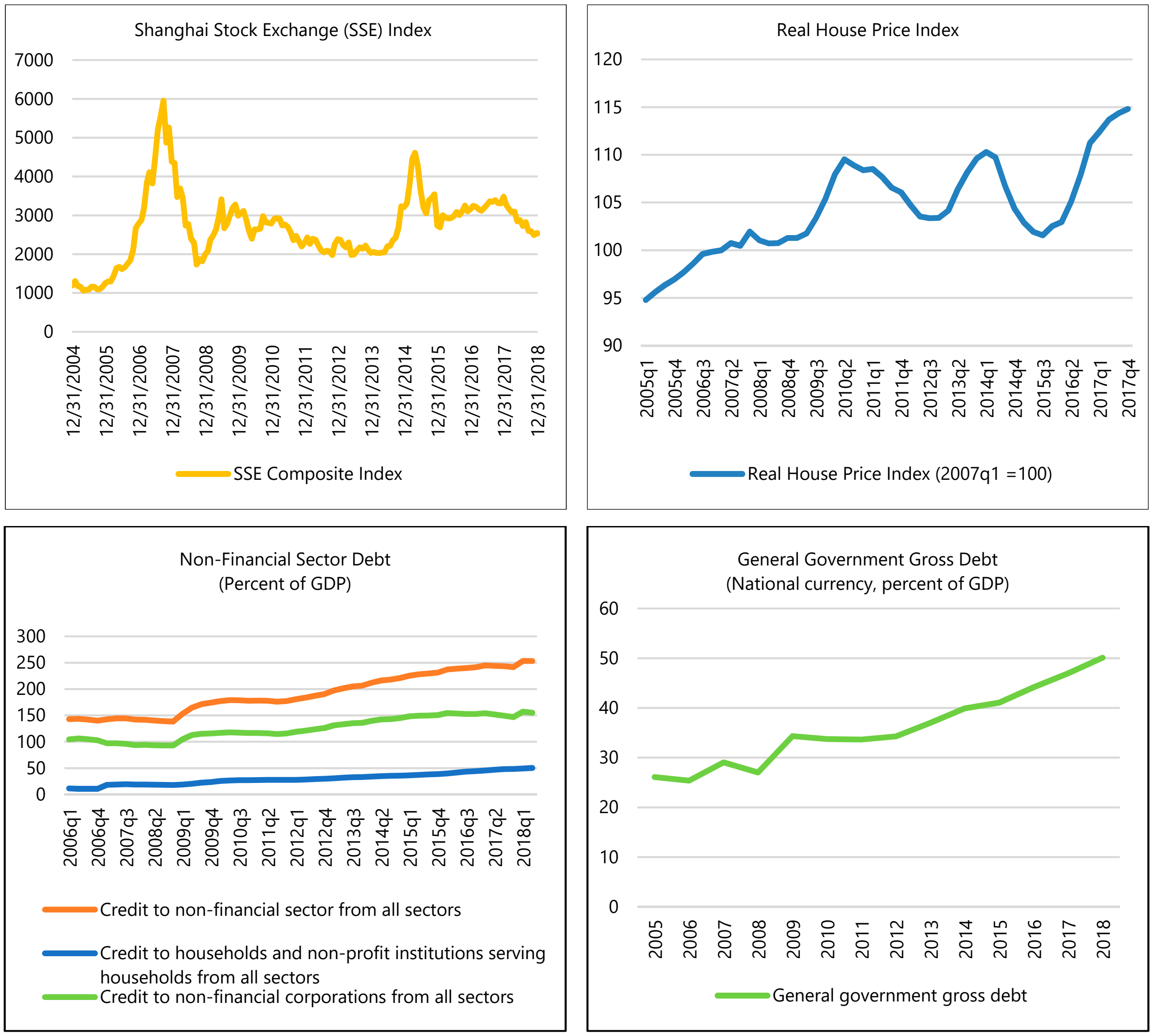
11. This section examines (i) whether and how the pre-GFC thrust of IMF advice changed over the past decade; and (ii) staff analysis of the extent of spillovers to China from UMP and how to deal with them.

12. Prior to the GFC, IMF advice had consistently been for greater exchange rate flexibility; further opening of the capital account; interest rate liberalization; modernization of monetary policy by using price instruments rather than quantity/credit-based instruments; and development of the financial sector, particularly bond markets. The authorities generally agreed with these policies as a medium-run goal, while noting that they had to be careful with regard to the timing and speed of implementation.

13. IMF staff noted that they did not feel that the GFC necessitated significant changes in their advice to China for the medium run. Some departures from the trajectory were deemed justifiable in the short run, such as the deployment of directed credit measures to stimulate aggregate demand and the greater use of CFM measures, but it was felt that these measures would not derail the broad direction of policies. Moreover, in some areas the pressures generated by the crisis moved things in the desired direction. For example, increased capital

inflows resulting from monetary easing in advanced economies put "welcome" upward pressure on the renminbi.

Figure 2. China: Real House Price Index and Total Debt



Sources: BIS (2018); IMF, Global Housing Watch (2018).

14. IMF endorsed the fiscal and monetary policy stimulus by the Chinese authorities in 2008–09 and its continuation into 2010. By 2011, staff advised that the monetary stimulus should be withdrawn and that the fiscal position "should return to broad budget balance in the next one or two years."

15. On capital account liberalization, discussions were dialed back somewhat in 2009–12, but by 2013 this again became a staple of IMF advice, although perhaps with even greater notes of caution about pace and sequencing than in the past; the IMF's First Deputy Managing Director Lipton advocated "a gradual and careful opening of China's external capital account" in his press

conference during the Article IV consultation that year. Earlier in 2013, the IMF and People's Bank of China (PBOC) had organized a joint research conference, which has since become an annual event seen as useful by the authorities. The conference participants discussed the lessons from international experience on capital flow management and the IMF staff advocated a cautious approach towards full capital account liberalization, noting that the path to it "while unequivocally beneficial overall has also been littered with dozens of accidents and crises" (Rodlauer, 2013).

16. On the exchange rate, before the GFC the Fund had judged the renminbi to be substantially undervalued, an assessment with which the authorities strongly disagreed. With the GFC there was strong upward pressure on the renminbi while the current account surplus moderated. By 2012, and with the adoption of the Integrated Surveillance Decision, disagreements about undervaluation narrowed. Staff noted in the 2012 Article IV report that "the authorities are facilitating a gradual increase in the international use of the renminbi," which was assessed to be only "moderately undervalued." By 2015, with the renminbi's inclusion in the SDR on the horizon, the staff judged the renminbi to be "no longer undervalued."

17. Turning to the second issue on IMF analysis of UMP spillovers, the Chinese authorities were keen from the start of the GFC that the IMF analyze the spillovers from the crisis and the effects of UMP adopted by the major advanced economies. They were also keen that the IMF provide advice to safeguard the international monetary system from the consequences of such spillovers.

18. The Chinese authorities expressed their concerns about the adverse effects of the GFC. In their view, the GFC caused a sharp decline in Chinese exports and complicated China's "adjustment tasks" and "macroeconomic management" by creating financial constraints on health care and pension reforms and limiting room for exchange rate movement (2009 and 2010 Article IV reports). According to former mission chiefs, the Chinese authorities took initiatives to launch exceptional credit expansion and fiscal stimulus in 2008–09 but were "very upset" by having to do so and slow down economic liberalization.

19. Statements from the authorities on the IMF country reports and policy papers often highlighted the impact of the volatile "external environment," and sometimes referred specifically to UMP spillovers. For instance, according to the 2008 Article IV staff report, the authorities stressed that "the dramatic easing of U.S. monetary policy had greatly complicated monetary management in the rest of the world, especially in China, which has had to deal with the resulting rise in liquidity." In commenting on the 2011 spillover report they noted that it did not fully capture the effects of "external shocks" for EMs and for China. UMP was specifically mentioned as they "not only fueled inflation pressures but also constrained the options regarding policy mix, as well as the timing, path, and pace of the monetary policy normalization in emerging market economies." The 2013 Article IV report mentioned the authorities' view that the reintroduction of FX interventions had arisen because of "an anomaly triggered partly due to the unconventional

monetary policies in advanced economies." In their comments on the U.S. Article IV reports, the authorities viewed the analysis of spillovers from the U.S. crisis as "inadequate."

20. While the authorities were apprehensive about large spillovers, IMF staff concluded that the spillovers from UMP to China would be small, based on its analysis that focused more on direct impact via trade and less on exchange rate or capital flow channels. Staff was not too concerned with the influence of UMP on capital flows because of China's effective capital controls. Former Chinese officials interviewed by the IEO indicated that they were more concerned about the management of capital flows as well as the global economic downturn. At the institutional level, the IMF was seen as somewhat slow in responding to the call for analyzing UMP spillovers, mounting a significant institutional response only in 2011—after Brazilian Finance Minister Mantega spoke of "currency wars."

21. The authorities welcomed the development of an Institutional View (IV) on the use of CFM measures to contain spillovers.[1] Staff on various country teams for China reported that, even before the adoption of the IV, they were already sympathetic to the use of temporary CFM measures in the face of the significant volatility in cross-border flows. In 2009–13, when China experienced large capital inflows, the authorities allowed outflow "leakages," while keeping formal restrictions on outflows.[2] After the taper tantrum and probably in the context of the volatile conditions in 2015, concerns pivoted to capital outflows, prompting the Chinese authorities to reinforce existing capital account controls and impose some additional measures. For example, rules concerning overseas spending and cash withdrawal by Chinese citizens were strengthened and banks were subject to a 20 percent unremunerated reserve requirement on forward FX sales. The IMF generally supported these measures, emphasizing the need to deal with underlying sources of uncertainty, including to communicate policy goals and actions early and clearly, and address concerns about excessive indebtedness.

C. Assessment

22. Overall, UMP did not necessitate significant changes in the thrust of the IMF's long-standing policy advice to China. The IMF endorsed the fiscal and monetary policy stimulus by the Chinese authorities in 2008–09 and its continuation into 2010. When the economy began to recover in 2011, staff advised for a gradual withdraw of policy stimulus. IMF has continued to call for exchange rate, financial market, and structural reforms. On the capital account liberalization, staff's post-GFC advice supports a cautious approach based on proper sequence of reforms.

23. The Chinese authorities valued the dialogue with the IMF during the period under review. Article IV missions had substantive and fruitful policy discussions at the highest levels, including

[1] See more discussion in Klein (2019).

[2] China has considerable restrictions on capital flows, especially on outflows. According to the IMF *Annual Report on Exchange Arrangements and Exchange Restrictions,* a majority of the 58 items still have some degree of control.

specially at the informal level with the governor and deputy governor of the PBOC. The resident representative and other senior IMF staff were also called in on an ad hoc basis to advise senior officials on various economic policy issues. Whereas the sophistication of the key policymakers in China is very high, and their policy orientation similar to views advocated by the IMF, there appears to still be a need to build up technical skills in the key institutions. Hence, there is significant appreciation for the technical skills of IMF staff and their contributions in specific areas through technical assistance and the sharing of cross-country views.

24. Officials and outside observers agreed that the relationship between China and the IMF had deepened over the past decade, starting from the "low point" when the IMF adopted the 2007 surveillance decision, which was seen in China as providing a channel for the United States to pressure China on its exchange rate. There is now a much greater degree of trust in the IMF. The adoption of the Integrated Surveillance Decision in 2012, the flexibility shown by IMF staff during the GFC, the renminbi's inclusion in the SDR basket, the efforts of the resident representative office, and the substantive technical assistance provided all helped build a strong relationship.

25. In general, IMF advice was seen as useful in informing technical staff and in internal discussions between the PBOC and other arms of the government. PBOC officials noted that there was broad agreement with the IMF on the medium-term direction of policies. Within China, the PBOC has been a strong advocate for overall economic reform, and particularly in monetary policy, exchange rate liberalization, capital account opening, and overall financial sector liberalization. It has seen the IMF as providing useful technical support in its domestic advocacy of such a policy direction.

26. Some officials noted that IMF advice could be more useful if it took into account more explicitly the particular context of China's financial structures and conditions. They observed that quantitative measures on credit allocation remain very important in a system dominated by state-owned banks that also conduct large-scale lending to state-owned enterprises. Hence, although a move to a more market-determined interest rate regime and a corresponding monetary policy framework based on policy interest rate changes is necessary, quantitative credit guidance and allocation will continue for some time. The IMF could also offer more concrete recommendations on process and sequencing, including based on other countries' experiences.

27. In this context, the joint economic conferences started by the IMF and the PBOC in 2013—with active participation by IMF technical staff, Chinese central bank and finance ministry technocrats, and policy experts and academics from several countries—were regarded as a useful innovation. Interviewees suggested that as EMs' own technocratic staff in central banks and governments increase in sophistication, the IMF can play a valuable role by using its convening power to share cross-country experiences.

28. While the overall assessment of IMF advice was quite positive, there was also some criticism. First, to some officials and other observers, the IMF's sustained support for QE by the

U.S. Federal Reserve (Fed) was not very evenhanded. While there was little criticism of the initial steps that needed to be taken to overcome the deep impairment in financial markets, the IMF's strong support of continued rounds of monetary easing was seen as unquestioning and paying inadequate attention to the potential negative impacts on EMs. It was also felt that too little attention had been given by the Fund to the fiscal-monetary policy mix best suited to addressing the problems in AEs.

29. Second, while the IMF endorsed the strong monetary and fiscal stimulus that China carried out at the start of the GFC to sustain economic growth, some outside observers felt that the IMF had not provided detailed advice about the magnitude and the nature of stimulus that was desirable for China. Some felt that the stimulus might have been excessive, leading to problems that continue to be felt now and are reflected in the elevated debt-to-GDP ratio, and suggested that the Fund could have cautioned more effectively against such risk. Investment in China increased significantly, accompanied by possible pressure to spend money on unnecessary or wasteful projects.

30. Third, and most important, it was felt that the IMF had not been sufficiently responsive to the impact of the crisis and the adoption of UMP on the volatility of cross-border capital flows and other spillovers, particularly in 2008–15. The authorities' views as summarized in Article IV reports and in the authorities' interventions during the Board discussions of the spillover reports in 2011 and 2012 reveal a fair bit of concern, reiterated during some interviews for this report. While the authorities appreciated the beneficial impact of UMP through the trade channel, they felt the crisis and the response to it had complicated their policy agenda and reform process in several respects.

III. India

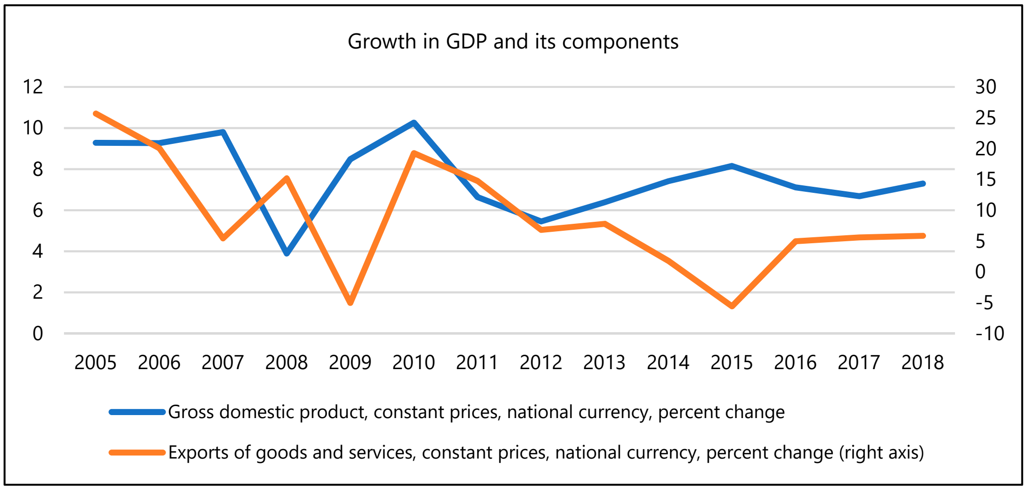
A. Economic Developments Since the GFC

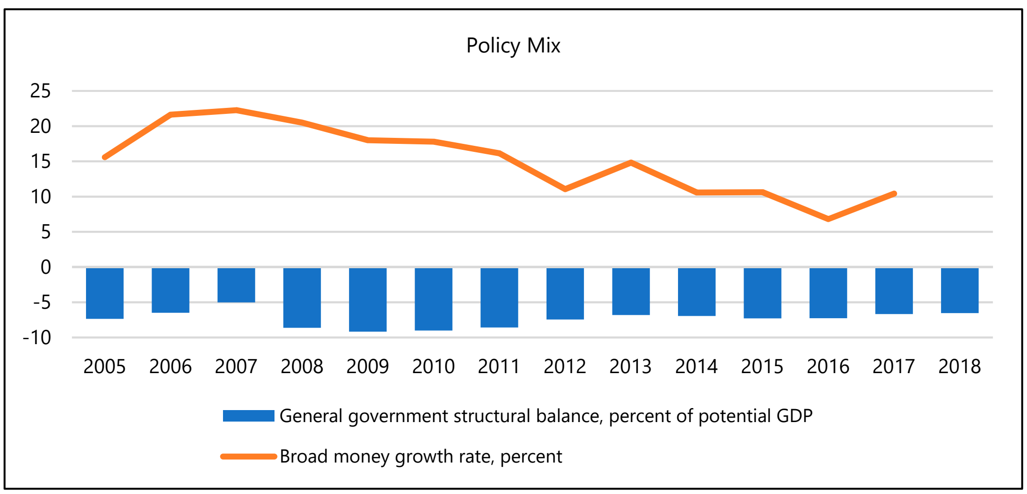
31. India enjoyed strong performance in the years prior to the crisis (Figure 3). Annual GDP growth exceeded 8.5 percent in the five years preceding 2008, inflation rates were stable in the 5–6 percent range, average annual export growth exceeded 20 percent over that period, and the fiscal deficit came down to about 3.5 percent of GDP in 2007–08. While the current account deficit was stable at less than 1.5 percent of GDP, the capital account experienced continuous large net inflows, raising foreign exchange reserves from US$113 billion in 2003 to more than US$300 billion by mid-2008.

32. The GFC had a significant economic impact on India. After the Lehman crisis in September 2008, India experienced a sudden drop in capital inflows. After reaching an unprecedented level of US$108 billion in 2007–08, net capital inflows fell sharply to just US$9 billion in 2008–09. While foreign direct investment flows exhibited resilience, portfolio flows reversed sharply, and access to external commercial borrowing and trade credits tightened significantly (Figure 4). Large-scale foreign exchange market intervention was undertaken to

compensate for capital outflows, along with liquidity management measures to restore stability in domestic money markets. Monetary policy was loosened considerably during late 2008 and early 2009 through a large policy interest rate reduction and the provision of special liquidity facilities for both banks and non-banks (most of which were eventually not used), and a significant fiscal stimulus was provided. Through these measures, the reduction in GDP growth was contained; GDP growth fell from 9.0 percent in 2007–08 to 6.7 percent in 2008–09.

Figure 3. India: Selected Economic Indicators

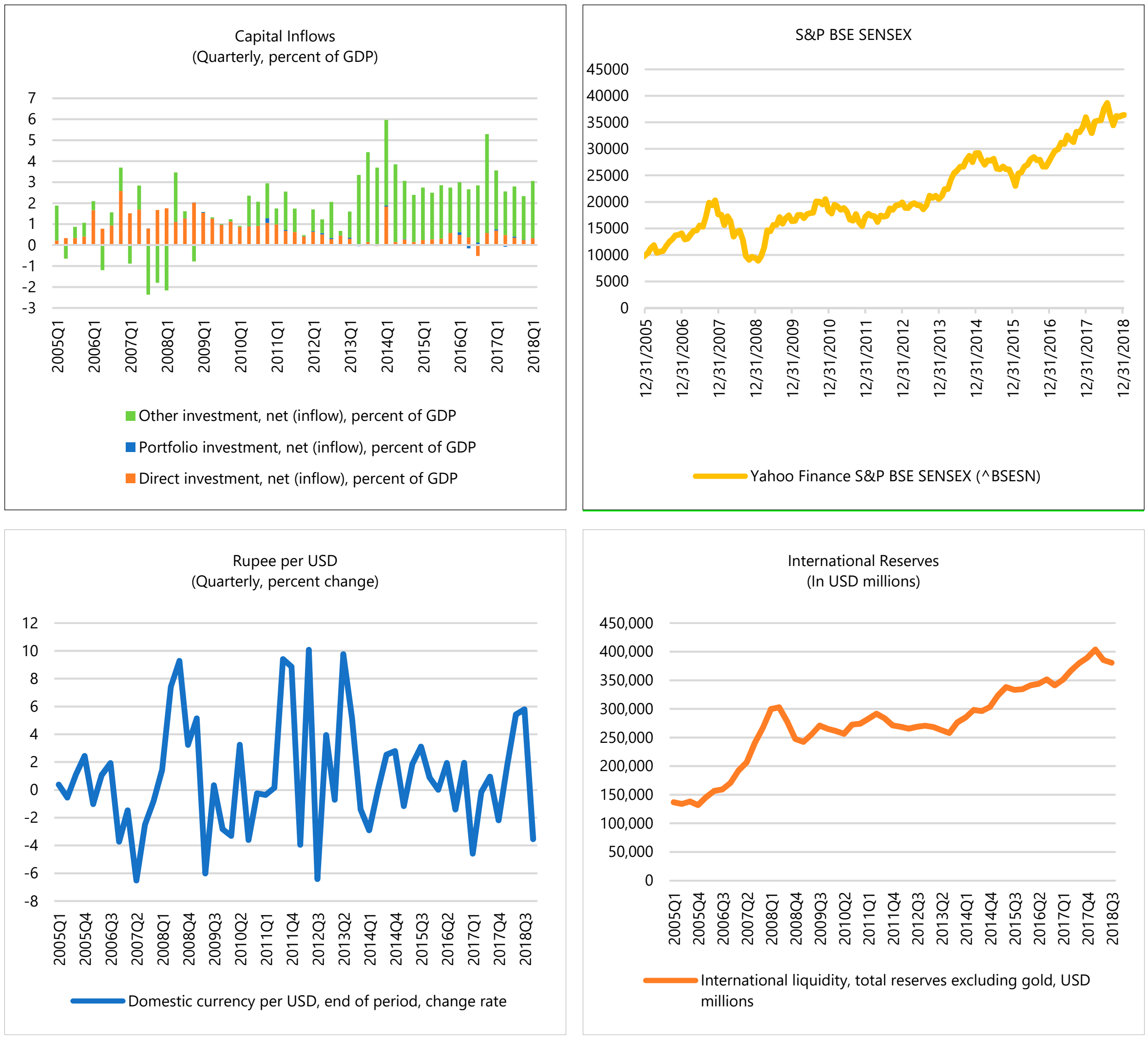




Sources: IMF, *International Financial Statistics* (2018); *World Economic Outlook* (2018); Yahoo Finance (2018).

33. Real GDP growth recovered rapidly in 2009–11 to an annual rate of 8½–9 percent. However, this strong recovery was accompanied by rising inflation, reaching an average of 9–10 percent during 2009–13. Monetary policy was tightened gradually from April 2010 to late 2013.

Figure 4. India: Capital Inflows, Stock Market, Exchange Rate, and International Reserves



Source: IMF, *International Financial Statistics* (2018); Yahoo Finance.

34. The RBI's capital account management and foreign exchange market intervention policies changed notably during 2009–13. During this period, the RBI took a hands-off approach. With the resumption of capital flows after 2009, both nominal and real exchange rates appreciated, accompanied by a widening trade and current account deficit until late 2011, but there was no corresponding foreign exchange intervention. Consistent with past IMF advice on the virtues of capital account liberalization, this hands-off approach to foreign exchange market intervention was accompanied by the loosening of restrictions on foreign portfolio investment in the domestic government securities and corporate debt markets. With falling global interest rates arising from UMP, debt portfolio inflows to India rose to nearly 2 percent of GDP in 2012 and the early part of 2013. The inflows added to the upward pressure on the exchange rate in the absence of intervention.

35. India came under significant market pressure in the summer of 2013 after the "taper tantrum." The exchange rate appreciation during the previous years, accompanied by high domestic demand and the loosening of restrictions on the import of gold into India, had led to a considerable widening of the current account deficit, which in turn contributed to making India a member of the "fragile five" in the eyes of institutional investors. Debt and equity outflows both accelerated (though predominantly from the recently opened domestic debt markets), and the rupee depreciated by nearly 16 percent in over just three months.

36. Subsequently, the hands-off approach was replaced with a broad array of policy measures, deployed to contain market turbulence and prevent a full-blown crisis. Fiscal policy correction was initiated after the previous years' excesses, a host of measures including subsidized FX swaps to attract non-resident inflows were taken to incentivize capital inflows and restore external account stability, FDI flows were further liberalized, and foreign exchange intervention was reintroduced. These measures together helped restore confidence, increase capital inflows, and reduce exchange rate volatility.

37. In 2014, following the double-digit inflation in previous years, the monetary policy framework was amended, and a flexible inflation targeting framework was formally adopted in 2016 with the establishment of a monetary policy committee, in line with a long-standing IMF recommendation. Since the adoption of this new framework, inflation has been contained within the target range of 4 percent ±2 percent.

B. IMF Engagement

38. As in the case of China, the advice to India before the GFC was to move towards greater exchange rate flexibility and further opening of the capital account and liberalization of capital outflows. On financial sector liberalization, the advice was to develop the corporate debt market, including opening to foreign institutional portfolio investment, and to develop derivatives markets.

39. Post-GFC, the focus of the Article IV reports between 2008 and 2009 was squarely on the impact of volatile capital flows. Unlike in the case of China, the IMF quickly acknowledged the volatility of capital flows as having a significant impact on the management of monetary policy, raising considerable challenges for India to manage external risk arising from these developments.

40. The IMF broadly supported the substantial monetary and fiscal stimulus measures that the Indian authorities took in 2008–09. The Fund was particularly supportive of the extent of monetary accommodation made in those years. In fact, the 2008 Article IV report advocated greater easing of monetary policy at that time. The Fund also supported fiscal stimulus on balance, while still noting debt concerns.

41. IMF staff were quick to observe India's robust recovery in 2009 and recommended the withdrawal of both monetary and fiscal stimuli by 2010. They were also early in expressing concerns about the potential deterioration of corporate balance sheets due to the domestic impact of the GFC. However, the Indian authorities were slow to tighten the policy stance. The withdrawal of monetary policy accommodation began gradually in mid-2010, while fiscal consolidation was delayed still further (2010 Article IV Report).

42. The Fund and the authorities differed on issues related to exchange rate flexibility and FX intervention. IMF staff advocated for further rupee flexibility as the "most effective way" to address the "impossible trinity" whereas the authorities preferred to consider "all possible options" for maintaining stability, including FX intervention and active capital account management measures (2008 Article IV Report).

43. For example, when capital inflows surged again in 2009, staff stressed that rupee appreciation should be the first response to capital inflows and tightening capital controls should remain a last resort given the need to deepen domestic capital markets. More specifically, the country team recommended that if pressures were to re-emerge, the rupee should be allowed to adjust freely to find a "floor" to provide incentives for capital inflows. It reasoned that the downside risks of such an approach for bank and corporates would likely be limited, because the rupee appeared "broadly in line with its equilibrium level." The authorities were skeptical and argued that in times of financial volatility there could be significant departures from the equilibrium level (2009 Article IV Report). They indicated that they intervened "only to reduce excessive volatility of the exchange rate rather than managing the level of the exchange rate" and noted that the Reserve Bank of India (RBI) would continue to adopt a range of measures to manage capital inflows as needed.

44. The 2010 Article IV report signaled a departure from the previous IMF views. In a way, the Fund became more amenable to the use of foreign exchange intervention and selective CFM measures to manage capital flow volatility, though as "last resort" tools. It is notable that this acknowledgment of the possible use of CFM preceded the adoption of the IV.

45. By early 2013, staff and the authorities also appeared to have moved closer on their views regarding exchange rate flexibility. Both agreed that exchange rate flexibility would remain the first line of defense, while reserve accumulation and macroprudential measures could be employed if strong inflows continued. The IMF's pilot external sector report and the updated External Balance Assessment concluded that India's current account and the value of the rupee were broadly consistent with medium-term fundamentals.[3] Staff concluded that rupee flexibility had offset inflation differentials and prevented exchange rate misalignment, and such flexibility would be particularly important in case of renewed global financial stresses. The authorities

[3] According to three different approaches, India's current account norm was estimated to be between -2.3 percent and -3.4 percent of GDP, the former is similar to the RBI's finding that India's sustainably financed current account deficit is around 2.5 percent of GDP.

agreed that the rupee would continue to float, though further capital account liberalization would be undertaken cautiously (2013 Article IV Report).

46. The significant impact of the "taper tantrum" seems to have taken both the staff and the authorities by surprise. While the 2013 staff report in March mentioned that "a major global financial shock would present serious funding and liquidity risks for India," risks related to the Fed's exit from UMP were not included in the list of external risks in the report.

47. The IMF eventually endorsed the various actions taken by the Indian authorities, including measures to encourage capital inflows in the 2014 Article IV report. In 2015, the country team prepared a study to assess the effectiveness of major EMs' policy actions after the 2013 taper episode, focusing on India and how its experience compared with others. The study found that from a medium-term perspective, EMs with decisive and comprehensive policy actions (such as India) saw the largest improvements in fundamentals and were relatively less affected during later bouts of market volatility.[4] Based on this study, the IMF staff reemphasized that exchange rate flexibility is an essential tool in coping with volatile capital flows. Thus, if capital account pressures were to resurface for India, continuing to allow the rupee to adjust flexibly to market conditions would be "essential."

48. Many Indian authorities, however took the view that exchange rate flexibility sometimes exacerbates market swings and related boom-bust risks rather than equilibrating them. For instance, former RBI governor Rajan found that countries that allowed the real exchange rate to appreciate the most also suffered the "greatest" adverse impact to financial conditions during the "taper tantrum" (Rajan, 2014). He noted political economy limits on EM policymakers' room for maneuver and called for AEs to do more to alter their own policies to avoid causing spillovers, while seeing "merit in assigning the IMF or a similar institution the responsibility of assessing the spillover effects of major central banks policies—much as the World Trade Organization does with trade rules."[5]

49. During her visit to the RBI in March 2015, the IMF Managing Director shared her lessons from the "taper tantrum" episode.[6] Her first and foremost lesson was that "advanced economies can help," but the second lesson was that emerging markets also need to prepare well in advance. Regarding the RBI response to the taper tantrum episode, she praised the policy actions that allowed the rupee to depreciate as well as the foreign exchange interventions to minimize disruptive movements in the rupee. Some ex-officials however, felt this public IMF endorsement came rather too late.

[4] IMF (2015).

[5] See Klein (2019) for more discussion on UMP spillovers.

[6] Lagarde (2015).

50. Since 2015, general IMF advice has returned to the pre-GFC policy messages: opening up capital account and financial markets and introducing greater exchange rate flexibility. As consistently advocated by staff, to minimize disruptive movements in the currency divorced from fundamentals, continued exchange rate flexibility could be accompanied by judicious FX intervention, either through spot and forward markets or via liquidity provision through swaps. The IMF has also endorsed the new monetary policy framework encompassing inflation targeting and the formation of a monetary policy committee, which was long-standing IMF advice (2017 Article IV Report), and an IMF technical team helped the RBI with modelling work to develop the new policy framework. Overall, IMF engagement with India is less intense than with China, particularly at senior levels. The final discussion of the annual Article IV exercise in China is carried out by the First Deputy Managing Director, while in the case of India even the director of the Asia and Pacific Department is not involved. In turn, in some years the RBI governor has not held meetings with the annual IMF missions; similarly, the finance minister would not, in general, interact with IMF staff at the conclusion of these missions.

C. Assessment of IMF Advice

51. Indian officials interviewed by the IEO generally expressed satisfaction with the overall engagement with the IMF during the review period. The Article IV consultation was regarded as a useful stock-taking exercise and a good check on the internal consistency of policies through the lens of an integrated macro framework. The monetary policy expertise of IMF staff on the Article IV team was considered adequate although lacking the depth that the RBI itself can bring. It was felt that staff technical expertise in the FSAP teams was better, and the modelling support in developing the new inflation targeting framework was also appreciated. There was some puzzlement that the IMF did not do more to exploit its comparative advantage, its cross-country experience, to enrich the Article IV dialogue; on many issues, open discussion of the cross-country experience would be useful to the authorities.

52. There was satisfaction among the Indian officials that several policy actions taken by the country over the years had subsequently become more accepted by the IMF. These included (i) the use of CFM measures, which were largely endorsed by the IMF's IV; (ii) the use of macroprudential policies as opposed to monetary policy to manage financial stability risks, which became the IMF house view over the past decade; and (iii) the "self-FSAP" carried out by the RBI prior to the crisis, which laid the basis for the 2011 and 2017 IMF FSAP programs.

53. Officials also provided a fair bit of specific criticism of IMF advice provided over the past decade. First, many officials characterized IMF advice as being "formulaic" and not sufficiently responsive to country needs of the moment. The example given most often was that of the IMF's continued call for greater exchange rate flexibility. Some interviewees noted that this advice was given even when the rupee was acknowledged to have moved very significantly in both directions (more than 10 percent real appreciation in 2007 and 23 percent depreciation in 2008) and despite staff's analysis that rupee flexibility was comparable with other currencies such as the Brazilian real or the Canadian dollar in those years. Moreover, the Fund should have also

cautioned against the risk of excessive rupee appreciation during mid-2009 to 2012 in the absence of intervention, which was seen by some as setting up India for trouble during the "taper tantrum."

54. Second, while the move toward the IV was welcome, it should have come in a more timely fashion, and staff had still been very cautious in endorsing policy actions outside the orthodox toolbox. Officials recognized that the change in staff advice to India did happen a bit earlier, but there was criticism that the Fund had still "left India high and dry" during the "taper tantrum," even though the current account deficit had not been reckoned too excessive and the exchange rate had been judged to be fair value just before the tantrum. It was felt that the IMF's public endorsement of the government's initiatives and actions could and should have come earlier to ease market tensions (as the Fund had done for China in 2015). In general, there was a tendency to blame the country's policies whenever they came under pressure from markets, regardless of the IMF's past judgments on these policies and the evidence that investors' judgments could be fallible, for example, by following a herding pattern.

55. Third, as in the case of China, some outside observers felt that there could also have been more forceful criticism of Indian policies from 2009 onwards when, despite a V-shaped recovery, accommodative monetary and fiscal policies—and regulatory forbearance—were maintained—although the IMF did begin to advise some withdrawal of the fiscal stimulus from its 2010 Article IV report issued in 2011.

56. Fourth, there was also criticism that the quality of advice suffered because it was provided through an "AE lens." Some observers felt that the spillover reports were not in the end very useful because it seemed that the ultimate policy message was always going to be "grin and bear it" when it came to any effects on India from advanced economies' UMP. It was felt that work by researchers at EM central banks on spillover effects was either ignored or cited in an off-hand manner. There was also the expression of a broader critique that the IMF's entire advocacy of UMP for AEs was essentially wrong because, in the absence of adequate financial repair, accommodative policies just fed leverage and a buildup of financial risks rather than real recovery. The United States did better than the others because it had done financial repair along with accommodative policies; the euro area languished because it hadn't. Changing the policy advice at the source would have been good for the EMs.

57. Finally, a few observers felt that the IMF had moved away from deep analysis of monetary and fiscal policy issues that should be its core competence, perhaps because of its analytical move to newer areas like inequality and poverty, where the Fund may not have comparative advantage. In countries like India, where the quality of monetary policy expertise is relatively high, IMF staff need deep expertise in order to provide value added. In the absence of such expertise, the IMF could lose credibility.

IV. CONCLUSIONS

58. The depth and value added of the IMF's dialogue with China during the period under review appears to have been higher than with India. In China, Article IV missions regularly have substantive and fruitful policy discussions at the highest levels, especially in the PBOC. The resident representative and other senior IMF staff are also called in on an ad hoc basis to advise senior officials on various economic policy issues. Whereas the sophistication of the key policymakers in China is very high and their policy orientation is similar to views advocated by the IMF, there appears to still be considerable room to build up technical skills in the key institutions. Hence, there is significant appreciation for the expertise of IMF staff and their contributions in specific areas through technical assistance and the sharing of cross-country views.

59. The IMF's relationship with India seems to be shallower than that with China. There appears to be much less high-level interaction of IMF management and senior officials with the Indian authorities than with the Chinese. Article IV teams engage in useful dialogue that is helpful as a cross-check and for stocktaking, but value added and influence seems less, in part because compared to China there seems less agreement on a shared agenda. For example, some staff felt that there may be an opportunity to build up the IMF's engagement with India through high-level attention, though it would of course require reciprocity from the Indian side. The setting up of the South Asia Regional Training and Technical Assistance Center (SARTTAC) in New Delhi was seen as a positive step to increase India's engagement with the IMF.

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Chapter 2—Korea and Selected ASEAN Economies

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I. INTRODUCTION

1. This chapter evaluates IMF advice to Korea and five ASEAN countries (Indonesia, Malaysia, the Philippines, Singapore, and Thailand—the ASEAN5) on dealing with the effects of unconventional monetary policies in the major advanced economies (MAEs). Korea and the ASEAN5 are highly open economies, well integrated into the global trade and financial system, and are subject to substantial spillovers from economic and financial developments in the major advanced economies.[1]

2. At the start of the Global Financial Crisis (GFC) these economies experienced a downturn and a sharp reduction in capital flows in 2008–09. However, the economies were quite resilient and experienced a turn to capital inflows the following year as the MAEs turned to unconventional monetary policies (UMP). Since 2010, the main challenge has been to manage inflows, though each country has also experienced threat of outflows, such as during the "taper tantrum" of May–June 2013 and more recently as MAEs exit from UMP.

3. This chapter focuses on IMF advice to these countries to manage capital flow volatility, particularly through macroprudential policies (MPP) and capital flow management (CFM) measures. These countries had already been in the forefront on the use of such measures before the GFC.[2] The assessment provides evidence on the extent to which the IMF was able to help the countries adapt these measures to meet the challenges they faced over the past decade. Section II provides background on policy developments in these countries; Section III describes IMF engagement on these issues; and Section IV provides an assessment.

II. ECONOMIC DEVELOPMENTS SINCE THE GFC

4. All six countries had strong macroeconomic performance prior to the GFC. Annual growth was in the 5–8 percent range, generally underpinned by sound fiscal positions, current account surpluses, and significant holdings of international reserves. Their financial systems were considered sound. The GFC resulted in a synchronized downturn and retrenchment in capital flows to these economies (Annex A1).[3] In Korea, there were intense dollar funding pressures following the collapse of Lehman as Korean banks depended on wholesale sources for about half of their funding. In addition, with a significant share of the equity market held by foreigners, the

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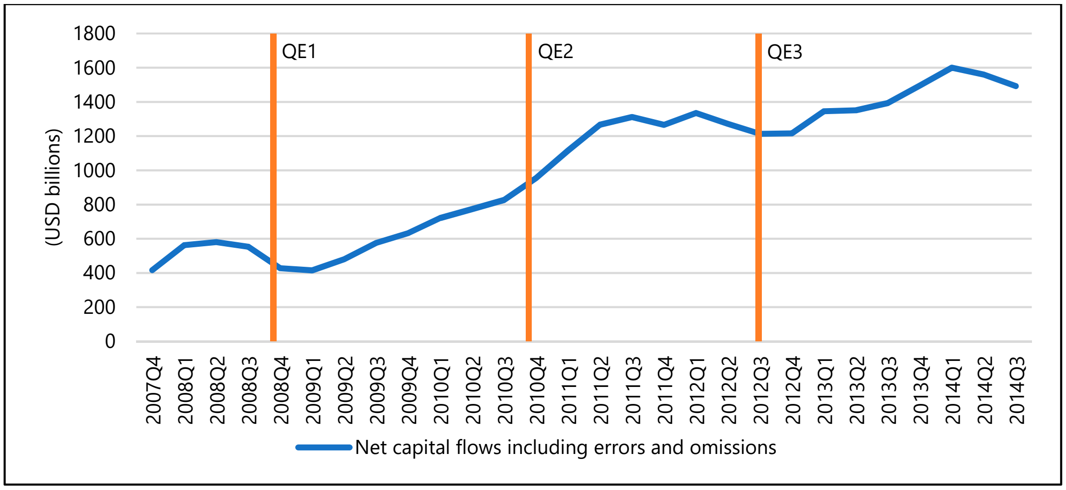
[1] Although Korea and Singapore are classified as advanced economies, they are sometimes included in the category of emerging markets in this chapter because they faced similar issues related to spillovers created by UMP.

[2] Malaysia for example made extensive use of capital controls in response to the Asian crisis, and Asia as a region recorded a sharp increase in the use of macroprudential measures in the period leading up to the GFC (Figure 2).

[3] Figure A1 in Annex 1 presents the data on capital flows to each of these countries from 2005 to the present.

stock market index fell sharply. Among the ASEAN5, the growth slowdown was most pronounced in Singapore and Thailand.

Figure 1. Net Capital Flows, Including Errors and Omissions
(Cumulative since 2005Q1)



Source: Institute of International Finance (2018).
Note: Emerging Asia includes China, India, Indonesia, Korea, Malaysia, the Philippines, and Thailand.

5. The countries implemented a comprehensive package of countercyclical measures in 2008 to mitigate the effects of the GFC. Expansionary fiscal policies were implemented, with Singapore the most aggressive among the ASEAN5. Policy interest rates[4] were reduced sharply; Singapore's monetary authority eased monetary policy by re-centering its exchange rate band to prevent appreciation. Extensive measures to provide liquidity were also undertaken (Yehoue, 2009). In Korea, these included guarantees on banks' external debt, relaxed conditions for won repos, and swap lines from the United States, Japan, and China. The ASEAN5 countries benefited from swap arrangements under the Chiang Mai initiative, although these were never activated, and Singapore also secured a precautionary currency swap agreement with the U.S. Federal Reserve (Fed) as part of the Fed's response to safeguard global dollar liquidity. These measures and buffers helped shore up confidence and bring about quick recoveries.

6. Over 2009–10, with economies recovering and the implementation of UMP in the major advanced economies, concerns turned to dealing with capital inflows, which remained the dominant concern until mid-2013 (Singh, 2014; and Figure 1).

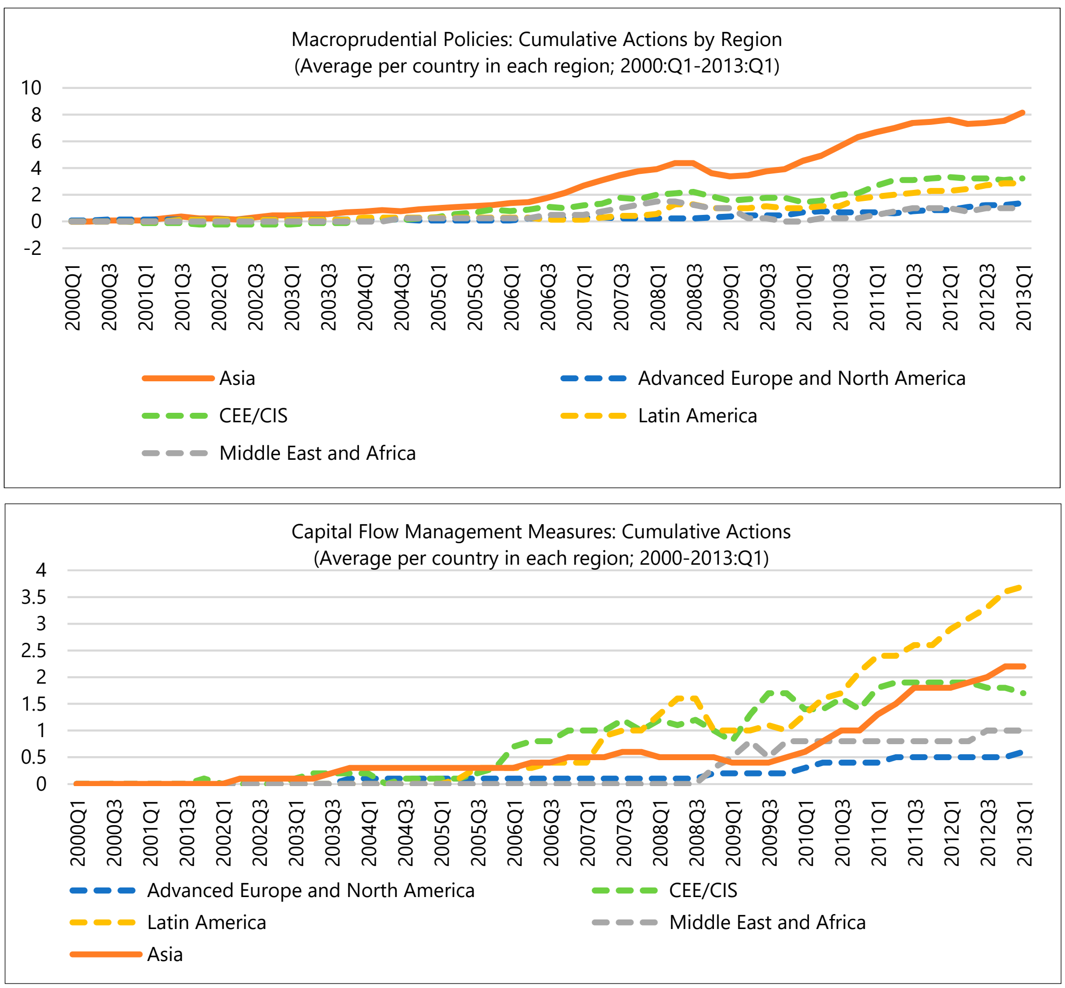
7. The countries used several means of adjustment, including some exchange rate appreciation (Figure A2 in Annex 1), buildup in international reserves (Figure A3), and

[4] The Philippines central bank cut policy rates by 200 basis points between December 2008 and July 2009, the Bank of Thailand by 250 basis points to a historically low level of 1¼ percent, the Bank of Korea and the Bank of Indonesia by about 300 basis points, and Bank Negara Malaysia by 150 basis points.

liberalization of limits on outward capital flows. Countries were reluctant to implement large adjustments in policy interest rates to cool credit growth and overheated housing markets, because of the fear that these would encourage further capital inflows and compound their challenges. In some countries, particularly Korea, the strengthened co-movement of their long-term interest rates with those of advanced economies weakened the ability of the central bank to control domestic financial conditions by changing their policy rates (Kim, 2014).

8. A distinctive part of the policy response in Korea and the ASEAN5 over 2010–13 was the extensive use of MPP and CFM measures, particularly the former. While these policies were implemented elsewhere as well, "Asia stands out" in the use of MPP.[5] As shown in the top panel of Figure 2, MPP were used more extensively in Asia than in other regions, while CFM were used more extensively in Latin America than in Asia (Figure 2, bottom panel).

Figure 2. Use of MPP and CFM, by Region



Source: IMF (2014).

[5] Zhang and Zoli (2014).

9. The main MPP and CFM used by Korea and the ASEAN5 over 2009–13 were the following:

(i) Caps on loan-to-value (LTV) for real estate lending ratios were the most actively used tool, as several of these economies faced overheating housing markets. Korea and Singapore were the heaviest users in this set of countries;

(ii) Changes in reserve requirements on local currency deposits;

(iii) Measures to discourage transactions in foreign currency, particularly in Korea and the Philippines, where foreign exchange-denominated or indexed loans were more widespread than in other countries. Korea, for example, imposed a levy on bank non-deposit foreign currency liabilities, set a ceiling on bank foreign exchange derivative positions, and used reserve requirements on foreign exchange.

(iv) Residency-based CFM measures. CFM were used in Indonesia and Thailand, included minimum holding periods for central bank bills in the former and withholding taxes for nonresident investors in the latter.

10. The "taper tantrum" of mid-2013 served as a reminder that the challenge could turn quickly from being one of managing inflows to one of dealing with outflows. The countries in question were affected to different degrees. Indonesia's large current account deficit at this juncture stoked investors' concerns, leading to its inclusion in the "fragile five" group of EM economies that were badly hit by the "taper tantrum." In general, however, these countries were able to weather the storm fairly well through a combination of exchange rate adjustment, use of international reserves and loosening of MPP. These countries had gained some experience with using MPP as a countercyclical tool during 2008–09, and this provided some basis for making judgments on how to calibrate these policies to deal with outflows during the taper tantrum.

11. Since 2013, the challenge has again been mainly to deal with inflows, though levels have generally receded, and some countries have gone through brief periods of turmoil when there was a threat of outflows in the context of shifts in global risk aversion. The Fed's turn to exit and the prospects for normalization of monetary policies among other advanced economies have also kept policymakers in these countries attuned to the need to be prepared for future episodes of flow reversals.

III. IMF ENGAGEMENT

12. Prior to the GFC in 2008, the IMF advice to Korea and ASEAN5 was generally to tighten policies in the context of strong economic performance and looming inflationary pressures. However, once the magnitude of the impact of GFC on the global economy was fully appreciated—and particularly after the collapse of Lehman Brothers—IMF advice quickly turned to supporting the easing measures taken in these countries. A good illustration is the case of

Korea, where the September 2008 Article IV report had urged that "an increase in policy rates would be appropriate at this time," but a month later the Managing Director released a statement welcoming the government's policy package to counter the effects of the GFC (Reuters, 2008).

13. When attention turned to managing the effects of capital inflows, Fund staff generally emphasized the role of exchange rate flexibility as an important adjustment mechanism. In 2009, as capital inflows resumed, staff urged Korea to let the exchange rate fully reflect supply and demand conditions with interventions limited to smoothing operations, advice that was repeated in most Article IV reports since that time. Likewise, Fund staff welcomed steps by the Philippine and Malaysian central banks to allow exchange rates to reflect market forces. That said, the Fund also supported some buildup in international reserves as a useful buffer against future external shocks. By 2012–13, however, reserves were judged to be excessive in the Philippines and Thailand. Fund staff also urged that policy interest rates be used as part of the adjustment process.[6] While Fund staff generally urged a faster pace of increases than the authorities were willing to entertain, they were not too critical of the slower pace of responses.

14. While urging adjustments through these traditional interest rate and exchange rate channels, Fund staff were sympathetic to the use of MPP and CFM by these countries, even in advance of the rollout of the Institutional View (IV) on capital flows. The Fund cautioned that CFMs should not substitute for "necessary macroeconomic adjustment"—and mentioned concerns about how effective such measures would be over the medium run—but Article IV staff reports provided considerable support for these steps. For instance, in 2012–13, staff supported the introduction of stricter prudential controls in Korea, Indonesia, and Malaysia, such as tighter limits on car and mortgage lending and tightened LTV limits on mortgages and tighter loan-to-deposit ratio (LDR). That year, they also noted that real estate prices had stabilized due to the authorities' effective macroprudential measures, such as the additional stamp duty. Staff also highlighted the success of LTV limits in the Philippines. Staff supported, as discussed below, the use of LTV limits on third mortgages by the Malaysian authorities, noting that it was effective in containing house price growth.

15. By 2013–14, as the Fund's corporate view turned to the use of macroprudential policies as the first line of defense against financial stability risks, Fund staff become very supportive of such measures, drawing on cross-country evidence accumulated about their effectiveness, at least in the short run, to tame credit growth and, in some cases, house price increases (IMF, 2014).[7] For example, in the case of Korea, the 2013–14 Article IV staff reports noted the

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[6] Malaysia was an exception as staff supported the authorities' monetary policy framework where interest rates were adjusted in response to domestic inflation and growth conditions.

[7] In 2011, staff had recommended that Korea use monetary policy to "lean against the wind" of financial stability risks, but this view was dialed back over subsequent years as the Fund's corporate view turned against leaning against the wind.

success of measures to curb external funding vulnerabilities of banks by limiting their short-term external debt and reducing foreign currency maturity. The use of debt-to-income and LTV ratios in Korea was also praised as reducing house price volatility, though staff noted that household debt continued to climb.

16. When the threat of capital outflows loomed after the "taper tantrum," the IMF gave differentiated advice to these countries depending on an assessment of their fundamentals and buffers. For instance, in Korea staff noted in 2013—in work done, after the "taper tantrum," for the 2013 Article IV staff report and reflected subsequently in a working paper—that the country was unlikely to be significantly affected by further turmoil from the U.S. monetary policy normalization (Ree and Choi, 2014). Similarly, in Singapore staff indicated that unwinding from UMP was likely to have minimal impact on Singapore, which partly reflected relatively small holdings of external portfolio liabilities. By contrast, risks associated with exit from UMP were emphasized in the staff reports of Indonesia, the Philippines, and Malaysia from 2012–17 and Thailand in 2013.

17. IMF staff supported the use of measures to supplement macroeconomic policy. In the 2011 Article IV report the IMF indicated that the CFM measures introduced by Indonesia (a one-month holding period on sterilization instruments) helped to alter the composition of inflows, reducing reliance on more volatile short-term funding. In 2013, staff welcomed measures in Malaysia to liberalize outflows, including elimination of requirements on residents to convert export earnings into ringgit. In 2013 staff supported amnesties by the Philippines central bank that allowed for foreign repatriation of investment proceeds, arguing that these should be permanent to facilitate outflows of "trapped" funds, together with making the import payment regime more flexible. The Fund noted that CFM might be warranted in the Philippines if macroprudential tools failed to contain financial stability risks. In 2013, staff suggested that Thailand could use capital flow measures to manage capital flow surges when necessary, indicating that CFM can be considered in the event of exchange rate overshooting, amid strong inflows.

18. Recently, some countries in this group (Indonesia, Malaysia, and Singapore) have expressed strong reservations that the IV is being applied too rigidly and with insufficient appreciation of country circumstances. For instance, in December 2016, Malaysia reintroduced measures for conversion of export proceeds into ringgit and a prudential limit on foreign currency investments by residents with domestic ringgit borrowing. The labeling of these measures as CFM has been challenged by the authorities on the grounds that they were taken for prudential reasons rather than to restrict capital flows. Similarly, in 2017 the Indonesian authorities argued that hedging requirements of short-term net FX liabilities should not be labelled as a CFM because it was aimed at ensuring financial stability by encouraging corporate risk management (Agung and others, 2018).

IV. Assessment

19. As a broad characterization, authorities in these countries found the IMF to be a valuable and trusted advisor over the past decade. Article IV discussions were welcomed as a useful opportunity to discuss the policy framework and challenges facing the country. Fund country teams were praised as being more open-minded and more "willing to put themselves in the shoes of EMs" than in the past. There was greater acceptance by staff of the complexity of monetary policy formulation in emerging markets and willingness to admit that the standard advice of interest rate changes and exchange rate flexibility needed to be complemented by additional tools.

20. Fund staff were not usually a first port of call in seeking external advice—officials generally used regional counterparts, central banking networks, and BIS staff, who tended to bring greater depth of expertise and understanding. Nevertheless, the Fund was viewed as periodically bringing a fresh pair of eyes to review policies put in place and consider if amendments were needed. Some interviewees noted however that while country teams in the field were sympathetic to "conditions on the ground," they subsequently faced difficulties in getting support for the authorities' views from other departments in the internal review process within the IMF. As a result, to some authorities, Article IV reports sometimes appeared disconnected from the discussions during staff missions.

21. Moving to the details, there was praise for the Fund's alertness to the spillovers on these economies from global developments and the policies of other countries. While the Fund was viewed as a cheerleader for UMP and for advanced economies' view that UMP had positive spillovers for emerging markets, there was also recognition that the Fund had tried to analyze the extent and nature of spillovers through multilateral products such as the spillover reports and its regional and bilateral surveillance. The Fund's regional and bilateral work was considered useful, particularly after the "taper tantrum," in providing reassurance that most countries in the region were resilient enough to withstand the possibility of normalization of monetary conditions in the advanced economies. The authorities also appreciated the Fund's attempts to help emerging markets by bolstering the global financial safety net through the launch of instruments such as the Flexible Credit Line (FCL), although these countries had not used the new instrument.

22. The Fund's work on macroprudential policies was considered particularly useful. Initially, the transfer of knowledge about these policies was as much from the authorities to Fund staff as the other way around. But after 2011, the Fund had moved quickly to create a database of macroprudential policies adopted around the world and—in parallel with efforts from other international organizations such as the BIS and regional entities—had worked hard to distill lessons from the cross-country experience with these policies. The work by country teams reflected in the 2014 Asia *Regional Economic Outlook* was mentioned by some as an example of useful analytic work done by staff on the impact of macroprudential policies in Asia on managing financial stability risks. In Korea, the authorities stated that Fund analysis of the housing market

and subsequent consultations with the Fund had helped in their design of macroprudential policies.

23. The Fund's increased openness on the use of CFM measures and the development of the IV were welcomed by officials as a departure from doctrinaire views. That said, it was felt that the IV still unduly limited the possibility of use for CFM within the toolkit of EM policymakers in dealing with volatile capital flows. In interviews with the IEO, central bankers from the region expressed the view that countries should be allowed to use CFM "in a pre-emptive manner" or as part of a simultaneously deployed "package of policy tools" rather than only in the face of pressures from flow surges or reversal, and then to be quickly reversed as the situation eased. This view was publicly expressed by the central bank governor of Malaysia, who stated "we should be able to use capital flows measures preemptively to minimize the overshooting effect from inflows" (Yunus, 2018).[8] Similarly a stock-taking of the ASEAN experience in using recent "capital safeguard measures" since the Asia crisis in 1998 raised a series of concerns with the application of the IV (ASEAN, 2018).

24. Recent differences of views over whether certain measures are MPP or CFM and broader questioning of the structure and application of the IV has the potential to erode some of the goodwill the Fund has gained over the past decade.

25. The authorities recognized the attempts by the Fund's staff and management in initiating the development of contingent financing instruments. A recent proposal for a short-term liquidity swap was seen as an example of staff's commitment, even though it did not get Board approval in part because of continuing concerns about design features that limited interest. Indonesia was happy to have actively supported the introduction of the FCL at the Board, although it did not utilize the facility because of residual IMF stigma effects from the Asian crisis. This signals that despite the progress made in rebuilding relations, work remains to be done to foster deeper IMF engagement in Asia.

26. In a majority of the countries, the authorities expressed their concern at the high turnover of mission chiefs (in one case the authorities explicitly highlighted this to Fund management as a problem) and the substantial turnover among country teams. The tenure of mission's chiefs to Asia at 2.1 years was the second lowest after Africa,[9] while over 50 percent of economists working on these countries during this period participated in only one mission. The short tenure of IMF economists inhibits the development of in-depth country knowledge.

[8] Reprinted in the *Financial Times,* October 16, 2018.

[9] Data based on the sample of countries in this evaluation, calculated by IEO staff.

V. CONCLUSIONS

27. The Fund has made strides over the past decade in becoming a trusted advisor to Korea and the ASEAN5. It provided sound advice and a sympathetic ear and helped through its analytic work on macroprudential policies and on spillovers. The development of the IV and greater openness to use of capital flow measures was welcomed in the region.

28. To sustain this progress, however, the Fund will have to consider whether it can narrow the distance between the IV as it is currently structured and implemented and the way that many central bankers in the region would like it to be applied. Cutting-edge analytic work on spillovers, as monetary policy normalization proceeds in the advanced economies, and on the efficacy of macroprudential policies will also help maintain the Fund's value added to the region. In addition, the Fund should seek ways to extend the length of staff tenure with a view to enhancing the Fund's traction by facilitating opportunities for staff to deepen their expertise on these economies.

ANNEX 1. KOREA AND ASEAN: EXTERNAL DEVELOPMENTS

Figure A1. Capital Flows to Korea and ASEAN5

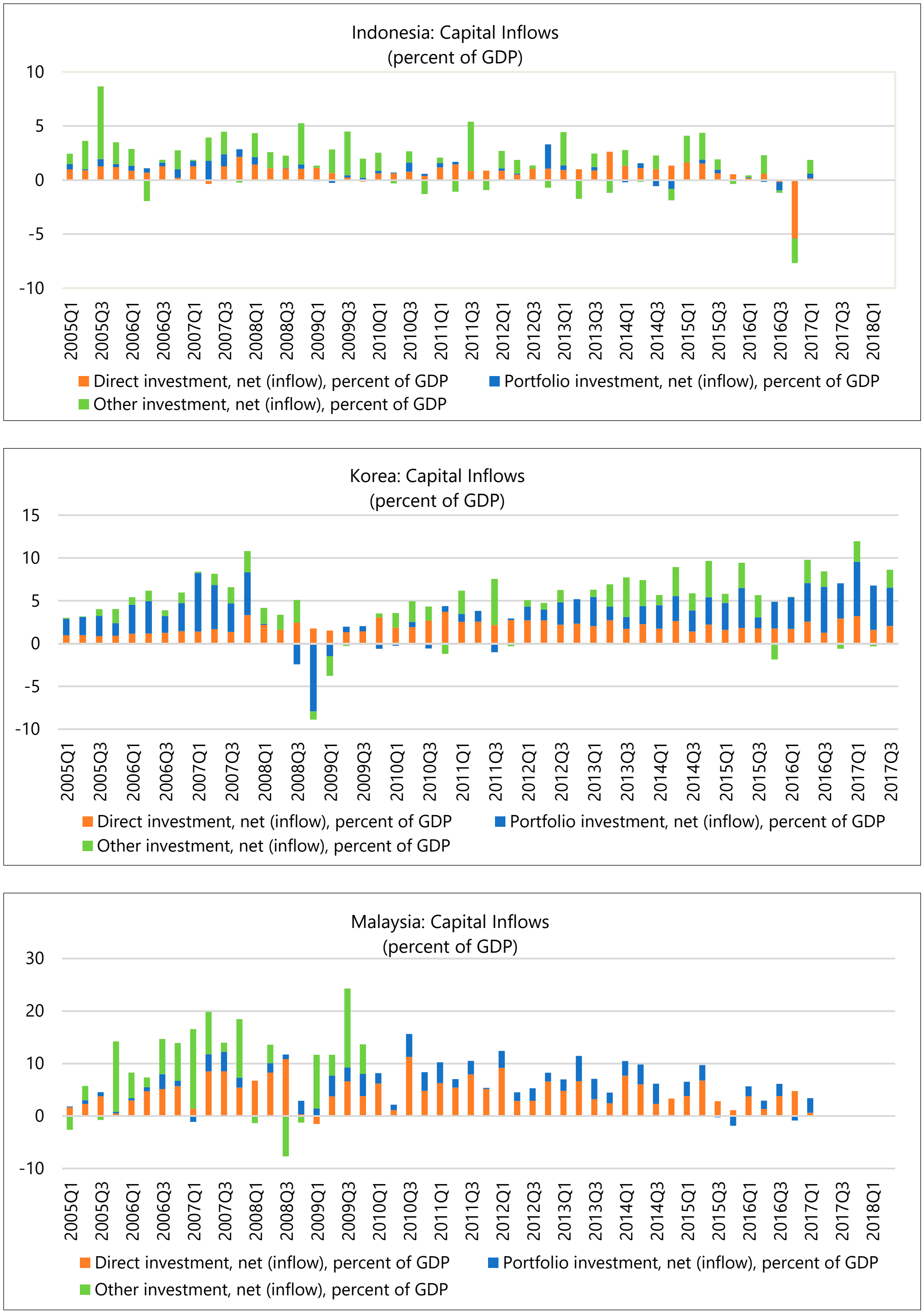
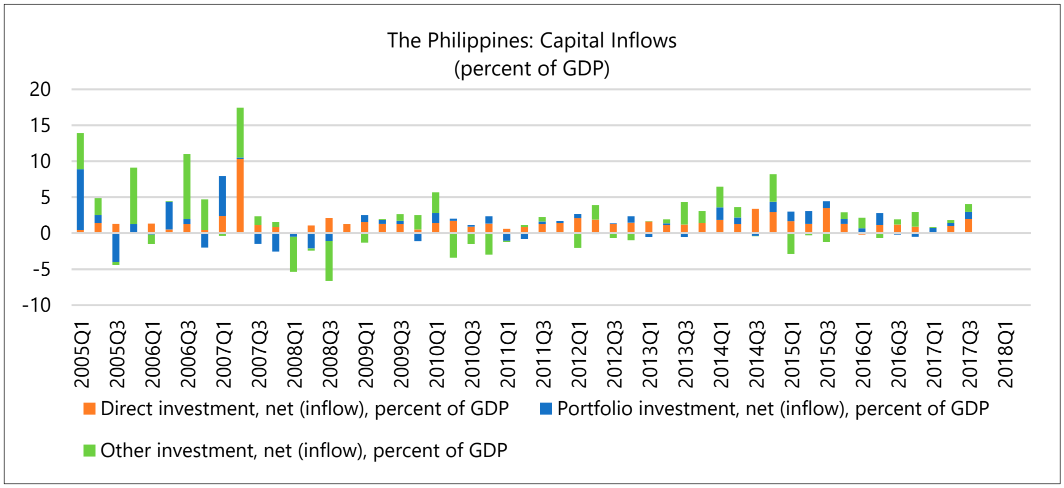
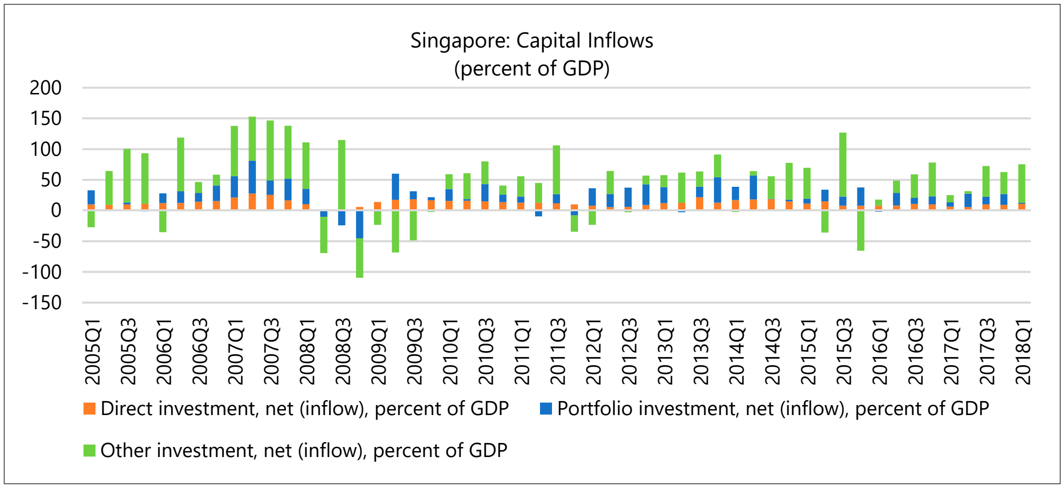
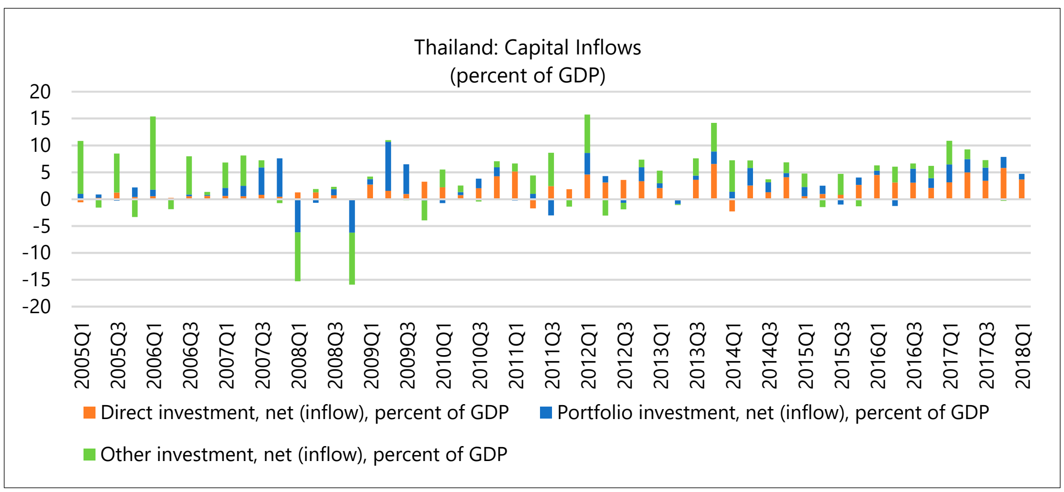


Figure A1. Capital Flows to Korea and ASEAN5 (concluded)

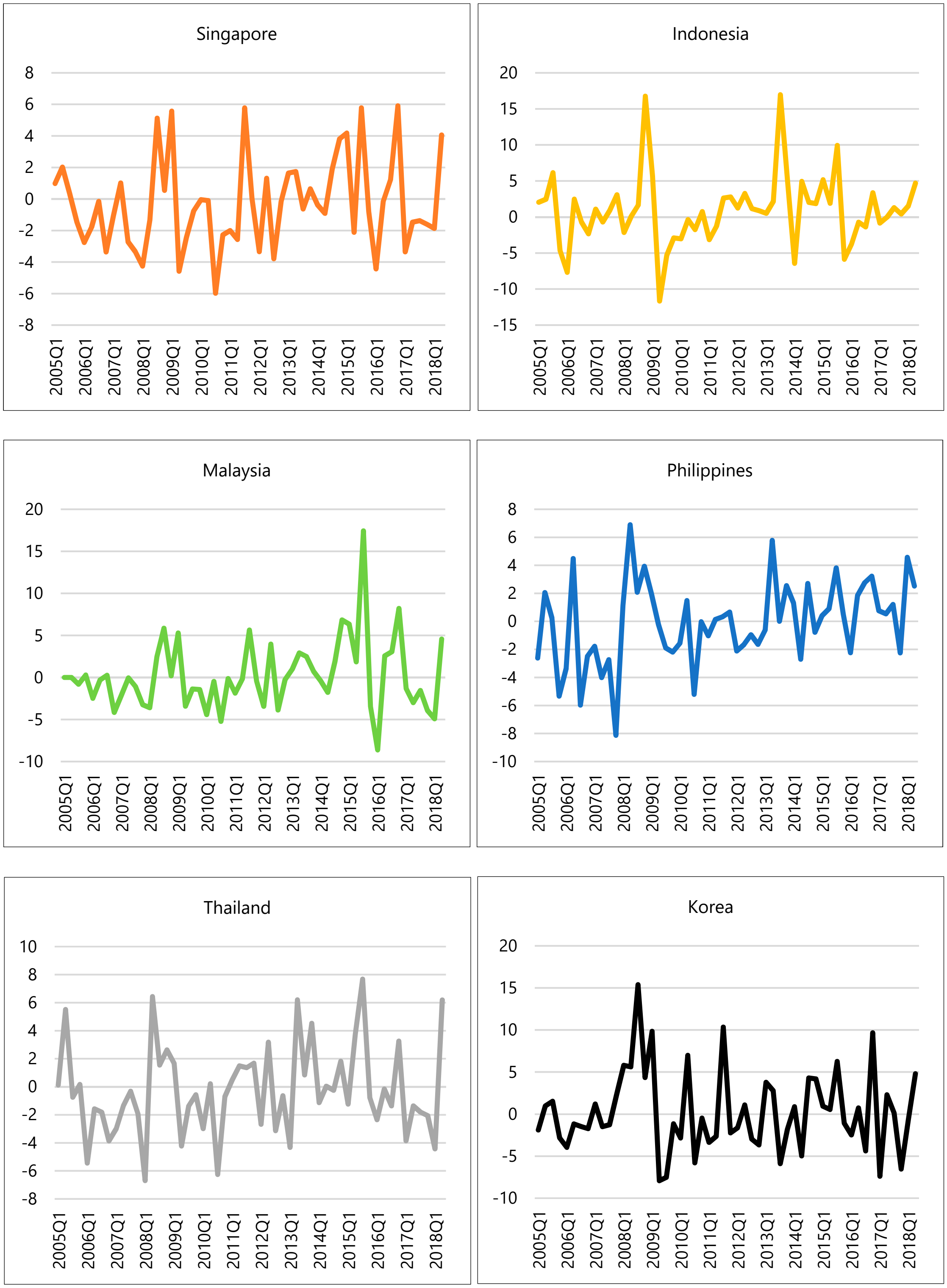






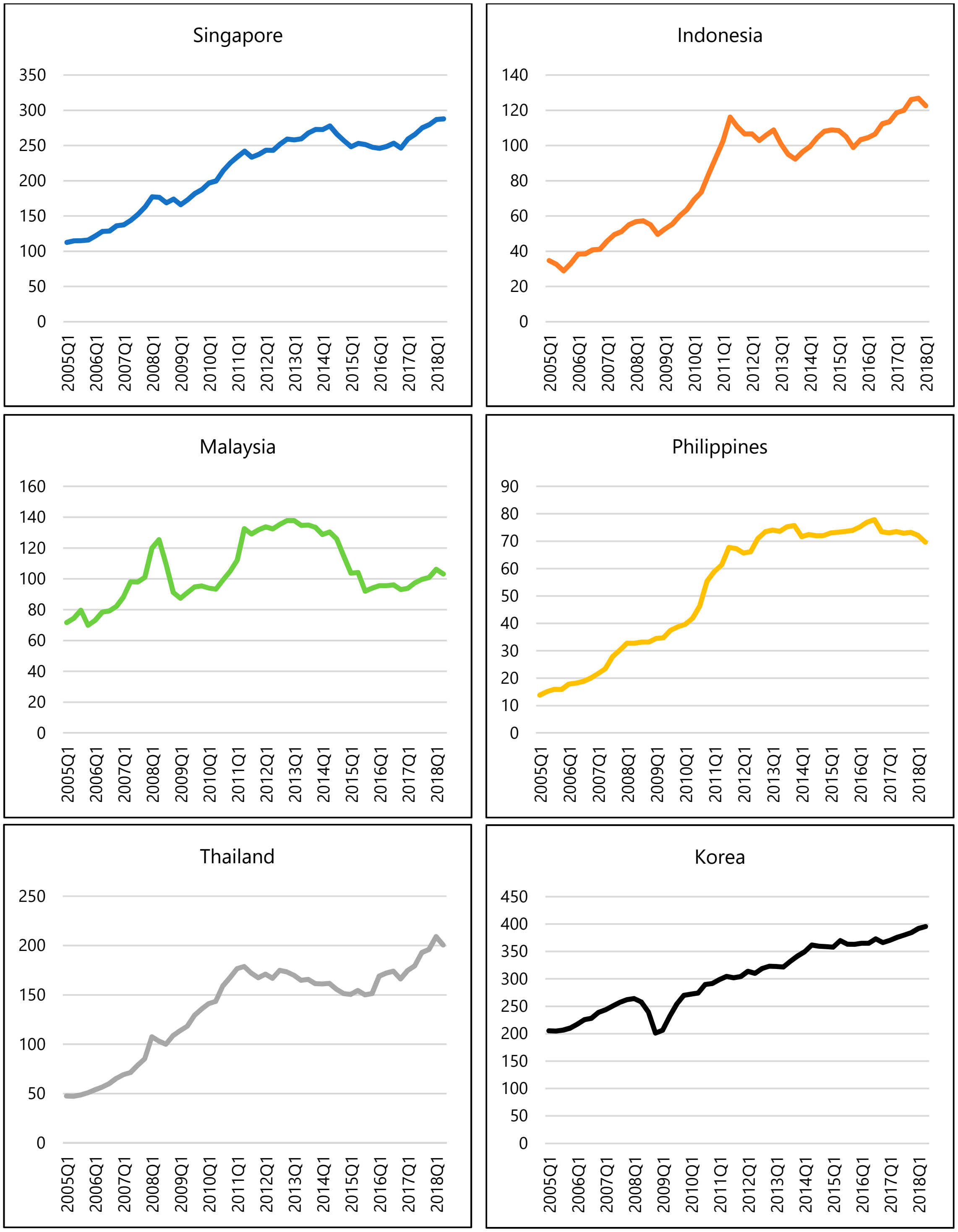
Source: IMF, *International Financial Statistics* (2018).

Figure A2. Exchange Rates
(Quarterly, Percent Change)



Source: IMF, *International Financial Statistics* (2018).

Figure A3. International Reserves
(In USD billions)



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