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A Changing Role for the IMF in Low-Income Countries

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1 Introduction

This chapter focuses on the role of the IMF in low-income countries. The IMF was set up to be a force for stabilisation in the global financial system. Lending to low-income countries is only a small part of that global role but, for the low-income countries themselves, the Fund plays a vital role as the "gatekeeper" to the much larger funding available for their development through debt relief and new aid. It agrees the policies they need to follow to receive such money and helps them to build their capacity to implement such policies. It is therefore at the core of development strategies in most of the world's 78 low-income countries.

The original role of the IMF was to help these countries to overcome temporary balance of payments crises, but in the course of the 1980s and 1990s, it has come to play a much longer-term role. This role includes providing long-term funds, providing a seal of approval to encourage capital flows by donors and foreign investors, designing and monitoring conditionality to ensure that balance of payments crises will be overcome, and, since the introduction of the Poverty Reduction Growth Facility (PRGF) in 1999, moving from a system of conditionality to one of country design and ownership of national poverty reduction strategies.

[1] This chapter draws extensively on the views of 35 low-income countries we work with; a HIPC Ministerial Network meets every six months to discuss what they think the role of the Fund should be in their countries. It is also based on an extensive literature review and a limited amount of original research.

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FONDAD, The Hague, June 2005, www.fondad.org

Since 1999, the new role of the IMF in the context of the PRGF has brought a need for major changes in IMF attitude, capacity and competence. These include the need for the IMF to: (i) reform its lending policies (in terms of concessionality or amounts) to ensure that it contributes to long-term debt sustainability; (ii) provide contingency funding on concessional terms to offset external shocks; (iii) improve its signaling function to promote long-term resource flows; (iv) nuance its signaling function for different groups of countries (pre-stabilisers, early stabilisers and mature post-stabilisers); (v) be more flexible in the design of macroeconomic stabilisation conditions, in order to promote economic growth and the attainment of the Millennium Development Goals (MDGs); (vi) eliminate structural conditions that are not essential to macro stability; (vii) be more realistic in its forecasting of the results of programmes, especially by including "predictable shocks" in its baseline scenarios; (viii) focus more on poverty reduction; (ix) enhance low-income country ownership of poverty reduction strategies; and (x) reform the Fund to increase its capacity to play a long-term role in low-income countries.

The chapter examines five areas: (1) the IMF's lending role; (2) its catalytic role; (3) its programme design and implementation, which covers a whole set of sub-areas; (4) ownership and capacity-building issues; and (5) the long-term capacity of the Fund.

2 The IMF's Lending Role

A primary function of the IMF is to lend to low-income countries with balance of payments problems, to fill balance of payments gaps. This section assesses how well it is fulfilling this function.

2.1 The Concessionality of IMF Lending

A first question is whether the Fund is providing sufficiently concessional financing. It is generally acknowledged that IMF resources available to low-income countries are insufficiently concessional. The PRGF has a grant element of 27 percent while other facilities theoretically open to low-income countries, such as other emergency assistance and the Compensatory Financing Facility (CFF), have much lower grant elements. This non-concessionality has two important effects that undermine IMF credibility.

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First, Fund programmes normally insist on a minimum 35 percent (occasionally 50 percent) grant element for all new lending to low-income countries, in order to encourage responsible borrowing policies and maintain debt sustainability. Yet, in order to retain a lending role the IMF has routinely to insert into PRGF agreements an exceptional clause which allows countries to borrow PRGF resources even though they breach the minimum grant element. IMF financing therefore represents the most expensive form of resources which low-income countries are allowed to access under IMF conditionality. The gap between the IMF and other financiers is particularly large in countries which are debt vulnerable or post-conflict, where institutions such as the African Development Bank (AfDB) and World Bank are initially providing grant. The IMF's credibility in advocating responsible debt management is further undermined by urging countries to refuse resources from other institutions (e.g. Islamic Development Bank, OPEC Fund), which have somewhat higher grant elements and fund priority development projects.

Second, in the context of discussions on debt sustainability during and after HIPC relief, IMF resources often risk making a key contribution to pushing countries into renewed debt unsustainability. Should this occur in the HIPC interim period, it can lead to accusations of irresponsible borrowing by the country, undermining its prospects of receiving topping up and continuing IMF programmes (e.g. Ethiopia, Rwanda). This is compounded by the practice in country Board papers of not projecting any IMF lending beyond the expiry of a current PRGF, which means that a follow-up PRGF will *ceteris paribus* lead to excess borrowing. In a few notable cases (Ethiopia, Rwanda, Uganda) countries have for this reason begun deliberately to reduce sharply their take-up of IMF loans, replacing them with cheaper IDA or African Development Fund (AfDF) resources.

So although the Fund has played a relatively credible role in trying to set ceilings for country borrowing and trying to restrain irresponsible borrowing by countries over the years, its own conditions for lending in the PRGF do not actually meet those criteria. Moreover, the low level of concessionality of the PRGF undermines the IMF's credibility in debt sustainability by breaching its own limits and makes the IMF money relatively lower quality compared to other sources of finance.

Therefore, we recommend that the grant element in IMF programmes should be increased to 35 percent minimum, and preferably to 50 percent for the poorest and most debt vulnerable countries. This is affordable

within the Fund's current resources. It is not an overextension of the Fund's role in development financing. Also, the maturity period of loans could be extended by, for example, 5 years. Currently, PRGF countries are borrowing for 10 years, with grace periods of 10 years, which virtually means borrowing for 20 years. Some have suggested that any greater concessionality would transform the Fund into a development financing agency – but the Fund is already a long-term lender (the IEO, 2004 has argued that PRGF funding is already tantamount to development financing) and a 5-year increase in the maturity period would not mean a major change in its status.

2.2 The Scale of IMF Lending

Recent IMF lending to low-income countries through the PRGF has been running at around SDR1 billion a year for the last eight years. Most recently, in 2002-05, this financing has been provided through an "interim PRGF", funded jointly by IMF and donor resources, which was due to be replaced by a "self-financing PRGF" from 2006. Is this amount of lending sufficient for each country? Though the maximum limit for three-year arrangements is 140 percent of quota (with an exceptional limit of 185 percent), in practice Fund staff have used norms of 90 percent for first-time users, falling to 65 percent for second and third programmes, and around 40 percent for fourth and fifth programmes. The Fund has proposed that it needs to set norms for second through fifth programmes of 55, 45, 35 and 25 percent of quota. However, it would seem more desirable to taper down Fund lending more rapidly to avoid excessive prolonged use, using norms of 55, 45, 25 and 10 percent, phasing out lending entirely after a maximum of five (preferably four) programmes. However, it is important that these norms be kept as indicative, thereby retaining the option of using PRGF drawings as contingent finance against later shocks for countries which can afford PRGF terms – see also 2.3 below.

These suggested norms would be in line with improved balance of payments performance and lower recent borrowing wishes by countries which have had several successive programmes (Rwanda 5 percent, Uganda 7.5 percent, Mauritania and Tanzania 10 percent, and Senegal 15 percent of quota). These reductions in borrowing levels have been in part motivated by the wish to keep debt sustainable and borrow from alternative more concessional sources. Therefore, if no increase in IMF concessionality is agreed, more conservative norms are more urgent.

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These norms should also preferably be linked to the degree of stabilisation achieved by a country rather than the number of programmes it has completed.

Does the IMF Have Enough Funding for Lending to Low-Income Countries?

Current IMF estimates (IMF, 2004c and 2004e) indicate that beyond 2005, demand should be estimated at SDR0.8-1.2 billion a year, which is consistent with recent disbursements. It indicates that ordinary PRGF disbursements would be expected to decline due to improved balance of payments positions for PRGF countries, country graduation to blend or Extended Fund Facility terms, and increased availability of grants from other sources. However, disbursements against shocks, for the Trade Integration Mechanism and for new countries with programmes (Liberia, Somalia, Sudan and maybe Zimbabwe) would increase.

We test a scenario in which ordinary disbursements fall in line with the lower norms proposed above, which are believed to be in line with developing country needs and wishes. Based on classifying 35 PRGF loan recipients between mature post-stabilisers, early stabilisers and pre-stabilisers, we make an indicative simulation assuming that all current post-stabilisers have their forthcoming PRGFs at 10 percent of quota, and that current post-stabilisers need no more IMF loans after 2010; and that two-thirds of the current early-stabilisers make sufficient progress with stabilisation to need an average of only 25 percent of quota by 2010. This would indicate that lending need could fall to around SDR650 million during 2006-10 and SDR250 million after 2010.

How much of this would be offset by higher anti-shock lending, new countries and the Trade Integration Mechanism? If the Fund doubled the frequency of anti-shock PRGF augmentations to once every three years, and kept them at the low average level of only 10 percent of quota (for debt sustainability reasons it is unlikely that higher loan levels would be desirable), this could absorb around SDR200 million a year. It is unlikely that new countries would absorb more than around SDR200 million a year (since, excluding India and Nigeria, they represent only 12 percent of PRGF country quotas). The impact of the Trade Integration Mechanism, which is very narrowly defined and can disburse a maximum of 10 percent of quota, is likely to be marginal. As a result, SDR1.05 billion a year on average in 2006-10 and SDR650 million a year in 2010-15 seem a reasonable indicative projection of needs, though this would not take account of any major spike caused by e.g. Nigeria or Sudan.

How Can This Lending Be Funded?

The Fund presents various scenarios for future financing (IMF, 2004c). Using only Reserve Account funds (a self-sustained PRGF) lending would be reduced to SDR660 million a year. In order to attain an average level of SDR1 billion a year throughout 2006-15, additional pledges of SDR500 million in bilateral loans would be needed. At first sight, there would seem, therefore, to be a case for mobilising additional financing. However, in a "sunset" scenario also presented, the IMF indicates that if loans were gradually tapered off, the Fund could afford SDR850 million in 2006-10, falling to SDR400 million thereafter and ending in 2015. This implies that the gap between financing needs and resources is only around SDR200 million a year during 2006-10 and SDR250 million during 2010-15. In addition, it is not clear from the paper whether the lending capacity takes into account the SDR80 million a year in administrative expenses which could be paid into PRGF-HIPC operations with legal approval by the Fund Board. Taken together, these factors might mean that the financing gap for the PRGF during 2006-10 (even allowing for the need to subsidise bilateral loans) is less than SDR100 million a year.

Moreover, the IMF dismisses the prospect of using General Resources Account resources to supplement the Reserve Account, and all recent Fund Board papers ignore the IMF's large additional own resources, which it could mobilise to fund future lending and debt relief. They do so because there is no international consensus to affirm the IMF's role as a lender of last resort for low-income countries by providing it with large amounts of additional concessional resources. As many have pointed out (notably Buira, 2003), IMF lending capacity has fallen sharply over the last 30 years, in relation to reserves of low-income countries and international financial flows, reaching only 3.5 percent of world imports and 1 percent of world GDP by 2000. It is highly regrettable that the Fund's role as direct lender of last resort is being abandoned to financiers with more concessional terms, and that the shortage of IMF funding leads to an attitude of "selectivity" and higher conditionality in the Fund Board, which removes its role as an anti-shock, low-conditionality lender.[2]

[2] See also Birdsall and Williamson (2002) for using Fund gold to protect against shocks; and Mohammed (2003) for a more cautious view based on Board consensus and the extra cost to middle-income developing country Board members.

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2.3 External Shocks

A second question concerning the IMF's lending role is whether the Fund is providing adequate financing to offset external shocks. We think that, if the Fund's money would be concessional enough, the absolute priority for Fund lending would be for financing against shocks. However, the Fund's current facilities to deal with external shocks are completely inadequate, both quantitatively in terms of lending compared to the scale of the shocks and qualitatively in terms of the types of shocks they cover up and the repetitiveness of those shocks.

There is an often-cited rule, which is supposed to determine Fund intervention in financing against external shocks – that a temporary shock should be largely offset by financing, while a permanent shock should be handled by adjustment. However, we do not endorse that rule, because (i) almost all low-income countries are suffering frequently repeated and large shocks, making it much more difficult to distinguish between temporary and permanent shocks; (ii) the Fund has not actually responded according to that rule, and is therefore engaging in frequent prolonged use of its resources; and (iii) in the short term, "adjusting" to rather than "financing" a shock in the context of the MDGs means cutting spending on crucial poverty reduction goals, which is not acceptable.

The Fund currently provides two types of financial response to shocks by (a) augmenting PRGF lending by an average of 10 percent of quota, and (b) providing 50 percent of quota in emergency assistance for natural disasters. This is completely inadequate given the scale of recent shocks for low-income countries, which have been estimated at an average of 3.5 percent and 5 percent of GDP for commodity price and natural disaster shocks respectively (IMF, 2003a). While 50 percent of quota (0.5 percent of GDP) could compensate for a small proportion of a natural disaster shock, 10 percent of quota (0.1 percent of GDP) represents a highly marginal proportion of commodity shocks. In addition, though low-income countries are likely to experience shocks (commodity and natural disasters combined) once every 1.4 years, PRGFs have been augmented only in roughly one of every six years.[3] There is therefore a huge gap between the scale and frequency of shocks and the scale and frequency of IMF response. The gap is filled by other donors or lenders or, more often, by additional adjustment by the developing country at the expense of spending on the MDGs.

[3] Data based on IMF (2004c) and IMF (2003a).

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An even more important shortcoming of Fund lending to counter shocks is its qualitative inadequacy. This is demonstrated in four ways. First, loans are not disbursed fast enough. Any decision on an augmentation of a PRGF requires at least one review mission and Board decision, which is likely to take around six months in total. Emergency assistance is also likely to take around six months. This time lapse (though comparable with or better than those for other facilities such as that of the EU) is likely to mean that the impact of the shock on the economy and MDG prospects is fully felt by the time the funding arrives. Second, the main facility designed to protect against commodity shocks – the CFF – is far too expensive for low-income countries to access. Third, countries that suffer commodity or other shocks but do not need full high-conditionality programmes are forced to resort to stand-by arrangements regardless of whether these are affordable or appropriate. Recently IMF staff have proposed the creation of a "stand-by-like" window within the PRGF using PRGF resources, to provide concessional resources but with the programme design features and duration of a stand-by. This appears to be abandoning the original aim of the CFF – low-conditionality finance to offset temporary shocks – in favour of full conditionality, and should not be adopted. Third, assistance is far too dispersed across different Fund facilities (a facet heightened by the Trade Integration Mechanism facility) requiring too many complex review processes and too micro-managing a view of economic needs.

Should the Fund provide anti-shock lending to both debt-distressed and non-debt-distressed low-income countries? It depends on the debt capacity of the countries. If the Fund cannot increase its lending concessionality substantially, it is questionable whether it should play the role of anti-shock lender at all in *debt-distressed* countries. Lending non-concessional funds to debt-distressed countries which have just been hit by a shock will compound their problem. Therefore, while the recent proposals (IMF, 2004c) for more frequent augmentations of PRGF loans are welcome, they should be limited to those *non-debt distressed* countries which can afford to borrow on PRGF terms (this could be defined according to the new long-term debt sustainability framework – see 2.2 below). It would seem reasonable to plan an augmentation of PRGF once every three years. The average augmentation could also be increased – and more directly related to the size of the shock for each country.[4]

[4] An alternative would be a "CFF-like" window within the PRGF, with lower conditionality and greater concessionality, but seems to complicate matters further.

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Another important line of defense against shocks would be the accumulation of additional reserves – preferably up to a level of six months of imports of goods and service for most low-income countries which are highly vulnerable to shocks. Where countries can afford IMF lending, it would be appropriate for them to continue to borrow in order to accumulate reserves more rapidly, or to borrow to replenish reserves if shocks reduce them.

For debt-distressed countries, the main source of anti-shock financing should be in the form of grants and therefore come from non-Fund (bilateral, EU, World Bank and AfDB) sources – but preferably through a more coordinated anti-shock facility. The most appropriate role for the Fund in these circumstances is in vastly improving its macroeconomic forecasts, to incorporate "foreseeable shocks" into them; and in alerting the international community rapidly to the arrival of shocks, in order to signal the need for more rapid anti-shock financing.

2.4 Relationship Between Lending and Programmes

A third question concerning the IMF's lending role is whether it makes sense to maintain a strict link between IMF programmes and lending. It has long been argued that such linking is essential, for which three reasons are given. First, the IMF loan itself will be a significant contribution to balance of payments financing. However, most studies have concluded that the role of the Fund's own finance compared to other sources is very small. Second, a formal IMF loan will provide a stronger seal of approval and signaling function to catalyse other financial flows to support the country. As will be discussed below, this is a highly doubtful assertion. Third, a formal IMF loan, because it places Fund resources at risk, will ensure that greater attention is paid to discussions on the country by Fund management and Board and therefore ensure a higher quality programme. Even if this has been true in the past, there is no reason why this logic should persist. So there are no compelling arguments to link programmes with lending. IMF loans are not an important source of financing for the balance of payments in most low-income countries, they are not essential for a catalytic role, and they are not essential for getting serious attention by IMF management.

The need for IMF funding depends, most of all, on the status of the low-income country. As suggested by the Fund (2003b and 2004c), three groups of countries can be distinguished: "pre-stabilisation" countries, "early stabilisers", and "mature post-stabilisers". Fund resources would be

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essential for "pre-stabilisation" countries[5] that are just embarking on programmes to stabilise their economies, and sometimes emerging from conflict or other disaster, to contribute to gap-filling where the commitment of other financiers to fungible support is limited. However, as discussed above, Fund lending would need to be highly concessional. Fund resources might continue to be important for "early stabilisers", requiring current PRGF access limits or norms to be used, with higher access levels for countries emerging from arrears or emergency assistance, and reduced levels for successor arrangements, falling to 10 percent of quota as soon as they reach indicators of "mature post-stabilisation" status.[6] And Fund lending could be abandoned altogether for "mature post-stabilisers", since other lenders and donors can provide the needed concessional finance to replace Fund lending. Additional resources could be made available to combat exogenous shocks or fulfil sudden unexpected financing needs, for all three groups. However, all such resources should be given on PRGF terms to avoid putting at risk the debt sustainability of the recipient countries.

3 The IMF's Catalytic Role

The IMF's endorsement of a country's programme has a potential catalytic role in promoting availability and stability of long-term resource flows to the country. Catalysing flows from other sources is important since the IMF's own financing of programmes has been reduced by the reluctance of major shareholders to allow it to expand its own resources.

There is a considerable literature that questions both the theoretical and empirical foundations for any IMF catalytic role, especially because other providers of finance are not sure that IMF conditionality means that a government is committed to economic policy reform and will implement the IMF programme, and that the IMF programmes will

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[5] Some sources suggest using the term "post-conflict", but we prefer to use groups based on performance because many "post-conflict" (or even conflict-ridden) countries such as Burundi, Central African Republic, Sudan or Togo have surprisingly good stabilisation performance. In addition, given the very small amount of Fund finance going to countries formally classified as post-conflict (only Burundi, Côte d'Ivoire, Guinea-Bissau and Sierra Leone), such a reclassification has only a marginal impact on Fund financing needs.

[6] Low-access PRGFs seem generally more desirable than precautionary PRGFs (see IMF, 2004c, para 34-36).

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produce improved economic performance. They are also worried that, because very few low-income countries have "graduated" from IMF assistance, the start of a programme may be signaling economic crisis and protracted use of IMF resources. Studies based on interviews with suppliers of funds, case studies and econometric work all demonstrate that the Fund's catalytic role is very limited.[7]

To examine the reasons for this weak effect, it is important to distinguish between official development finance, private sector finance and debt relief, for which the "seal of approval" acts rather differently.

3.1 Official Development Finance

For official finance, it is possible to distinguish three potential roles of the Fund: signaling, gatekeeping, and mobilising funds.[8]

The Fund has a role in *signaling* that a country needs additional funds, by determining whether there are financing gaps in the balance of payments or budget. However, while the Fund regards official flows as in principle desirable to fill financing gaps, many Fund staff also see large aid increases as likely to provoke "Dutch disease", higher budget deficits or long-term aid dependence, or as exceeding government capacity to absorb funds or to sustain long-term funding of resulting programmes. This goes against almost all the recent literature, including that of the Fund, which indicates that the risk of Dutch disease is minimal and that countries have large extra capacity to absorb aid.[9] As a result of these concerns, Fund staff often do not take maximum advantage of a potential catalytic role by projecting higher levels of aid. Compared with global commitments to increase aid to low-income countries by around $20 billion a year (40 percent), forecasts in IMF programmes are lagging way behind, and there is no clear rationale

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[7] See Bank of England (2003); Buira (2003); Bird and Rowlands (2003 and 2002); Dreher (2003); IEO (2002); Killick (2004); Morris and Shin (2003).

[8] According to IEO (2004), Fund internal guidance in 2002 advised staff to "present normative projections of grants and concessional loans" and to "demonstrate efforts to seek higher aid commitments in cases where needed and appropriate", while taking account of Dutch disease and absorptive capacity concerns. PDR guidance in 2003 asked mission chiefs to "determine whether the negative macroeconomic consequences of higher externally-financed poverty-reducing spending outweigh its benefits".

[9] See especially Adam and Bevan (2003b), and Mwanza (2004) on Dutch disease; and Foster (2003) and World Bank (2003) on absorptive capacity.

behind programme projections.[10]

The IMF has a catalytic role also in *gatekeeping* funds, because donors tie parts of their funds (especially budget support or programme aid) to IMF approval of a macroeconomic programme and its implementation. This reflects partly a response to hoped-for positive results of IMF conditionality, but especially their wish to maximise donor coordination. In a few countries, growing amounts of multi-donor budget support are linked to Fund reviews or disbursements. However, donors have increasingly tended to link only part of their funds in this way, preferring to link the rest to annual progress in the PRSP and make it less subject to potential "stop-go" processes in Fund reviews. On the other hand, programme aid is only 10 percent of global aid and many donors stick with strategic and project-financing motivations for country support, which is also strongly influenced by natural disasters and conflicts.

The Fund's role in *mobilising* official funds has until now been minimal, confined to occasional contacts with donors to urge them to disburse balance of payments or budget support funds to fill financing gaps or offset exogenous shocks, for individual countries, and to participating in Consultative Group and Round Table meetings to provide endorsement of economic policies.

3.2 Private Sector Finance

Private flows are linked to IMF programmes in a very different and less predictable way. Evidence from investor surveys indicates that a country having to apply for a first (or repeated) IMF programme may be seen as a negative signal, with its negative implication for the quality of recent national economic management offsetting any positive implication of having Fund support. This can be seen clearly in the reaction of rating agencies to mark down a country's creditworthiness! Fund support is not always seen as positive, and is many times regarded as a sign that a country failed to solve economic problems and restore sustained high growth.

In addition, private sector financiers are not a homogeneous group.

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[10] Fund staff also argue that low-income countries are themselves pessimistic about aid prospects, having experienced years of declining aid or disbursement shortfalls or believing that they have reached the limits of donor commitments. The Ugandan government has also been worried about macroeconomic effects of its recent massive increase in aid flows, but this is an exceptional circumstance.

While rating agencies and portfolio (equity and bond) money managers look closely at such aspects as fiscal policy, commercial bank lenders look at their exposure, debt burdens and market opportunities. Actual direct investors in countries are far more interested in the impact of policies – especially whether they create economic stability, a growing market and growing domestic investment, and improving human, physical and financial infrastructure.[11] They are therefore often critical of Fund programmes where they are perceived as creating financial or corporate instability due to volatile interest or exchange rates, contributing to recession or lower domestic investment. As with official finance, IMF programmes' catalytic role for private finance is likely to emerge only over a long period, and due to consistent and sound low-income country government policies.

3.3 Debt Relief

A third type of financing catalysed by the IMF is that of debt relief. Here the theoretical and empirical case is much stronger, given that all major debt relief agreements for low-income countries (Paris Club, IDA Debt Reduction Facility) require an IMF agreement to be in place before signature (Marchesi, 2001). The Fund's catalytic effect on debt relief has been particularly strong in the HIPC Initiative, where relief is tied entirely to progress with IMF programmes and the Fund plays a very prominent role in signaling debt relief needs through debt sustainability analyses (DSAs) (IDA, 2003). More recently, the Fund and World Bank have moved further to propose a framework for long-term debt sustainability which includes conditionality as to the amounts (as well as the concessionality) of funds low-income countries should mobilise (World Bank/IMF, 2004).

However, it is questionable whether the catalytic role of the IMF results in *additional* development financing. Studies conducted so far reach varying conclusions.[12] The views of HIPC Finance Ministers (2002 and 2003) seem most reliable – that additionality depends not just on their track record and the signaling effect of having a Fund programme,

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[11] For more details, see Martin and Rose-Innes (2004) and Bhinda *et al.* (1999).

[12] Dijkstra (2003), Killick (2004) and OED (2003) find no additionality. However, HIPC Ministerial Network (1999 to 2003), IDA (2003), Martin (2004), Martin *et al.* (2003) and World Bank (2003) see additionality for the majority of HIPCs.

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but on their wider relations with donors (including faith in their fiscal management). They indicate that there is insufficient relationship between their economic performance and the degree to which donors support their programmes, with some countries awash with donor funds (Mozambique, Tanzania, Uganda) while others with comparable performance records (Benin, Mali) receive much less aid and fewer grants or less budget support.

3.4 Impact on the Stability of Financial Flows

A final issue is whether the IMF seal of approval contributes to *stability* of flows. On the side of official flows, there is some evidence (Bulir and Hamann, 2001) that staying on track with IMF programmes does sharply reduce the volatility and shortfalls of aid flows – though both still remain remarkably high even with Fund programmes. HIPC Ministerial Network (2002 and 2003) indicate that one factor explaining continued volatility and shortfalls is that some Fund staff give behind-the-scenes negative signals to donors about country commitment, while failing to explain the complex interaction of external shocks, programme misdesign and poor implementation.

On private flows, the evidence is that the IMF catalytic role is especially weak in capital account crises (Cottarelli and Giannini, 2002) – which happen surprisingly frequently in low-income countries even though they are not noticed by the international community (Martin and Rose Innes, 2004).

3.5 Improving the IMF's Catalytic Role

A recent assessment concludes that three types of action are *not* likely to improve the Fund's catalytic role: strengthening conditionality, increasing IMF financing, and encouraging countries to turn to the Fund earlier in crises (Bird and Rowlands, 2003).

How can the IMF's catalytic role for official financing and private financing be improved? For official financing, first, the Fund should base its signal on better analysis. IMF views on the macroeconomic desirability of aid should be discussed more openly with governments and donors, based on detailed country-specific analysis, led by the low-income country government with assistance from independent analysts. Where firm evidence of negative effects is unavailable, the presumption should be that higher aid will have a positive effect on development. Low-

income country governments should also analyse their absorptive capacity and MDG spending costs, to show a case for aid beyond gap-filling, and for measures to build their aid management capacity. These findings should then be integrated with the macro framework, to ensure that it allows the MDGs to be funded. IMF projections of official flows should take maximum advantage of global aid trends and quality improvements such as increased grants and higher budget support. The IMF should play an even more active role, together with UNDP and the World Bank, in presenting systematic assessments of the degree to which donors are supporting PRSPs and providing funding in a balanced way linked to country progress, and of when shortfalls are derailing programmes, at a country or global level (see also IEO, 2004; Trocaire, 2004).[13]

Second, the IMF should gatekeep with maximum responsibility. The Fund needs to take particular care to signal more clearly in discussions with donors, notably urging them to continue disbursements while a government is continuing discussions with the Fund to overcome track record problems, and avoiding *ex ante* speculation about possible non-compliance. Of course, much of this process is up to donors. Pending more progress in reforming IMF conditionality, donors need to retain flexibility to assist and analyse countries independently of the Fund, based on overall PRSP progress. This requires them to have expertise in country to interpret economic developments, and to insist on transparent country-led donor meetings with the IMF rather than private IMF-donor briefings. Ideally, for post-stabilisation economies, the catalytic role of the IMF should be limited to providing views on the macro framework, and the Multilateral Development Banks-style agreements should have performance matrices taken entirely from PRSPs (see also IEO, 2004; Oxfam, 2003; Trocaire, 2004, for similar suggestions).

Third, the IMF should help other institutions to mobilise funds. UNDP and the World Bank are the key donor coordination agencies in low-income countries and need to play an even stronger role in mobilising donor flows. However, the IMF can play a crucial role in ensuring that these funds materialise.

For private financing, the Fund should encourage country authorities to engage themselves in far more dialogue with investors to explain to them the motivations behind and likely results of policies, and to

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[13] To this end the expanded analysis of donor behaviour in World Bank/IMF (2004) is highly welcome.

gather their opinions in an objective way about desirable future policies. IMF programmes should place stronger emphasis on reinforcing economic stability, accelerating growth and investment, and allowing fiscal space for spending to improve human, physical and financial infrastructure. Advanced contingency measures should be designed to protect against capital flow shocks, taking a more cautious attitude on private flows. Long-term analysis and simulations should be made of the sustainability of different paths to increase low-income country access to private flows over the next 20 years.

The main catalytic function of the IMF relates to official flows, and their providers could be expected to be fully informed about the signaling intentions and strength of policy stances implied by different IMF treatments. Staff-Monitored Programmes have been seen as having less of a catalytic effect than formal programmes, but this is because they are in general of lower quality. There is no reason to assume that any of the changes recommended in this chapter (such as moving to surveillance rather than lending for mature stabilisers) would damage the catalytic effect. Indeed, to the degree that such a move is presented transparently as a reflection of reduced balance of payments problems and strong policy effort (i.e. graduation from needing IMF lending), and receives strong support from official sources, it might well have a greater catalytic effort on private flows than continued prolonged use of IMF resources. For more stabilised countries, as suggested by IEO (2004), the proposed Joint Staff Assessment Note of PRSP progress could even be an adequate signal for catalytic purposes.

4 IMF Programme Design

4.1 Macroeconomic Flexibility

Given the shift from short-term balance of payments support to the long-term strategy of promoting economic growth and achieving the Millennium Development Goals, one would expect the IMF to have become more flexible in the design of macroeconomic stabilisation conditions. Unfortunately, however, the evidence seems to indicate that the introduction of the PRGF has not led the IMF to place more emphasis on economic growth. According to recent and forthcoming reviews, even though pre-programme growth rates have been slightly higher for PRGFs than for ESAFs, the targeted growth rates under

PRGF have, if anything, been slightly lower than under ESAF. Projected growth rates have stayed at around 5 percent, which for most PRGF countries is below levels needed to attain the MDGs.[14]

Even more unfortunate is that there is strong evidence of shortfalls of actual GDP compared to programme growth objectives. Actual growth levels have been closer to four percent, according to the IEO (though there has been a major negative terms of trade shocks during the same period, and PRGF countries have overcome this better). One crucial reason for growth shortfalls compared to projections is that PRGFs and Poverty Reduction Strategy Papers (PRSPs) show little evidence of detailed analysis of what will drive key sources of growth (either in terms of savings and investment; or in terms of sectoral composition) and therefore of real sector measures needed (see also Killick, 2004 and World Bank/IMF, 2004). Yet, according to HIPC Ministerial Network, the Fund's reaction to shortfalls has too often been to say that it is not possible to design ways to accelerate growth, and therefore to insist that growth rates are cut compared to those necessary to attain the MDGs – to make the programmes "realistic" (a view reflected, for example, in IMF, 2003d).

Obviously, the most important design issue for Fund programmes, with their focus on stabilisation and macroeconomic balances rather than the real sector or distributional issues, is the degree to which stabilisation contributes to growth, and the risk that there might be a trade-off between stabilisation and growth. Stabilisation targets at levels of inflation, fiscal deficits, and reserves. We will discuss each of these targets in turn.

Growth-Maximising Inflation Rates

If one looks at studies, including by the IMF, of what the growth-maximising inflation rates for low-income countries would be, the answer is that they should lie between 5 and 10 percent.[15] This means that inflation above 10 percent is likely to be inimical to growth, but so is inflation below 5 percent: excessive efforts to reduce inflation from high to low single digits can be pernicious for growth. Though reducing inflation

[14] Country analysis conducted in 14 of the 34 HIPC CBP countries, based on growth/poverty reduction elasticities, indicates that the average growth rate needed to attain the MDG of halving poverty by 2015 is 6.3%. Other more global studies (UNDP) suggest levels of around 7%.

[15] See Adam and Bevan (2001) and Ghosh (1998).

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is important, almost all recent analyses of low-income countries conclude that, while the demand factors stressed by the IMF (money supply growth, fiscal deficits) are important to causing or reducing high inflation, inflation below 10 percent is much more strongly influenced by supply factors such as food prices, energy shortages, oil import price rises, and devaluations (see Catao *et al.*, 2003; Ljungqvist and Sargent, 2000; Fischer *et al.*, 2002). As a result, accelerated pro-poor growth itself can be a powerful factor in reducing inflation by increasing supply response and removing supply-side influences on inflation.[16]

Fiscal Deficits

The relationship between fiscal deficits and inflation is more complex. It seems that it is the level of deficit rather than the level of spending which is inflationary. Within spending, consumption spending is more inflationary. By this is meant not recurrent spending – because much of this is necessary to support MDG investment spending – but spending on low-productivity programmes and projects. The past view of desirable and undesirable spending needs to be changed – especially to get away from functional classifications of spending such as "salaries are bad" – because the international community is trying to move towards programme budgeting where the objective rather than the type of spending is crucial. Therefore salaries of staff making a major contribution to growth and poverty reduction are desirable. This is because spending on anti-poverty programmes is supply-enhancing and counter-inflationary (Adam and Bevan, 2003a).

The definition of the fiscal deficit is also a vital issue, because it is linked to how the deficit is financed. An acceptable level of deficit is what can be financed sustainably e.g. through (i) external grants which are projected to continue over the medium term; (ii) concessional external borrowing which does not exceed sustainable levels; (iii) domestic borrowing which does not exceed sustainable levels; or (iv) credit to government which does not provoke inflation, crowd out credit to the private sector or reduce foreign exchange reserves. For this reason, most are agreed that the budget deficit should be measured after

[16] This is not to argue that monetary policy should accommodate relative price movements, but rather to argue that policy should be directed to avoid their inflationary impact in the first place.

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grants.[17] Another important issue is the composition of donor funding. Project support tends to be low value for money and to drive up prices in key non-tradable sectors of the economy, such as construction. Therefore budget support is preferable.

One theoretical reason often cited for the need to reduce fiscal deficits is the need to reduce "crowding out" of private sector credit by freeing funds for banks to lend to the private sector, increasing private sector investment. However, almost all recent studies indicate that this is an extremely slow process. And indeed, there is little evidence of increased financing of private sector production in any PRGF programme, as banks tend to increase their reserves, excess deposits and investments in government domestic debt rather than lending to the private sector (see also Adam and Bevan, 2001; IEO, 2003b).

However, the deficit before grants should not be allowed to rise too high. In Uganda, for example – in an exceptional position – it doubled to 13 percent of GDP between 1996-97 and 2001-02. Though this was financeable with donor grants, the resulting extra injection of money into the economy had to be offset by extra sales of government securities and foreign exchange into the domestic market, to keep inflation below 5 percent. These policies dramatically increased interest rates and domestic debt interest costs and appreciated the Uganda shilling against the dollar. As a result, Uganda is now trying to reduce its deficit before grants to 6.5 percent of GDP by 2009-10, by increasing domestic revenue mobilisation, and by increasing expenditure by less than GDP growth (Government of Uganda, 2002).

For all of these reasons, the literature concludes that reducing the deficit further below one percent of GDP (after grants) is not particularly helpful in fighting inflation. However, Adam and Bevan (2003a) suggest that there is more room for government spending, classifying as "stabilised" those economies that have budget deficits of less than 3 percent of GDP after grants, and stating that the growth-maximising level of budget deficit after grants is 1.5 percent.

Reserves

Another possible target for stabilisation, in order to provide countries

[17] Adam and Bevan (2001) have also suggested including the grant element of net loan flows in the calculation, which would reduce deficits by around 1-2.5% of GDP for countries we have examined.

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with maximum protection against external shocks, is a minimum level of reserves, measured in months of imports of goods and services. A generally accepted minimum prudent level here is 3 months, and a sufficient level is 4.5 months.

Pre-Stabilisers, Early Stabilisers and Post-Stabilisers

The literature provides no precise consensus on when an economy is "pre-stabilisation", "early stabilisation" or "post-stabilisation". Its definitions include different variables – though there is a general consensus to include inflation, budget deficits and reserves. It also includes several ways to measure them. However, broadly, the tough end of the literature implies that a low-income country economy should be considered to be post-stabilisation when its inflation rate is below 5 percent, its budget deficit below 1 percent of GDP (after grants), and its reserves at 4 to 5 months of imports. The more flexible end sets these thresholds at 10 percent, 3 percent and 3 months respectively.[18]

How do countries perform compared to these thresholds? Based on the most recent performance by 48 PRGF borrowers,[19] we calculate that 27 countries reach the toughest threshold on inflation, but only 5 on the budget and 17 on reserves (if the grant element of loans is included, 18 countries qualify on the budget deficit). If the less tough thresholds are used, 37 countries qualify on inflation, 19 on the budget (30 if the grant element of loans is included) and 27 on reserves. The low inflation levels for the vast bulk of countries underline how much stabilisation has already been achieved. The much lower levels of qualification on the budget threshold seem to indicate an even weaker link between fiscal deficits and inflation than expected, and might indicate that the budget deficit threshold should be set nearer three percent (or take into account the grant element of loans).

[18] Many other definitions have been suggested elsewhere. Some (Adam and Bevan, 2003a and Ames and Devarajan, 2001) have also suggested that a certain level of positive GDP growth should be included in this definition, but this conflicts with the aim of examining a trade-off between stabilisation and growth, so it is not considered here. The World Bank PRSP Sourcebook suggests real GDP growth over 2%, inflation under 20% and a primary fiscal surplus over 3%.

[19] Various time periods were analysed, including a three year average, a two year average, and the current year but virtually no difference was found in results, especially for inflation. A three-year average was chosen as representing consistent performance over a medium-term period.

What would this mean in terms of classifying countries as pre-stabilisers, early stabilisers and mature post-stabilisers? Weighting the inflation criterion (seen by the Fund as most fundamental) double the others, we calculated that approximately one quarter of PRGF countries could securely be regarded as mature post-stabilisers and given more scope for growth; around half (early stabilisers) would need to be looked at closely to analyse the desirable balance between stabilisation and growth and keep a constant eye on scope to increase growth; and the other quarter (pre-stabilisers) would need to focus heavily on stabilisation.[20]

Flexibility in Stabilisation Targets?

The IMF could make stabilisation targets more flexible in four ways: (i) it could design stabilisation targets with less emphasis on continued stabilisation in order to accommodate faster growth where this will not undermine stability; (ii) it could allow low-income countries to propose alternative means of achieving stabilisation targets; (iii) it could build flexibility into programmes through "adjusters", which would allow higher expenditure if more aid or revenue materialises than expected (or cut it if there were shortfalls); and (iv) it could interpret compliance with implementation of stabilisation targets more flexibly, allowing waivers if intent to stabilise is clear and if programme results are still within the ranges suggested as "sufficiently stable".

How does the IMF fare with regard to the first possibility for flexibility: less emphasis on continued stabilisation? Our analysis indicates that virtually all Fund programmes continue to target reduction of *inflation* to levels below 5-6 percent, even at the risk of compromising growth.[21] The literature has concluded that 5-10 percent inflation is not pernicious, but virtually all programmes with inflation between 5 and 10 percent target continued reduction. Given that 5 percent is the growth-maximising inflation-rate, *all* programmes with initial inflation at this level should be targeting equal inflation, whereas 36 percent of them are

[20] The results do not change significantly if post-conflict countries are excluded, as one (Guinea-Bissau) has a score below 1.5, two (Côte d'Ivoire and Sierra Leone) are below 2.5, and one (Burundi) is above 2.5.

[21] Between 34 (if the threshold is 5%) and 39 (if the threshold is 6%) of 48 programmes examined. In addition, in virtually all the cases where higher inflation was targeted it was because the starting point was much higher, therefore not marking any degree of additional flexibility.

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still targeting lower inflation. The average target of IMF programmes is between 3 and 4 percent, which is too low for accommodating growth. In sum, there has been no real change from ESAF programmes.

Across the range of programmes, there is considerable extra flexibility in projected *current account* targets, with ESAF programmes projecting considerable reductions in the deficits, while PRGFs allow moderate increases. However, the degree of fiscal flexibility in PRGF programmes is smaller, because the underlying assumption is that it is possible to free resources for the private sector this way. But this assumption is wrong. Lower government deficits do not free up credit for the private sector, as various IEO reports have shown; banks are simply unable to transform this into new lending for the private sector. The IEO has found that there was some more flexibility in providing "fiscal space" in PRGFs than in ESAFs, but the question is whether there is enough flexibility. The average current target for PRGF fiscal deficits is 2.8 percent. However, fiscal space has not always been allowed. In addition, for countries whose deficit is not at pernicious levels (those with deficits including grants between 1 and 3 percent), 7 of 10 programmes are currently targeting further deficit reduction.

Overall, stabilisation is not a never-ending road, but the Fund does seem to expect countries to reach 3 percent inflation and a 1 percent budget deficit after grants before allowing any room for more flexible policies.

Disaggregating further, the targeted means to fiscal adjustment has changed somewhat. PRGF programmes tend to use revenue increases to bear most of the burden, though some also include small expenditure cuts as percentage of GDP (ESAFs used large expenditure cuts). If increases in revenue or aid, or cuts in debt service free funds, PRGFs are allowing governments to spend slightly more of them rather than increasing repayments to the banking system. However, this is not always the case. In Ghana, Ethiopia and Zambia, for example, funds have been used for financing sector restructuring or domestic debt repayment, which were also seen as crucial to stability and growth.

Moreover, the actual outcomes of Fund programmes have not been positive. Due to shortfalls in external financing flows, PRGFs have necessitated *more* fiscal adjustment than ESAFs. In spite of considerable revenue increases, on average countries have had to cut expenditures (especially in 2000-02). So the Fund's slightly better intentions have been undermined by donor and creditor behaviour, highlighting the need for greater efforts to live up to aid promises.

It is important to remember that the design of most of the recent revenue measures in Fund programmes has (insofar as they are based on indirect taxation) probably been regressive. It is impossible to judge the overall incidence of small expenditure increases and large tax increases on the poor, because so little analysis has been done of the poverty impact of Fund programmes (see below), but it is too simplistic to assume that switching from expenditure cuts to revenue increases is pro-poor.

There is strong evidence that the Fund has been more flexible in changing fiscal targets for the few PRGF countries which see dramatic increases in grants. The IEO cites Tanzania, and similar flexibility has been seen in changing fiscal targets in Ethiopia, Guinea, Mozambique, Uganda and Rwanda. However, the changes in targets generally lagged well behind commitments of donor funding. This has been because the Fund has seemed to perceive higher inflows of aid and government expenditure as inflationary, and new (even highly concessional) external borrowing to finance the MDGs as potentially undermining debt sustainability. As a result, according to HIPC Ministers' views, the route to flexibility has been long, typically involving independent analysis or intervention by other donors or the World Bank.

Overall, across the range of 45 countries, the Fund appears to be targeting faster budget adjustment for countries which are receiving higher grants – the reverse of what one would wish! There is no significant relationship between end of current programme targets for inflation or budgets and the level of grants, or between the scale of inflation adjustment and the level of grants. HIPC Ministers indicate that this is because in many countries, the Fund has argued that aid is likely to decline, so there is no room for budget flexibility.

However, it is important also to remember that many low-income countries have set themselves regional convergence targets (with input from the IMF, and referring also to EU targets) which limit room for flexibility and are out of line with the programme objective, medium-term expenditure framework-style fiscal analysis surrounding budget support and the MDGs.[22] These targets will need themselves to be set

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[22] The CEMAC, EAC, UEMOA and WAMZ zones which between them cover 22 African countries have set targets which vary from 3-5% inflation, and 0-3% budget deficits. The CEMAC and UEMOA zones also have many sub-targets which aim, for example, to reduce salary expenditures or to increase domestically-financed investment expenditures, which are not in line with MTEF-style categorisation of budget expenditures by objective rather than by type of expenditure.

and interpreted more flexibly if countries are to attain the MDGs.

Finally, there continues to be remarkably little explanation in Fund papers of why particular levels of fiscal adjustment are targeted, i.e. their demonstrated effects on inflation, the prospects of the private sector using "freed" funds for investment, the spending needs to reach the MDGs, and the availability of grants, in spite of IEO suggesting this and Board agreeing in 2003 (IEO, 2004).

How does the IMF fare with regard to the second possibility for flexibility: alternative means of achieving stabilisation targets? Here evidence of flexibility is very limited, largely to the best performers such as Uganda. Officials and Ministers of 34 HIPCs have indicated repeatedly that attempts to propose alternative policies for stabilisation have been rebuffed by Fund missions. However, more recently the Fund has shown itself willing to be more flexible – not with alternative policies but with alternative scenarios for aid flows, placing in the PRGFs for Benin and Cameroon baseline and accelerated scenarios, with the accelerated scenario based on mobilising higher aid flows. The effect of these scenarios is not clear – in Benin it looks as though it has pushed donors to move on increasing programme aid flows (or perhaps vice versa) but it has had less effect in Cameroon.

How does the IMF fare with the third possibility for more flexibility: the application of "adjusters", which would allow higher expenditure if more aid or revenue materialises than expected (or cut it if there were shortfalls)? Adjusters have become very common (in two-thirds of new programmes) but only around half of them allow the government to spend extra funds rather than saving them or repaying them to the banking system. However, unfortunately aid and revenue shortfalls compared to programme aims are much more common and therefore the effect of the adjusters is to reduce rather than increase fiscal space (IEO, 2003b). This is particularly true in conditions where cash budgets further reduce fiscal flexibility (see also Addison, 2000; Adam and Bevan, 2001).

Finally, how does the IMF fare with the fourth possibility for more flexibility: allowing waivers if intent to stabilise is clear and if programme results are still within the ranges suggested as "sufficiently stable"? Again, evidence of flexibility is limited. We have found that for a sample of 63 programmes, 30 have had interruptions, and 16 have broken down irreversibly. This appears to mark a slightly higher success rate than previous analyses of ESAFs and PRGFs (Ivanova *et al.*, 2003; Killick, 2004). The IEO also finds a slightly higher level of programme compliance under PRGF than ESAF, but no significant difference in disbursement percentages

or frequency of interruptions. According to HIPC Ministerial Network (2002 and 2003), this reflects the streamlining of structural conditionalities, which has reduced the need for waivers,[23] but is being somewhat offset by *less* flexibility on macroeconomic stabilisation conditions, so that even with adjusters built into programmes, they still fail (Fund staff indicate that there have been numerous instances of *de facto* flexibility). In addition, HIPC Ministerial Network cite delay or suspension of IMF programmes as one of the biggest causes of aid volatility.

The Future Role of the IMF in Promoting Growth and Poverty Reduction

The Fund should not be transformed into an institution which targets growth and poverty reduction regardless of macroeconomic stability, because stability is vital to attaining growth and poverty reduction. However, it should be required to design programmes where stability is a means to growth and poverty reduction instead of a goal in itself. In every programme, the Fund should design its macroeconomic stability performance criteria in order to maximise growth and poverty reduction.

In order to achieve this change, the Fund needs to work harder to reverse its traditional logic of designing programmes on the basis of inflation targets and availability of financing. Instead, the Fund should start from the GDP growth rates needed to attain the MDGs.[24] These can be based on poverty reduction/growth elasticities, the effects of future policy changes in making growth more pro-poor, and analysis of the sectoral sources of growth, such as those conducted by the World Bank or the Millennium Project (www.unmillenniumproject.org). Based on these findings, it should design a macroeconomic framework to promote necessary levels of pro-poor growth while maintaining the levels of stabilisation discussed above.

In designing such a framework, IMF missions need to ask the following questions:

- What are the levels of public and private investment needed for

[23] IMF (2002) indicates that the most frequent waivers were given for non-core structural conditions, which are precisely those that have been streamlined recently – see 4.2 below.

[24] The Fund is sceptical about studies identifying growth rates needed to attain the MDGs. However, many econometrically robust and reliable studies exist (far more reliable than those which indicate that money supply growth is the principal cause of inflation). The Fund must work with these analyses while more reliable and nationally-calibrated models are developed to quantify growth rates more precisely.

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sustained growth, and the levels of poverty reduction spending needed to reach the "costable" Millennium Development Goals? To what degree does government investment crowd in private investment by providing infrastructure and human capital, rather than crowding it out by preventing bank lending to the private sector?

- What are the main causes of inflation? If it is supply or devaluation-led, what is the scope for increasing supply by increasing budget expenditure and the budget deficit, or for increasing monetary growth to accommodate a higher budget deficit or private sector credit, without increasing inflation?
- If inflation is falling or has been low for several years, to what degree is private sector confidence and demand to hold money increasing (velocity of circulation falling); and to what degree are monetary anchors or targets appropriate (as opposed to inflation outcome targeting)?
- What are the recent structural changes in the banking system or financial regulations, and how do they change the scope for expanding some elements of money supply and compressing others within the overall monetary ceilings in such a way as to maximise growth?
- Will repayments to the banking system promote private sector access to credit or private-sector led growth? Can the financial sector intermediate the repayments into productive investment or will repayments to the banking system merely lead to excess liquidity in the banking system and increase its holdings in unremunerated reserves or in volatile assets such as property, commerce or government domestic debt?
- What are the sustainable sources of non-inflationary budget deficit financing? How can the most sustainable grants and concessional external loans be increased to match anti-poverty spending needs?

Within this logic, it would be possible for the Fund to allow low-income countries to propose alternative means of achieving stabilisation targets by: promoting supply response to offset inflationary pressures through public investment or higher credit to the private sector; changing the programme assumptions about velocity of circulation; and mobilising additional sustainable budget deficit financing through revenue measures, grants, concessional loans or limited recourse to domestic debt.

All of these questions should particularly be asked in mature post-stabilising countries, but also in early stabilisers, to ensure that the assumptions underlying the programme are justified. In addition, it would be possible to set some guidelines:

- Targeted GDP growth and anti-poverty spending should not be below the levels seen as necessary to attain the "costable" MDGs

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unless financing is absent and it is demonstrated why the targeted budget deficit cannot be increased.[25]

- Fund staff must detail in PRGF papers their analysis of the sources of domestic savings, private sector investment and real sector growth, to justify GDP forecasts.
- They must also justify the anti-inflation and fiscal path chosen more fully.
- Once inflation has reached 5 percent and budget deficit 3 percent of GDP including grants, there should be no further effort to reduce these.
- There should be more effort to establish a systematic relationship between the availability of financing and loosening of stabilisation targets, especially for the "mature post-stabilisers".
- The Fund should be much more flexible in encouraging higher financing levels (even concessional debt flows where necessary) provided that debt sustainability is maintained.[26]
- There needs to be a major effort by the IMF to reorient the regional convergence targets being set by low-income countries in Africa, in order to provide full scope for growth and poverty reduction as well as stabilisation.
- There should be explicit discussion of alternative proposals for stabilisation measures and at least one alternative scenario for financing and expenditure in all programmes, demonstrating the effect of lower financing on reaching the MDGs.
- Adjusters should be standard in all programmes. All additional aid, revenue or debt relief should be allowed to be spent on additional expenditure unless it is demonstrated this will be less productive of investment (or more inflationary) than repayments to the banking system.
- In terms of interpreting programme execution more flexibly, the Fund needs to distinguish even more clearly in interpreting compliance between exogenous factors, programme misdesign and mis-implementation factors. If in doubt, it needs to err on the side of

[25] Of course, there is also much that can be done to reduce unproductive spending, increase the pro-poor focus and efficiency of "poverty reduction" spending, and to balance spending efforts between immediate basic service provision and longer-term poverty reduction goals.

[26] In this context the Long-Term Debt Sustainability framework proposing higher thresholds for good performers is welcome – though it suggests thresholds which are too high (Martin and Johnson, 2004).

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continuing the programme in order to avoid delay or suspension, which give on-off signals to donors and result in macroeconomic or aid instability. The potential effects of such instability on MDG progress should be an explicit factor in deciding whether to insist on compliance or to grant a waiver.

A final question revolves around the desirability of *outcomes-based conditionality*. Various authors (European Commission, 2002; Killick, 2004; Wood, 2004) seem to see moves in this direction, and other similar steps such as floating tranches as a good idea in terms of giving governments more power to decide how to achieve the outcomes, or when to introduce the measures. Others (e.g. Maxwell, 2003), however, have written forcefully against outcomes-based targets on the grounds that they are harder to specify and monitor and that there is often a need to define *ex ante* the best path to the outcome. Unless the process of negotiation becomes more flexible so as to allow much more macroeconomic flexibility, genuine space for alternative measures and timing, and accelerated progress in streamlining structural conditionality, a move to outcomes-based conditionality by the IMF will have little effect. For example, the experience of HIPC has been that floating decision points caused delay because they involved too many conditionalities. Similarly, selectivity is not really an alternative to conditionality – rather it represents "prior action" conditionality taken to its extreme, and will not work any better unless the targets are reformed more fundamentally.

4.2 Structural Conditionalities

Around the time of launching the PRGF, an initiative was taken to streamline conditionalities, especially reducing the number of structural conditions and focusing the IMF more on its core mandate of macroeconomic policy.[27] It is important to acknowledge that this was, at least in the minds of many Fund management and Board members, conceived of as a relatively limited exercise, designed only to reverse an earlier dramatic proliferation of structural conditions (from 2 per programme in 1987 to 14 in 1999), to define more clearly what should constitute Fund conditionality, and to enhance division of labour

[27] Shortly before then, various analysts including ODC had suggested that the Fund should abandon structural conditions altogether and leave them to the Bank.

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between Fund and Bank.[28] It also fell way short of what some analysts had recommended (e.g. ODC) – an end to IMF structural conditions.

What Has the IMF Achieved in Streamlining Structural Conditionalities?

The PRGF has managed to streamline and eliminate some structural conditionalities, but the overall conclusion of the literature is that streamlining has fallen short of expectations. On average, the number of structural conditions in PRGFs has been reduced by between one quarter and one third, with progress in successive PRGFs and in moving from ESAFs to PRGFs. However, progress has varied dramatically across countries, with reductions of 50 percent in some and virtually none in others (Adam and Bevan, 2001; EURODAD, 2003a and 2004; Killick, 2002 and 2004; IMF, 2002a). IEO (2004) finds a smaller degree of reduction and the same level of variability, without any apparent link to a country's track record.

More recently, we have found that the average number of conditions has risen from 11.8 in the 2002 review to 13.2 in the latest programme reviews, marking a reversal of streamlining, and a return to almost the peak levels of 13.5-14 identified in 2000 (though still below the ESAF average of 16). The number of structural conditions ranges from 6 to 29, showing that efforts to streamline vary dramatically across countries.[29] Importantly, the remaining number of structural conditions appears to bear little relation either to the overall stabilisation performance of the country, or the World Bank's CPIA score of the country on structural conditions – indeed, quite the reverse, with the number of conditions correlating strongly negatively with the CPIA score.

Which types of structural conditions are streamlined? This is examined in two ways. First, distinguishing *types* of conditions: (i) The number of *prior actions* has fallen overall by 30 percent since 2000, to 2.1. Prior actions have shown a consistent trend of decline, especially for strong performers; (ii) The number of *performance criteria* has fallen by only 15 percent, to 4 per programme. They have risen somewhat since the

[28] Buira (2003) has also pointed out that proliferation of structural conditionalities marked an abandonment of earlier conditionality guidelines which were not very different from those of 2001.

[29] It is interesting to contrast this with the World Bank, which, according to Bedoya (2004), has reduced conditions by 33% in its programmes since 2000, increasing programme effectiveness.

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IMF PRGF review (2002a), though less so for good performers. (iii) The number of *structural benchmarks* has, in contrast to the positive reduction in prior actions, risen to 7.1 on average, from 6 in the 2002 review, with little difference between good and less good performers.

Second, distinguishing *content* of conditions: Under PRGF conditions are defined in three groups: (i) *core,* which include tax policy and administration, fiscal transparency and management, monetary and exchange rate regime and policy, and macroeconomic data; (ii) *shared* (with the World Bank) financial sector reform, trade policy and private sector promotion; and (iii) *non-core* public enterprise reforms, privatisation, marketing and pricing reforms, civil service restructuring, social safety nets, monitoring poverty reduction, and sectoral policies. The IMF stressed that under the streamlining initiative, all but core conditions were to be eliminated unless others have "such a direct critical macroeconomic impact that the PRGF programme would be derailed unless the measure was implemented." (IMF, 2002a, p. 31).

Our analysis indicates considerable progress here, with around two-thirds of conditions being in "core" areas. Fiscal conditionality has become dominant, moving much more into details of administration and specific tax measures than before. However, one area in which there has been large-scale proliferation of conditions in recent years is in governance, transparency and anti-corruption measures. If this is not considered to be part of the Fund's core areas (which it was not until recently) then the core percentage would be only around 45 percent. Among the shared areas, more than half of programmes still contain conditions in one or more area, with the emphasis on financial sector reform (which, in some other documents, is listed as a "core" area). There continue to be non-core conditions in 33 programmes (if governance is treated as core; if not, non-core conditions are in virtually all programmes), with civil service reform appearing in 8 of 48, and sectoral policies relating to state enterprise reform or privatisation appearing in 17. Marketing and pricing reforms (apart from energy) barely appear, and poverty reduction is absent.

Even before the streamlining initiative, Fund staff and other analysts regarded only about a third of structural conditions as crucial to programme success (Buira, 2003; Goldstein, 2000), so the initiative appears only to have eliminated a proportion of these unnecessary conditions. Some of the conditions eliminated were even multiple steps to the same objective such as designing, and introducing, a VAT.

It is also highly doubtful that "streamlining" conditionality (as

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defined by Fund management) could have been expected to enhance country ownership significantly (Killick, 2002). Most fundamentally, as discussed below, there is no evidence that streamlining has been led by borrower countries identifying those conditions which they do not consider essential to Fund programmes. Indeed, HIPC Ministers have indicated that the pace of elimination of structural conditionality has been much slower than they had expected. This, added to the fact that remaining conditions are perceived by borrowing countries (HIPC Ministerial Network, 2002 and 2003) as being implemented more strictly than before, means that the potential for increased ownership of programmes offered by "streamlining" is not fully materialising.[30]

Some of the most "difficult" structural conditions in PRGFs for governments, notably some of those which engaged in pointless micro-management, have been eliminated (Killick, 2002) or interpreted more flexibly.[31] However, some programmes continue to have excessively micro-conditions, such as issuing identification cards for all teachers or training programmes for customs staff. It is difficult to believe that any of such micro-conditions were essential to macroeconomic stability.

In addition, the replacement of micro-conditions by more intrusive conditionality on governance, public expenditure management and precise percentages of budget spending allocated to various social sectors (rather than wider anti-poverty spending programmes), as well as the more frequent monitoring missions by Fund and Bank in the context of PRGF, PRSC, HIPC and other initiatives, and the more numerous and micro-managing floating completion point conditions under HIPC, have led to perception by HIPC Ministers of much tighter structural conditions.

Moreover, HIPC Finance Ministers have argued that structural conditions which have been eliminated from Fund programmes have

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[30] Fund staff indicate that structural conditionality may have a general tendency to proliferate or become more micro as the result of the logic of formulating a programme – when a government does not fulfil a condition, the tendency is to disaggregate it to try to improve compliance and keep some momentum in programme implementation. They also indicate that "reformists" in governments often "request" more or micro conditions to buttress their position.

[31] See various recent HIPC completion point documents (e.g. Burkina Faso or Senegal) (IMF, 2004a), which have requested waivers for structural micro-management conditions, which have proven impossible to implement because baseline data were incorrect or unexpected circumstances arose.

been "transferred" to other lenders such as the World Bank (and more exceptionally to other bilateral lenders). This was also suggested by the IMF in its 2002 review, and by the World Bank's 2001 Structural Adjustment retrospective. The IEO (2004) indicates that the numbers and overlap of conditions seem to have fallen recently, though there is still overlap on governance and the financial sector. However, all analysts have suffered from the lack of a systematic attempt to monitor conditions across the range of donor agencies in each country (IEO, 2004; Killick, 2004).

At the same time, to the degree that donors are now rallying behind multi-donor budget support arrangements, there has been a dramatic increase in cross-conditionality between other donors and the IMF, making countries potentially much more vulnerable to volatility of aid flows due to conditionality. As a result, these arrangements need themselves to make maximum efforts to streamline conditionality, and to allow a considerable degree of flexibility in interpreting execution, especially in promoting dialogue between the IMF and the government rather than suspending disbursements due to an on-off signal from the IMF.

It is vital that low-income country governments lead the process of coordinating discussion between the IMF and other donors, in formal meetings between the IMF, the government and all budget support donors, as well as having other donors present as observers in all discussions with the IMF.

Which Structural Conditionalities Enhance Long-Term Growth and Poverty Reduction in Low-Income Countries?

This could be the subject of a separate book – not least because judgments on structural conditions are heavily disputed. Here the question can be answered only briefly and superficially. In general, most authors would agree that:

- Revenue mobilisation and transparency, and improved public expenditure management are essential to growth and poverty reduction, but need to be very carefully designed if they are to have positive effects on poverty reduction.
- Financial, monetary and exchange rate/external sector liberalisation are generally desirable, but if poorly sequenced can lead to extreme volatility and undermine growth and therefore poverty reduction.
- The jury is out on whether trade liberalisation (as currently being designed by the WTO) has promoted growth and poverty reduction

or whether more heterodox export promotion and import protection trade policy has worked better.

- Financial sector reform has worked in a few cases, but more often has failed to prevent a cycle of financial sector collapses, and has failed to promote private sector savings and investment which are vital to growth and poverty reduction.
- All agree that private sector promotion is desirable but it has proven to be a complex and long-term process, and not amenable to short-term liberalisation measures alone. Sectoral and industrial or agricultural strategies have sometimes proven essential to long-term growth successes.
- Privatisation has had mixed results, mostly depending on the degree of regulation, supervision and competition introduced. It is certainly no panacea for growth and poverty reduction, and can sometimes be replaced by public sector improvements.
- Marketing and pricing reforms, while desirable, have had considerable negative effects on the poor when badly designed or sequenced, and when interpreted as implying abolition of all government involvement in the real economy (for example abolishing extension and research as well as marketing services).
- Investment climate reforms in the narrow sense of liberalisation have helped somewhat to encourage investment, but need to be supplemented by improvements to infrastructure and labour skills which, together with natural resource availability, are the key factors attracting investment.[32]
- Civil service reform has not so far been very successful, partly it has been designed more from a cost-cutting than an institution-building perspective, and has not made any significant strides in promoting growth or poverty reduction.

In short, it is very difficult to categorise structural conditionality into measures which work for growth and poverty reduction and those which do not. It is possible only to give indications of policies which seem to have been more successful than others, and to caution that all simplistic or generic recipes are bound to fail.

What More Could the Fund Do to Streamline Structural Conditionalities?

In light of this analysis, structural conditionalities should be divided into three groups. The first group consists of those structural conditions

[32] For more on this, see Martin and Rose-Innes (2004).

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which are certain to enhance stabilisation. These (if core measures) should stay within the Fund's remit of conditionality but be eliminated from the conditionality of other lenders and donors. The most important of these are revenue-raising measures – though they need to be analysed for their equity impact – but central bank reform, monetary and exchange rate policy are also vital. In exceptional circumstances, financial sector reforms which would have a major impact on macroeconomic variables might also be included. Even so, these conditions and the macroeconomic framework would be the top priorities for Poverty and Social Impact Analysis (see below), to examine how to ensure actions in these areas would have maximum impact on poverty reduction.

The second group consists of structural conditionalities which will enhance growth and poverty reduction, or have an important macroeconomic impact, but are not "core" or shared IMF conditions. They should be discussed by the World Bank and other donors, to maximise comparative advantage and minimise cross-conditionality. It would seem that these could include trade policy in the sense of export promotion, private sector promotion in a broader sense which includes sectoral strategies rather than just liberalisation, and investment climate reforms which go beyond liberalisation to include infrastructure and labour skills improvements. Responsibility for PSIA of these conditions should be transferred entirely to other donors and lenders.

The third group consists of structural conditionalities which have no key direct macro or growth impact and for which the evidence of enhancing growth and poverty reduction is much less strong. These could be eliminated from all donor conditions. This would apply especially to various micro-management conditions. But it should also apply to conditions which have not been proven to have a decisively positive impact on growth and poverty reduction (such as privatisation, civil service reform, trade liberalisation and financial sector reform), or to conditions whose design has subsequently proven incompatible with growth and poverty reduction, or non-viable (e.g. electricity privatisation given the lack of buyers in current international markets). These conditions would be low priorities for Poverty and Social Impact Analysis (see below), which would be undertaken only in order to examine whether any actions in these areas would be beneficial.

A few other measures are needed:

- There needs to be a renewed push to streamline all structural conditions, to reverse the recent increase in structural conditions. This would in-

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clude cutting prior actions and performance criteria to an average total of three per programme and structural benchmarks to three or less.

- This should be particularly true for "mature post-stabilisers" where it can be much less convincingly argued that any structural condition is "essential to stabilisation" as stabilisation has already been achieved. Especially if these countries also have reasonably high CPIA structural scores, prior actions should be eliminated and the overall number of structural conditions reduced very sharply. A preferable solution would be to eliminate all structural conditions for mature post-stabilisers.
- More can still be done to eliminate from IMF programmes all shared and non-core conditions and micro-conditions, and to analyse the extent of cross-conditionality and proliferation (or reduction) as a result of Multilateral Development Banks arrangements. The joint BWI review of PRSPs planned for 2005 should make this a major focus.
- It should also be a priority for the forthcoming IEO review of structural conditions to set a clear basis for defining structural conditions more carefully: for example, to be very clear on what are core, shared and non-core conditions (preferably eliminating shared areas entirely to avoid cross-conditionality) as well as circumstances (if any) under which micro-conditions would be permissible.
- There should be an urgent review of effectiveness of proliferating governance conditions, given a considerable literature (e.g. Kapur for G-24) which finds them to be ownership-undermining and ineffective, and efforts by other donors to avoid them except in so far as major governance problems would preclude any funding.
- To the degree that the combined Bretton Woods Institutions fail to streamline structural conditionality, it is essential for donors to retain flexibility to disburse a large proportion of funding (including budget support) independently of the BWI seal of approval, and especially regardless of compliance with non-essential structural conditions, while encouraging countries to maintain overall relations with the BWIs, in order to reduce the volatility of external funding.
- Most important, it is vital for the borrowing countries to lead the discussion on streamlining structural conditions, by defining before negotiations begin which structural conditions they consider to fall in each of the three categories identified above, and therefore which they would like to see retained and made priorities for PSIA, which transferred to other lenders or donors, and which eliminated entirely.

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This should be undertaken transparently in PRSP consultations. Finally, there is a massive literature showing that *ex ante* conditionality is ineffective (see Killick, 2004, for an excellent summary). Therefore the BWIs should maximise efforts to move away from *ex ante* conditionality altogether (see also Chapter 5 below), whether structural or macroeconomic.

4.3 Alternative Scenarios for Results

One of the key features of the PRGF was to give more space for projecting alternative scenarios to reflect risks to programme success and the attainment of the MDGs. This is partly indicative of a general consensus that baseline scenarios of IMF programmes have not proven realistic. This has been true for many years (see Mistry and Martin, 1992) and across the range of Fund programmes (see Bird and Rowlands, 2003; Killick, 1998). More recently, analyses of prolonged use (IEO, 2002), fiscal conditionality (IEO, 2003b), the PRGF (IMF, 2002a and 2002b) and the HIPC Initiative (OED, 2003; Martin and Alami, 2001) have repeated this message, though indicating a trend to somewhat more realistic projections over time (see also World Bank/IMF, 2004).

Divergences from programme projections are explained by four main types of factors: overoptimistic programme projections; poor design of programme measures; non-compliance with programme measures; and "external shocks".[33] It is evident that "external shocks" have been very large and frequent (see Martin and Alami, 2001; Martin and Bargawi, 2004; IMF, 2003a) and caused major disruption to programmes. The most important types of "shocks" have been, in order of magnitude and frequency: shortfalls of aid, commodity price changes (especially export price falls but also oil import price rises), and climatic shocks or natural disasters.

However, it is clear that a large proportion of these shocks were not really shocks – given the past experience of the borrowing country, they could and should have been predicted in programmes and overcome by designing up front contingency mechanisms and financing to reduce and offset their impact. Given that shocks of similar magnitude have happened many times in recent decades, a

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[33] For a more detailed review of the prevalence of shocks in African low-income countries and what the international community could do to protect against them, see Martin and Bargawi (2004).

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secular decline in commodity prices is beyond doubt, and climatic shocks occur with alarming frequency, it is surprising that they are not in baseline projections. For example: Malawi has had a climatic shock every two years for the last twelve years, yet no such shock is envisaged in programme projections. Increasing the proportion of budget revenue to GDP has proven notoriously difficult to maintain after initial major changes, yet many programmes project continual important rises. UNAIDs and the World Bank have already calculated that the HIV-AIDS pandemic could reduce growth by 2.5 percent a year in the worst-hit countries, but only 3 of 32 HIPC Initiative projections have factored this in.

These factors – together with a wish on all sides to see better results from PRGFs – mean that BWI projections are systematically over-optimistic, in spite of recent strong efforts by the BWIs to reduce their over-optimism, and that most shocks are really "non-shocks" because they should have been expected and predicted to occur. The importance of shortfalls compared to programme projections – whether called shocks or not – is accentuated by the fact that every shortfall of budget revenue or aid, for example, requires cuts in expenditure including, potentially, on key measures to reach the MDGs. Whereas before "adjustment to shocks" was a reasonable alternative, now foreseeing and preventing shocks is paramount. As already discussed, the Fund has introduced "adjusters" into many programmes to plan against shocks, and has made limited financing available to offset them, but these have had very limited effects on keeping programmes working in the presence of wider exogenous factors which undermine programmes.

How Can the IMF Project Realistic Scenarios and Overcome Shocks?

It would be much better if the Fund focuses on pre-empting and preventing the negative impact of shocks from occurring. This can be done in various ways.

First, by making its baseline scenarios more realistic. This would involve relating all projections more closely to recent trends, and including in them simulations of the scale, frequency and probability of climatic shocks, commodity price volatility and aid shortfalls based on the last 10-20 years of national experience – as well as the impact of new variables such as HIV-AIDS. Use of volatility and probability forecasting techniques would make this relatively straightforward, though it would require more analysis of the scale, frequency and macro impact of shocks

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for each country.[34] Second, by extending the analysis of the impact of shocks through to their effects on poverty reduction (this would require more complex techniques and more time). Third, it is essential that all scenarios in Fund programmes begin by aiming to attain the MDGs and PRSP national goals. PRGFs should strive to attain the MDGs in their forecasts even in the baseline scenarios. Recent IMF papers on PRGF alignment with PRSPs and World Bank/IMF papers on PRSPs have suggested that baseline scenarios could abandon the MDGs and leave them as "aspirational goals" for an accelerated scenario which might not be financeable. However, only in conditions where the baseline scenario was unable to reconcile potential shocks with attaining the MDGs, would each PRSP and PRGF contain an accelerated scenario. Such a scenario would show how, in spite of the shocks, more financing and more policy effort by governments, including measures to reduce vulnerability to shocks, could attain the MDGs. Financing would therefore preferably be committed up front on a contingent basis so as to be available immediately when any "shock" materialises, and included in baseline scenarios through contingency allowances in the budget and reserves.

4.4 Poverty, Social and Distributional Aspects

To What Degree Are PRGFs Taking Into Account Poverty Aspects?

Since PRGFs are supposed to have fundamentally changed the emphasis the Fund places on poverty reduction, social sector and distributional issues, the question arises whether PRGFs are based on nationally-designed PRSPs which stress poverty reduction.

It is agreed by HIPC Ministerial Network (2002 and 2003), independent analysts (Adam and Bevan, 2001; Killick, 2002 and 2004), NGOs (CAFOD *et al.*, 2003; EURODAD, 2003) and the IMF's own evaluations (IMF, 2003d; IEO, 2004) that though PRGFs and PRSPs resemble one another, many PRSPs do not have a clearly defined macroeconomic framework and growth strategy – especially not one which is realistic, internally consistent, prioritised and taking account of potential shocks. PRGF macro frameworks have not been based on

[34] The HIPC CBP already does this type of analysis in its national Debt Strategy workshops, as the basis for pessimistic/realistic macroeconomic scenarios. Martin and Alami (2001) also provide some analysis, and the IMF (2003a) has recently done more systematic analysis of the impact of shocks.

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the PRSP, and there are several examples of Fund documents abandoning growth targets set in PRSPs as "unrealistic" when finalising PRGFs (Benin, Bolivia, Cameroon, Mali, Rwanda). None of the macro-economic frameworks contained in PRGFs has been fully discussed in a participatory manner in the process of preparing the PRGF, and the IEO has criticised the Fund for not playing a sufficient role in the PRSP process. PRSPs also appear to have allowed little debate about structural conditions and to have provided virtually no scope for participatory discussions to "streamline" them (e.g. Killick, 2002).

The IEO (2004) suggests that this may be in part a transitional problem, where countries need to learn to improve the macro frameworks in PRSPs before these can be used by the Fund for PRGFs. However, given the virtual lack of major capacity building and participation efforts on macro issues, it appears that in some cases countries are learning that it is simpler to construct the PRGF macro framework and use it as the basis for a new PRSP, to avoid discrepancies and conflict (see also Trocaire, 2004).

A second question is whether PRGFs conduct sufficiently detailed *ex ante* analysis of the poverty reduction, social and distributional impact of recommended policies. It is evident from PRGFs that the Fund has conducted virtually no analysis of poverty reduction, social or distributional effects of its programmes. In virtually all PRGFs, such analysis (sometimes known as a "broad" definition of PSIA) is limited to one page, and the vast bulk continues to consist of assumptions about the national impact of key measures, based on theoretical models or multi-country literature, which remain unproven or unanalysed at the national level. There is virtually no mention of the MDGs in any PRGF document (Killick, 2004, confirmed in examination of 72 programmes). The very few exceptions to this picture consist of descriptions of Poverty and Social Impact Analysis (PSIA) conducted under programmes funded by the World Bank, the UK Department for International Development (DFID) and other donors. Most important, there is no evidence of PSIA of the macroeconomic framework in *any* country programme (and no mention of the seminal PSIA of Rwanda's macro framework commissioned by DFID or the analysis of Tanzania's fiscal framework conducted independently).

How Can the Fund Better Link PRGFs with PRSPs?

The Fund needs to begin by ensuring that PRGFs spring from PRSPs and

not vice versa – in terms of holding to the GDP growth and budget spending needed to attain the MDGs and national goals defined in the PRSPs, and limiting structural conditions to those contained in the PRSP. A prerequisite for this is to build country capacity through independent sources, to conduct annual updates of the macroeconomic frameworks and more detailed analysis of a growth strategy, in order to form a realistic basis for PRGFs. As part of the process of improving PRSPs, recent and current PRGF macroeconomic frameworks (especially growth, inflation and employment targets; and fiscal, monetary and external sector policies) and the key structural conditions which the IMF will include in its programme, need to be discussed in a participatory manner, in a macroeconomic working group of the PRSP process, with the IMF discussing its views much more intensively with civil society. It needs to make sure that PSIAs of macro frameworks and structural conditions support the PRSP rather than PRGF, and are country led, with full participation of civil society, full discussion of results, and transparent decisionmaking. In order for these participatory discussions to be productive and specific, it will be essential for donors to enhance efforts to build capacity in civil society organisations on macro issues. A paper due for the Fund Board towards the end of 2004, on the IMF's role in the PRSP and the macroeconomic framework, needs to take account of all these issues and those revolving around the macro framework discussed in 4.1 above. The IEO (2004) and BWIs (World Bank/Fund, 2004) have recently made suggestions for improving the Joint Staff Assessments (JSAs) or PRSPs made by the BWIs and transforming them into JSA Notes, for delinking JSAs from IMF lending decisions, and for allowing the Annual Progress Report on PRSP to be more integrated into wider government processes and timetables. All of these recommendations are welcome. However, it would be desirable to move away from such a separate assessment and instead have a joint partner review which would be agreed with other donors, and discussed in a balanced way along with reviews of the behaviour of donors and civil society organisations (see IEO, 2004; Trocaire, 2004).

Poverty Reduction and Distributional Effects of Policy Alternatives

The Poverty and Social Impact Analysis (PSIA) should have the widest possible remit in examining alternative measures rather than just timing, sequencing or the mitigation of macroeconomic measures already agreed. However, in line with the Fund's core mandate, PSIA conducted by the Fund would be expected to focus (in order of

priority) on:

- the effects of the macroeconomic framework on growth (including notably the issues and questions raised in 2.3 above);
- the equity impact of tax revenue raising measures and anti-poverty expenditures;
- the impact of other major fiscal, monetary, external (not trade which specialised bodies such as UNCTAD and WTO should do) or financial sector reforms;
- the potential impact of shocks and alternative macroeconomic and financing scenarios on poverty and prospects for the MDGs.[35]

In this light, it is worrying that current internal Fund guidelines cited by IEO suggest limiting PSIA by the Fund to specific tax policy, tariff and exchange rate measures.

Some have suggested that such types of PSIA (especially PSIA of the macro framework) are not feasible within a PRGF time frame, and will not produce meaningful results. However, if they are narrowly focused on the types of questions discussed in 4.1 above, and conducted rapidly in real time, they would be crucial inputs to the IMF programme negotiation process. In addition, there are no major technical constraints to such analysis, in the sense that macroeconomic models exist such as IMMPA, and those of MIMAP and AERC, and data constraints are being resolved by more frequent household surveys and Participatory Poverty Assessments. In addition, it is vital to analyse in every PRGF review progress to the MDGs and the potential contribution of the PRGF macro and growth framework. Without such analysis, the IMF is not taking the MDGs seriously.

Who should conduct such PSIA? Fundamentally, the PSIA should inform the PRSP framework so that it can be the basis for the PRGF, not vice versa. Ideally, therefore, the PRSP should be informed by systematic independent PSIA of the macroeconomic framework, which would begin 6-12 months before signature of a letter of intent and new PRGF. It could also be conducted before a specifically targeted review of a programme, or in exceptional circumstances such as a large shock. National multi-stakeholder groups (a macro sub-group of the PRSP process) would commission such PSIA, identify terms of reference and key issues, and take policy decisions. The PSIA would ideally be conducted by national researchers.

[35] PSIA of non-core structural reforms would be conducted by other donors than the Fund.

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The Fund would also need to analyse such PSIA and occasionally conduct its own (if resources permit – see World Bank/Fund, 2004), for the sake of its own due diligence in contributing to attain the MDGs. It is therefore very welcome that the Fund is establishing a PSIA unit with around 6-10 staff, whose remit will be to focus on macroeconomic PSIA. However, that unit should preferably commission independent analysis, drawing on the growing number of experts cited above, and with clear leadership by national stakeholders and perhaps an independent group of advisors (see Trocaire, 2004). It should not conduct it as an internal staff function to support Fund analysis. To ensure independence, it is desirable that this work is funded separately by donors outside the Fund's normal budget – and it would be best located in the IEO to ensure independence and transparency.

5 The IMF's Way of Doing Business

The Poverty Reduction Strategy approach requires a very different way of organising IMF work. As defined by the IEO (2004, p.13), it implies a country-driven strategy that sets priorities based on country analysis; a broader policy debate rather than traditional programme negotiations; and operating within a partnership framework so that IMF contributions are only one part of a broader picture. This would require a fundamental change in the institutional approach or "business culture" of the Fund, which is only just beginning to occur, in part because there has not been Board or management clarity or agreement on how far it should proceed.

The change needed can be summed up in four necessary trends, with the IMF moving from conditionality to ownership, from technical assistance to capacity building, from negotiation to participation, and from "first among equals" to "one among many".

5.1 From Conditionality to Ownership

The most fundamental component in success of Fund programmes has been domestic political-economy factors (IMF, 2001a and 2001b; Killick, 2004; Ivanova *et al.*, 2003; Thomas, 2003). The main ways that the Fund can increase ownership are therefore *not* through public training or education, but by allowing genuine participation in designing and implementing macroeconomic and structural reforms, by streamlining structural conditionality much more dramatically, and

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by undertaking more rigorous programme projections and encouraging country-led PSIA. For that reason, many these days prefer to talk of encouraging country "leadership" rather than ownership.

At times donor discussion of ownership sounds like how to convince a country through public education that donor conditions are correct – as on the occasion where a head of an IFI said to an African Finance Minister "I won't approve this programme unless you tell me you own it".

Until we have a genuine discussion in countries between country civil societies and governments and donors and the Fund, rather than something that is largely between Fund technicians and country technicians, we cannot expect real ownership. Ownership in the sense of a few technicians in the ministry of finance and the central bank agreeing with what the Fund suggests – or the cabinet having a discussion about the programme before it is approved – does not represent ownership by parliament or civil society and is unlikely to be sustainable over the longer term.

The country should lead the programme design, the decision on how to implement it to reach the targets, and the decision of how to mobilise the finance. This means that we need much more flexible financing procedures, more macro flexibility, more streamlining of conditions, the abolition of structural conditions in the Fund programmes for the more stabilised countries, and a fully participatory poverty and social impact assessment led by the country and its civil society.

The PRSP process initially led to a surge of expectations by borrowing governments that they would be placed more in control of programme design and implementation, with a concomitant rise in ownership. However, the ownership has waned where countries have not seen enough macroeconomic flexibility, streamlining of conditionality etc.

The PRSP process also has marked a major step forward for the involvement of civil society in macroeconomic and IMF-related issues. Even though not thoroughly consulted let alone participating in the design of most PRGF/PRSP macroeconomic frameworks, they have debated the issues somewhat more than before.

One of the advantages of prolonged use of IMF resources in some countries – those with political "ownership" – has been a gradual but very considerable transfer of economic management skills, through a combination of dialogue with missions, training and technical assistance (IEO, 2002). Particularly where combined with initial independent advisory and capacity-building support, more in-depth institutional change and more comprehensive training programmes, this has allowed various countries to reach the point where they have considerable

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capacity to design and implement their own programmes (e.g. Rwanda, Uganda, and Tanzania). However, much depends on the degree to which the IFIs are prepared to listen to the ideas developed by the countries. Where the Fund has failed to change its negotiating behaviour (Killick, 2002, sees this as the usual experience) ownership has not increased. Indeed, in part prolonged use has reflected low "ownership" and failure to implement reforms.

Apart from the measures discussed earlier (participation, linking to PRSPs, streamlining, macro flexibility, outcomes-based conditionality and floating tranches), the Fund has also passed new conditionality guidelines for staff, setting out even more clearly "the explicit presumption that the primary responsibility for the design of the programme lies with a member's authorities" and many guidelines make conditionality more effective. As discussed above, if implemented fully, all of these initiatives should lead to a dramatic increase in ownership, but HIPC Ministerial Network (2002 and 2003) and independent analysts (Killick, 2002) are sceptical as to whether Fund practice in the field is really changing in line with these guidelines.

What More Can the Fund Do to Improve Country Ownership?

Most fundamentally, the Fund needs to reverse its logic and have less strict programmes where ownership has been proven over time – i.e. for the mature post-stabilisers. It needs to see ownership as obviating rather than facilitating strong conditionality. This would involve much looser briefing papers with explicit openness to alternatives, and transparent discussion of these with government, the donor community and civil society during missions. Governments, not the Fund, would draft letters of intent before missions. The Fund would also need to decentralise much more wholeheartedly to field offices, in order to ensure a higher level of political dialogue and participation.

5.2 From Technical Assistance to Capacity Building

To avoid excessive dependence on IMF knowledge and opinions, or on conditionality, the Fund should be building low-income governments' capacity to design policies to manage their own economies, thereby improving their ownership.

The Fund has extensive technical assistance, training and research programmes. These are highly valued by borrowing governments, have

been positively evaluated, and have high excess demand for their services, and their management and monitoring has improved dramatically in recent years (IMF, 2004b and 2004d) However, more decentralised training and technical assistance (e.g. through AFRITACs and CARTACs, governed and executed by regional experts) and country-leadership of technical assistance has been much more successful than technical assistance largely designed in headquarters.

IMF technical assistance has often not led to long-term and sustainable capacity building. Short-term missions have generally been for needs assessments or urgent policy recommendations and have often left little long-term capacity behind them. Even long-term advisors have too often been absorbed into doing local officials' jobs for them and advising the policymakers, rather than training them and helping to create sustainable institutional structures, often because their terms of reference have been written that way. A modality of regional centres and peripatetic regionally-based advisors with frequent visits is in principle preferable because it allows more scope for development of national capacity (see also IMF, 2004b).

Technical assistance should ideally be fitted into a *country-led* long-term strategic framework which identifies capacity-building priorities. Within this framework, the country should have the choice of providers of assistance in each area, and design their terms of reference. It is important to prioritise capacity building according to government priorities, which may mean reducing efforts on IMF core areas and moving far higher funds across to analysis of long-term growth paths.

Insufficient attention was paid to wider systemic political or institutional factors (such as civil service reform programmes) which may cause staff turnover or demotivation and undermine the capacity created, though this is now changing.

There does not yet appear to be in the Fund a systematic objective way of conducting quantitative analysis which links technical assistance and training inputs to their outcomes in terms of policies, institutions and performance, and which puts borrowing countries in charge of evaluating the assistance, though initiatives are under way to make this possible (see IMF, 2004d).

Training does not focus enough on adapting policies to national circumstances. Though there have been some important advances in decentralisation via organisations such as BCEAO, MEFMI and WAIFEM, much more could be done to empower national officials to conduct their own PSIA or other analyses.

The Fund has somewhat too many and too confusing links with multiple regional organisations in the same sub-regions, and in addition is creating new institutions with overlapping mandates and high capital costs. It would be desirable for the Fund to work with one organisation for decentralisation in each sub-region – preferably one created, owned and funded by the countries themselves.

The research programme of the Fund, while improving its relevance to low-income countries, still does too much work on more wealthy members, which potentially duplicates research by major developed country institutes. There is insufficient evaluation of the impact of research on developing country policies, or even of its impact on the practices of IMF missions.

Is it desirable for the Fund to have the dual role of conditionality designer and technical assistance provider in the same issue areas? In the absence of independent technical assistance with equal expertise, the Fund is obliged to play this role. However, it runs the risk of major conflicts of interest, undermining long-term ownership or capacity building. Technical assistance designed to recommend donor-approved policies is a key aspect of "soft conditionality", which allows IMF-recommended policies to be adopted even when they are not part of a formal conditionality matrix.

The PRSP/PRGF process has not in itself increased country capacity, except where additional assistance was provided for this purpose. Such assistance has been far too little and far too directed via the Bretton Woods Institutions, and therefore, with the exception of few notable areas such as Public Expenditure Management, and Debt Management, not achieved as much as it could have. For example, it is astonishing that virtually no PRGF country has in place either a reliable system for costing anti-poverty spending or a country-designed and owned model for simulating and projecting poverty reduction.

What More Can the Fund Do to Increase Country Capacity?

The Fund's decentralisation policy for technical assistance and training should be refined with one clear regional partner chosen in each sub-region, preferably an institution run by all member governments in the sub-region, avoiding overlap or duplication.

All terms of reference, choice of delivery mode and experts, project monitoring and evaluation should be led by the country authorities.

The Fund should assess all of its technical assistance and training

interventions more systematically for their long-term capacity-building impact, and as part of country-led strategic frameworks for macroeconomic capacity building, and conduct more long-term capacity-building interventions in low-income countries.

To ensure that country capacity to negotiate policy options with the Fund is enhanced, other donors need to provide much more funding for *independent* capacity building for governments and civil society organisations in the core macroeconomic areas treated by the Fund and poverty and social impact analysis.

A final crucial aspect will be reinforcing civil society capacity in low-income countries. Recent programmes such as EPEP or Oxfam's programmes with its local partners have given them new skills in macroeconomic policy analysis which could be used in future dialogue with government and IMF, but are in urgent need of expansion.

5.3 From Negotiation to Participation

Another crucial change in the Fund's business culture, to promote country ownership, should be a movement away from pressurised negotiations, which take 2-3 weeks every quarter and are held almost entirely behind closed doors, to a broader and more permanent process of participation in national debates on macro and structural issues as part of the PRSP process.

The Fund has tried in some countries to get more involved in dialogue with civil society and parliaments in countries, in order to extend ownership beyond core technocrats. However, depending on the communications skills of Fund staff, at times these events have come across more as public education than consultation or dialogue.

In addition, in spite of additional recent efforts, the Fund still needs to give more seniority and responsibility to resident representatives, to ensure a constant dialogue between resident representatives and the local civil society. There are a few recent positive examples of more senior resident representatives genuinely participating in the PRSP process, but much more needs to be done.

Various NGOs have suggested mechanisms through which PRGF programmes themselves could be designed in a more participatory way (Oxfam, 2003; Trocaire, 2004) – as Trocaire puts it, "opening up PRGF negotiations to a multistakeholder process". This end-goal would involve roughly a 12-month cycle for designing a new 3-year PRGF, and a comprehensive review of each existing PRGF. Draft PRGFs or briefing

papers would be released publicly, and the IMF would debate its macroeconomic forecasts (including alternative scenarios) and measures in the macroeconomic working group of the PRSP. Others have suggested less radical steps. For example, IEO (2004) has proposed that the IMF produce a note on key macroeconomic issues and targets, and that this rather than the full PRGF would be the subject of the consultation. Another possibility would be for all Article IV documents to be released in this way. Perhaps most feasibly, it has been suggested that the IMF would join the donor budget support group and participate in the joint policy matrix (itself taken from the PRSP) negotiations of any multi-donor framework, between government and donors. Once these were finished, it would then select a few key conditions from the matrix and use them as the basis for its PRGF.

All acknowledge that for participation to be fruitful, huge investment in capacity building among government (e.g. parliament) and civil society agencies is needed. In addition, whichever route is chosen, the relevant documents need to be made public as early as possible in the process (provided that the government is amenable) to give civil society the maximum opportunity for input at an early point.

5.4 From "First Among Equals" to "One Among Many"

Already in the suggestion above that the IMF participate in donor support groups, it is implied that the Fund moves away from a "first among equal" position where it takes the lead on all aspects of macroeconomic and some structural conditions, and other donors' money is generally dependent on its seal of approval. Instead, a far preferable position would be one of being one among many partners of a government, where all negotiate with government simultaneously and with equal priority in a Consultative Group or Round Table meeting that would act as a "partnership forum". This type of meeting would allow three-way monitoring among external donors/lenders, government and civil society. It could also be informed if necessary by an independent report assessing all three groups, and could produce a joint partners report that could replace the IMF/World Bank JSA (though allowing space for specific views by them if necessary).

For the most stabilised countries, the IMF role would naturally recede further. Instead of negotiating conditions, it would be responsible for presenting a report on macroeconomic policy and stability to the regular meetings of government and donors, providing donors with continued faith in macroeconomic policy. In other words, its role would be tailored

to whether the issues in which the IMF has comparative advantage are the top priority for the country.

Most fundamentally, the Fund needs to reverse its logic and have less strict programmes where ownership has been proven over time – i.e. for the mature post-stabilisers. It needs to see ownership as obviating rather than facilitating strong conditionality. This would involve much looser briefing papers with explicit openness to alternatives, and transparent discussion of these with government, the donor community and civil society during missions. Governments, not the Fund, would draft letters of intent before missions. The Fund would also need to decentralise much more wholeheartedly to field offices, in order to ensure a higher level of political dialogue and participation.

6 Key Priorities for the Fund's Role in Low-Income Countries

6.1 Capacity and Competence for a Long-Term Role?

Given that the Fund was created to solve short-term balance of payment crises, it is often questioned whether it has or should have the capacity and competence to play a long-term role in low-income countries. However, it has a very strong capacity to play a long-term role in low-income countries – although ideally, if its programmes and financing worked more effectively, they would not need it to do so! It has demonstrated this capacity by allowing low-income countries to undertake prolonged use of its financial resources, with the Board and management showing considerable flexibility in going beyond the short-term nature of the Fund's mandate, and in finding extra financing to fund relatively concessional financing. Nonetheless, the amounts provided and their concessionality has been well short of what has been needed. PRGF has been more of a continuity with ESAF in terms of amounts and concessionality, and has represented even more prolonged use. Almost all Board members and independent sources acknowledge that low-income countries are likely to take longer to recover from external shocks and need longer-term interventions and more concessional funding. However, the question remains for how long prolonged use should continue.

The Fund's catalytic role through its seal of approval has been less clearly successful. Even though it has clearly facilitated large amounts of debt relief, and helped to mobilise some official financing, its role in

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promoting private financing has been much less positive. PRGF linked to PRSP and HIPC has probably enhanced this catalytic role somewhat. Most Board members seem to believe that the Fund needs to continue to play a "seal of approval" role, but there is no reason why this needs to continue to be through a lending role for "mature-post-stabilisers".

The Fund is probably weakest in its conditionality role in low-income countries. Though the PRGF has brought some major steps in the right direction, through a little more macro flexibility, some streamlining of structural conditions, and a little more realism in forecasts, Fund conditionality remains fundamentally ill-adapted to low-income countries. The Fund's conditionality links to PRSPs and the MDGs are very unsatisfactory and its analysis of poverty and social impact has until now been cursory. In addition, the logic and effectiveness of *ex ante* conditionality is highly questionable. Without the fundamental reforms of its conditionality recommended above, it is questionable whether the Fund should continue to be so prominent in low-income countries.

Fund assistance in building capacity is increasingly being adapted to the needs of low-income countries, through decentralisation, long-term planning and prioritisation though it has some way to move from technical assistance to genuine capacity building. The Fund is highly valued by borrowing governments in its core areas of activity, though in principle, there is some conflict of interest between its conditionality and technical assistance roles, and therefore an independent office might be better placed to organise the technical assistance. There is no direct evidence that the introduction of the PRGF has enhanced the IMF's role in capacity building.

Future Role of the Fund

Above all, the IMF needs to adapt its conditionality to the needs of low-income countries and their wishes for genuinely country-led PRSPs and more IMF flexibility – especially for "mature post-stabilisers". To have a successful long-term role, and create the conditions for accelerated growth and poverty reduction, IMF programmes need a lot more flexibility in the design of the macroeconomic framework, including strong PSIA of its effects on poverty and prospects for attaining the MDGs, much greater streamlining of structural conditionality, and systematic use of baseline forecasts including "probable shocks".

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The IMF needs to improve its building of capacity in low-income countries by more empowerment of the borrowing governments, more decentralisation, more long-term planning, and more analysis of ownership and implementation factors which undermine long-term impact unless tackled up front. Country governments and civil societies urgently need the skills to which the Fund has access in the design of core macroeconomic policies, but they also need access to a wider range of assistance with more heterodox views, to ensure that they are able to express their views fully in national PRSP consultations and negotiations with the Fund. In addition, ideally an independent office would be created to manage technical assistance to avoid any conflict of interest with the conditionality function.

There is no reason, on the other hand, why the Fund should continue to play such a prominent lending role. If its major shareholders could be induced to use the huge additionality it can have in its resources (through SDRs, gold etc.) to fund more concessional and/or greater resources to protect countries against shocks, and these resources are compatible with long-term debt sustainability for low-income countries, it would be ideal for it to play more fully its role as lender of last resort. However, with its current limited and non-concessional funds, it should reduce and eliminate its lending to countries with the best track records as soon as possible.

There is also no reason why the link between Fund lending and a seal of approval needs to continue. Even if the seal of approval function is worthwhile, it is largely limited to official financiers and debt relief providers, all of whom could be equally well convinced to line up behind a surveillance programme for the countries with the best track record.

6.2 Organisational and Procedural Changes

Finally, if the Fund is to play these changed roles, it will need to make several organisational changes which will enhance its ability. Here it will be important to realise that the Fund cannot do everything with limited resources (and indeed as discussed above, should not):

- Most fundamentally, far more staff resources need to be allocated to low-income countries, which accounted for more than 75 percent of Fund lending programmes, but received only 11.5 percent of administrative funds in 2003. This applies not only to area departments, but also to units of other departments that work on low-income countries. Some IMF departments (Africa, Policy Develop-

ment and Review Department (PDR) have already begun to change in these directions, but most have not gone very far. Among these would be: (i) reinforcing the Fund's capacity in the Official Financing Operations Division of PDR, to analyse and mobilise official financing; (ii) reinforcing the Fund's capacity to participate in *country-led* PSIA, to conduct more flexible analysis of macro-economic frameworks and of the impact of aid on the economy, and to make more realistic but MDG-oriented projections (much of which would be designed in FAD); and (iii) decentralising Fund mission chiefs and staff to the countries themselves, to bring them closer to country discussions.

- To save money, the Fund could hand its technical assistance and research functions to an independent office which can commission them independently.
- Recruiting more staff from developing countries, at all levels.
- Recruiting more staff with a multidisciplinary (or at least applied rather than theoretical economics) background, to analyse the complexities of development in programme documents.
- Training more staff in key positions (resident representatives, mission chiefs, front offices) in negotiation and communication skills and in ways to design and interpret programmes more flexibly.
- Revised promotion structures in order to encourage staff to work on countries for longer periods and develop more knowledge and firmer working relationships.
- Providing improved internal guidelines for staff on such aspects as fiscal flexibility, judging the reliability of growth objectives, PSIA, the potential resource envelope and how to exercise the IMF catalytic function.
- Reducing the numbers of documents to be produced (for example abandoning the JSA and allowing joint assessments by all partners).
- Finally, the IEO needs to have more resources. It is doing an excellent job but could do more and faster with more staff. It should be given responsibility for doing PSIAs and *ex ante* assessments of programmes.

The above may seem a rather long list but, as with many of the other recommendations made in this chapter, the IMF Board (and some members of senior management) needs to realise that the Fund could have a role in low-income countries for many years to come. If the Fund can adapt its lending, its catalytic role, its programme design and its business culture, it can play a major role in helping low-income countries to reach the MDGs.

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