Appraising the IMF's Performance

A review of the first three studies by the new Independent Evaluation Office

Peter B. Kenen

DOES THE IMF adopt a one-size-fits-all approach to fiscal policy in countries that seek its assistance, requiring retrenchment in every instance? Were the fiscal provisions of IMF programs responsible for the large output contractions in the countries beset by the Asian crisis of 1997–98? Why were those programs so slow to halt the capital outflows from those countries? Do IMF programs depress growth, and do they hurt the poor? And why have some countries been chronically dependent on IMF financing, which is supposed to be temporary?

Fresh answers to these questions are now available in the first set of studies produced by the Independent Evaluation Office (IEO) of the IMF, and if they are typical of the studies it will produce in the future, the IMF and its member countries will benefit significantly. Its analyses are thorough, combining careful quantitative work, detailed country studies, and discussions with IMF staff, national officials, and others. Its conclusions are eminently sensible, and most of its recommendations should be adopted, although some of them run afoul of an intractable conflict between candor and transparency.

The IEO chose three subjects for its first year's studies: fiscal adjustment in IMF-supported programs, the role of the IMF in three capital account crises (Indonesia, Korea, and Brazil), and the prolonged use of IMF resources.

Assessing fiscal strategy

The IEO report on fiscal adjustment poses two main questions: Have IMF programs required excessive fiscal adjustment? Has the fiscal adjustment been adequate in quality—in composition, sustainability, and incidence, especially in its impact on social spending and the vulnerable members of society?

A country obliged to improve its current account balance often has to make more resources available for the production of exports and import-competing goods and must then reduce aggregate domestic demand. For this reason, if no other, it is often necessary to tighten fiscal policy. But the amount of tightening cannot be chosen without first projecting aggregate expenditure, especially domestic investment. In some cases, moreover, a tightening is needed because of constraints on governments' ability to borrow or the need to achieve or maintain debt sustainability.

Yet the IEO finds that the link between the fiscal and current account balances in IMF programs is weaker than might be expected. A cross-sectional analysis covering 143 recent programs does reveal a positive link between the sign of the targeted change in the primary fiscal balance and the sign of the projected change in the current account balance, but the two are quite different in size. When the current account is projected to improve by 1 percent of GDP, the fiscal balance is supposed to improve by only one-fifth as much. A far larger share of the targeted change in the fiscal balance is explained by the initial state of that balance. If a government has a big budget deficit, it is supposed to reduce it.

The same pattern emerges in Table 1, which classifies most of those same programs by the projected changes in the two balances. Although 70 percent of them call for an improvement in the fiscal balance, only two-thirds of that group call for improvement in the current account balance. The main

Table 1

Varying approaches

Not all IMF programs called for improvements in both the fiscal balance and the current account balance.

Category	Percent of programs	Initial as percent of GDP: Current account	Fiscal balance
Improvement in fiscal balance:			
Improvement in current account	43	–6.6	–5.7
Deterioration in current account	27	–1.9	–4.4
Deterioration in fiscal balance:			
Improvement in current account	15	–8.2	–1.1
Deterioration in current account	15	–3.7	–1.1

Source: IEO, *Evaluation of Fiscal Adjustment*, Table 2.3.

Table 2

Is growth depressed?

The IEO found that countries grew *faster* with an IMF program in place.

(percent)

Category	Trend in prior decade	Preprogram year	Program years First	Program years Second
All programs	1.6	1.4	2.2	3.8
Low-income countries[1]	1.7	2.8	4.4	4.3
Transition countries[2]	–2.1	–3.3	0.4	3.0
All other countries[3]	3.6	2.4	0.9	3.7
Capital account crises	4.8	2.9	–5.0	4.7
Other programs	3.4	2.3	2.1	3.5

Source: IEO, *Evaluation of Fiscal Adjustment*, Table 5.1.

[1]Average for 64 programs using the Enhanced Structural Adjustment Facility or the Poverty Reduction and Growth Facility.

[2]Average for 34 programs using a Stand-by Arrangement or the Extended Fund Facility.

[3]Average for 61 programs using a Stand-by Arrangement or the Extended Fund Facility, of which 10 involved the capital account crises for which the outcomes are shown separately.

feature of programs that call for an improvement in the fiscal balance is the initial size of the fiscal deficit. Conversely, half of the programs that contemplate a deterioration in the fiscal balance still call for an improvement in the current account balance.

Invoking these and other findings, the IEO concludes convincingly that IMF programs do *not* display a one-size-fits-all strategy. Furthermore, its findings suggest that IMF programs do not depress economic growth. Table 2 presents some of the relevant evidence. Typically, GDP growth in the preprogram year was much slower than trend growth in the prior decade, save in low-income countries. And, in all but one country group, growth in the first program year was faster than in the preprogram year, and it was typically higher in the second program year. The table also shows that the exceptional case—slower growth in the first program year—was due chiefly to sharp economic contractions in the small number of countries beset by the capital account crises of the past few years, a subject discussed below.

The IEO evaluation also addresses the common criticism of the IMF that it is not sufficiently sensitive to the effect of fiscal adjustment on vital social programs, such as health care and education. To this end, the IEO compares the relevant levels of government spending by individual countries in years when they had IMF programs with levels of spending in other years. In the vast majority of cases, there was no significant difference, no matter how spending was measured. Where there were significant differences, moreover, the number of cases in which spending rose typically exceeded the number in which it fell. The IEO points out, however, that the vulnerable members of society are not always well protected from the effects of fiscal tightening, and it cites a distressing example:

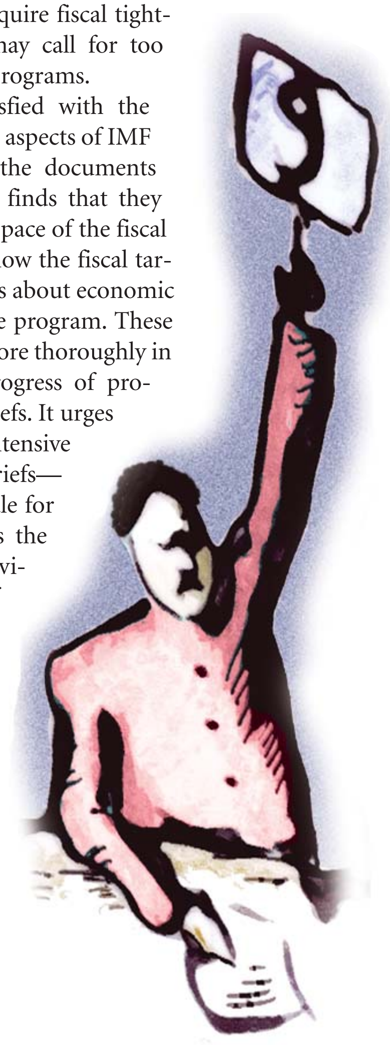
In 1999, Ecuador suffered a macroeconomic crisis. Inflation rose to 60 percent, public sector wages rose by 34 percent, and the currency depreciated sharply. But the health budget rose by only 12 percent. Therefore, six public hospitals were visited to see how they coped with higher wage costs and the much higher costs of medical inputs caused by the depreciation. As the hospitals had to cut back patient care, outpatient care fell by more than 25 percent, the number of prescriptions dispensed dropped sharply in three hospitals, and patients' food rations were cut in at least one hospital although staff rations stayed relatively constant.

The IEO concludes that the protection of small but critical nonwage budgetary items poses a major challenge for the design and monitoring of fiscal adjustment—and one that the IMF cannot meet by itself. Help from the World Bank is needed to design the requisite expenditure safeguards.

Design and implementation of fiscal adjustment

Although the IEO rejects the most common criticisms of the fiscal measures in IMF programs, it raises three concerns about the design and implementation of those measures.

First, excessive optimism about the recovery of output and, especially, investment tends to impart a contractionary bias to those fiscal measures. As a result, the current account balance adjusts more strongly than projected. Reviewing 52 conventional programs (those that did not involve the transition countries or the low-income countries eligible for concessional financing), the IEO finds that the projected change in the current account during the second program year was typically close to zero, yet the actual improvement was typically larger than 1 percent of GDP. And this result obtained even though the actual improvement in the fiscal balance was typically smaller than the projected improvement. Although the IMF does not require fiscal tightening in every program, it may call for too much tightening in too many programs.



Second, the IEO is dissatisfied with the rationale provided for the fiscal aspects of IMF programs. Having examined the documents pertaining to 15 programs, it finds that they often fail to justify the size and pace of the fiscal measures and do not explain how the fiscal targets mesh with the assumptions about economic recovery or with the rest of the program. These matters, it notes, are covered more thoroughly in subsequent reports on the progress of programs, but not in the initial briefs. It urges the staff to undertake more intensive brainstorming in the initial briefs—to articulate clearly the rationale for the fiscal measures, as well as the risks to programs and the revisions that might be needed if those risks materialize. In its response to the IEO, the staff points out that the key assumptions of IMF programs have to be negotiated with the governments involved and that the excessive optimism mentioned earlier may reflect the governments' desire to achieve a rapid revival of confidence and to generate domestic support for the programs. When that is true, however, the viability of the programs may well be at risk.

These two concerns, taken together, are reinforced by another finding. When programs are reviewed for the first time, most of the revisions in the fiscal measure are minor, and the few major revisions are distributed rather evenly between upward and downward changes in the fiscal targets. But when programs are reviewed for the second time, more fiscal targets have to be relaxed than tightened, suggesting that the initial fiscal targets were too demanding.

Finally, the IEO criticizes the sorts of fiscal measures found in many programs. They stress the revenue side more than the expenditure side, and the revenue measures themselves are too narrowly focused. On the revenue side, the IEO says, the IMF rightly views the value-added tax as the cornerstone of a modern tax system, but it has not paid enough attention to income and property taxes and to the need to combat tax evasion. On the expenditure side, the IEO says, the IMF has focused too heavily on cutting public employment or capping public sector wages, measures that tend to be short lived because they are easily reversed.

The IEO concedes that these defects reflect an unavoidable mismatch of time frames; IMF programs do not last long enough to see deeper reforms to completion. Therefore, the IEO rightly urges the closer integration of programs and surveillance. Programs should exploit the previous findings of surveillance, and surveillance should monitor the completion of reforms introduced by programs.

The IMF and recent capital account crises

Concerns about fiscal adjustment in IMF programs also appear in the IEO study of three capital account crises: the Indonesian and Korean crises of 1997–98 and the Brazilian crisis of 1998–99. In the first two crises, it says, the IMF called for too much fiscal tightening because it failed to foresee the collapse of investment and resulting fall in output. In the Brazilian crisis, it says, the IMF called for too little tightening, given the need to achieve debt sustainability. Like IMF staff studies of these crises (the 1999 account of the Asian crisis by Timothy Lane and others, and the 2002 study of capital account crises by Atish Ghosh and others), the IEO blames the collapse of investment in Indonesia and Korea on the balance sheet effects of the currency depreciations, effects that were not foreseen at the time. Like those staff studies, moreover, the IEO notes that the IMF modified its fiscal targets quickly and thus absolves it of blame for the large fall in output. In Brazil, by contrast, the IMF went in the opposite direction. It called for more fiscal tightening after Brazil had to let its currency float and the subsequent depreciation raised the government's debt burden, as much of its debt was dollar denominated or dollar linked.

The IEO is less firmly supportive of the monetary policies prescribed by the IMF, apart from noting that Indonesia and Brazil failed to follow those policies during the early stages of their crises. Recent research, it says, has not dispelled doubts about the net benefit of raising interest rates when a country confronts a currency crisis. Theoretical work has shown that higher interest rates can strengthen or weaken a currency, empirical work has not settled the matter, and the issue is even harder to resolve when a country faces a banking crisis as well as a currency crisis. In light of these considerations, the IEO concludes, it is difficult to pronounce definitively on the appropriateness of monetary conditionality in the three crisis countries.

The IEO is less circumspect when assessing the results of the IMF programs. The initial programs failed in that they did not stabilize the three countries' currencies. In Indonesia, the IEO blames the government for refusing to take ownership of the program and, indeed, subverting it. In Korea, it blames the IMF's major shareholders for attaching vague conditions to the use of the bilateral financing they provided and for taking too long to involve Korea's private sector creditors. In Brazil, it divides blame between the government and the IMF for trying to defend an overvalued currency and failing to address the government's adverse debt dynamics. But it also faults the IMF for failing to detect some of the vulnerabilities that explain the severity of the Korean and Indonesian crises and for failing to flag the vulnerabilities it did, in fact, detect.

"The IEO should contemplate follow-up studies to ask whether its recommendations have had the expected effect."

The detailed accounts of the crises in the IEO evaluation are well worth reading for the light they shed on relations between the IMF and its major shareholders. It is widely believed that the IMF and the U.S. Treasury worked closely together to resolve the crises under study. There were marked differences of view, however, between the IMF and its major shareholders. In Korea, the IMF quickly concluded that the available financing was insufficient and immediately pressed its major shareholder governments to achieve a rollover of bank credit lines, but to no avail. In Indonesia, a long list of structural reforms was attached to the January 1998 program at the urging of major shareholders in the belief that confidence could be restored only by signaling a clean break with the past. The IEO finds that this strategy deflected attention from vital reforms in the banking sector and reduced the willingness of the Suharto government to take ownership of the program.

The IMF has already addressed some of the issues raised in the IEO evaluation—a fact that the IEO readily acknowledges. The IMF has decided, for example, that programs should not include structural reforms unless they are required to achieve the macroeconomic objectives of the programs. We should not expect to see again long lists of structural reforms like those in the Indonesian and Korean programs. It may be harder, however, to implement some of the IEO's other recommendations, notably those that pertain to IMF surveillance. At times, the IEO suggests that candor and transparency are complementary—that the publication of the IMF's views can stimulate public debate about national policies and bring market pressure to bear on a recalcitrant government. Elsewhere, it concedes that they can conflict. When candor is combined with transparency, markets may react abruptly—faster than governments can react constructively.

In an effort to marry candor and transparency, the IEO suggests that the IMF find ways of engaging in escalated signaling when, in the course of surveillance, the staff has identified key vulnerabilities and they have not been cured after several more rounds of surveillance. This approach, it says, would strike a balance between the role of the IMF as confidential advisor to governments and its role in providing information to markets. But this approach assumes implicitly that markets will respond in a graduated way to the escalating signals from the IMF, and there is little reason to expect that outcome. It may thus be better to rely on confidential warnings that a government will not qualify for large-scale IMF financing if, by failing to cure key vulnerabilities, it succumbs eventually to a capital account crisis.

What should the staff tell the Board, however, when the risk to an IMF program does not derive from unforeseen shocks or perceived vulnerabilities but is instead political—the risk that a government will be unwilling or unable to implement an IMF program? The IEO tackled this question in its report on prolonged use.

Prolonged use of IMF resources

The IEO treats a country as being a prolonged user if it has had IMF programs for 7 or more years in any 10-year period. Under this definition, a country is not likely to be a prolonged user unless it has had at least two 3-year programs within a 10-year period. Nevertheless, the IEO finds that prolonged use has risen since the 1970s, whether measured by the number of countries involved or the total financial exposure of the IMF. To a significant extent, prolonged use reflects the adaptation of IMF policies and financial facilities to meet the special needs of low-income countries. Most prolonged users belong to that group. But much of the increase in financial exposure resulting from prolonged use reflects the involvement of middle-income countries, such as Argentina, Mexico, and Turkey. The IEO finds, moreover, that both sorts of prolonged use are due partly to flaws in IMF policies and programs.

Though the findings in this report derive from studying prolonged use, some have wider applicability. The IEO's case studies of prolonged use, for example, yield valuable findings about the design of conditionality:

- The specific structure of conditionality is less important than an underlying domestic political commitment to core policy adjustment.
- Excessively detailed conditionality—whether used because of a weak track record, doubts about ownership, or to support reform-minded groups within a government—does not appear to have been effective.
- Conditionality focused on policy rules or procedures, rather than discretionary onetime actions, was ultimately more effective.

The IEO also discusses the political economy of conditionality and the problem raised above: How and where should political feasibility enter into the IMF's decision-making processes? The IEO finds that judgments about political feasibility influence IMF mission chiefs working with national governments on the design of programs and that staff members often understand the political risks to a program. It also finds, however, that these judgments do not surface in staff reports to the Board. But its conclusion suggests a different solution to this crucial problem. Judgments about political risks should be clearly distinguished from judgments about other risks and should be made in a transparent manner at the level of the Managing Director and the Executive Board, who are accountable for them. But this surely implies that the staff should be strongly encouraged to advise the Managing Director, if not the Board itself, of the concerns that it may have about the political risks to a particular program.

Returning to the narrower problem of prolonged use, the IEO finds that aid donors and others, including the Paris Club of official creditors, often key their own decisions to those of the IMF—that is, an IMF program is seen as a seal of approval. This practice, it says, may lead the IMF to tolerate prolonged use, and it should therefore develop other ways to signal its approval of a country's policies, including more frequent use of enhanced surveillance, shadow programs, and precautionary arrangements.

Unfortunately, the IEO does not explore sufficiently another explanation for prolonged use. The IMF may tolerate prolonged use because it is loath to face the obvious consequence of refusing to approve an additional program—the failure of a large middle-income country to repay what it already owes. When tracing the involvement of the IMF in concessional lending to the low-income countries, IMF historian James Boughton notes that it began when the IMF started to worry about the ability of those countries to repay concessional loans from the trust fund set up in the wake of the first oil crisis. Similar concerns may help to explain the recent growth of prolonged use by some middle-income countries. It is hard to believe that those concerns did not influence the decision to approve a new program for Argentina in 2003.

Looking ahead

Reflecting on the IEO's work to date, the topics of its next three studies, and the published list of topics on which it may work thereafter, I offer two general observations:

The IEO's initial studies dealt with a large subject, although two of them also contained detailed country studies. As a result, some of its recommendations have been cast too broadly to elicit firm responses from the Executive Board. Almost all of the recommendations made in the study of prolonged use are applicable generally to the work of the IMF and have thus far elicited rather vague responses. The IEO has made operational recommendations, one of which the Board rejected—the proposal that prolonged users be charged higher interest rates. Yet concrete recommendations may stand the best chance of producing focused debate in the Board and, when they find favor, subsequent implementation. The Board, for example, has agreed to adopt an operational definition of prolonged use and to use that definition to assess the effectiveness of IMF programs involving prolonged use.

Broad subjects, moreover, tend to spawn long documents, and the first three from the IEO were rather long indeed. To be sure, they were well organized, with executive summaries at the start and technical annexes at the end. Nevertheless, they may be too long to serve effectively one of the main purposes of the IEO—promoting wider understanding of the IMF. Shorter studies of narrower subjects might be read more widely.

Looking further ahead, the IEO should contemplate follow-up studies to ask whether its recommendations have had the expected effect. It will not run out of new subjects to study but should not wait long to revisit old ones. ■

Peter B. Kenen is Walker Professor of Economics and International Finance at Princeton University

References:

Boughton, James M., 2001, Silent Revolution: The International Monetary Fund, 1979–1989 *(Washington: International Monetary Fund).*

Ghosh, Atish, and others, 2002, IMF-Supported Programs in Capital Account Crises, *Occasional Paper 210 (Washington: International Monetary Fund).*

Independent Evaluation Office, 2002, Evaluation of Prolonged Use of IMF Resources *(Washington: International Monetary Fund).*

______, 2003, The IMF and Recent Capital Account Crises: Indonesia, Korea, Brazil *(Washington, International Monetary Fund).*

______, Fiscal Adjustment in IMF-Supported Programs *(Washington: International Monetary Fund).*

Lane, Timothy, and others, 1999, IMF-Supported Programs in Indonesia, Korea, and Thailand: A Preliminary Assessment, *Occasional Paper 178 (Washington: International Monetary Fund).*

Statement of Ownership, Management, and Circulation required by 39 USC 3685.

1. Title: *Finance & Development*. 2. Publication No. 123-250. 3. Date of filing: December 12, 2003. 4. Frequency: Quarterly. 5. Number of issues published annually: four. 6. Annual subscription price: NA. 7/8. Complete mailing address of known office of publication/publisher: *Finance & Development*, International Monetary Fund, 700 19th Street, N.W., Washington, DC 20431. 9. Full names and complete mailing address of the headquarters of general business offices of the publisher and editor: International Monetary Fund, Washington, DC 20431; Editor-in-Chief: Laura Wallace, same address. 10. Owner: International Monetary Fund, 700 19th Street, N.W., Washington, DC 20431. 11. Known bondholders, mortgagees, and other security holders owning or holding 1 percent or more of the total amount of bonds, mortgages, or other securities: None. 12. Tax status: has not changed during preceding 12 months. 13. Publication title: *Finance & Development.* 14. Issue date for circulation data below: December 2003.

15. Extent and nature of circulation	Average no. of copies each issue in preceding 12 months	Actual no. of copies of single issue published nearest to filing date (December 2003)
A. Total number of copies	52,625	52,200
B. Paid and/or requested circulation	43,120	42,675
C. Total paid and/or requested circulation	43,120	42,675
D. Free distribution outside the mail (carrier or other means)	6,320	6,409
E. Total distribution (sum of C and D)	49,440	49,084
F. Copies not distributed	3,187	3,116
G. Total (sum of E and F)	52,625	52,200
Percent paid and/or requested circulation	87.22	86.94

I certify that the statements made by me above are correct and complete.
Laura Wallace, Editor-in-Chief

Blunt Approach Does the Trick

Karin Lissakers, former U.S. Executive Director

I WAS an early supporter of independent evaluation of the IMF's programs and performance. It seemed important, not just to answer outside critics who grew more vociferous during the 1990s, but also to help the institution respond to new and growing challenges posed by global financial markets.

Some Executive Directors, including me, thought at first that the ad hoc Board-guided approach we experimented with would do the job. The evaluation of the Enhanced Structural Adjustment Facility, for example, provided valuable insight. However, the superior performance of the IEO points to the wisdom of those like former Canadian Executive Director Tom Bernes, who advocated a professional standing operation. It also points to the wisdom of the choice of Montek Singh Ahluwalia to head the IEO.

The IEO's performance to date is impressive. Its reports have been thorough and blunt. The high quality of the IEO reports indicates that the IMF and its individual member governments are cooperating and giving the evaluation teams good access to information. Evaluations would not be meaningful without such cooperation. Both the Executive Board and management appear to be taking the evaluation process and recommendations to heart.

The topics chosen for evaluation in 2002–03 deserved priority attention. Fiscal adjustment under IMF programs has been more roundly criticized by outsiders than any other aspect of IMF conditionality. The 1990s capital account crises put the IMF to its biggest test, placing unprecedented demand on IMF financing and confronting staff with probably the most complex set of policy challenges it had ever faced. Perhaps the most important of the three is the study of (very) prolonged use of IMF resources by a handful of countries. Prolonged use is a mark of institutional failure. It suggests IMF resources are being used for purposes not indicated by its Articles of Agreement. Worse, prolonged use suggests either that the IMF has been giving bad advice or that countries are ignoring the advice and continuing to receive financing anyway.

Prolonged users

The individual case studies of countries that are prolonged users of IMF resources are particularly illuminating. They trace the often complex and sometimes surprising interplay of program design, country implementation, and board decisions. In Pakistan, for example, political ownership of reform seems chronically weak, and program implementation equally so. The IEO study concludes that, contrary to what one might have expected, decades of IMF advice, collaboration, and conditionality did not strengthen implementation but instead seems to have weakened it by "crowding out" a needed domestic policy debate essential to building a strong political constituency for reform.

The IMF repeatedly took Pakistan's political leadership and ruling economic class off the hook both financially and in terms of policy responsibility. Pakistani officials themselves remark that repeated IMF waivers of conditionality created moral hazard. The staff's position was compromised by overoptimistic growth and export projections and a failure to build in policy adjustments to compensate for chronically weak implementation. Both the Board and the review process led by the IMF's Policy Development and Review Department failed to demand clear justifications for the program parameters. The Board was complicit in this recipe for failure by being all too willing to give Pakistan second, third, fourth, and fifth chances, usually simply because the faces in the cabinet had changed even though the underlying political dynamic had not. The IEO concludes that bilateral political considerations came into play, but also that staff did not always alert the Board to just how badly things were going. The same pattern repeated itself in the Philippines and other cases of prolonged use. In Pakistan, there was the added element of scandalous wholesale fakery of economic data by the authorities.

IMF as gatekeeper

The IEO makes a number of interesting recommendations for avoiding prolonged use. I like the recommendation for enhanced due diligence, and I gather that it has already begun. I do not entirely agree with the idea that the IMF should try to mitigate "seal of approval" pressures to continue programs for nonperformers by providing "credible alternatives to IMF lending arrangements as a condition for other official flows." A country that demonstrates weak commitment to an IMF program is unlikely to make good use of other donor resources. There is a history of staff informally telling other lenders that a country is "broadly on track," which releases them to lend or allows Paris Club deals to proceed when, in fact, performance on the IMF program is far from acceptable. The results have not been positive for either the country or the other lenders. Weakening IMF "signaling" also runs contrary to the new trend of bilateral donors orienting most of their aid flows to strong performers. Donors are relying more than ever on the IMF to play gatekeeper. Therefore, rather than trying to minimize the signaling effect of its lending decisions or giving poor performers a pass to avoid the fallout of saying no, the IMF should redouble its efforts to ensure that its programs don't just look good on paper but can and will be implemented, precisely because the stakes are so high.

I do agree that in cases where the only reason for an IMF loan is to reassure other donors or creditors, some other way should be found for the IMF to vet and certify the quality of a country's policies and performance. In principle, that could be surveillance if Article IVs (IMF examinations of member countries' economies) were made sufficiently unambiguous in their assessments. Or perhaps some sort of policy performance rating system, along the lines used by rating agencies.

New blood needed

Many of the lessons learned from these cases apply to other programs as well, as the evaluators point out. For example, they show that IMF technical assistance does not generate lasting capacity improvements in program countries and that the IMF is still not very good at dealing with political and governance hurdles despite increased attention to such issues.

The first problem should be fairly easy to remedy with increased training and mentoring and greater investment in building up local expertise rather than simply sending in IMF SWAT teams to fix things. The latter may seem quicker, but the former is likely to produce more durable results. Rotating more mid-career officials from member countries in and out of the IMF, which the Board has long advocated, could play an important role. We have seen how former senior staff (and Executive Directors) who have left the IMF to take posts in governments and central banks have raised the level of performance of their new institutions. The IMF should try to make cross-fertilization of expertise routine rather than rare.

More new blood would also help with the weakness in addressing political and governance obstacles to economic reforms in program countries. The staff task force recommends "modest investment" in political-economy education for staff. That may help, but it is no substitute for bringing in politically experienced staff at middle and senior levels and drawing people with more diverse backgrounds into the Economist Program—the entry-level program for IMF economists.

Some welcome recommendations

The examination of the IMF's response to capital account crises drew some important—and very welcome—conclusions. Among them is that the IMF should pay more attention to the balance sheet effects of macroeconomic developments and policy measures. A few of us on the Board had been arguing that position for a long time, to limited effect. Another conclusion is that being too timid with official financing increases the likelihood of failure of crisis programs. Controversy notwithstanding, the Mexico "tequila crisis" intervention was a very successful response to a capital market crisis largely because there was no doubt about the adequacy of official financial coverage for Mexico's external obligations. The bold decision to give Brazil an unexpectedly large financing package in its most recent crisis indicates that the IMF and a majority of its shareholders have finally taken this lesson on board.

"The IMF should redouble its efforts to ensure that its programs don't just look good on paper but can and will be implemented."

The IEO's 2003 annual report makes an important contribution by pulling together common strands from each of the evaluations done to date. Probably the most important common conclusion is the need to toughen surveillance, including stress testing, and to not let program reviews substitute for annual consultations with member countries. For some time, the Board has been advocating stress testing to improve its ability to anticipate and prevent capital account crises. And it is highly likely that program weaknesses and chronic failures of implementation in prolonged user cases would have been exposed and corrected far sooner if these countries had been subject to regular surveillance by staff not directly involved in the negotiation and design of their programs. The recent shift to presumptive publication of Article IV reports is a welcome step, although mandatory publication would be preferable.

It is probably too early to say how completely the IEO's recommended reforms will be incorporated into the IMF's day-to-day work. The institution seems to still be evaluating some of the evaluator's recommendations and deciding how exactly to implement them. But it is clear that the IEO is already having an impact and more can be expected in the future. I look forward with anticipation to the Argentina evaluation and to the other studies in the pipeline. ■

Karin Lissakers is an Advisor to George Soros on globalization issues.

Enhancing the Learning Culture

Jean-Claude Milleron, former French Executive Director

ONE OF the major purposes of the IEO is to enhance the "learning culture" of the IMF. Those who laid the foundations of the IEO—and I was one of them—obviously had in mind not only IMF staff and management but also the Executive Directors themselves, whose learning culture stood to be improved in many areas.

In this context, it makes sense for a former IMF Executive Director to try to answer the following question candidly: Would I, as a member of the Board, have been better equipped if the IEO's analysis of today had been available to me? My answer is definitely affirmative, but with two caveats. First, the information available to the IEO today is often much broader than the information that was available to the Board in the past when it was making difficult decisions. Second, the IEO is able to analyze those decisions—which were often made under extreme pressure—with the benefit of hindsight. Thus, my answer to this question must be taken with a grain of salt.

Concepts

The first thing one must look at is what can be called the "conceptual framework" of the IEO's work. For the IMF Executive Board, clear definitions—including of such a framework—agreed upon in advance by its members are a prerequisite for careful and consistent decision making and comparative cross-sectional analysis. For instance, the IEO's remarkable effort to define what "prolonged use of IMF resources" really means should be an excellent point of departure for many board decisions related to requests for renewed financing. I remember various times when, for lack of a precise definition of what constitutes a prolonged user of IMF resources, the Board may not have been consistent, or even fair, in its decision making. This situation reminds me of a comment by Leon Blum, the great French socialist politician, who once said "clarifier c'est moraliser" [to clarify is to moralize].

The IEO's review shows how important a common analytical framework is for the IMF's work. It is correct to say that IMF management and staff were fully aware of the fragility of the assets in many countries' financial institutions, but it is also true that we in the IMF did not fully understand the possible consequences of such fragility. Ultimately, for people of my generation, there is, in the work of the IEO, an invitation to reread Don Patinkin's well-known work, *Money, Interest and Prices*, which represented the first serious attempt toward integration, through real balance effects, of financial aspects in general equilibrium analysis. If I had reread it, I could have improved my learning culture, but, unfortunately, I did not.

I am pleased to see that the IEO supports the emphasis the IMF has placed in its programs and policies on the prevention of and response to shocks, external shocks in particular. This is especially apparent in the IEO's program paper on Argentina, and I congratulate it for such an orientation. When I was with the United Nations in the mid-1990s, I set up a working group in which we focused the analysis of development strategy on such an approach. In retrospect, I have the feeling that the IMF Board did not easily accept following this type of approach.

Let me conclude this first section with a respectful wish. Defining the proper conceptual references for the IEO's assessments is not an easy task. The references must be explicit, as well as independent of fashions or dominant ideologies. For instance, when I read that, in a capital account crisis, "there was insufficient appreciation of the large currency depreciation which might occur in view of the possibility of multiple equilibria . . .," I was not sure how to interpret the sentence. As a former Executive Director, I would not feel too guilty if I refused to oblige when implicitly requested to enter into sophisticated rational expectations equilibrium

analysis. If that is what the IEO authors have in mind and if they consider that such an approach is crucial for this kind of appreciation, it has to be justified and presented clearly!

Defining policy in a political context

As a former Executive Director of both the IMF and the World Bank, I have fond memories of many discussions and controversies with colleagues of the Boards and staffs of both institutions. The work was challenging. Sometimes it was tough, often it was instructive, but always it was friendly. When that work shows up in my nightmares, I cannot help thinking that I would have been much better equipped if I had had the useful information and references provided by the IEO. Let me mention a few examples.

First, the IEO demonstrated the importance of a balanced presentation of facts. For instance, it may be the case that, under Korea's IMF-supported program in 1997, fiscal policy was too tight. Early on, the IMF's Policy Development and Review Department identified tight policies as a weakness of the program. Tight policies are still often mentioned as a traditional feature of an IMF program and are intended, according to their detractors, to promote salvation through suffering. But we are also reminded by the IEO that, in 40 percent of a cross-country sample of 169 programs, the fiscal deficit was designed to **increase** as a percentage of GDP.

A related point is the question of social spending, essentially for health care and education. The IEO made a remarkable and useful contribution when it found that countries with an IMF program have higher social spending, on average, than they would have had without a program. Thus, the naïve view that the IMF always proposes a "one size fits all" approach for countries in distress is a myth, broadly disseminated by poorly informed academics and nongovernmental organizations. Cross-sectional econometric studies are often the proper response to ideology. Such studies would have been very useful, in particular when the IMF was under fire from its colleagues in the World Bank. In the same spirit, I also remember difficult hearings in the French parliament in which I would have been much more comfortable if I had had such useful and interesting studies to rely on.

I also like the IEO's approach to analyzing the appropriateness of IMF advice on monetary policy as summarized in its 2003 annual report. It is true that a huge question mark remains about the effectiveness and real consequences of a tight monetary policy. But the IEO is right when it emphasizes that, in various cases and for various reasons, the policy designed by the IMF was not implemented. It was certainly true in Indonesia and, at least in the initial stages of the program, Brazil (two of the capital account crisis countries). I remember discussions with World Bank chief economist Joseph Stiglitz, who had good theoretical points on the irreversible effects and costs of too strict a monetary policy. It is probably true that few of us at that time questioned whether the policy we were talking about had actually been implemented. There is no doubt, again, that we would have been better off if we had had the IEO's findings.

Finally, the question of whether proposed policies are politically feasible is answered with the simple idea that the Board should evaluate a country's ownership of the reforms, as well as the probability that they will succeed, before an IMF program is approved. That is exactly what we should have done. But, when reading the IEO's 2003 annual report, I got the feeling that the IEO team was not fully aware of the constraints that limit Directors' independence of judgment. Indeed, there is a code in the Board—as exemplified in the ritualistic sentence: "My authorities think that . . ."—that has to be interpreted with the proper nuances. And when the "instructions" to Executive Directors from their authorities say something like "Don't be isolated within the Group of Seven," the poor Directors sometimes have to behave like weathercocks, changing their mind depending on the direction the wind is blowing.

"I got the feeling that the IEO team was not fully aware of the constraints that limit Directors' independence of judgment."

Surveillance

Looking for greater candor to make surveillance more effective is a serious endeavor, and the IEO's suggestions, as they appear in each of its three reports, seem to me well taken and fully relevant. However, let me briefly mention, as food for thought, a few points that I recall as questionable.

First, it must be clearly remembered that candor is incompatible with misreporting (that is, deliberately providing incorrect information to the IMF) by member countries. When I left Washington two years ago, this issue of misreporting had become very important. Should the silence of today be interpreted as meaning that the problem has disappeared?

Second, in the field of surveillance, we faced difficult tensions between the IMF's area [regional] and functional [technical] departments. Were such tensions identified by the IEO? Is it not an area in which management should fully play its coordination role? Is it not an issue that should be addressed in an effective manner to improve the overall credibility and usefulness of surveillance?

And, finally, need we be reminded that the value of financial assets in countries requesting IMF assistance has to be evaluated by experts (most of the time outside the IMF) who should be fully independent of those who could advise possible rescuers of the concerned companies ? I am not sure that, in Asia for instance, a guarantee of "independence" was always fully assured. ■

Jean-Claude Milleron is retired and divides his time between Paris and Pelvoux in southwest France.

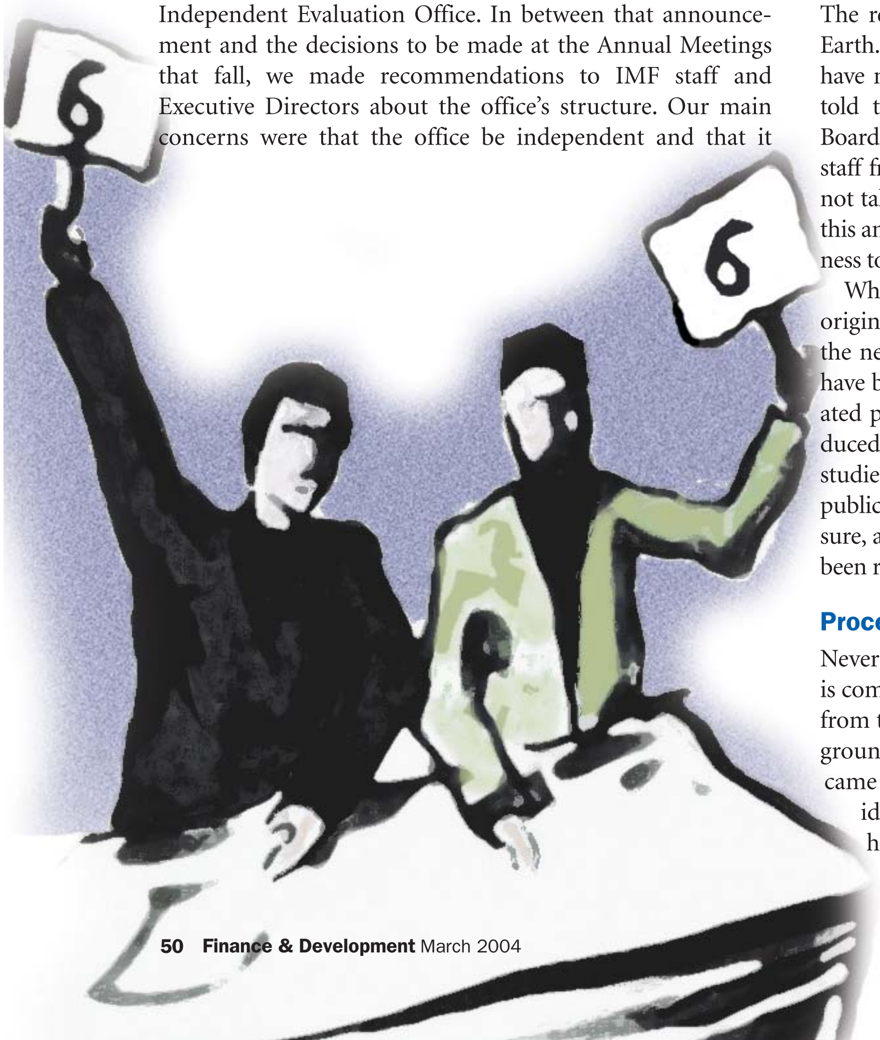
Credible Start, Untested Impact

Carol Welch, Friends of the Earth

THE ESTABLISHMENT of the IEO was an extremely important step in efforts to increase the IMF's transparency and accountability. The previous practice of internal review—supplemented by the occasional external review—was widely seen by the civil society community as a back-patting exercise that failed to address crucial issues. But an independent review body that conducts flawed assessments, or is ignored by the institution it is supposed to influence, would also be of little use. A look at how the IEO, after its first full year of conducting evaluations, has met its objectives is another important undertaking.

Friends of the Earth had long advocated the establishment of an office that would conduct independent evaluations of the IMF. When an ad hoc external review process was launched in 1997, we monitored its implementation, commented on the reviews, and offered input into the review process and its implementation, which we viewed as flawed for falling short of its promised two to three reviews a year. We continued to argue for a permanent body.

We therefore welcomed the announcement, at the 2000 IMF–World Bank spring meeting, of the establishment of the Independent Evaluation Office. In between that announcement and the decisions to be made at the Annual Meetings that fall, we made recommendations to IMF staff and Executive Directors about the office's structure. Our main concerns were that the office be independent and that it report to the Board of Directors. It was also a priority, in our view, that the IEO have as few constraints as possible on its authority to select review topics.



We were particularly concerned about the Chairman's concluding remarks after an August 3, 2000, board discussion that "policies and procedures under active discussion in the Fund and current Fund programs would not be appropriate areas for EVO [its original acronym] evaluation." We perceived this statement as an effort to limit the new office's mandate. In a letter to Managing Director Horst Köhler, several international nongovernmental organizations (NGOs) wrote that the Chairman's remarks represented a departure from the background papers on the evaluation office, which called for no "a priori" restrictions on its mandate. Civil society groups also wanted to participate in the development of the new office's work program and supported the hiring of an external staff with field expertise.

In our assessment of the IEO, we looked at its structure, the review process, and the topics selected for review.

Structure

The result was quite pleasing for groups like Friends of the Earth. The IEO would report directly to the Board and would have no a priori restrictions on its mandate, although it was told to avoid "interfering" with operational activities. The Board also committed to bringing in the majority of the IEO's staff from outside the IMF and decided that its director could not take an appointment at the IMF thereafter. We considered this an important indicator of the director's ability and willingness to be free from undue influence by IMF management.

While some NGOs, including Friends of the Earth, had originally suggested that a committee directorship might give the new office added prestige, it is now clear that this would have been cumbersome. Under its director, the IEO has operated professionally and efficiently. In its first year, it has produced three deeply researched and extensively evaluated studies on contentious topics. The Board did not promise to publicly release all reviews but indicated a bias toward disclosure, and, in fact, all three reviews that went to the Board have been released.

Process

Nevertheless, there are still outstanding issues. While the IEO is committed to ensuring that a majority of its staff will come from the outside, information about the staff and their backgrounds is not easily accessible. Some of the external hires came from the World Bank—hardly the infusion of new ideas and perspectives that many civil society groups had hoped for. The IEO may also hire outside consultants to supplement staff expertise, but it is difficult to evaluate those hires and whether they are adequately supplementing staff expertise.

While the IEO makes genuine efforts to be open and has responded favorably to requests for meetings from Friends of the Earth and our colleagues, some room for improvement remains. The IEO should take a proactive stance and reach out to civil society groups, particularly in the developing world. The majority of its consultations have taken place in Washington, D.C., or in the capitals of the other major industrial countries. In its first year, the IEO spent less than one-third of its budget line item on outreach seminars. Admittedly, its staff is small and may not have the resources for outreach. The IEO may also be reluctant, justifiably, to depend on the IMF's External Relations Department to conduct this outreach. It wants to establish itself as an evaluation body and not as part of the IMF's external relations effort. Nevertheless, the IEO could work more through international civil society organizations to organize consultations. It could also use civil society gatherings, such as the World Social Forum or parallel events around trade ministerials or similar meetings, to broaden its outreach. Such efforts would enable the IEO to contribute more to the objectives of promoting understanding of the IMF and, potentially, of strengthening the IMF's external credibility.

Some complaints have been voiced about the scope for civil society groups to suggest topics for review. Although the IEO has diligently solicited comments on its draft work plans, it is unclear whether outside input has actually influenced the final work program. In fall 2001, the IEO posted on its website a long menu of evaluation topics; parallel to its request for input, a "second stage" document, with a shorter list of topics, was sent to some NGOs, creating an impression of two standards for consultation. The NGOs felt they were commenting on outdated information that no longer formed the basis for decision making.

Outside parties had also requested—before and after the IEO's inception—that an evaluation office provide a formal mechanism for outside stakeholders to raise concerns about IMF programs and procedures and to receive formal responses. For civil society, this would do the most to boost the IMF's external credibility.

Review content

The IEO's reviews have been extremely comprehensive and have certainly boosted my understanding of the IMF's work. The IMF's Executive Board also has reacted positively to the IEO's reports. However, staff responses are worrying in that they do not appear to genuinely welcome the opportunity to enhance the IMF's learning. For example, the staff response to the fiscal adjustment study is a triumphant vindication of the IMF's fiscal stance. The staff response to the prolonged use study is defensive: the first paragraph emphasizes that the staff grapples with these issues every day and already implements many of the IEO's recommendations. The impression it gives is one of "thanks for your concern, but we have it under control." The staff task force report on the study fails to address many key issues raised in the report, such as the recommendation that IMF staff offer alternative policy options for countries to debate. The staff should have heard this before because NGOs have made the same recommendation for the Poverty Reduction Strategy Paper reviews. Other important recommendations are often deferred to ongoing internal evaluations and review efforts, yet staff responses do not consider whether the substantive point raised by the IEO is being addressed in the IMF's internal processes.

One concern about the IEO's operations to date is that it has too narrowly interpreted its mandate not to interfere with IMF lending programs and therefore has essentially limited its reviews to evaluating the programs after the fact. For example,

"The IEO should not be prevented from assessing how the IMF is incorporating lessons from previous programs in current arrangements."

in its capital account crisis evaluation, the IEO elected not to include the current Indonesia or Brazil programs. In its proposal to assess Turkey's Stand-By Arrangement with the IMF, the IEO's draft work plan is careful to say that it will evaluate the program that was canceled in February 2002 and not the arrangement set to expire in December 2004. Given the debate about its mandate, the IEO may feel pressured not to evaluate current programs. Although it should not interfere with the staff's negotiation and monitoring of ongoing programs, the IEO should not be prevented from assessing how the IMF is incorporating lessons from previous programs in current arrangements. This may limit the IEO's contribution to the IMF's culture of learning.

Going forward

The IEO has made an excellent start in setting a high quality of work and tackling issues that are highly relevant for the IMF. There will likely be two main challenges as the IEO goes forward. One is implementation. Will the IEO's recommendations be taken seriously and be adequately considered? Will the agreed-on recommendations be implemented throughout IMF operations? If they are ignored, will the IEO soften its criticism or tackle less central issues?

The other challenge is scope. Will IEO studies be seen mainly as evaluations of completed activities? If so, this would allow inaction, with the excuse that business is already changing. Will those affected by IMF policies see such studies as irrelevant to their struggles and agitate instead for a substitute, such as a grievance mechanism? In one year of full operation, the IEO has achieved a good deal. No one should diminish its significance, and no stakeholder—the Executive Board, the staff, management, and those affected by IMF operations—can afford to waste an opportunity to get the most out of it. ■

Carol Welch is Director of International Programs at Friends of the Earth.