INTERNATIONAL MONETARY FUND

Role of the Fund in Low-Income Member Countries over the Medium Term—Issues Paper for Discussion

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I. Introduction

1. **This paper raises a number of issues for discussion about how the Fund can best support low-income members and contribute to the intensified global effort towards the achievement of the Millennium Development Goals** (MDGs). The strategy endorsed by the international community for fighting poverty and achieving the MDGs, the Monterrey Consensus, is based on low-income countries pursuing sound policies and good governance matched by better and stronger international support. The country-driven and participatory Poverty Reduction Strategy Paper (PRSP) approach provides the framework for implementing this strategy at the country level.

2. **The broad principles of the comprehensive development strategy expressed in the PRSP approach and the Monterrey Consensus provide the appropriate framework for the Fund's engagement with low-income countries.** While there is room for improvement in the design and implementation of this framework, the staff believe the current framework should remain at the center of the basic architecture of cooperation among the major development partners.

3. **The focus of this paper is on how best the Fund can contribute to the successful implementation of these initiatives.** The paper lays out several important considerations in support of this objective:

- **The Fund's policy advice to low-income members will need to adapt**. There has been significant progress in many low-income countries in achieving a stronger macroeconomic foundation for higher growth rates, although these achievements remain fragile, and a sustained period of more rapid growth will be necessary to continue progress toward the MDGs. With improvements in macroeconomic policies, our focus needs to be on how to contribute to stronger microeconomic and supply-side fundamentals that are necessary to raise growth over time.

- **The overall objective of Fund policy advice and financial assistance should be to facilitate the transition to the point where low-income members can rely predominantly on private sources of financing**. For most low-income members this is a long-term objective. During this transition, the Fund will need to intensify support to low-income members in its core areas of competence—fiscal, monetary, exchange rate policy, and the stability and soundness of financial systems and macroeconomic governance issues—through policy advice, technical assistance, capacity building, and temporary financial assistance.

- **The Fund needs to strengthen its cooperation on these matters with the World Bank and others that play a critical role in supporting reform programs**. Many of the areas of policy reform that are necessary to enable countries to achieve the higher growth rates—property rights and other aspects of the enabling environment for the private sector, and the delivery of basic public goods like rural infrastructure, access to clean water, and health and education—fall outside the Fund's core areas.

- **The Fund needs to be more selective about the circumstances in which it engages in a program relationship,** particularly in cases where the lack of political commitment and capacity constrains what can be achieved.

- **There will need to be some evolution in the Fund's existing instruments in three areas**: (i) supporting post-conflict countries to move to where they can implement PRGF-supported programs; (ii) assisting those countries with a more durable record of macroeconomic performance to move to a surveillance-based relationship; and (iii) providing policy advice and financial assistance to help member countries deal with exogenous shocks.

- **The Fund's financial role in low-income members should be focused** on the provision of temporary financial assistance in support of macroeconomic reform efforts, and the policy response necessary to help countries adjust to the effects of external shocks.

4. This paper is structured as follows. Section II reviews the changing nature of the principal economic challenges facing low-income countries. Section III outlines some general principles to define the Fund's contribution to the cooperative global effort to help these countries confront these challenges. Section IV discusses the implications of this changing environment for the design of Fund-supported economic programs and how the Fund can contribute to a stronger and more effective partnership with other institutions that support the development process, including a clearer delineation of relative responsibilities and accountability. Section V examines the appropriate types of Fund engagement across the diversity of circumstances of low-income members, and how best to support successful transitions from a sustained program relationship with the Fund. Section VI sets out some general tenets for further consideration of the role of Fund financing in the low-income members. The paper concludes with a set of issues for discussion and next steps.

5. This paper does not review the status of initiatives now underway, such as the HIPC initiative, efforts to strengthen the PRSP process, and many others, which involve the Fund and play an important role in our efforts to improve economic outcomes in low-income countries. Our objective here is to look beyond the immediate horizon of these efforts to assess how we can build on them over the medium term.

II. The Changing Environment for the Fund's Work with Low-Income Members

6. **Low-income members have made substantial gains toward achieving macroeconomic stability and higher growth rates.** As indicated in Box 1, since the mid-1990s, there has been a marked improvement in inflation performance as well as fiscal and

external positions of low-income countries, with these gains being even stronger in countries that have had, or now have, PRGF arrangements.

- Inflation rates in low-income countries are at their lowest levels in two decades, reflecting receding macroeconomic imbalances. Fiscal deficits have also narrowed. And while current account deficits have remained broadly unchanged, external reserve positions have strengthened considerably.

Box 1: Macroeconomic Stability and Growth in PRGF Countries

The stylized facts of macroeconomic development in low-income countries since the mid-1990s, and in particular countries with a PRGF arrangement, are encouraging. Real GDP growth is up, inflation is down, budget deficits have shrunk and foreign exchange reserves are also up markedly. In general, the performance of countries that have had PRGF arrangements since 1998 (hereafter PRGF countries) was stronger than that of low-income countries (LICs). This box and accompanying figures outline developments in key macroeconomic aggregates in the low-income countries since the 1980s.

Output growth in low-income countries has increased markedly in recent years. Median GDP growth in the LICs accelerated from 3 percent in the 1980s to close to 4 percent after the mid-1990s (Figure I). The performance of PRGF countries was stronger still, rising from 2½ to 4½ percent over the same period. Further, this growth performance was fairly broad based, with the number of LICs recording negative growth rates falling from 12-14 in the 1980s to 6 in the late 1990s.

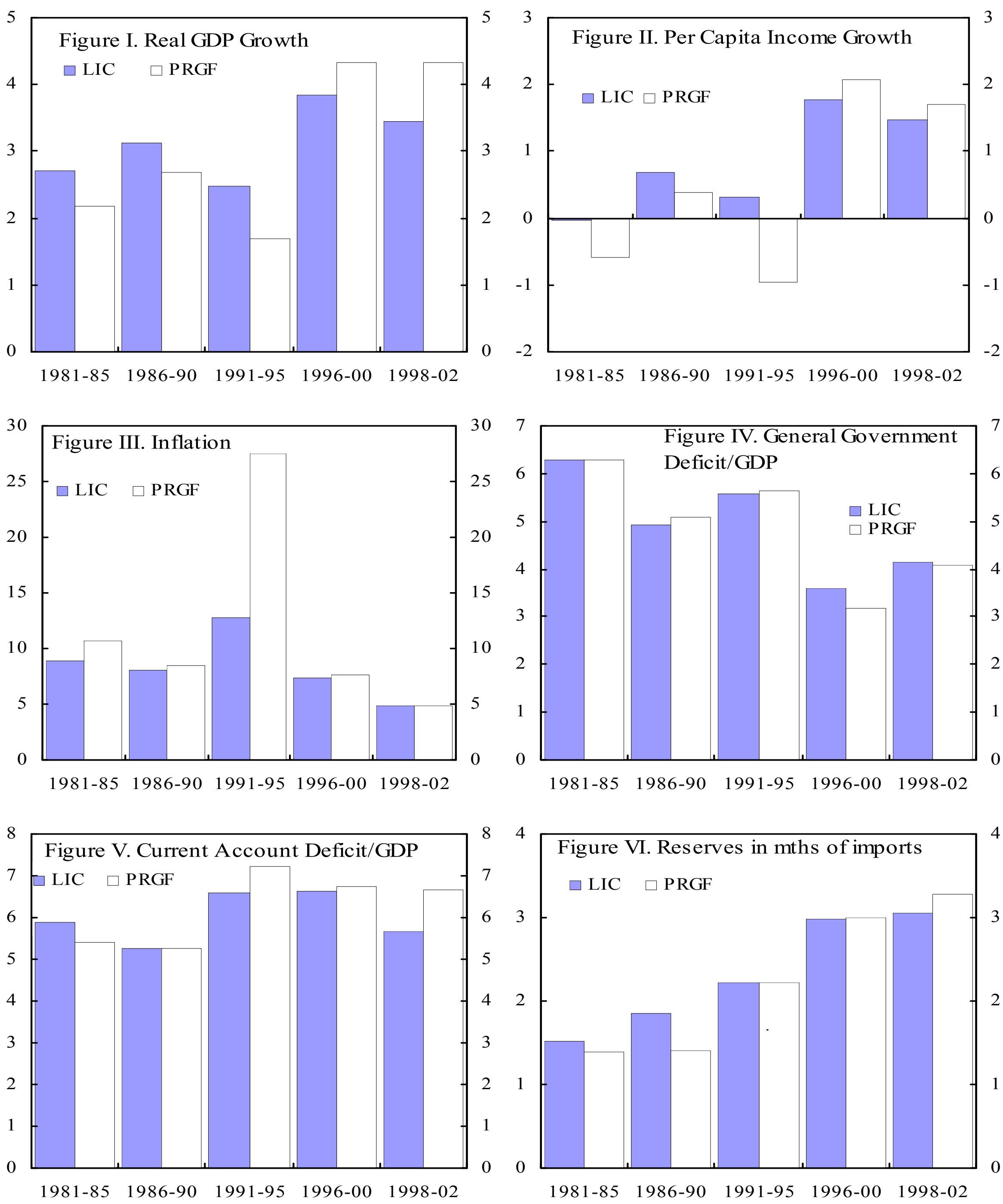
Higher output growth has been reflected in higher per capita income increases. Per capita income growth in the LICs, which averaged less than ½ percent in the 1980s, has been growing by more than 1½ percent since the mid-1990s (Figure II). The improvement for the PRGF countries is better still, from mildly negative rates through the 1990s to increases on the order of 2 percent since 1996. The variance of per capita income growth has declined relative to the early 1990s and is broadly similar to the levels that prevailed in the 1980s.

Inflationary pressures have subsided. The median inflation rate in LICs has decelerated from more than 12 percent in the early 1990s to under 5 percent since 1998 (Figure III). Again, the inflation performance of the PRGF sub-sample is better still and compares favorably with other developing countries and indeed the industrialized countries. More generally, inflation is now at its lowest level in more than 2 decades.

Fiscal deficits in low-income countries have narrowed. The median fiscal deficit in both the LIC sample and PRGF sub-sample has declined from 6½ percent of GDP in the 1980s to around 4 percent of GDP more recently (Figure IV).

Partly on account of higher export growth, current account deficits have declined marginally and foreign exchange reserves are at their highest levels for two decades (Figures V and VI). The median current account deficit in PRGF countries has declined by around 1 percentage point of GDP to 5½ percent of GDP since the early 1990s. This was partly made possible by the increase in the rate of growth of exports of goods and services, which increased from 1.7 percent to 4.3 percent, notwithstanding a deterioration in the terms of trade for LICs. Foreign exchange reserves are also up, with the median reserves countries now sufficient to cover more than 3 months of imports of goods and services, compared to 2 months in the early 1990s and just over 1 month in the 1980s.

Box 1 Continued. Macroeconomic Stability and Growth in PRGF Countries 1/



Source:World Economic Outlook, Summer 2003.
1/ In all cases, median values of the variables for the country groupings are included. Excluded from the LIC sample are Afghanistan, Bosnia, and Somalia for lack of data and India because it has many of the attributes of middle-income countries, although nominally PRGF eligible.

- Against this backdrop, GDP growth rates have picked up after a slowdown during the early 1990s, again with notable gains having taken place in countries benefiting from PRGF arrangements—annual per capita income growth, which stagnated between 1980 and 1995, has risen to almost 2 percent in 1998-2002. Moreover, this improvement was relatively broad based and not an artifact of strong performance by a small number of countries (Figure 1).

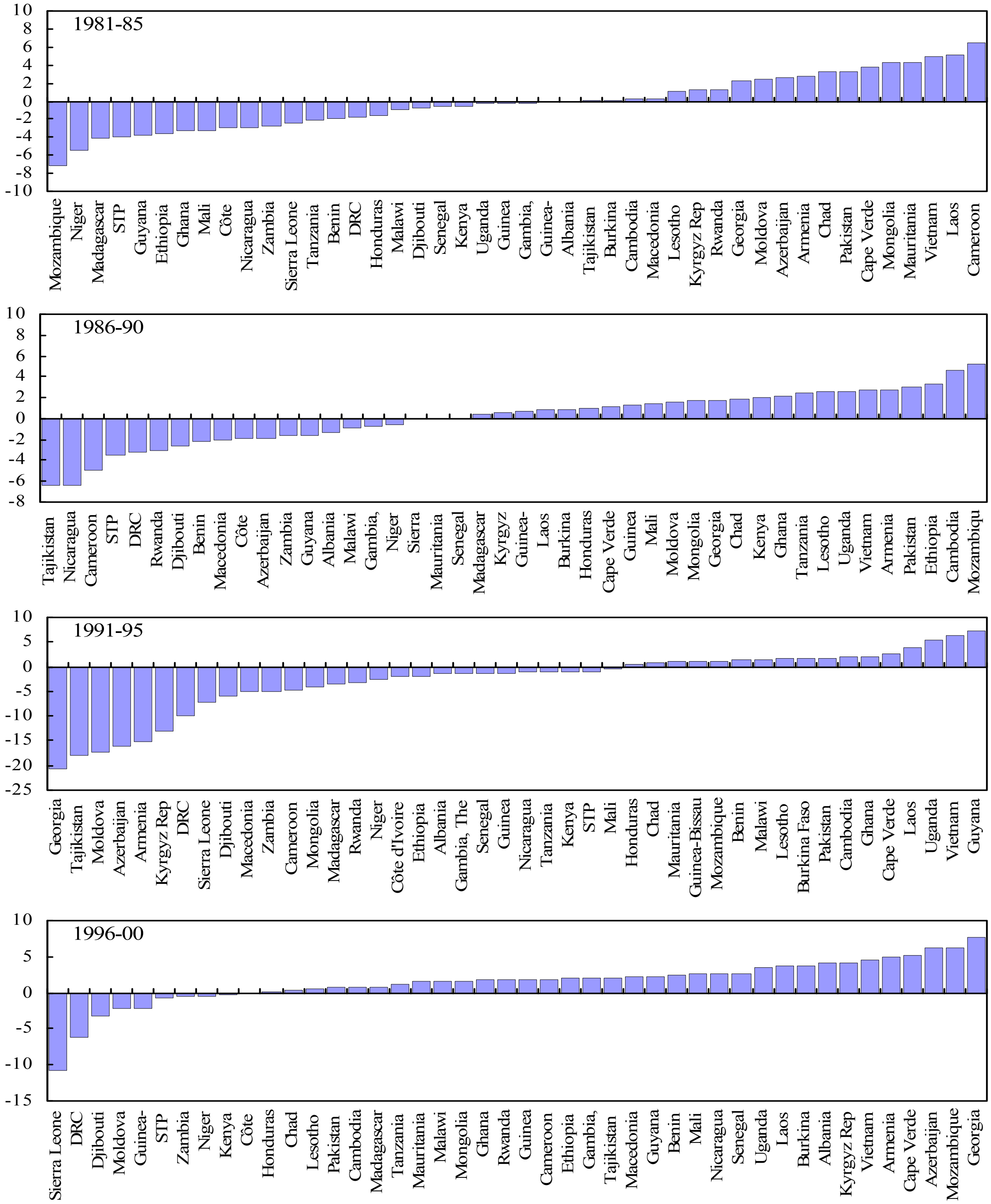
7. **The progress in macroeconomic policies and the associated improvement in economic outcomes are critical for the objectives of poverty reduction and higher living standards**. But they do not yet provide a sufficient basis for achieving the sustained period of higher growth rates necessary to make rapid progress toward the MDGs. At current growth rates, it would take almost 40 years for low-income countries to reach the *current* median income level of other developing countries. Even sustaining recent growth rates will be a challenge. Institutional capacity in low-income countries for macroeconomic management is often very weak, leading to uneven policy implementation over time, especially in the face of rapidly changing external circumstances. The economic growth that has been registered has not generally been accompanied by a significant rise in investment rates from current low levels, suggesting there has been increased efficiency in the use of resources, but raising the question of how long such non-factor growth is sustainable. Sustaining progress towards debt sustainability provided by the HIPC initiative will require strong policy performance to improve the returns to Official Development Assistance as well as greater concessionality in future flows of assistance.

8. **Building high quality institutions represents a major challenge**. Economic development is a long-term phenomenon, depending as much on the creation of an environment that encourages capital accumulation, skill acquisition, and technological innovation and transfer as much as the maintenance of macroeconomic stability. In practical terms, this requires the development of transparent structures that recognize property rights and facilitate their transfer, curb corruption, and provide oversight over economic activity (for example, effective banking supervision). Governments need to supplement this with the provision of social and infrastructure services. The dividends to pursuing these institutional aspect of the development challenge are large.[1] Indeed, absent such an environment, economic growth will be lower and progress more vulnerable to reversal. The Fund and other development partners will need to continue providing considerable support for capacity building to low-income members to enable them to acquire effective social and economic institutions and get the microeconomic underpinnings for growth right.

9. **The political and social environment presents significant challenges for accelerating growth**. Many low-income countries have weak political systems and lack

[1] See Chapter III of the May 2003 *World Economic Outlook* for a review of the emerging consensus of the importance of institutions for development.

Figure 1. Per Capita Real GDP Growth 1981-2000
in Countries with a PRGF Arrangement



Source: WEO.

broad political consensus for reform. Governance is weak, particularly in the formulation and enforcement of laws governing property rights and in the fight against corruption. Both external and internal security can be tenuous. The very difficult public health situation—particularly the prevalence of diseases such as malaria and AIDS[2]—and the limited availability of basic public goods such as access to clean water, education, and rural infrastructure present formidable challenges to greater progress in improving standards of living.

10. **Low-income members also remain acutely vulnerable to exogenous shocks.** As detailed in the background paper (SM/03/288), shocks such as natural disasters and sharp terms of trade movements can have a significant adverse consequence on growth prospects (by reducing investment and, in the extreme, the capital stock), macroeconomic stability (for example, reducing export earnings and/or tax revenues), and the incidence of poverty (with the low-income countries less able to cushion the effect on the poor). By diverting scarce resources towards urgent short-term needs, shocks can also disrupt long-term development plans.

III. Guiding Principles For the Fund's Work with Low-Income Members

11. **Given this changing environment, what are the broad principles that should guide the Fund's work with low-income members?** The following general propositions could provide a useful complement to the IMF's Articles of Agreement and the decisions of the Executive Board in laying out such guidance.

- **The Fund needs to remain engaged in assisting low-income countries over the long term.** The macroeconomic policy and institutional challenges inherent in low-income countries' efforts to achieve sustained high levels of growth are complex and successful efforts to confront them require a sustained effort over time. The Fund should be willing to play a constructive role in supporting this process of development and transition, even after macroeconomic stability has been established.

- **The Fund's support for low-income members should continue to embrace the principles of the PRSP process and support for the MDGs**. The principles underlying the PRSP approach are that national poverty reduction strategies be country-driven, results-oriented, comprehensive, and long term in perspective, and that PRSP development be based on a participatory process, which includes domestic

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[2] See for example, UNAIDS, *Report on the Global HIV/AIDS Epidemic*, July 2002; and Markus Haacker (2001), *The Economic Consequences of HIV/AIDs in Southern Africa* (WP/02/38).

and external development partners. The PRSP serves as a framework for cooperation among the Fund and other development partners.[3]

- **The Fund will focus on its core areas of competence, while ensuring its efforts complement the work of the World Bank and other developmental institutions**. In the past few years, the Fund has made an effort to define its core mandate more clearly, with its focus on the areas of fiscal, monetary, exchange rate policy, strengthening the stability, and soundness of financial systems. These are a necessary but not sufficient condition for achieving higher growth rates and reducing poverty, and need to be complemented by substantial support from other development partners.

- **The overall objective of Fund policy advice as well as technical and financial assistance is to help low-income members move to a point where they can rely predominantly on private sources of financing**. Our role is to promote greater resilience to shocks and a more stable macroeconomic and institutional framework for private sector investment and growth that will permit the evolution from a sustained program engagement.

- **Sustained improvements in economic outcomes in low-income countries depend significantly on the policies of the rest of the membership**. An important role for Fund surveillance is to assess the implications of policies of the major economies for global economic growth and to encourage policy reforms in industrial countries, including in trade policy and agricultural support, and in the provision of development assistance that are critical to the economic prospects of low-income countries.

IV. Implications for the Work of the Fund and Other Development Partners

12. **These broad principles have several implications for the role played by the Fund in providing policy advice and technical assistance, in the design of programs and the financial assistance provided in support of those countries, and in our role in cooperation with other institutions**. In particular, they suggest that the role of the Fund in helping low-income members should be predominantly directed to: (i) *establishing macroeconomic frameworks that can support sustained high growth*; (ii) *identifying and helping countries manage sources of macroeconomic risks and vulnerabilities*; and (iii) *strengthening institutions and policies that underpin sound macroeconomic management*, including the management of public financial resources as well as exchange, monetary, and financial systems through capacity building and technical advice.

[3] The recent paper on PRSP/PRGF alignment (SM/03/94) considers some of the current issues in ensuring that the Fund's support of low-income countries' programs is consistent with the PRSP approach.

13. **The Fund also needs to ensure that the focus and mix of policies fit country circumstances and respond to the macroeconomic problems country authorities face in promoting sustained high growth and reducing poverty**. These policies differ from and are more complex than those that are necessary to curtail macroeconomic imbalances. There are a number of areas where an evolution in Fund program design is appropriate, including how to build in the flexibility of macroeconomic frameworks and monetary programs to accommodate higher growth, to promote development of financial systems, tax policy, and legal reforms than can better support private investment, and to support fiscal reforms and borrowing strategies more consistent with long-term sustainability. Box 2 outlines a preliminary list of issues where there is scope for evolution in the policy advice to low-income countries. *The staff is in the process of a broad review of Fund policy advice and program design issues in PRGF countries which staff expect to bring before the Board in mid-2004*.

Box 2. Evolution in Program Design

This box outlines a preliminary list of areas where the design of PRGF programs might be refined to help contribute to higher output growth that is sustainable.

- *Beyond macroeconomic stabilization, how can Fund-supported programs better facilitate higher output growth*? Do programs take sufficient account of the differing needs of low-income countries—lack of diversification, weak institutions, segmented labor markets, susceptibility to shocks, etc.? *Which macroeconomic institutional reforms in low-income countries have the greatest pay-off in terms of growth*?

- *What is the appropriate strategy to facilitate development of the private sector?* Do reforms pay enough attention to the underlying legal and judicial framework to support indigenous capital formation? Can policies to encourage financial intermediation be improved?

- *What is the preferred monetary framework for facilitating higher private sector credit growth?* Are monetary programs designed on the assumption of constant velocity too conservative for partially monetized and/or are subject to large supply and demand shocks that make money demand unstable? What is the appropriate inflation range for low-income countries?

- *How can macroeconomic frameworks best accommodate higher aid inflows?* What is the appropriate path of the fiscal deficit, excluding grants, given aid expectations and the country's ability to service additional domestic and external debt?

- *Are tax rates too high in low-income countries and what can be done to widen tax bases?* How can Fund-supported programs best ensure that tax policies are transparent, simple, and non-distortionary?

- *How can we best ensure that macroeconomic frameworks in Fund-supported programs strike the right balance between realism and ambition*? Growth projections need to be realistic if they are not to lead to undesirable fiscal outcomes, but programs must also accommodate higher growth outcomes.

14. **The Monterrey Consensus recognizes that development partners have complementary responsibilities toward low-income countries, and that there are clear advantages to each partner specializing in its area of expertise**. This will be of particular importance in helping low-income countries develop an environment conducive to private sector development. In some respects, the failure over the last 40 years of low-income countries to increase growth significantly has been the failure to put in place systems which promote an efficient, entrepreneurial, and innovative private sector. And absent progress in this area in the years to come, the large investment that the international community is expected to undertake in the health, education, and infrastructure of low-income countries will not provide a sufficiently strong foundation for achieving the MDGs. The Fund has sought to refocus its role in low-income countries in recent years, including through streamlining conditionality on its core areas of expertise and macro-critical structural issues.[4] But greater progress towards the attainment of the MDGs also requires reforms in areas outside the Fund's direct expertise to proceed apace.

15. **The Fund's main contribution towards private sector development and growth will remain in helping member countries maintain a stable macroeconomic framework in which entrepreneurship can thrive**. The return from maintaining a stable macroeconomic environment are quite high. Such an environment is a necessary condition for the private sector to develop by reducing uncertainty and promoting efficiency. Our contribution to better macroeconomic policy choices and in cushioning the adjustment to shocks and imbalances is the principal means through which the Fund contributes to poverty reduction. Beyond this, the Fund plays an important role in fostering better public sector expenditure management.[5] The Fund (taking into account the World Bank's on-going work) can also contribute to providing an enabling environment for the private sector through assisting in financial sector development; enhancing governance, particularly in the area of public finance; building institutional capacity; helping to promote investment; looking for ways to facilitate low-income countries' access to capital markets; and promoting trade. The Fund also needs to recognize and encourage low-income members' efforts to better exploit regional synergies—for example, there are large potential benefits from removing infrastructural impediments and lower trade barriers to enable the development of larger regional markets.

16. **There are, however, a number of areas where the Fund's work will not be sufficient to provide low-income members the needed expertise and guidance and where other institutions must take the lead if the private sector is to flourish and poverty is to be reduced** (Box 3).

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[4] See *Conditionality in Fund Supported Programs—Overview* (SM/01/60) and *Streamlining Structural Conditionality—Review of Initial Experience* (SM/01/219).

[5] *Bank/Fund Collaboration on Public Expenditure Issues* discusses collaboration among the Bank and Fund in this area more fully (SM/03/73).

- The Fund's contribution to helping countries formulate their growth strategy should focus on the macroeconomic underpinnings of growth, but the World Bank and other development partners must take the lead on advice to countries on specific sectoral strategies, including privatization reforms.

- The Fund can help determine the appropriate budget envelope, improve the effectiveness of the tax system as well as help put in place adequate budgetary management mechanisms. But it does not directly contribute to improving the efficiency of government spending in general or specific types of public sector investment in particular, and its impact on improving the country's human and physical capital will be indirect.

- In the area of governance, the Fund can contribute to improvements in the areas of tax policy, expenditure management, trade and exchange rate reform, and the institutional framework for the financial sector. But promoting accountability and transparency in the wider public sector, civil service reform, and the creation of an enabling environment for private sector development fall outside the scope of the Fund's core responsibilities.

- In the broader context of private sector development, the Fund has a key role in helping to foster the development of the financial sector. However, the legal environment in which the sector operates—the framework for corporate governance, accountancy, and insolvency regimes, as well as the definition, transferability, and enforcement of property rights—is also critical. While the Fund has a contribution to make in this area, the World Bank has the institutional lead.

Box 3. Structural Conditionality and Areas of IMF Expertise[6]

Core	Shared	Non-Core
Tax Policy	Financial sector reform	Public enterprise reforms
Fiscal transparency	Trade policy	Privatization
Fiscal management	Private sector promotion	Marketing and pricing reforms
Monetary policy		Civil service restructuring
Foreign exchange regime		Social safety nets
Exchange rate policy		Monitoring poverty reduction
Macroeconomic data		Sectoral policies
Tax and customs administration		

[6] From *Is the PRGF Living Up to Expectations? An Assessment of Program Design*, Occasional Paper No. 216, International Monetary Fund, Washington, D.C., 2002.

17. **The importance of these areas for growth and poverty reduction highlights the need for continuing work on collaboration with other development partners**. In particular, as Fund programs focus more on our core areas of expertise, increased coordination and cooperation with the work of other development partners becomes ever more important. The review of Bank-Fund collaboration expected to be completed by end-2003 will give us an opportunity to take up some of these issues, including how to better define accountability, ways to improve our cooperation in support of reforms in the institutional environment critical to the private sector, and areas where we can improve cooperation with other multilateral development banks and bilateral donors.[7]

V. The Modalities of Fund Engagement in Low-Income Members

18. What are the implications of these developments and challenges for the full range of ways in which the Fund engages with low-income countries?

A. Modes of Fund Engagement

19. **The surveillance framework provides a universal platform for dialogue with the Fund's member countries on the national and international consequences of their economic and financial policies**.[8] Typically, in low-income members, surveillance has focused on the role that fiscal, monetary, and exchange rate policies play in fostering economic growth, with considerable attention given to the structural impediments to such growth. Surveillance in many low-income member countries takes place in the context of reviews of ongoing Fund-supported programs. The Fund is in the process of implementing a range of initiatives to strengthen surveillance in program countries, to help provide a fresh perspective and a broader reassessment of the challenges facing the member and how those challenges can best be addressed. The Financial Sector Assessment Programs (FSAPs) and Reviews of Standards and Codes (ROSCs) provide an important complement to the Fund's surveillance activities, with more in-depth assessments of institutions, prioritization of reforms to strengthen those institutions, and a framework for focusing technical assistance and follow-up work.

20. **The Fund's extensive technical assistance programs provide an important source of support for the development of institutional capacity for policy design and implementation**. The areas of the Fund's technical assistance intervention are focused on the

[7] The PRGF/PRSP alignment paper (SM/03/94) outlined a number of areas where the Fund can help contribute to the ongoing efforts to improve cooperation among development partners. The forthcoming PRSP progress report will examine a related set of questions.

[8] The principles of surveillance were set out in a 1977 Board decision, which established that the ultimate objective of surveillance is to help member countries achieve financial stability and sustainable economic growth. While these principles remain the same across all member countries, the framework for surveillance has evolved and the emphasis given to policy areas varies according to country circumstances.

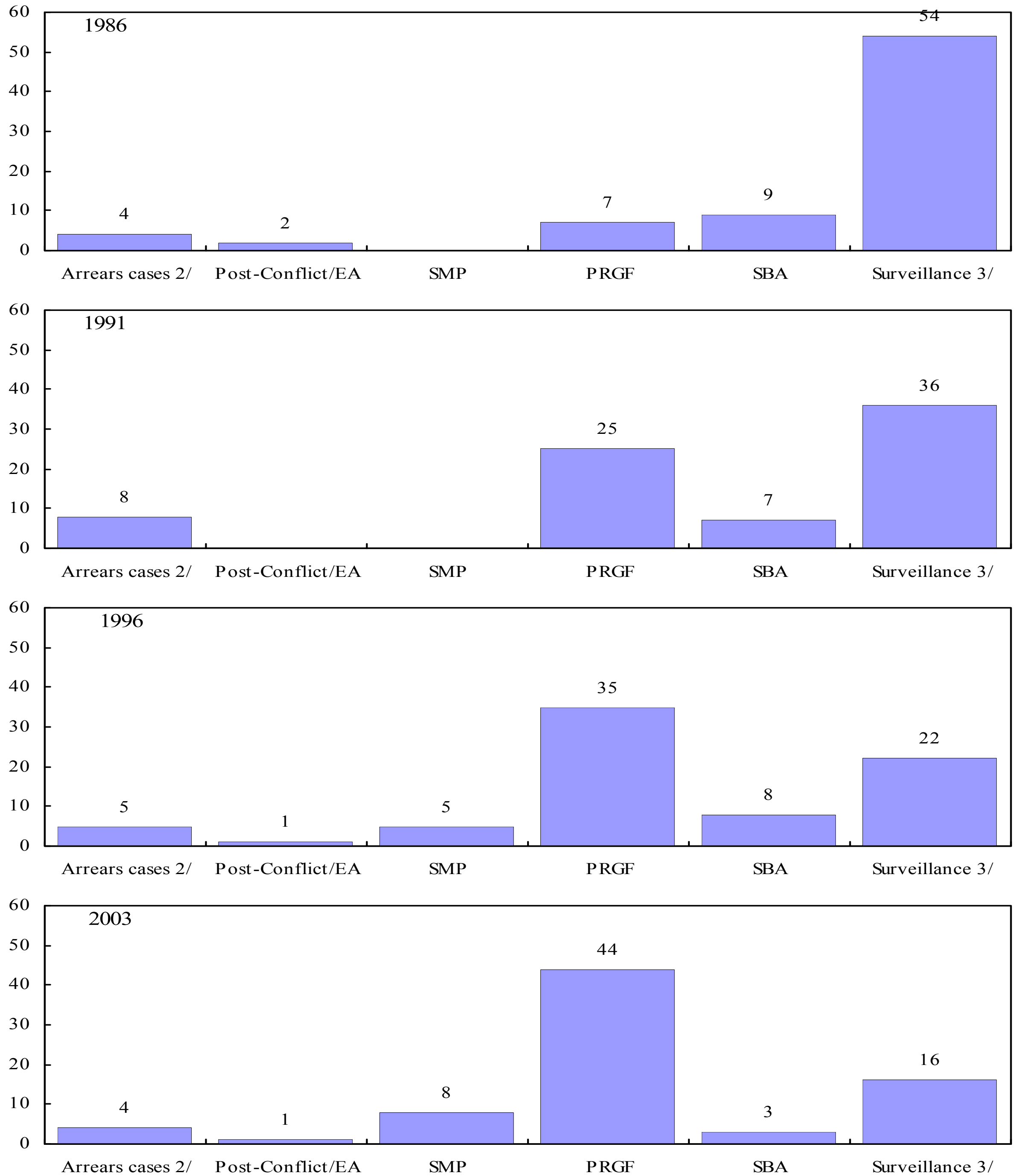
core areas of building monetary institutions and providing long-term, ongoing advice on monetary policy; reinforcing government expenditure management and budgetary systems; helping to design the appropriate modalities of taxation and the capacity to raise revenue efficiently; and ensuring statistical systems are adequate for macroeconomic policy formation and monitoring. The Fund has taken a number of recent steps, including through the establishment of the regional AFRITAC centers, to intensify and improve the quality of its technical assistance to low-income members. The forthcoming review of the Fund's technical assistance strategy will provide a broad overview of ways to improve the targeting and effectiveness of this important form of support for capacity building.

21. **In addition to the policy advice and support provided in the surveillance and technical assistance context, the Fund provides temporary financial assistance in the context of Fund-supported programs**. Low-income members that have drawn on Fund resources have tended to do so in a sustained manner, through a succession of Fund programs, and this tendency has become more pronounced over time. Indeed, increasingly, the main manner in which the Fund now engages low-income countries is a program relationship (Figure 2). With an increasing number of low-income countries having moved towards macroeconomic stability and progress in implementing the HIPC initiative, this is an appropriate time to consider how program design should evolve and how and in what circumstances the strong performing low-income countries can move to a point where a sustained program relationship with the Fund is no longer necessary or appropriate.

22. **There are strong arguments in favor of sustained engagement by the Fund to support reform efforts in low-income members**. The intensity of a program relationship allows and requires the Fund to understand more clearly the economic obstacles faced by the authorities and to be better attuned to the political hurdles to implementing reforms. Fund arrangements play an important role in helping authorities committed to reform advance politically difficult policy decisions, and in instilling internal discipline in policy execution, especially across departmental or institutional lines. The commitments associated with a Fund-supported program can be used to buttress internal commitment to reform that may be weak, uneven within the government, or besieged by special interests or political pressures. The framework of conditions in a Fund arrangement can help give assurance to donors that their financial support is more likely to bear fruit over the medium term. Finally, an arrangement can provide a framework for quick intervention by the Fund if there are destabilizing exogenous shocks that merit policy adjustments and additional financial assistance.

23. **There are, however, also reasonably strong arguments for considering the circumstances when it makes sense for a country to move from a sustained financing relationship to one based on Article IV surveillance and technical assistance as needed, but back-stopped by the possibility of temporary financing when needed**. The report of the Independent Evaluation Office on Prolonged Use of Fund Resources pointed to the

Figure 2. Modalities of IMF Engagement in SAF/PRGF Eligible Countries, 1981 - 2003 1/



Source: Board Documents.

1/ The total sample comprises the 76 PRGF-eligible countries as of March 31, 2003. Post-Conflict/EA are countries that received Emergency Assistance.

2/ Protracted arrears cases; Sudan, which has an SMP is placed under this category.

3/ The Surveillance category includes countries with a broad range of policy frameworks, including those without sufficiently strong policies to merit Fund support.

negative consequences of serial program engagement and a quasi-permanent state of policy making in that context, in undermining ownership, encouraging a culture of blaming the Fund for necessary policy reforms, and undermining the development of capacity to produce "homegrown" macroeconomic policies. The presumption that Fund program involvement is a necessary condition for substantial development assistance by the MDBs and bilateral donors also carries negative consequences for the Fund, creating pressure for a program relationship where the policy conditions are not strong enough to support one, and as well as where the policy framework is strong enough to make a program relationship and Fund financial support unnecessary.

24. **The relative merits of the arguments for and against a sustained program relationship will depend on a number of factors:** the authorities' capacity for policy development and execution, on their ability to sustain political support for a sufficiently credible policy program, as well as on the scale and nature of the support the country seeks from development partners. Countries progress at different speeds in these various dimensions, and there is no *a priori* ideal length of time for program involvement with the Fund. It may be useful, however, to try to define criteria that could help guide decisions by the member and the Fund on the most appropriate form of Fund support, when a sustained program relationship makes sense, and how best to support the transition to the point where follow-on programs are neither necessary or desirable.

B. A Typology of the Differing Economic Circumstances of Low-Income Members

25. **Before turning to the adequacy of Fund instruments to address the needs of low-income countries, it is useful to consider in broad terms the different types of challenges facing low-income members at different stages of development**. Members do not fit neatly into the stylized types developed here and they are likely to move along the implied continuum of types at varying speeds and not always in the desirable direction.

26. **The first type of country could best be characterized as one with extremely weak governmental institutions—both political and economic**. Such cases include, but are not limited to, *post-conflict countries*. In such instances, the minimum institutional capacity to execute a Fund-supported program has yet to be established, while the humanitarian and balance of payments needs are great. In many cases, an active financial role for the Fund is circumscribed. Fund members can avail themselves of Emergency Post-Conflict Assistance (EPCA)[9] with an initial drawing of up to 25 percent of quota. A forthcoming review of Fund policy advice to these countries indicates that in some instances the Fund may have moved

[9] EPCA can be made available if there is an urgent balance of payments need, administrative capacity is not yet adequate to permit the country to implement a comprehensive program but where it is nonetheless sufficient for planning and policy implementation, and where there is a demonstrated commitment on the part of the authorities. In addition, support from the Fund must be part of a concerted international effort. See *Fund Involvement in Post-Conflict Countries* (SM/95/216) and the associated Summing Up (BUFF/95/98).

too quickly from support under the EPCA to that under the PRGF before adequate institutional capacity, ownership, and political will were in place.[10] The result has been subsequent program difficulties and, in the extreme, loss of some gains made during the EPCA period. The review suggests that, when implementation capacity is particularly weak, the technical assistance component of the EPCA program needs to be strengthened and movement to a PRGF delayed until the country is ready.

27. **A second type of country has weak but growing institutional capacity, yet political consensus is fragile; macroeconomic stabilization can be a dominant issue.** We might refer to such a country as an *"early stabilizer."* Often in such cases, key country officials support reform, but overall political support is tentative, often awaiting the results of the reform program. The participatory process underlying the PRSP can be weak, reflecting the fragile political climate; the poverty strategy that is developed is incomplete, internally incoherent, or both. In such cases, active Fund financial involvement can provide a measure of support to the reformers within government, promote some degree of stabilization, give economic institutions the chance to take root, provide technical assistance at a relatively formative institutional stage, and help mobilize more enduring donor support. Financial and reputational involvement is clearly risky in such countries, as it is likely that the financial need (relative to Fund quota and availability of PRGF resources) is great, and there is a significant chance of uneven policy implementation or wholesale reversals. As long as safeguards are deemed adequate, there is no *a priori* reason to exclude Fund program involvement in such cases. Nevertheless, should Fund support become excessively prolonged, with the member remaining in the *early stabilizer* category, the Fund may seek to reduce its financial exposure, in line with the recommendations of the Task Force on Prolonged Use.[11]

28. **The third set in the typology includes countries where political and economic institutions are in place and macroeconomic stability is reasonably well established**—these countries might be called "*mature stabilizers*." The government, the donor community, and the public at large still look to a Fund program to provide a framework for macroeconomic policy implementation, and an assessment of the strength of the policy program relative to the country's particular challenges. In these cases, the PRSP puts forward a coherent policy framework that unites macroeconomic and sectoral poverty reduction policies. However, the complex process of integrating the PRSP with a sound multiyear macroeconomic framework still requires close involvement of the Fund in a program relationship, given the related challenges of managing inflows of donor aid, debt sustainability, and multiyear budget planning and monitoring. Donors may also require continued Fund program involvement as they gradually shift from project to programmatic

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[10] A forthcoming paper will be circulated to the Board for the information reviewing Fund experience in post-conflict countries and issued subsequently as an Occasional Paper.

[11] See SM/03/46 and BUFF/03/51, op. cit..

lending. In such cases, there should also be a change in the nature of reforms contained in Fund-supported programs—they should be aimed more at managing vulnerabilities, encouraging the development of the private sector, engendering foreign and domestic investment as well as financial intermediation, and increasing the dissemination of macroeconomic information. Reflecting the largely institutional and capacity building content of the reform agenda, the Bank, among the Bretton Woods Institutions, is likely to play the more intensive and expanded role in such countries.

29. **Finally, one could envisage a fourth type of country where the policy formation and execution process are more mature, both within the government and in society as a whole**. These countries might be referred to as *"pre-emerging market countries."* In such cases, government goals are well articulated and closely linked to macroeconomic policies. A strong private sector is emerging; both domestic and foreign direct investment are increasing. Information on the macroeconomic situation is sufficiently transparent that donors can deduce clear signals and make independent decisions on aid allocations. The PRSP process would have matured to the point that it is well-integrated with budgetary decisions and reflects a general consensus as to how to reduce poverty; sufficient programmatic donor support would be available to execute a coherent mix of social policies. Such a country, while still low income, would present a case for an end to a sustained program relationship, with the Fund playing predominantly a surveillance function. The Fund's role as advisor would focus especially in looking out for emerging vulnerabilities as the country transits to market access to capital and normally be provided in the surveillance context and its financial support limited to discrete circumstances where needed to support policy measures in response to an external shock or external need related to a domestic imbalance.

C. Are the Available Fund Instruments Adequate?

30. **The broad objective of Fund support in low-income countries—through surveillance, technical assistance for capacity building, and programs—should be to help member governments put in place the conditions that will enable them to advance along this continuum of circumstances**. Are the Fund's instruments adequate to deal with the challenges facing low-income countries in these various stages of vulnerability and institutional development? This initial review suggests several conclusions.

31. **For the *early stabilizers and mature stabilizers,* the PRGF-supported programs are a good fit—although the nature of the programs will vary considerably across countries and in these two broad types of cases**. In the *early stabilizer*, the program is likely to be focused on reinforcing fragile macroeconomic stability, building institutions, generating a track record of policy implementation, and reinforcing a weak political consensus for reform. In the *mature stabilizer*, the PRGF-supported program is more likely to focus on the post-stabilization macroeconomic policies of managing increasing aid flows in a multiyear budgetary setting, ensuring debt sustainability, and laying the groundwork for an increasingly dominant private sector. Technical assistance will change its focus in parallel with the nature of the country's reform agenda.

32. **The challenges we face in post conflict and/or those countries with severely impaired institutions are less comfortably addressed within the PRGF-supported program framework**. As noted above, the EPCA can provide resources for immediate balance of payment needs, but may not provide a sufficiently long bridge to an environment where a PRGF-supportable program could be envisaged. And while purchases of up to 50 percent of quota are possible under EPCA,[12] this can lead to a quick increase in indebtedness to the Fund even before the member's repayment capacity has been ascertained. For countries unable to meet the criteria for a PRGF-supported program, alternatives to EPCA are:

- To move to a staff-monitored program to establish a track record for a PRGF. This does not entail Fund financing; and donors may not be willing to provide financing in this context because of concerns about the policy framework, in part because track record SMPs have generally been associated with sustained periods of past policy failure.

- To lower program standards for the PRGF, placing an emphasis on institutional development rather than macroeconomic reform, in the recognition that access to longer-term concessional resources would be desirable to encourage policy continuity and ensure the continuation of donor support. However, this approach, which could be characterized as "PRGF-light," would violate the requirement that PRGF arrangements have upper credit tranche conditionality, as well as uniformity of treatment among low-income country members.

Overall, it is clear that careful planning and provision of technical assistance will play a key role in ensuring that countries emerging from conflict and/or with severely impaired institutions move rapidly to being able to undertake a PRGF-supported program. More generally, the role for Fund financing is necessarily more limited, reflecting the fact that the safeguards to Fund resources are weak and the returns to the reforms that these countries need to undertake are unlikely to be realized in the typical timeframe of a Fund loan repayment period, and as such are more suitable to grant financing.

33. **The Fund does not presently have in place an instrument that is appropriately suited to facilitating the transition between the *mature stabilizer* and the *pre-emerging market* country**. There is no simple way to define the point at which countries should move from a sustained use-of-Fund resources relationship to more normal surveillance relationship with episodic programs. There are a range of possible adaptations to Fund instruments that could help define this transition.

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[12] In circumstances where a country has drawn an initial 25 percent of quota under EPCA but, after a period of about a year and despite the best efforts of the authorities, it is not yet ready to adopt a PRGF-supported program, the Fund may provide up to an additional 25 percent of quota.

- Progressively lower-access PRGFs might be one way to facilitate the transition to a pure surveillance relationship. This approach would be consistent with the expectation that the Fund's relative financial role diminishes as performance improves and institutional development advances and other donor financing increases, but it would not send that clear a signal of evolution.

- Precautionary PRGF arrangements could also be considered, but in the past these have been ruled out because (i) they require setting aside scarce PRGF Trust Fund resources; and (ii) there could be pressure on the authorities to draw on these concessional resources to take advantage of the subsidized interest rate.

- Another approach to bridge the gap would be a Fund-monitored program (FMP); however, FMPs were established in the context of arrears clearance and incorporated as part of the Rights Accumulation Program (RAP), and have not been widely used in other circumstances.

- An additional option would be to extend post-program monitoring to PRGF-eligible countries. Consideration could also be given to a precautionary stand-by arrangement, cancelled and replaced by a PRGF arrangement if a financing need arises.

- And finally, though this is not a comprehensive list of possible alternatives, the Fund could revisit the recent discussion on signaling to see how a monitoring instrument might be best constructed to provide the Fund and donors: (i) an initial assessment of the country's economic situation and the authorities' policy stance; and (ii) periodic monitoring of and reporting on progress made in implementing needed reforms and on vulnerabilities facing the country, with the frequency and intensity greater than in Article IV consultations.

D. Selectivity and Evolution in the Program Relationship

34. **Regardless of the modalities of the Fund's support of a member's program, what criteria should the Fund use to frame its choice as to whether to support a member's program at all?** Beyond a member's balance of payments need, there are two other broad considerations that can help frame this judgment.

- The member's capacity to implement the reforms necessary to address the economic problems that it is facing. This is an important consideration because it has a bearing on the member being able to repay the Fund.

- The member's commitment to the necessary reforms. While commitment to reform need not be uniform throughout the government, and political consensus may be fragile, ownership of reforms by key country authorities is essential if programs are to succeed, especially if governance is weak. Absent such commitment, the Fund should not enter into a program relationship.

The Fund needs to take great care in considering the political commitment and capacity in making judgments on providing financial assistance through a program relationship. Beyond these considerations, however, it is not possible to establish objective, easily measurable selectivity criteria for Fund-program support. Instead, decisions will necessarily be judgmental based on a country-specific analysis. The mere duration of a sustained relationship, number of programs, or number of unmet program conditions does not necessarily indicate a lack of commitment or capacity to engage in reforms; instead, they are a function of the initial conditions of the country when it first began to have Fund-supported programs, the difficulty of the reforms undertaken, and the nature and extent of shocks.

35. **Sustained use of Fund resources through successive arrangements should not be the norm for low-income members, even if the economic challenges they face require a sustained reform effort.** Instead, any proposal for follow-on PRGF arrangements should trigger a fresh look at the nature of the Fund's involvement with the member, its reform efforts under past programs, and the merits of continuing financial support. This will be particularly important in light of the tensions inherent in the "gatekeeper" role played by the Fund in mobilizing donor support. As the Independent Evaluation Office (IEO) noted in its study of the prolonged use of Fund resources,[13] there are pressures from donors and member countries for the Fund to provide continuous financial support so that development assistance from others will continue. Much of the pressure for sustained involvement under the PRGF has come from the need to provide a framework for debt relief, be it in the Paris Club or under the enhanced HIPC initiative. As HIPCs reach their completion points, the pressure for automatic repeat use should abate. In any case, the Fund is able to signal its views on a member's policies without sustained Fund financial involvement.

36. **How might the Fund approach the question of defining the point where countries, with a sustained record of strong macroeconomic policies and efforts to improve institutions, should move away from a sustained PRGF-supported program engagement**? There are a range of possible approaches.

- Use an income-based threshold, whereby a per capita income exceeding the current per capita GNI level for PRGF eligibility—US$875—could be used to automatically limit continued PRGF engagement. This would not provide an early exit from prolonged program involvement in most PRGF countries, as it will take the average PRGF country some 25 years to reach this threshold, implying very long Fund involvement.

- Define a threshold based on the number of successive Fund arrangements or the number of years of Fund program engagement. We are unlikely to find an empirical basis for setting such a duration-based threshold, and defining one arbitrarily could

[13] See *IEO Evaluation Report on the Prolonged Use of IMF Resources*, (EG/02/7/1 and EG/02/7/2).

lead to an excessively long engagement or premature termination of a program relationship.

- Use the completion point of the HIPC framework or one PRGF program past that point to signal when a member would be expected to move away from a sustained program relationship. This approach would have a similar set of problems as the former one.

- Reduce potential access to PRGF resources significantly with each successor program, independent of the needs and performance of the member, as a way to deter serial program engagement.

37. **Given the limitations of these different approaches, there is merit in exploring what set of factors or criteria would help inform a judgment by members, by the donors, and the Fund on the point at which a successor program is no longer an appropriate presumption**. Some of the indicators that could help inform such a judgment include:

- The degree of macroeconomic stability that has been achieved, the durability of that record, and the resilience of the economy to external shocks;

- The strength of the institutional capacity to formulate and implement macroeconomic policies;

- An assessment of fiscal and debt sustainability;

- The extent of continued reliance on official development assistance; and

- The strength of the private sector and domestic resource mobilization.

These are criteria that are not easily amenable to the identification of specific thresholds that could be applied across countries in diverse circumstances. A critical test will be whether the member itself no longer considers a program necessary and donors are willing to provide the scale of development assistance that member seeks without the context of a program that establishes conditions on key macroeconomic policies and a framework of periodic monitoring and assessments of those policies.

VI. THE ROLE OF FUND FINANCING

38. **The changing nature of the economic challenges facing low-income country members highlighted above has implications for the Fund's role in financing their reform programs**. There is an emerging consensus among the major providers of development assistance about several aspects of the development assistance challenge that should accompany efforts to encourage greater domestic resource mobilization:

- Substantially more concessional resources need to be provided in support of effective national policy initiatives to achieve the MDGs;
- An increase in the share of grant financing is important given the limited capacity of these countries to service more debt; and
- A reduction in the substantial administrative burden that now accompanies aid and an improvement in the predictability of aid flows to facilitate planning are important to improving the returns associated with development assistance.

Against this backdrop, this section puts forward several broad tenets for guiding considerations on the role for Fund financing in low-income countries.

39. **The role of Fund financing should be to provide temporary financial support so as to ease the burden of adjustment while macroeconomic imbalances are being addressed** (Box 4). The Fund does not have the capacity or mandate to contribute to the long-term flow of resources needed by its low-income country members to meet the MDGs. While the Fund has a critical role to play in support of poverty reduction and growth in low-income countries, its role is not as a provider of long-term development assistance, but rather to help ensure that the conditions are in place for that assistance to be mobilized and deployed productively and to complement the more effective mobilization and utilization of domestic resources.

Box 4. Forms of Financing for Low-Income Countries

It is useful to distinguish four main forms of external financing for developing countries. The first is *private market financing* that will ultimately be the main external financing vehicle supporting economic growth. The second is long-term *development finance* from bilateral donors and from multilateral development banks. Finance to meet the MDGs falls under this category. The third is *adjustment financing* to help countries stabilize and adjust their policies to cope with the normal conditions that face them, and to remove the main obstacles to growth. The Fund is an important source of such financing. The fourth form of financing is that for helping the country cope with *exogenous shocks*, and the Fund also has a role in supplying such assistance.

40. **The Fund needs to continue to have the capacity to fulfill its role in providing financing to low-income members on terms more concessional than those that apply to resources from the General Resources Account (GRA)**. While the concessionality of PRGF resources is limited, it nonetheless can still be an important source of financing for low-income members while they are making adjustment efforts without exacerbating their debt burdens. Resources available in the PRGF-HIPC trust are intended, in due course, to provide for a self-sustained PRGF, and thus cannot be used to effect a substantial permanent net resource transfer to low-income countries. A self-sustained PRGF starting in 2006 will be able to make annual commitments of only about SDR 650 million of commitments—about half the average current annual commitments. This raises the question of whether such a decline in annual commitments is consistent with the Fund's important, albeit limited, financial role in support of poverty reduction and growth in low-income countries.

41. **The Fund needs to have the appropriate set of instruments in which to meet a variety of financing needs faced by low-income members**. The typology of countries spelled out earlier can be useful in characterizing these needs.

- For *post-conflict countries,* relatively quick disbursing assistance from the Fund to support the initial transition and establishment of a basic institutional framework, but the principal financial support will need to come in the form of humanitarian assistance and aid.

- For *early stabilizers,* the Fund is likely to be one of the lead institutions giving financial support through PRGF arrangements.

- For *mature stabilizers*, the Fund's financial role in longer-term program support is likely to be increasingly limited as macroeconomic stability is more firmly established.

- For *pre-emerging market countries*, the Fund would not normally be involved in a program framework, except in circumstances where there was a discrete need associated with an adjustment program in response to the emergence of a major imbalance or in response to an external shock.

42. **In light of this range of needs, there are a number of issues about how the Fund can best provide financial support to its low-income members.** Further consideration is needed on:

- How to bridge the gap until countries can implement a PRGF-supported program, with particular attention to the appropriate level of access given countries' need, their capacity to repay the Fund, and the available resources to subsidize interest payments.

- The extent to which the credibility of the Fund's assessment of the member's macroeconomic policy framework depends on provision of new financing by the Fund in the context of a PRGF arrangement.

- The ways in which the Fund can support adjustment by countries in response to exogenous shocks. The accompanying background paper considers some alternatives but further consideration is needed.

More generally, careful consideration will need to be given as to what the expected commitment needs in low-income countries are likely to be over the next 10-15 years and how those needs can be best addressed with available Fund resources. *Thus, staff will prepare a paper putting forward options for financing programs in low-income countries and for structuring Fund concessional resources, which will be considered by the Board after the 2003 Annual Meetings.*

VII. Issues for Discussion and Next Steps

43. As noted at the outset, this paper is meant to be an initial reflection on how the role of the Fund in the low-income members might be reconsidered in light of the changing circumstances of these member countries and the changing modalities of engagement by the entire donor community. Informed by the Executive Board's discussion, the staff plan to undertake consultations with officials of low-income members, multilateral development banks, bilateral donors, and civil society organizations on the following issues:

- What should be the principles guiding the role of the Fund in its work with its low-income country members?
- What are the areas of concern about the scope and content of Fund-supported programs in low-income countries, especially with a view to promoting sustained growth and reducing poverty once macroeconomic stabilization has occurred?
- In what areas does the Fund need to coordinate its work more closely with other development partners to ensure the full range of assistance needed by low-income members is provided? In what areas are there gaps in coverage?
- How can the Fund best support private sector development in its programs and in conjunction with other development partners?
- Are the Fund's facilities adequate to provide financial support and advice to low-income members, given members' varying economic and institutional development?
- Regardless of the modalities of assistance, what criteria should the Fund use to decide if it should support the program of a low-income member at all?
- What role should the Fund play in cushioning the impact of shocks on low-income countries?
- How can the Fund best facilitate the transition from a sustained program relationship with a low-income country member to a relationship based primarily on surveillance with possible occasional financing?

44. Benefiting from the Board and external consultations, it is expected that the staff will return to the Board with a paper or series of papers with more concrete proposals in the following areas:

- An examination of macroeconomic programs and conditionality in low-income countries;
- A refinement of the instruments available to low-income countries to access Fund advice, technical assistance and financing, with particular attention to (i) countries

coming out of post-conflict situations, but not yet prepared to engage in a full program relationship, and (ii) countries in transition from a prolonged program relationship with the Fund to a surveillance relationship;

- A further exploration of how the Fund should be dealing with shocks in low-income members, and where it should move to a presumption of low-access PRGF arrangements for prolonged users, and a review of the Compensatory Financing Facility (CFF); and

- A reconsideration of how the Fund's resources can be best structured to mobilize adequate concessional resources to support low-income members, in the light of these revised strategies.