The IMF Research Program on Low-Income Countries 1/

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TABLE OF CON TENTS

1/ Prepared by the Fiscal Affairs Department, Policy Development and Review Department, and Research Department with input from the African, Asia and the Pacific, European 1, European 2, Middle East, and Western Hemisphere Departments.

I. Introduction

The poverty reduction strategy paper (PRSP) approach has become broadly accepted by low-income countries and the donor community as the framework for bringing together national policies and development assistance in support of these countries' efforts to achieve progress towards the Millennium Development Goals (MDGs). The Fund, along with the World Bank and other multilateral and bilateral development agencies, has committed to use the PRSP as the operational framework for its support to low-income countries under the Poverty Reduction and Growth Facility (PRGF) and to align the content and process of its operations to reflect this new framework. There is a recognized need, however, for further progress over the medium-term on key analytical issues relevant to the PRSP approach.

The March 2002 joint Bank/Fund review of the PRSP approach and IMF review of the PRGF identified significant knowledge gaps in key areas regarding the development, implementation, and monitoring of national poverty reduction strategies. The IMF is playing a leading role in taking the macroeconomic portion of this global analytical agenda forward, both by pursuing a comprehensive research program on topics within its particular area of competence and by facilitating the coordination of ongoing research in related areas by other development partners and academia.

In taking the macroeconomic analytical agenda forward, the IMF is therefore pursuing a two-stage process. In collaboration with the World Bank and the government of the United Kingdom, the IMF hosted a technical workshop in Washington, D.C. in April 2003 on macroeconomic analytical issues in taking the PRSP approach forward. The workshop brought together participants from low-income countries, bilateral and multilateral donors, academia, and civil society organizations involved in relevant macroeconomic analytical work to discuss draft guidance on selected macroeconomic-related issues. The workshop also provided a forum to identify a set of priority topics for research by the international community over the medium-term. Subsequently, the Fund and the Bank plan to jointly convene an international research conference on macroeconomic management in low-income countries in 2004. This forum will allow development partners, including the Fund staff, to share their preliminary results from the medium-term research efforts, drawing on the research agenda identified during the technical workshop.

This webpage provides a summary of the IMF's forward-looking low-income country research agenda, as well as a synopsis of recent analytical work carried out by IMF staff on low-income country issues. It also provides links to the web pages of other development partners involved in research on low-income countries, as well as to the conclusions of the April 2003 technical workshop on macroeconomic analytical issues in taking the PRSP approach forward. This webpage will be updated periodically.

II. The Forward-Looking IMF Analytical Work Program on Macroeconomic Issues

The Fund is carrying out an extensive research program which examines key macroeconomic issues confronting low-income countries in designing and implementing their national poverty reduction strategies. Drawing on the findings of the 2002 Bank/Fund Joint Review of the Poverty Reduction Strategy Paper (PRSP) approach and the IMF Review of the Poverty Reduction and Growth Facility (PRGF), research projects are being planned and conducted in the following five priority areas: (a) improving growth outcomes; (b) assessing the macroeconomic impact of larger aid flows; (c) addressing vulnerability and exogenous shocks; (d) assessing debt sustainability; and (e) accessing private capital markets. Some of these projects are ongoing, while others are presently at the planning stage. Research projects within each of these categories are highlighted below and the status of these and any subsequent research projects on low-income countries will be updated periodically.

A. Improving Growth Outcomes

Increasing and sustaining growth rates is essential for poverty reduction in low-income countries. The Fund's research program will contribute to this priority area by looking into the role of macroeconomic policies in generating growth, as well as the specific transmission channels between macroeconomic polices and growth outcomes.

"Sources of Growth in Sub-Saharan African Countries, 1970-2002"

Undertakes an analysis of the sources of growth in sub-Saharan African countries during 1970-2002 using a growth accounting framework. The paper will investigate stylized facts about factor accumulation versus productivity growth in the countries in the region. As the literature on the sources of growth in developing countries has focused primarily on Asia and Latin America, this study will attempt to fill the gap that exists regarding sub-Saharan African countries.

- African Department: Dhaneshwar Ghura (Dghura@imf.org)
- Expected Completion Date: September 2003

"Explaining the Growth Surge in the CIS-7"

Details the sources of the recent growth in each of the CIS-7 countries from both the supply and the demand side perspectives. The application of a traditional growth accounting framework points to a very sharp turnaround in total factor productivity. The study will examine whether this turnaround can be interpreted as an indication of a fundamental improvement in productivity in response to structural reforms, or whether the growth surge can be explained through specific identifiable factors, such as linkages to the booming oil exporting economies in the region.

- European 2 Department: David O. Robinson (drobinson2@imf.org) and Elena Loukoianova (eloukoianova@imf.org).
- Expected Completion Date: October 2003

"Achieving Sustainable Growth and Poverty Reduction in Nicaragua"

Uses the case of Nicaragua to answer the question of what policies lead to sustainable growth and poverty reduction. It will comprise several self-contained chapters which underpin the overall topic, including sources of growth, poverty reducing policies, fiscal sustainability, external and domestic debt sustainability, financial sector reform, etc.

- Western Hemisphere Department: Marco Piñón (mpinonfarah@imf.org)
- Expected Completion Date: December 2003

"Is there hope for a poor country? The case of Nicaragua"

Focuses on the structural barriers to growth in Nicaragua, including institutional weaknesses, and the role of external aid. The paper will address the question why is it that, despite the generous support from the donor community, Nicaragua remains one of the poorest countries in the Americas?

- Western Hemisphere Department: Oscar Melhado (omelhado@imf.org)
- Expected Completion Date: December 2003

"Fiscal Policy and Growth in Low-Income Countries: An Examination of Transmission Channels"

Scrutinizes the links between the fiscal stance and growth identified in earlier research undertaken at the Fund.[1] While fiscal consolidation has generally been demonstrated to be good for growth in the short and long run in low-income countries, the present study will examine the channels through which such growth occurs. Key questions will include the following: Is the impact of fiscal consolidation on growth due to its impact on inflation? Does fiscal consolidation have favorable effects on interest rates and the availability of credit

[1] Gupta, Sanjeev, and others, 2002, "Expenditure Composition, Fiscal Adjustment and Growth in Low-Income Countries," IMF Working Paper No. 02/77 (April).

to the private sector, thereby triggering higher private investment? Does fiscal consolidation lead to improved external sector performance and a more stable exchange rate, providing a better environment for attracting foreign direct investment or reducing capital flight?

- Fiscal Affairs Department: Arye Hillman (Ahillman@imf.org), Emanuele Baldacci (ebaldacci@imf.org;), and Naoko Kojo (nkojo@imf.org)

- Expected Completion Date: November 2003

"Impact of tax policy on growth in low-income countries"

Explores the following questions: Does a shift from trade to domestic taxes spur growth? Does a change in the composition of taxes from direct to indirect taxation have a positive or negative effect on growth? What is the relationship between the tax effort and growth? Do distortionary tax systems, as measured by the number of exemptions and the level of marginal tax rates, hamper growth? Does administrative simplicity of the tax system, proxied, for example, by the number of income tax rates, have a bearing on growth? These and related questions will be addressed by regressing the annual rate of real per capita GDP growth on a set of regressors, including variables measuring the composition of revenues and other control variables.

- Fiscal Affairs Department: Ben Clements (bclements@imf.org)

- Expected Completion Date: November 2003

"External Public Debt and Growth in Low-Income Countries"

Assesses the debt-growth nexus in low-income countries, including heavily indebted poor countries (HIPCs). Recent work by Fund staff suggests that excessive external debt may hamper growth, but provides little evidence on the transmission channels. For example, does public debt service divert budgetary resources from the public investment necessary to stimulate growth? Does government debt service reduce the amount of domestic saving available for private investment? Do high public debt service payments retard growth by reducing government outlays for growth-enhancing public outlays for health care and education? Is it debt service that matters in explaining the relationship between debt and growth, or the net present value (NPV) of debt? These and related issues will be explored through the use of a structural econometric model.

- Fiscal Affairs Department: Rina Bhattacharya (rbhattacharya@imf.org; and Erik Lueth (elueth@imf.org)

- Expected Completion date: August 2003

"What are the Channels through which External Debt Affects Growth?"

Explores empirically the extent to which the effects of external debt on growth operate through capital accumulation or total factor productivity (TFP) growth. Following up on earlier research[2], the project will examine whether debt has nonlinear impacts on capital accumulation or TFP growth. The project will also examine the main channels for the impact of debt on income, capital, or TFP growth. For example, does external debt affect these variables by influencing the stance of policies, levels of corruption, infrastructure, or the public/private investment mix? The paper will explore these types of questions using panel data for a large set of developing countries.

- Research Department: Catherine Pattillo (cpattillo@imf.org)
- Expected Completion Date: April 2004

"IMF Financial Programs and Economic Growth: What is the Link?"

Examines whether achieving the policy targets in Fund-supported programs leads to the growth and inflation outcomes that underpin those targets within the financial programming framework. The results could have important implications for program design (i.e., which policy targets matter and how?). The analysis will also illuminate some of the factors behind debt unsustainability and IMF lending (see also Section D below).

- Research Department: Rodney Ramcharan (rramcharan@imf.org), Ratna Sahay (rsahay@imf.org), and Reza Baqir (rbaqir@imf.org)
- Expected Completion Date: January 2004

B. Assessing the Macroeconomic Consequences of Aid

Countries with sound poverty reduction strategies and public expenditure management systems should benefit from higher aid flows under the PRSP approach. In most countries, these flows should be easily absorbed without any significant negative macroeconomic consequence. In some cases, a substantial and rapid increase in concessional flows can raise important macroeconomic considerations. The Fund's research program in this area will

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[2] Pattillo, Catherine A., Helene K. Poirson, and Luca Ricci, 2002, "External Debt and Growth," IMF Working Paper 02//69 (Washington: International Monetary Fund).

therefore focus on assessing how monetary and exchange rate policy should respond to increased aid inflows, as well as the implications of debt and grant aid flows on key macroeconomic variables.

"How monetary and exchange rate policy should respond (or not) to increased aid inflows."

Develops a framework that accounts for productivity-enhancing effects (i.e., formation of human capital), as well as adverse effects (i.e., Dutch Disease) of official development assistance. In doing so, the paper will also take into account the timing of disbursements and the composition of aid. The project will discuss whether sterilizing the monetary impact of aid inflows is appropriate and how this policy should take into account the degree of concessionality of aid flows and the possible crowding out of investment. The study also uses a novel measure of real exchange rates based on black market exchange rates. Preliminary results suggest that episodes of large foreign aid inflows are generally associated with a real exchange rate appreciation. Preliminary results suggest also that the appreciation takes place mainly in the parallel exchange market. The findings also show that sterilization significantly reduces the real exchange rate appreciation associated to foreign aid inflows.

- Research Department: Alessandro Prati (aprati@imf.org), Ratna Sahay (rsahay@imf.org), and Thierry Tressel (ttressel@imf.org)
- Expected Completion Date: October 2003

"Exchange Rate Flexibility and the Monetary Management of Aid Flows in Africa"

Focuses on a select number of African countries that through money-based stabilization programs in the 1990s succeeded in bringing inflation to relatively low levels while maintaining a market-determined exchange rate. The paper focuses on highly persistent shocks to aid flows, including PRSP-related increases in net flows. Such shocks have beneficent long-run effects but when the substitutability between domestic and foreign currencies is relatively high, they can produce dramatic macroeconomic management problems in the short run. The paper therefore addresses the question of what is the appropriate mix of money and exchange rate targeting and the role of temporary sterilization? In doing so, it develops an intertemporal optimizing model in which the budgetary contribution of aid may be partly spent and partly devoted to reducing the government's seigniorage requirement. Preliminary results indicate that when the credibility of policymakers' commitment to low inflation is firm, some degree of dirty floating, together with partial sterilization of increases in the monetary base, appears to be the most attractive approach in the short run.

- Research Department: Catherine Pattillo (cpattillo@imf.org)
- Expected Completion Date: June 2004

"Debt Relief, Additionality, and Aid Allocation in Low-Income Countries"

Provides an empirical analysis of whether provision of debt relief to low-income countries has crowded out other aid flows, and if debt relief has had a significant impact on the overall level of resource transfers received by debtors concerned from official donors as a group. The paper will use an aid allocation model and compare the experience of IDA-only countries receiving debt relief with those that have not.

- African Department: Robert Powell (rpowell@imf.org)
- Expected Completion Date: September 2003

"Grants Versus Loans"

The purpose of this research project is to analyze the main trade-offs that international developmental agencies face when they have to determine the grant component of an aid package. The project will also assess the extent to which the relative effectiveness of grants versus loans in promoting growth depends upon recipient countries' characteristics and policy environments.

- Research Department: Tito Cordella (tcordella@imf.org), Ratna Sahay (rsahay@imf.org), and Hulya Ulku (hulku@imf.org).
- Expected Completion Date: December 2003

Conditional Aid, Sovereign Debt, and Debt Relief

Addresses the question, "Is debt relief the best instrument to increase the consumption of the poor in HIPCs?" To answer this question, the paper develops a model of conditional aid based on an implicit contract between altruistic donors (concerned about the consumption of the poor) and recipient governments (representing the interests of the well-off). This contract is played out over an infinite horizon and is supported by punishment threats for deviation. The framework will also provide a new explanation of why aid flows can be procyclical, and why donors who are also debt-holders keep providing aid without granting debt relief.

- Research Department: Tito Cordella (tcordella@imf.org), Giovanni Dell'Ariccia (gdellariccia@imf.org), Ken Kletzer (UC, Santa Cruz).
- Expected Completion Date: October 2003

C. Addressing Vulnerability and Exogenous Shocks

Macroeconomic research in this area examines the role that commodity prices play in determining exchange rate fluctuations and designing inflation targets in commodity-dependent low-income countries.

"How Monetary and Exchange Rate Policies Should Take Into Account Commodity-Price and Terms of Trade Shocks"

Is currently underway and has thus far concentrated on determining which countries have "commodity currencies"—meaning that their real exchange rates are chiefly determined by movements in the real prices of their commodity exports.[3] For countries with commodity currencies, the majority of which are low-income countries, commodity prices can be a useful benchmark to determine when exchange rates have deviated excessively from their equilibrium value. In addition, policymakers in commodity-currency countries can also use spot or futures prices on world commodity markets as important pieces of information to guide the conduct of monetary policy. Subsequent stages of this research project will examine: (1) the efficacy of alternative nominal exchange rate anchors, especially the use of spot (world) commodity prices, in commodity-dependent countries; and (2) the role that commodity prices may play in the design of inflation-targeting arrangements in commodity-dependent countries with, or desirous to move toward, greater flexibility in their nominal exchange rates.

- Research Department: Paul Cashin (pcashin@imf.org)
- Expected Completion Date: October 2003

"Identifying Vulnerabilities in CIS Countries"

Takes stock of the peculiar features of the CIS economies and attempts to identify their vulnerabilities to specific shocks. The emphasis in the general literature on volatile short-term capital flows and banking sector fragility is less relevant in CIS countries because of the absence of links to international capital markets and the small size of their banking sectors. Instead, these countries are more prone to commodity price (especially oil) shocks, an economic downturn in Russia, or domestic shocks (e.g. political, weather-related, etc.),

[3] Cashin, Paul, Luis Céspedes and Ratna Sahay, 2002, "Keynes, Cocoa and Copper: In Search of Commodity Currencies," IMF Working Paper 02/223 (December). Cashin, Paul, Luis Céspedes and Ratna Sahay, 2003, "Commodity Currencies," *Finance and Development*, forthcoming. Chen, Yu-Chin, and Kenneth Rogoff, 2002, "Commodity Currencies and Empirical Exchange Rate Puzzles," IMF Working Paper 02/27 (February).

magnified by structural and institutional rigidities. The impact of the Russia crisis in 1998 will be explored and might provide useful evidence. The study may also construct hypothetical scenarios that lead to full-blown crises.

- Research Department and EU2: Ratna Sahay (rsahay@imf.org), Jose Fajgenbaum (jfajgenbaum@imf.org), and Francesco Luna (fluna@imf.org)

- Expected Completion Date: August 2003 (draft)

D. Assessing Debt Sustainability

Higher aid flows in support of poverty reduction can also have important implications regarding the debt sustainability of low-income countries and overly optimistic projections regarding growth and export performance can paint a distorted picture regarding such sustainability. The Fund's research program in this area will focus on developing a debt sustainability framework for low-income countries and assessing over optimism in the projections underpinning debt sustainability analyses to date.

"Debt Sustainability in Low-Income Countries"

Will discuss how the debt sustainability framework recently adopted by the IMF for middle- and upper-income countries can be adapted to low-income countries. The framework will cover issues of both external sector sustainability and fiscal sustainability, and will examine the conditions under which countries can achieve sustainability on both fronts. Creating an appropriate framework for low-income countries presents a number of analytical challenges, given their marked differences from middle-income economies: They are usually characterized by limited access to private capital markets, have highly concessional debt that is usually at an interest rate far below projected growth, and are heavily reliant on a few primary commodities for exports. Consequently, debt sustainability analysis for low-income countries should cover a longer projection period to capture the implications on debt sustainability of their future graduation from highly concessional assistance. The study will apply the new framework to a number of countries and conduct various stress tests to demonstrate the effects of different shocks on external and fiscal sustainability. These shocks include, for example, the impact of lower commodity prices, or lower economic growth. The paper will also discuss the broader implications for debt sustainability of official financing in a post-HIPC setting.

- Fiscal Affairs Department: Emanuele. Baldacci (ebaldacci@imf.org) and Kevin Fletcher (kfletcher@imf.org)

- Expected Completion Date: October 2003

E. Accessing Private Capital Markets

A country's vulnerability to shocks, as well as the perceived quality of its policies, are considered decisive determinants of the ability of its government to tap into private international credit markets. Fund research in this area will examine the ability of low-income countries to borrow from such credit markets. Research will also examine financial market deficiencies between urban and rural finance.

"Private Capital Market Access by Developing Countries: The Role of Policies and Vulnerability"

Examines the determinants of the ability of developing country governments to borrow from private international credit markets, using detailed data on sovereign bond issuances and public syndicated bank loans since the outset of the Latin American debt crisis in 1982. In addition to the factors traditionally identified in the literature, this project will investigate the importance of vulnerability—such as with regard to terms of trade shocks—in determining credit constraints. Moreover, the role of government policies will be examined in more detail than has been typically done in the past through the use of : (1) a comprehensive data set on the quality of government policies; and (2) a panel approach that allows for controlling for fixed country characteristics and time-varying global conditions.

- Research Department: Gaston Gelos (ggelos@imf.org) and Ratna Sahay (rsahay@imf.org)
- Expected Completion Date: August 2003

"Overcoming Financial Market Deficiencies in Sub-Saharan Africa—Building the Missing Link Between Urban and Rural Finance and Filling the Missing Middle in Low-Income Countries in Africa: Stepping Beyond Microfinance Institutions"

Looks at financial market deficiencies in sub-Saharan Africa and examines efforts worldwide to overcome institutional and regulatory hindrances to financial services in rural areas and to access to credit by small-and medium-size enterprises.

- African Department: Lelde Schmitz (Lschmitz@imf.org)
- Expected Completion Date: August 2003

III. Synopsis of Recent IMF Research on Low-Income Countries

A substantial amount of research has been carried out at the IMF on major issues confronting low-income countries. This section summarizes the key research areas and is organized around the following themes: (a) determinants of growth; (b) fiscal policy and poverty reduction; (c) external sector policies and poverty reduction; (d) monetary and exchange rate policies and financial market issues; (e) structural reforms; and (f) accessing capital markets. A comprehensive bibliography broken down by each of these six categories can be found at the end of this section.

A. Determinants of Growth and Poverty

The number of research papers on low-income countries written by Fund staff in this area varies widely across subjects and are mostly empirical. While there are several studies on growth — especially in sub-Saharan Africa — and poverty and income distribution, there are relatively few papers on savings and investment in low-income countries.

Growth

Growth-related papers are grouped into three areas: (a) cross-country studies which analyze the relationship of a number of factors to economic growth, using large data sets; (b) regional studies, which analyze growth determinants in a particular region; and (c) individual country studies, which often try to explain a particular growth performance puzzle, or test a specific model.

Among *cross-country studies*, several papers have examined the relationship between inflation and growth. Both Sarel (1995) and Khan and Senhadji (2000a) find threshold effects with inflation rates above 7–11 percent lowering growth. Ghosh and Phillips (1998) show that the negative relationship between inflation and growth holds at all but the lowest inflation rates, and that the short-run growth costs of disinflation are relevant only for the most severe disinflations, or where initial inflation is well within the single-digit range.

A number of other papers look at the relationship between growth and available resources or financing (foreign exchange from natural resource production, external debt, foreign direct investment (FDI), and financial development). For example, Leite and Weidman (1999) show that the growth effects of natural resources and corruption depend on an economy's state of development. Pattillo et al. (2002) find that external debt has nonlinear effects on growth. Borensztein et al. (1994), demonstrate that the contribution of FDI to economic growth is enhanced by the level of human capital in the host country. Khan and Senhadji (2000b) find that the size of the effect of financial development on growth varies with different indicators of financial development. Another interesting recent paper is Gupta et al. (2002b), which shows that fiscal consolidation is generally associated with higher growth, both in the short and long term, and that the composition of spending also matters for growth.

Among *regional studies,* there are quite a number of papers examining macroeconomic factors and growth for sub-Saharan Africa, using cross-country data from different sub periods. Calamitsis et al. (1999) show that growth in sub-Saharan Africa is positively influenced by economic polices that raise private investment, promote human capital development, lower budget deficits, safeguard external competitiveness, and stimulate export growth. Turning from macroeconomic policies to institutions and uncertainty, Hernandez-Cata (2000) concludes that growth in sub-Saharan Africa has been hampered by economic distortions and institutional deficiencies that have increased the risk of investing and lowered productivity. The region-wide findings on the importance of human capital are challenged by Sacerdoti et al.1998), who find that while private capital is particularly important for growth in West Africa, human capital appears not to be significant. Berthelemy and Soderling (2002) use a model stressing labor reallocation and economic diversification to simulate future growth scenarios for a group of African countries, and find that Africa is not likely to reach "Asian tiger" levels of growth. Iwata et al. (2002) assess the sources of growth in East Asia. On the impact of growth on poverty, a recent paper by Moser and Ichida (2001) confirms a strong and robust relationship between economic growth and poverty reduction in sub-Saharan Africa. For the Middle East and North Africa (MENA), Dhonte et al. (2000) discuss growth implications of the demographic transition, while Eken et al. (1997) argue that fiscal reform is key for fostering growth. Also, Abed (2003) explores why has the MENA region, given its natural resources, has lagged in raising growth and benefiting from globalization.

Among *single country studies*, some analyze a particular growth experience puzzle. For example, Zettelmeyer (1998) seeks to explain Uzbekistan's mild 'transformational recession' and recovery; Subramanian and Roy (2001) find that existing explanations of the Mauritian miracle may be incomplete, although institutions-based stories are somewhat promising; and Aziz and Duenwald (2002) show that financial development played a small role in China's post-1978 growth performance, as the nonstate sector and faster-growing provinces made only minimal use of the domestic financial system. Khan (2002) uses Pakistan and Malaysia as case studies to derive conclusions on whether growth helps the poor. Other papers test particular models: Morales (1998) develops an error-correction model of growth in El Salvador, with structural factors affecting technology, and macroeconomic factors explaining deviation from long-run trends; Ghura's (1997) endogenous growth model for Cameroon shows positive externalities generated by human and physical capital accumulation; Beddies (1999) finds similar results for Gambia; and Soderling (2002) uses a computable general equilibrium model to show Gabon's dependence on private foreign financing in the face of a decline in oil production, its main source of growth. In addition, some studies look at the growth impact of a particular factor. Cashin and Sahay (1996) examine growth across the states of India and find evidence of absolute convergence—initially poor states grew faster than their initially rich counterparts. Finally, in a forthcoming study, Akitoby and Cinyabuguma (2003) analyze the sources of economic growth in the Democratic Republic of the Congo during 1960-2000, and find a strong role of macroeconomic policies in explaining economic growth.

Savings and Investment

There are relatively few studies on *savings*. Two interesting papers develop theoretical models and test their predictions with developing country data. Ostry and Reinhart (1992) estimate values of the intertemporal elasticity of substitution and the intratemporal elasticity of substitution between traded and nontraded goods to analyze the relationship between temporary terms of trade shocks and private savings. Ogaki et al. (1995) find support in the data for a model implying very different responses of private saving to real interest shocks, depending on the level of development. Feltenstein and Iwata (2002) estimate the impact on private savings of various incentives, using Pakistan data. There have been a few comprehensive empirical studies on the determinants of private savings. Masson et al. (1995), using a sample that includes developing countries, find that changes in the government's fiscal position can have a significant impact on national savings. Other important savings determinants are demographic variables, and higher foreign savings, which tend to depress private savings. For sub-Saharan Africa, Hadjimichael and Ghura (1995) show that strong macroeconomic policies improve savings.

On *investment*, there are several papers on Africa, one type using macroeconomic data and another using firm-level micro data. An example of the first is Hadjimichael and Ghura (1995), which finds that policies aimed at low inflation augment private investment in Africa by reducing macroeconomic uncertainty and the debt burden and promoting financial intermediation. Papers using micro data include Pattillo (1998), which uses panel data on Ghanaian manufacturing firms to show that uncertainty has a negative effect on investment levels that is greater for firms with more irreversible investment. Bigsten et al. (1999) use panel data from four African countries to explore the low sensitivity of investment to profits; while Bigsten et al. (2000) show that lumpy investment patterns are important for explaining aggregate manufacturing investment in these countries. Ghura and Goodwin (2000), using pooled data from Asia, Africa, and Latin America, find a role for increased government investment, financial deepening, and enhanced educational attainment in stimulating private investment.

On *foreign direct investment,* Basu and Srinivasan (2002) use a case study approach to demonstrate that sustained political and macroeconomic stability, and structural reforms have been key for certain African countries that have attracted substantial volumes of FDI.

Productivity

An important paper in this area is Coe and Hoffmaister (1994), which shows that a developing country can increase its productivity by trading with an industrial country that has a large "stock of knowledge" from its R&D activities. Other cross-country findings are that increased import competition in medium-growth (but not low-or high-growth) manufacturing sectors enhances overall productivity growth (Choudri and Hakura, 2000); and that macroeconomic policies influence cross-country differences in TFP levels (Senhadji, 1999). Analyzing firm-level data from three African countries, Mengistae and Pattillo (2002) find that exporters are more productive than producers of nontradables and that particularly high productivity premiums are received by direct exporters and exporters to outside Africa—a finding that could be consistent with learning-by-exporting effects. In an interesting country-level study, Jonsson and Subramanian (2000) demonstrate a significant positive relationship between trade and TFP growth in South Africa. Finally, Senhadji (2002) focuses on the growth accounting framework, and provides a review of recent IMF research on the subject.

Poverty, Income Distribution, and Social Safety Nets

The IMF's Fiscal Affairs Department has done substantial work on poverty-reducing expenditure, which were noted in Section B. This section highlights a few papers on macroeconomic determinants of poverty and income inequality; country-level studies on poverty and microeconomic determinants of inequality; and theory papers modeling macroeconomic and structural factors and poverty, with several highlighting the role of human capital.

Among *cross-country studies,* Cashin et al. (2001) survey the literature on the links between macroeconomic policies and poverty reduction, and explore the association of measures of well-being with macroeconomic factors; Bulir (1988) shows that inflation worsens income inequality; and Chu et al. (2000) find that governments have not been able to use tax and transfer policies to reduce income inequality and that social spending is not well targeted, though its incidence tends to be progressive. Gupta et al. (2002c) provide evidence that corruption increases inequality and poverty with the findings being robust to several instruments for corruption. A recent paper by Ghura et al. (2002) identifies four "super pro-poor" policies, that is policies that directly influence poverty after accounting for the effect of growth: inflation, government size, education, and financial development. *Policy issues* relating to financial development and poverty alleviation (Holden and Prokopenko, 2001,), rural poverty (Khan, 2000), and the role of government in influencing inequality (Tanzi, 1998) have also been explored. Eken (2003) provide a regional perspective on what is needed to raise living standards in MENA countries.

An interesting *country-level study* is McDonald et al. (1999), which shows that regional and urban-rural disparities, as well as education differences explain Uganda's increasing inequality. Aziz (2002) focuses on state-level poverty trends in India, an important case of success in reducing poverty, and finds that the better success of some states in reducing poverty in the 1990s was, in part, due to higher growth and lower inflation. Thomas and Canagarajah (2002) decompose a decline in Nigeria's poverty rate into growth and income distribution factors. Clements (1997b) analyzes the impact of Brazil's macroeconomic stabilization program of the mid-1990s, the Real Plan, on poverty and income distribution. Also of interest is a study by Jung and Thorbecke (2001), which appraises the impact of public expenditure on human capital on distributional outcomes in a multi-sector CGE model for Tanzania and Zambia.

There are a few *theoretical contributions* in this area: Chand and Shome (1995) set up a general version of a financial programming model to explore the impact of policies on a poverty index; and Chander (2001) presents a framework of characterizing the optimal pattern of subsidies for poverty alleviation under budgetary constraints. Sectoral and structural issues are explored in Masson (2001), which shows how an urban poverty trap can develop in a model of rural-urban migration and costly skill acquisition. Finally two conferences at the IMF dealt with the impact of macroeconomic policies on income distribution and poverty, the proceedings of which were published in Tanzi and Chu (1998) and Tanzi et al. (1999).

Another set of papers deals with the impact of macroeconomic crises on poverty and countervailing social safety net measures (see Chu and Gupta (1996, 1998), Gupta et al. (1998a)), as does a paper produced jointly by the staffs of the World Bank, the African Development Bank, the Inter-American Development Bank, and the IMF (2001). Baldacci et al. (2002) explore the impact of financial crisis on the incidence of poverty and income distribution, and discuss the policy options. They find that the provision of targeted safety nets and the protection of specific social programs from fiscal retrenchment remain the main short-term pro-poor policy responses to financial crisis.

HIV/AIDS

The IMF's African Department have prepared a number of research papers on the macroeconomic impact of HIV/AIDS, and many IMF staff reports highlight the role of HIV/AIDS in their economic assessment. Together with contributors from other departments, institutions, and international organizations, the African Department is preparing a comprehensive study on macroeconomic aspects of the HIV/AIDS epidemic, which is preliminarily scheduled for publication in May 2004.

Analytical work so far includes papers on the macroeconomic impact of HIV/AIDS in Botswana (MacFarland and Sgherri, 2001), the demand for HIV/AIDS-related health services (Haacker, 2001), the broad macroeconomic consequences of HIV/AIDS (Haacker, 2002a), the role of dual labor markets and returns to capital in modeling the impact of HIV/AIDS on output and income (Haacker, 2002b), and the welfare implications of HIV/AIDS (Haacker and Crafts, 2003). Also, the October 2000 World Economic Outlook has covered the macroeconomic impact of HIV/AIDS in some detail. Overall, this research highlights the very adverse impact of HIV/AIDS on all aspects of the economy, including economic growth, the fiscal balance, the sustainability of external debt, and the income distribution.

B. Fiscal Policy and Poverty-Reduction

Work in this area at the Fund has focused on poverty-reducing expenditures and the link between fiscal adjustment and growth. FAD has also a substantial research program in place.

Poverty-Reducing Expenditures

Recent econometric work confirms that increased public spending on poverty-reducing activities, such as education and health care, can lead to better performance on social indicators, similar to those used to monitor progress on the Millennium Development Goals

(MDGs) (Gupta and Verhoeven, 2001, Gupta and others 2002h,i, and Baldacci et al., 2002b). These estimates are being used to estimate the resources needed to help countries meet the MDGs. This exercise, however, is subject to a number of caveats, as it assumes that higher foreign financing has no adverse effect on domestic revenues, and that this additional spending will be at least as efficient and well-targeted to the poor as in the past. Another set of papers explores the effects of corruption on education, health, and military expenditures, the impact of higher military outlays on social spending (including in conflict-afflicted countries), and the impact of debt relief on public health outlays: Abed and Gupta (2002), Chu and others (1995), Gupta et al. (2001a,b,c; 2002a,e,f,). A recently completed working paper (de Mello and Tiongson, 2003) examines empirically the question of whether more unequal societies spend more on income redistribution than their more egalitarian counterparts, finding that more unequal societies spend less on redistribution. Dabla-Norris and Matovu (2002) examine education spending and its impact in Uganda. The role of poverty and social impact analysis (PSIA) in PRGF-supported programs is assessed in Inchauste (2002) and a suggested framework for Poverty Social Impact Analysis is provided in Hossein (2003). Lopes (2002) analyzes trends in regional social indicators, their correlation with three major scaled measures of government spending, and discusses underlying policy implications. Finally, a recent study by Davoodi, Tiongson and Sachjapinan (2003) explores the potential role of incidence analysis in the context of Poverty Reduction and Strategy Papers (PRSPs) and Joint Staff Assessment (JSAs) pointing out the usefulness of benefit incidence analysis.

Fiscal Adjustment and Growth

A recent paper shows that fiscal adjustment has a positive effect on growth in low-income countries, even in the short run (Gupta et al., 2002b). The composition of public expenditure also matters: countries where spending is concentrated on wages tend to have lower growth, while those that allocate a higher share to capital expenditures enjoy faster output expansion. Tanner (2002) looks at the relative importance of fiscal and monetary policy in adjustment.

C. External Sector Policies and Poverty Reduction

Commodity Prices, the Terms of Trade, and the Real Exchange Rate

About 25 percent of world merchandise trade consists of primary commodities, and many low-income countries continue to rely on a few commodities for the bulk of their export earnings. Research on commodity-related issues has concentrated on studying the implications of commodity-price movements for the external earnings of commodity-dependent countries. The focus has been on understanding the attributes of commodity-price cycles, analyzing the small long-run downward trend in real commodity prices, and the large variability of commodity prices. Importantly, shocks to commodity prices have been found to typically be long-lasting. The macroeconomic determinants of oil and non-oil commodity prices have also been examined, as has the effect of climatic variability on world commodity prices and economic activity.

Closely related to the price of primary commodities is the terms of trade, which is a key determinant of the macroeconomic performance of low-income countries. Research has been chiefly aimed at understanding the channels through which exogenous terms of trade shocks affect the external imbalances and macroeconomic performance of low-income countries. Other studies have focused on the persistence and volatility of terms of trade shocks, and their correlation with innovations in national consumption, investment, and output.

Fund research has also paid particular attention to the effect of real exchange rate movements, often driven by capital flows, on the growth prospects of low-income countries. The determinants of equilibrium real exchange rates in low-income countries have also been studied, emphasizing the influence of commodity-price movements, terms of trade fluctuations and productivity differentials as drivers of developing-country real exchange rates. Another prominent channel of IMF research has assessed the applicability of purchasing power parity-based models of the exchange rate for gauging the competitiveness of exchange rates in low-income countries.

Current Account

A large proportion of research on current accounts in low-income countries has focused on two related issues: the determination as to whether a given current account imbalance is optimal or "excessive", and whether the current account is sustainable from a long-run perspective. A closely-related strand of Fund research has examined the causes of current account reversals, and the relationship between recent external crises and large swings in current account imbalances. Another research approach has focused on analyzing the determinants of current account balances, and the response of the trade balance and the current account to different types of exogenous shocks. Several studies of the determinants and dynamics of net foreign assets have also been conducted, along with the construction of an important historical database on their magnitude.

External Trade

Several studies have examined the role of external trade in promoting national and regional economic growth and poverty-reduction in low-income countries. Research has focused on the implications for optimum currency arrangements of cross-country trade flows, and the effects of trade liberalization on fiscal balances and inflation expectations. In other research, international trade linkages have been found to exert a strong role in the propagation of currency crises across countries, particularly for countries which entered crises with large current account imbalances. Gravity models have also been used to model north-south bilateral trade, finding that while the level of north-south trade carried out by the low-income countries of Sub-Saharan Africa is not unusual, the trend decline in such trade in recent decades is unusual when compared with the trends in other low-income countries. Finally, the fiscal, employment, and inflation implications for low-income countries of greater trade liberalization have been a prominent topic for study by IMF researchers.

D. Monetary and Exchange Rate Policy, and Financial Market Issues

A substantial amount of research has been carried out at the IMF on monetary and exchange rate policies in low-income countries. Research in these core areas has played a substantial role in supporting IMF advice to developing countries in the past, and could play an even more important role in the future with improvements in data compilation and availability.

In the monetary policy area, research at the IMF focused on issues related to the choice of optimal monetary regimes, and to the estimation of money demand functions. Honohan and O'Connel (1997) study how alternative monetary policy arrangements have influenced the performance of monetary policy in presence of fiscal imbalances in sub-Saharan Africa. Masson and Pattillo (2001a) discuss the issue of whether a monetary union in West Africa is desirable and of how it can be achieved, while Masson and Pattillo (2001b) assess whether it could affect fiscal discipline in the region. Agenor et al. (1992) examine the issue of the relative demand for domestic and foreign currencies in developing countries. Jenkins (1999) studies money demand and stabilization in Zimbabwe; Egoumé-Bossogo (2000) analyzes the behavior of money demand in Guyana in the period of its transformation from a centralized to a market economy; and Piñón-Farah (1998) estimates an error-correction model for narrow money demand in Mozambique. Nachega (2001a) uses co-integration analysis to investigate the empirical relationship among money, prices, income, and a vector of interest rates in Cameroon during the period 1964-94, and in another study (2001b) analyzes the impact of financial liberalization on broad money demand and inflation in Uganda during the period 1982-98. Barajas and Steiner (2002) look at credit stagnation in Latin American countries.

With respect to exchange rate policies, particular attention has been paid to how developing countries should choose their exchange rate policies, weighing international competitiveness and price stability considerations. Aghevli (1991) specify the factors that should be considered in deciding between a fixed or flexible exchange rate arrangements; and Eichengreen (1998) discuss policy options for countries that intend to move toward greater exchange rate flexibility. Nashashibi and Bazzoni (1993) analyze the link between alternative exchange rate strategies and fiscal performance in Sub-Saharan Africa. Khan and Ostry (1991) study the response of the equilibrium exchange rate to real disturbances in developing countries, and find results that are relevant for the design of real exchange rate targets in response to various shocks. Hansen (2000) focuses on the welfare effects of Uzbekistan's foreign exchange regime and estimates the costs associated with the existence of quasi-fiscal multiple exchange rate regimes. Jbili and Kramarenko (2003) explore the advantages of moving from fixed to flexible exchange rate regimes. A recent study by Keller and Richardson (2003) examine the increasingly important role played by monetary policy in the choice of exchange rate regimes in CIS countries.

Regarding financial market issues, the focus has been on the links between financial development and economic growth. De Gregorio and Guidotti (1992) find that measures of financial developments have a significant positive impact on long-run growth; and that the impact of financial intermediation on growth is mainly the result of its impact on the productivity rather than the volume of investment. Marston (1995) focuses on the financial sector reform in Jamaica during 1985-1992, and derives lessons for the Caribbean region. Mlachila and Chirwa (2002) look at financial reforms and interest rates in the commercial banking system in Malawi, while Di Calogero et al. (1992) look at some critical issues in the compilation of banking statistics in the FSU republics. Ball and Felstein (2001) develop a dynamic general equilibrium model to evaluate the causes of bank insolvencies in developing countries and apply the model to stylized data from Bangladesh. Their main finding is that the combination of a monetary policy that compensates banks for deposit withdrawals and restrictive fiscal policy may offer the best way of responding to a bank crisis. Creane et al. (2003) discuss reform of financial sectors in the MENA region.

E. Structural Reforms and Poverty Reduction

Structural Reforms

Two areas where there has been some work are *gradualism versus big-bang reforms*, and *civil service reform*. In the first area, in Lian and Wei's (1998) theoretical model, shock therapy that replaces old institutions all at once is shown to be not optimal. Separately, Ramcharan (2002) analyzes how IMF involvement affects the reform process, noting that IMF's role need not always be welfare enhancing. While most papers in this literature are theoretical, Feltenstein and Nsouli (2001) argue that the issue is too complex to draw simple conclusions. They develop a model parameterized with Chinese data to look at privatization, devaluation and tariff reform, and conclude that results depend on the objectives being sought, the time frame, and the sustainability of the macroeconomic situation. Badiane et al. (2002) argue that prospects for poverty reduction in the countries of West and Central Africa would be improved with the reform of the cotton sector in order to enhance competition and allow a larger share of the world price to be passed through to farmers. Adam (2003) discusses main structural challenges of the MENA region. Papers on c*ivil service reform* have stressed that both wage and non-wage policies are important for improving performance in the civil service. Haque and Sahay (1996) model the link between government wage policy and administrative efficiency, and show that lower civil service salaries are associated with higher levels of tax evasion. Haque and Aziz (1998) argue "second-generation" civil service reform in Africa should focus on the development of human capital in the public sector, repatriation of the "brain-drain", and reducing reliance on foreign technical assistance. Lienert and Modi's (1997) assessment of civil service reform in Africa finds progress in reducing excessive staffing levels and the wage bill, but little progress in decompressing salary differentials. They stress the need for qualitative reforms that reward performance and improve civil service management. The proceedings of an IMF and World Bank seminar on civil service reform look into the determinants of successful civil service reform (see IMF and World Bank, 2001).

Finally, a number of papers look at structural reform policies in particular countries: agricultural policies in Turkmenistan, general structural reform issues in Arab countries, structural reform agenda in Albania. Several country-specific Occasional Papers also devote substantial attention to structural reforms.

Privatization

Some topics covered in this area focus on the macroeconomic and fiscal effects of privatization; social effects; and lessons from the first decade of privatization in transition economies. Most of the studies used samples that include both low- and middle-income countries. For example, Barnett (2000) finds that privatization proceeds transferred to the budget tend to be saved, and that total privatization is associated with higher real GDP growth and lower unemployment. Gupta et al. (2001d) find that public sales and auctions can have more negative effects on workers but maximize the government's revenue gains. They review the experience of several countries trying to mitigate the social impact of privatization. Havrylyshyn and McGettigan (1999) review lessons for privatization in transition countries. Issues include: reasonable expected-actions of the speed with which this vast task could be accomplished; how to maximize efficiency gains; whether some methods of privatization address agency problems better than others; the relative importance of privatization and encouraging new start-ups; and the development of a competitive environment.

Corruption

Tanzi (1998) surveys and discusses the causes, consequences, and scope of corruption, and possible corrective actions. He emphasizes that the fight against corruption cannot be independent from reform of the state.

On the *scope of corruption* in a particular set of countries, Weder (2001) finds that, as a group, the transition economies (including transition economies in Africa and Asia) are no longer distinguishable from other economies on governance indicators, but there are large differences within the group of transition countries. On *determinants of corruption*, Van Rijckeghem and Weder (2001) present theoretical and empirical evidence pointing to low civil service wages as a cause of corruption; while de Mello and Barenstein (2001) show that improved governance (including lower corruption) is associated with fiscal decentralization.

Consequences of corruption are well-documented: Mauro (1996) finds that corruption lowers investment and economic growth and alters the composition of government expenditure by reducing the share of spending on education; Gupta et al. (2001c) show that corruption is associated with higher military spending as a share of both GDP and total government spending; Gupta (2001a) shows that corruption has an impact on the provision of social services and therefore on social indictors; Gupta (2002c) demonstrates that corruption increases income inequality and poverty; Tanzi and Davoodi (1998, 2001) present evidence that higher corruption is associated with higher public investment, lower government revenues, lower expenditures on operations and maintenance and lower quality of public infrastructure; Abed and Davoodi (2000) shed light on corruption in transition economies; and Ghura (1998) shows that corruption lowers tax revenue to GDP ratios in sub-Saharan Africa.

Finally, on the difficult question of *controlling corruption,* Chand and Moene (1997) use a case study and model to argue that providing bonuses to tax officers is useful, but not enough. Corruption at higher levels of management must be contained to allow an incentive system to become more effective and thereby to initiate a virtuous circle. Some of the above articles are included in Abed and Gupta (2002), which provides further useful references on the roots of, and remedies for corruption. Dabla-Norris and Feltenstein (2003) use the Pakistan case to analyze entry into the underground economy via a general equilibrium model.

Labor Markets

There are relatively few papers in this area, most of them are country-specific. Some examine unemployment and consider macroeconomic, structural and institutional determinants. For example, Chadha (1994) finds that South African unemployment is largely associated with supply rather than cyclical factors. Alleyne and Subramanian (2001) argue that South Africa's labor market institutions are not functioning well, as unemployment levels are high even though trade patterns show that South Africa is labor abundant. Brooks (2002) shows that employment growth and unemployment declines in the Philippines were positively associated with growth, and negatively associated with the real minimum wage. On labor markets in a macroeconomic context, Bodart and Le Dem (1995) present a quantitative macroeconomic model accounting for key features of the labor market in Côte d'Ivoire: the informal sector plays an important role in the response of nominal wages and inflation to shocks and policies. Gardner (2003) argues that with its large, growing labor force, MENA needs to foster growth to create jobs.

F. Accessing International Capital Markets

Almost by definition, the group of low-income countries comprises those countries that have not yet been able to attract much private capital. Partly for this reason, issues related to capital flows, liberalization, and sequencing in these countries have not been the focus of extensive research at the Fund. There are, however a number of cross-country studies on these topics that include some low-income countries. Others have focused more specifically on foreign direct investment in selected low-income countries. There seems to be ample scope for further work on the determinants of capital market access of poor countries.

Determinants and Consequences of Capital Controls

A number of papers have examined the determinants and effects of capital controls in studies including low-income countries. Grilli and Milesi-Ferretti (1995), for example, find that capital controls are likely to be associated with higher inflation, a higher share of seigniorage in total taxes, and lower real interest rates. They also find that capital controls are more likely to be imposed in countries with government-controlled central banks and in countries with less developed tax systems (see also Johnston and Tamirisa, 1998). Tamirisa (1998) reports a strong negative association between capital controls and trade volume.

Given their size, India and Indonesia have been the subject of various case studies on capital controls and capital account liberalization. Callen and Cashin (2002) find India's external borrowing not to be consistent with the predictions of the standard intertemporal model of the current account and attribute this to the presence of capital controls. Habermeier (2000) reviews India's experience with the liberalization of capital flows, suggesting that it may have contributed to faster economic growth during the 1990's. Kohli (2001) also discusses capital inflows to India extensively. The 1999 World Economic Outlook reviews reasons why some developing countries were not affected by contagion, and discusses India's capital controls as possible reason. In studies that include Indonesia, Montiel and Reinhart (1999) and Carlson and Hernández (2002) argue that capital controls can be effective in influencing the mix of capital inflows received. Johnston, Darbar and Echeverria (1997) review in detail Indonesia's experience with capital account liberalization.

Attracting Capital Flows

Some cross-country studies of the determinants of capital flows included low-income countries in their samples. Ghosh and Ostry (1993) find economic fundamentals to be the most important determinants of capital flows to developing countries. Bhattacharya, Montiel, and Sharma (1997) discuss private capital flows to Sub-Saharan Africa and suggest that a number of structural reforms are necessary to attract higher flows. Basu and Srinivasan (2002) review the experience of seven Sub-Saharan African countries that have succeeded in attracting foreign direct investment. They suggest that political and macroeconomic stability as well as structural reforms were the key elements in that success. Garibaldi, Mora, Sahay, and Zettelmeyer (2002) study the determinants of capital flows to 25 transition economies, finding that economic fundamentals help to explain the pattern of foreign direct investment, but not portfolio investment. Zebregs (1998) finds that the standard neoclassical model cannot explain the distribution of FDI flows. Khan and Reinhart (1995) discuss the experience of the APEC region with capital flows, including Indonesia. Collier, Hoeffler, and Pattillo (2001, 2002) analyze capital flight from developing countries as a portfolio choice. They find that 40 percent of Africa's private wealth is held abroad and attribute this fact to exchange rate overvaluation, adverse investor risk ratings, and high indebtedness. Lastly, the International Capital Markets Report and the World Economic Outlook have regularly covered developments in capital flows to the major low-income countries.

A few studies have focused on the link between corruption and capital flows. Wei (2000, 2001) points out that more corrupt countries tend to receive less FDI, controlling for other factors. Similarly, Wei and Wu (forthcoming) examine the relationship between governance and the composition of capital flows, finding that poor public governance is associated with a higher loan-to-FDI ratio. This, in turn, suggests a link through which countries with low governance scores may be more vulnerable to crises.

G. Other

Conditionality, Program Design, and Evaluation

A substantial amount of research has been produced at the Fund on the critical issues of IMF conditionality, program design, and evaluation. The potential value added of new original research in these areas remains, however, very high, as IMF researchers have a true comparative advantage vis-à-vis the academic community in these areas. A few papers have addressed the question of how to optimally design programs explicitly recognizing time inconsistency or imperfect information problems. Khan and Sharma (2001) use finance and agency theory to establish that conditionality attached to IMF-supported programs is justified, and that ownership of programs by the borrowing country is crucial for their success. Boughton and Mourmuras (2002) review the theoretical basis for the importance of ownership and suggest a strategy for strengthening it. Dhonte (1997) argues that Fund member countries that adopt market-friendly policies often encounter a credibility problem that can be lessened by committing to an IMF-supported program and endorsing its conditionality. Mayer and Mourmouras (2002) analyze the determinants and welfare impacts of conditional and unconditional assistance, and show that while conditionality may raise international financial institution welfare, it may not always raise recipient country welfare. Cordella and Dell'Ariccia (2002) study the limits of conditionality in poverty reduction programs and show that while conditionality enhances poverty reduction, it also entails an inefficient allocation of resources so that aid policies should be carefully tailored to the recipients' characteristics. In a separate paper, Cordella and Dell'Ariccia (2003) study the relative effectiveness of conditional budget support and project aid in fostering development. Ramcharan (2002) analyzes the role of IMF conditionality in facilitating domestic reform, noting that IMF involvement does not always lead to improvements in welfare. In a separate paper, Ramcharan (2003) discusses how the link between conditionality and IMF lending can become severed when the stock of country debt becomes sufficiently large.

Regarding the effects of IMF lending to developing countries, research at the IMF has focused on the links between macroeconomic stability, poverty reduction, and economic growth. Dicks-Mireaux et al. (2000) estimate the independent effects on economic development of ESAF-supported programs and find statistically significant beneficial effects on output growth and debt/service ratios but no effects on inflation. Hicks and Brekk (1991) focus on Malawi and study the impact of structural adjustment on the poor. They find that the real incomes of the poor have been most clearly affected by the pricing policies of the agricultural parastatal and the overall anti-inflationary measures incorporated in the program. Looking at the Sub-Saharan African region, Fisher et al. (1998) argue that to meet the challenges of globalization and sustain the recent growth momentum, the countries in the region will need to combine policies aimed at macroeconomic stability with enduring structural reforms to encourage private investment. The performance of Fund-supported programs under the ESAF is evaluated in Bredenkamp and Schadler (1998) and Abed et al. (1998). More recently, the design of PRGF-supported programs was assessed in Gupta et al. (2002g), while social issues in IMF-supported programs are discussed more generally in

Gupta et al. (2000a). Khan and Haque (1998) look at the empirical evidence to determine the effects of Fund-supported programs.

External Debt and Aid

The analysis of problems related to developing countries' debt has historically been at the center of the IMF agenda. Substantial efforts have recently been undertaken to study the HIPC Initiative. Claessens et al. (1997) analyze the HIPCs' external debt crisis and compare it with the debt crisis that middle income countries faced in the 1980s. Brooks et al. (1998) look in greater detail at the external debt history of ten low-income developing countries, while Ajayi (2000) analyzes the external debt of the severely indebted sub-Saharan African countries and estimates the magnitude of capital flight from such economies. Beaugrand et al. (2002) focus on Central and Western African countries and review the principles and practical considerations involved in the choice between foreign and domestic financing of fiscal deficit. Boote and Thugge (1997) describe the debt burden of low-income countries and the traditional mechanisms that have been implemented by the international community to alleviate it. Pattillo et al. (2002) assess the non-linear impact of external debt on growth using a large panel data set of 93 developing countries. Daseking and Powell (1999) estimate the costs of debt relief initiatives since 1988, and compare it with the estimated cost of debt relief under the HIPC initiative. Ross and Abrego (2001) argue that the HIPC initiative—by substantially reducing HIPCs' debt stocks and debt service payments—provides a solid basis for debt sustainability, while for poverty reduction broader international support is needed. Cordella et al. (2003) address the question of whether debt relief is necessarily the best instrument for achieving an increase in social welfare spending in HIPCs when the dynamics (and enforcement) of conditional aid relationships are explicitly taken into account. Heller and Gupta (2002) address some of the challenges associated with the possible expansion of development assistance. A recent study by Gupta et al. (2003) looks at the impact of aid flows on government spending and domestic revenue mobilization. Finally, Gupta, Clements, and Tiongson (2003) examine the cyclical properties of food aid with respect to food availability in recipient countries.

Fiscal Decentralization

Research on decentralization has focused on the relationship between decentralization and its impact on expenditure and revenues, the risks following decentralization, and country studies of decentralization.

With regard to the relationship between fiscal decentralization and government expenditure, de Mello (1999) finds that it is associated with larger subnational government outlays. Similarly, Baqir (2001) finds that government expenditure increases as the number of legislators increases. Regarding the relationship between fiscal decentralization and economic growth, Davoodi and Zou (1998) find a negative relationship in developing countries, but not in developed countries. On the other hand, de Mello (2000) finds that fiscal decentralization can boost social capital. Some studies have also focused on tax externalities and how they can distort the tax system. Keen (1998) and Keen and Kotsogiannis (2002) find that the strength of vertical and horizontal tax externalities depends on the interest responsiveness of the supply of savings and demand for capital, the extent to which immobile factors are taxed by the states, and the strength of preferences between federal and state expenditures.

Recent research underscores the risks of decentralization and the importance of institutional and administrative capacity to manage these risks. De Mello (1999) suggests that coordination failures are likely to result in a deficit bias under decentralized policy making, particularly in the case of developing countries. De Mello and Barenstein (2001) find that the higher the share of transferred revenue, the stronger is governance. Drummond and Mansoor (2002) find that good governance and appropriate incentives, rules, and coordination mechanisms among levels of government are the key to successfully maintaining fiscal control. In the lead chapter in a volume edited by the same author, Ter-Minassian (1997) notes that while decentralization can entail gains in terms of efficiency and welfare, it is also likely to make it more difficult to carry out both the redistribution and macroeconomic management objectives of fiscal management. This volume also includes a number of studies with practical policy advice on expenditure and revenue assignments, inter-governmental transfers, and how to control subnational government borrowing. Tanzi (1995) and Tanzi (2002) argue that decentralization is more likely to be successful if there is little or minimal tax competition among regions; developed local institutions; clear and nonoverlapping revenue and expenditure responsibilities; and provision of good and timely data by local governments.

Cross-country and country-level studies have largely focused on developing countries. Dabla-Norris and Wade (2002) examine key aspects of the ongoing decentralization process in transition economies. Bogetic and Stotsky (2000) examine inter-governmental issues in the Caribbean countries. Country-level studies include Cuevas (2003) on intergovernmental fiscal relations in Argentina, Ahmad et al. (2002) on the intergovernmental grants system in Indonesia, Ahmad et al. (2002), Ahmad and Mansoor (2002), and Afonso and de Mello (2002) on managing decentralization in China, Indonesia, and Brazil, respectively. Ter-Minassian (1997) includes studies on country-specific practices in twenty one industrial, developing, and transition countries.

Economic Policy and the Environment

Research works on the environment have focused on the effect of environmental taxes, government spending, and trade on environment. With regard to the effect of taxes, most works have focused on designing and applying Pigovian environmental taxes, which can be used to ensure that prices reflect the full social costs of producing goods and services. Ligthart (1998a) analyzes the question of how to design optimal fiscal policy when the tax system must perform the dual tasks of internalizing externalities and raising revenue. Some works study the use of revenues from environmental taxes. Ligthart (1998b) argues that using this revenue to cut other taxes may yield employment and environmental dividends if the tax burden can be shifted to agents outside the labor market. Brett and Keen (2000) argue, from a political economy perspective, that earmarking funds for announced programs may help raise environmental taxes in the face of political uncertainty. Leruth, Paris, and Ruzicka (2001) argue that, given the complex factors that influence exploitation, the basic Pigovian framework may not work effectively and propose a bond mechanism instead. Mani (2003) suggests environmental taxes or charges, user fees, and debt-for-nature swap for an efficient management of natural resources for a specific country, the Kyrgyz Republic.

Research on the spending side is rare. Gupta, Miranda, and Parry (1995) identify areas of public expenditure policy that interact with the environment and argue that a reform of certain types of subsidies, increased operations and maintenance expenditures, and a thorough environmental assessment of capital projects will benefit the environment. Heller and Mani (2002) provide practical policy advice to developing countries that are vulnerable to climate changes.

A number of papers have studied the environmental implications of trade. Fredriksson and Mani (2001) develop a political economy framework to show that trade integration, in general, increases environmental taxes by reducing industry lobbying efforts, if the political system is relatively stable. The use of trade measures, such as tariffs and export taxes or outright bans for promoting environmental objectives has also been analyzed. In a study on Costa Rica, Kishor, Mani and Constantino (2001) show that eliminating log-export bans could generate considerable economic as well as environmental benefits, provided the resulting increased demand is met from sustainably managed forests.

Transition in Low-Income Countries

Fund economists have conducted a large amount of research on the transition of the formerly centrally planned economies of Central and Eastern Europe, and Central Asia, toward market-based structures. While a significant share of this research has been on groups of transition economies as a whole, including the ones in the low-income category, a fair amount of research has focused on individual low-income transition countries. Many studies investigated issues related to the output losses and high inflation rates encountered by the countries as they moved away from central planning. Others analyzed the structural and macroeconomic challenges the countries faced along their transition paths. In particular, issues relating to privatization, poverty and social sector policies, and the design of appropriate fiscal and monetary polices received much attention.

The collapse of output in the initial stages of the transition process and the subsequent resumption of economic growth has been a major topic of research at the IMF. An overview of the early experience with macroeconomic stabilization and growth in the transition economies is provided by Bruno (1992) and Fischer (1996a,b). Examples of country specific analyses of growth issues in low-income transition economies are Black (2001) on Mongolia, Taube and Zettelmeyer (1998) on Uzbekistan, and Cornelius and Lenain (1996), and Havrylyshyn (1999a) on Ukraine. Berg (1999) study the differences in the evolution of output among transition countries.

The behavior of inflation following the liberalization of prices has also been studied in a large number of papers. Sahay and Végh (1996) develop a model to understand inflationary pressures and stabilization in nonmarket economies. Koen and De Masi (1997) summarize the stylized facts associated with prices and inflation in the transition. The real appreciations caused by high inflation rates have also been the subject of much policy research. Krajnyák and Zettelmeyer (1998), for instance, estimate for a group of transition economies the level of dollar wages consistent with the countries' capital and labor stocks, to assess whether their real exchange rates exceeded their equilibrium values.

An important step in the transition process was the privatization of state-owned enterprises, which has been the subject of a substantial body of research. Havrylyshyn and McGettigan (1999b,c) summarize the privatization experience in the first decade of transition. Husain and Sahay (1992) study whether sequencing of privatization matters in reforming planned economies. Pivovarsky (2003) explores for the case of Ukraine the impact of privatization on ownership structures, and the linkages between the latter and enterprise performance. Elborgh-Woytek and Lewis (2002) distill lessons on privatization procedures and their outcomes from the Ukranian privatization experience. A comprehensive overview of privatization and other economic reforms undertaken by the Central Asian states is in Gürgen (1999).

The impact of the transition on poverty, and the role of social safety nets have been analyzed in a number of studies, such as Van Rijckeghem (1994) on Albania, and Paull (1991) and Chu (1995, 1996) for a set of transition economies. Heller and Keller (2001) review the impact of the transition process on social policies and institutions, and provide recommendations for future social sector reforms. The appropriate size and scope of government in transition economies is analyzed by Gupta (1996).

Fiscal and monetary policy issues have also been the topic of many research papers. Tanzi (1992) focuses on fiscal policy in the economies of transition. Buiter (1997) studies fiscal performance under Fund-supported programs. The fiscal adjustment experience in the transition is overviewed in Purfield (2003). Monetary and exchange rate policy options for the transition economies are assessed by Klyuev (2001), who develops a model of exchange rate regime choice taking into account the particular aspects of transitional economies. Sløk (2000) studies monetary policy and the demand for money in Mongolia, finding a greater role of transactions demand for money in transition economies relative to industrial economies. Grigorian and Manole (2002) empirically analyze the determinants of commercial bank performance in the transition. Sahay and Végh (1995) discuss the policy implications of dollarization in transition economies.

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