

INTERNATIONAL MONETARY FUND

**The Role of the Fund in Low-Income Countries**

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(In consultation with other departments)

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## EXECUTIVE SUMMARY

**This paper takes stock of the work over the past four years on the role of the Fund in LICs, and outlines a comprehensive approach for Fund engagement.** It responds to the Board's request for a synthesis of the full range of policy decisions and developments related to the Fund's work in LICs since 2004. A key purpose is to ensure that, as the Fund is refocusing its work, LIC-related objectives and responsibilities are well articulated and understood.

**The environment affecting LICs and the Fund's approach have evolved since the PRGF, PRSP process, and Enhanced HIPC Initiative were introduced.** Macroeconomic policies and performance have improved markedly in many LICs. The largely favorable global environment seen until recently raised new policy issues for many members (e.g., stronger capital inflows), and deteriorating conditions may now create different challenges including those related to high food and fuel prices. In light of developments, independent feedback, and internal review and analysis, the Fund refined its approach to: become more flexible on fiscal targets and inflation, encourage the full use of aid, and emphasize debt sustainability. Its instruments have been modified and new ones created, including the Policy Support Instrument (PSI) and Debt Sustainability Framework (DSF).

**The Fund's engagement with LICs is similar in scope to its work with other members in its emphasis on macroeconomic and financial stability, but its success often depends on reforms in areas covered by development partners.** While the Fund is not a development agency, its advisory, financing, and capacity building work is essential for LICs to be successful in achieving their development objectives, including poverty reduction.

**The Fund will remain closely involved with its low-income member countries to help them achieve the macroeconomic and financial stability needed to raise growth, reduce poverty, and progress to middle-income status.** In doing so, the Fund draws on country-owned development strategies and tailors its advice and engagement given the specific characteristics of LICs: many are exposed to shocks, dependent on external assistance, and have or had high debt levels. The immediate objectives of Fund engagement include in general single-digit inflation, financial sector stability, policies supportive of export growth and external stability, and debt sustainability.

**The Fund uses a range of instruments to provide policy advice, capacity building assistance, and, if needed, balance of payments support.** The Fund provides advice through the Article IV surveillance process, program engagement, and capacity building, and signals its view of country macroeconomic and financial policies through a variety of means. Greater use of cross-country and regional perspectives is strengthening surveillance, which can take into account LIC-specific characteristics while remaining focused on external stability. The Fund provides balance of payments support to LICs when needed through the

PRGF and other instruments, and offers policy support through the PSI. Promoting debt sustainability among LICs and helping eligible LICs secure debt relief through the HIPC Initiative and MDRI remains a priority. Technical assistance and training help LICs build skills and institutions that support effective macroeconomic management.

**Given the multitude of development partners actively assisting LICs, effective cooperation and clear communication are essential to reduce overlaps, build on complementarities, and improve the efficiency of the global community's efforts.** The effectiveness of the Fund and development partners depends on two-way cooperation. If the Fund is to refocus its efforts while remaining effective, it will have to rely more on others, which should yield benefits that enable the Fund to engage more efficiently in LICs.

**The Fund aims to strengthen communication on its LIC policies to build greater understanding and support, and to be responsive to the views of others engaged with LICs.** Through active engagement with the media and a broad range of actors, the Fund seeks to articulate more clearly its role and relevance in LICs, and its continued commitment to supporting growth and poverty reduction while focusing on its core areas of expertise. The Fund's communications strategy emphasizes ensuring that its rhetoric, policy, and practice in LICs are fully aligned. The Fund also must remain responsive to outside concerns, and steps have been taken to address past disconnects; in particular, policies have been clarified to refocus the Fund on its areas of expertise and avoid "over-promising."

**The Fund's LIC strategy will continue to evolve as economic conditions and the needs of low-income members change.** The Fund's work in LICs will be shaped by its broader refocusing exercise with a strong emphasis on helping LICs secure and maintain macroeconomic stability while also modernizing and streamlining the Fund's work practices. Sharply rising food prices, continued high fuel prices, and risks of economic slowdown pose serious near-term challenges that the Fund will take up in its advice and assistance. Efforts by the Fund to help countries maintain debt sustainability in a changing financing environment and to engage with non-traditional donors and creditors will continue. As countries mature, with the objective of graduating to middle income status, the Fund will help with the implementation of more sophisticated economic management approaches, supportive financial sector policies, and market access issues. Country progress may also imply movement away from medium-term financial support toward more intensive policy engagement and intermittent financing to help countries manage external shocks. The PSI and ESF will be reviewed to ensure that these instruments are meeting the needs of LICs. Further work is also expected on the Fund's approach to fragile states.

**Expected trends do not suggest a significant reduction in staff resource needs related to LICs in the medium term although some resource savings will be achieved** through refocusing, streamlining, and efforts to reduce overlaps both within the Fund and among entities involved in LICs.

## I. INTRODUCTION

1. **Work on Low-Income Countries (LICs) constitutes a large share of Fund’s activities** (Text Figure). The Fund has program or near-program relationships with more than half of all LIC members,<sup>1</sup> and 80 percent of Fund-supported programs are with LICs. On average, there are three times more missions per year to LICs than to the rest of Fund members, including four times more Technical Assistance (TA) missions. Two-thirds of its resident representative posts are located in LICs.

2. **This paper seeks to take stock of the Fund’s work in LICs, and to outline a comprehensive approach for Fund engagement.**

It responds to the Board’s request for a paper synthesizing a range of policy decisions and developments over the past few years related to the Fund’s work in LICs.<sup>2</sup> A key purpose is to ensure that, as part of the Fund’s refocusing exercise, its LIC-related objectives and responsibilities are well articulated and well understood by its member countries and the international community.<sup>3</sup>

3. **The Fund’s engagement with LICs is similar in scope to its work with other members in its emphasis on macroeconomic and financial stability, but the task is complex and its success often depends on reforms in areas covered by development partners.** While the Fund is not a development agency, its advisory, financing, and capacity building work is essential for LICs to be successful in achieving their objectives, including the Millennium Development Goals (MDGs), which are likely to remain out of reach for many countries. Macroeconomic and financial stability is a pre-requisite for growth, development and poverty reduction. At the same time, macroeconomic and financial stability alone cannot produce growth and reduce poverty; achieving these goals requires a wide-

### **Fund Engagement in LICs — 2007**

Work in LICs – 78 Countries



- 25 percent of front-line staff time
- 1/3 of Board’s time
- 1/2 of technical assistance
- 80 percent of Fund programs
- 2/3 of Resident Representative positions
- 32 fragile/post-conflict states

<sup>1</sup> In addition to PRGF-related work, this includes SMP, PSI, EPCA, ENDA, and near-program work.

<sup>2</sup> Board discussions in August 2003 and August 2004 considered how the Fund can best support its low-income member countries, see International Monetary Fund, 2003, “Role of the Fund in Low-Income Member Countries Over the Medium Term—Issues Paper for Discussion” and International Monetary Fund, 2004 “The Role of the Fund in Low-Income Member Countries”.

<sup>3</sup> See International Monetary Fund, 2008 “Strategic Directions in the Medium-Term Budget—Statement by the Managing Director”. See also International Monetary Fund, 2002 “The Managing Director’s Report on the Fund’s Medium-Term Strategy” and International Monetary Fund, 2006 “The Managing Director’s Report on Implementing the Fund’s Medium-Term Strategy”.

ranging approach to development by the country, on which development agencies and donors are better placed to advise. Thus, while the Fund needs to focus its work in LICs on those issues that are within its core competencies, it will need to collaborate closely with other stakeholders in order to be able to fulfill its mandate successfully.

4. **In the late 1990s, the Fund developed instruments to support growth and poverty alleviation explicitly in its low-income members.**<sup>4</sup> The Poverty Reduction and Growth Facility (PRGF) and the Poverty Reduction Strategy Paper (PRSP) process were at the center of the new approach, reflecting the importance of supporting country-led policies, and the need to work in collaboration with development agencies and civil society in order to help countries achieve the MDGs. The Fund has also played a central role in providing debt relief, under the HIPC Initiative and the 2005 Multilateral Debt Relief Initiative (MDRI).

5. **Over the last ten years the scope of the Fund's work in LICs has evolved substantially,** reflecting both the changing needs of LICs and the Fund's own assessments of how it could improve its support in light of feedback received from country authorities and outside observers.

- **In many LICs, macroeconomic policies and performance have improved markedly** (Figure 1). Better economic policies and debt relief in many LICs have contributed to the highest growth and lowest inflation rates in decades and improved external prospects. While important risks and fragilities persist, many LICs have overcome the challenges of unsustainable fiscal deficits and high inflation, and now seek more sophisticated macroeconomic and financial management tools.
- **At the same time, the favorable global environment of recent years has become more complex.** Since mid-2007 global economic conditions have worsened and rising fuel and food prices pose immediate fiscal and balance of payments challenges to many LICs. During the earlier part of the decade, increased revenue from commodity exports and rising private inflows allowed many LICs to build up reserves. Official development assistance still plays a key role, but its relative significance has declined as FDI, remittances, private development flows, and portfolio flows have risen sharply.<sup>5</sup> With some countries benefiting from aid scaling up, participation of non-residents in domestic debt markets, or large-scale loans and

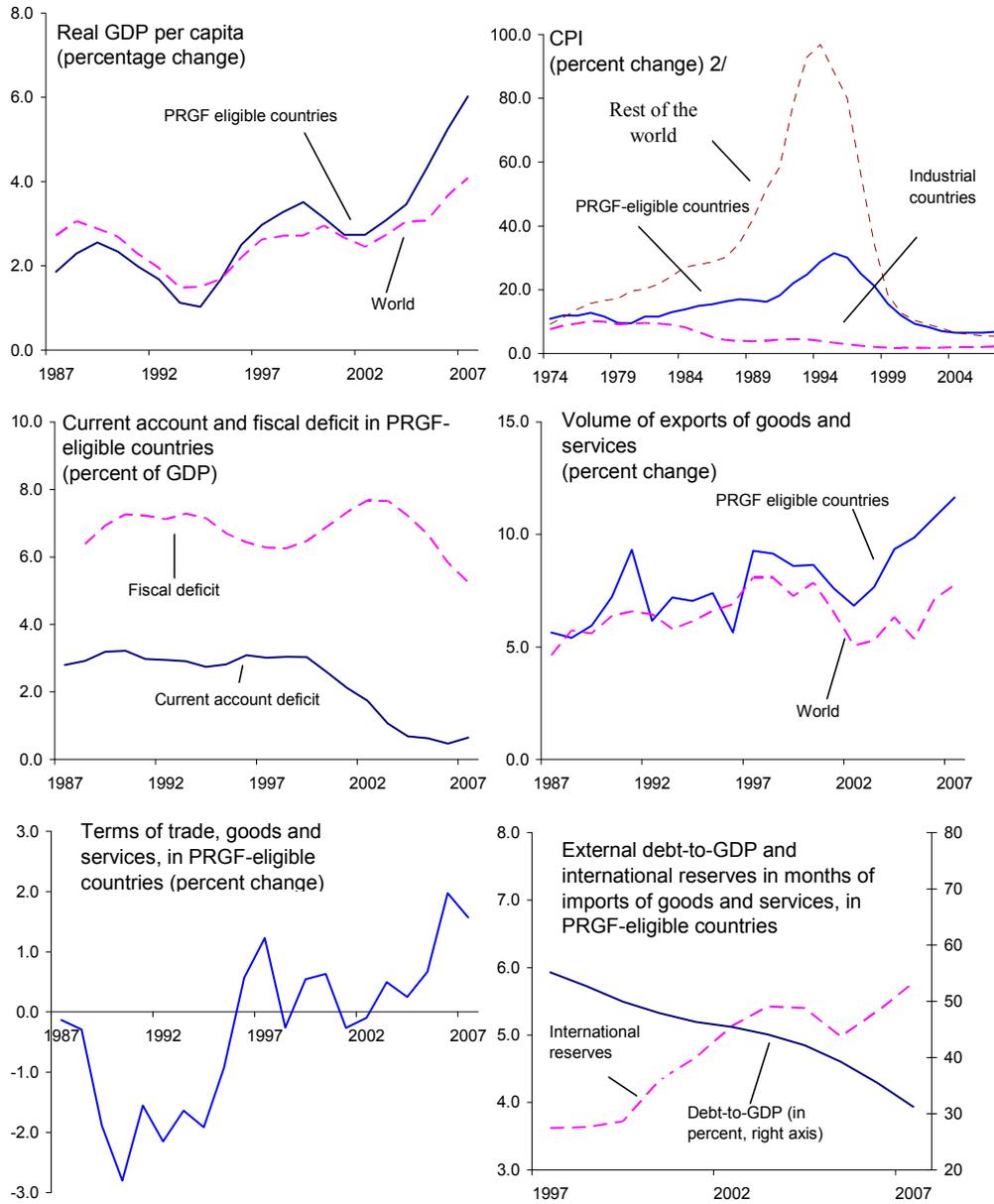
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<sup>4</sup> The evolution of the Fund's LIC work and key papers are described in detail in a separate background paper.

<sup>5</sup> Dorsey, Thomas, Helaway Tadesse, Sukhwinder Singh, and Zuzana Brixiova, 2008, *The Landscape of Capital Flows to Low-Income Countries*, IMF Working Paper 08/51 (February), (Washington: International Monetary Fund). See also Lael Brainard and Derek Chollet (eds.), 2008, *Global Development 2.0: Can Philanthropists, the Public, and the Poor Make a Poverty History?*, Brookings Institution Press, for a discussion of rising private development flows.

grants from non-traditional creditors and donors, the focus is shifting from debt relief to helping countries deal with managing new inflows and assuring debt sustainability.

Figure 1. Economic Developments in LICs (1987-2007) 1/



Source: World Economic Outlook.

1/ Moving average of past five years (weighted average).

2/ Geometric average of annual CPI inflation, weighted by PPP-adjusted GDP. The peak of the rest of the world is mainly due to Argentina and Brazil.

**6. In response, the Fund has refined the analytical underpinnings of its work and adapted the means by which it engages with its LIC members.** Over the years, the Fund has gained a deeper understanding of how macroeconomic policies can best be geared towards sustaining growth and poverty reduction, leading to more flexible Fund advice to

LICs including with respect to fiscal targets and inflation, more support for the full use of aid, and increased emphasis on debt sustainability. In parallel, it created new tools—the Policy Support Instrument (PSI), the Exogenous Shocks Facility (ESF), and the Debt Sustainability Framework (DSF)—or modified existing instruments—e.g., standardizing low-access PRGFs and subsidizing emergency assistance for natural disasters—to respond to new needs. As the scope of Fund advice and conditionality has become more aligned with its core areas of macroeconomic and financial stability,<sup>6</sup> effective collaboration with partner institutions in areas outside the Fund’s core expertise has become more critical. The Fund’s operational involvement in LICs was also strengthened through stepped-up efforts to engage with a wider set of stakeholders—including legislative bodies, civil society organizations (CSOs), labor groups, private sector representatives, and academics.

7. **This paper thus provides an updated statement on the role of the Fund in LICs.** Chapter II outlines the main elements of the Fund’s mission in LICs. Chapter III discusses the Fund’s evolving modalities and instruments for engaging with LICs. Cooperation and communication issues are addressed in Chapter IV, followed by a discussion of the challenges ahead including the need to adapt to a tighter budget environment in Chapter V.

## II. SUPPORTING SOUND MACROECONOMIC FOUNDATIONS FOR GROWTH

8. **The Fund will remain closely involved with its low-income member countries given the importance of macroeconomic stability for supporting growth and poverty reduction, their vulnerability to shocks, and their need to integrate more into the global economy.**<sup>7</sup> Following improvements in achieving stability across many LICs, the Fund is working to maintain this progress in the face of new challenges, to anchor it through stronger institutions, and to assist those countries where stabilization has not yet been attained. Box 1 outlines guiding principles for Fund engagement with LICs.

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<sup>6</sup> Independent Evaluation Office (IEO), International Monetary Fund, 2007, *An IEO Evaluation of Structural Conditionality in IMF-Supported Programs*, Washington, DC: IEO.

<sup>7</sup> For a discussion of the importance of these issues, see World Bank and International Monetary Fund, *Global Monitoring Report 2005*, Washington, D.C.

### **Box 1: Mission Statement**

**The IMF's mission with respect to low-income countries is to help them achieve the macroeconomic and financial stability needed to raise growth and reduce poverty.**

The Fund helps its low-income members put in place macroeconomic policies and institutions conducive to economic stability and strong, sustained growth, which are preconditions for effective poverty reduction. As with other members, it provides policy advice, capacity building, and, where appropriate, financial assistance. Its work is tailored to countries' evolving needs, and supportive of countries' own development objectives. The Fund focuses on its core areas of expertise, namely macroeconomic stabilization and fiscal, monetary, financial, and exchange rate policies, and underlying institutions and closely related structural policies. Building on cross-country experiences and rigorous analysis, the Fund provides:

- (i) advice on macroeconomic policies and institutions that support internal and external macroeconomic stability, foster economic growth, and enhance integration in the international trade and financial system;
- (ii) assistance in building capacity and institutions for sound macroeconomic management and financial stability; and
- (iii) concessional balance of payments support.

Effective collaboration with the international community is critical to ensuring that the Fund's work is coordinated with the international effort to reach the Millennium Development Goals.

**9. The Fund brings a unique set of competencies to the challenges facing LICs, focusing on macroeconomic and financial policies, informed by global trends and developments.** The Fund provides the benefits of its specialization in three distinct ways:

- The Fund contributes an integrated macroeconomic and financial perspective, including for countries' poverty reductions strategies, and in so doing, helps countries set appropriate macroeconomic objectives from both short- and long-term perspectives.
- For a given set of macroeconomic objectives, Fund staff can provide insights, best practices, and international and cross-country experience on *how* to achieve these targets with a view to ensuring favorable impacts for poverty reduction and growth (see Box 2).
- Fund balance of payments financing helps promote macroeconomic stability by giving countries time to implement orderly and coherent adjustment policies, and by helping to catalyze donor support on appropriately concessional terms.

### A. Context for Fund Advice

**10. The Fund considers the context in which it provides its advice to help ensure that it is appropriate for the specific needs and circumstances of LICs.**

- Policy advice and program design seek to reflect country-owned development and poverty reduction strategies (contained in a PRS for many LICs), enhancing coherence between macroeconomic and development policies to help foster achievement of the MDGs.<sup>8</sup> The Fund assists country authorities in developing macroeconomic scenarios underlying the PRS. Advice and program design draws on relevant poverty and social impact analysis (PSIA) conducted by other institutions.
- The Fund's work in LICs is enhanced through collaboration with development partners, in order to deliver coherent advice and assistance.
- LICs' administrative and technical capacity constraints and data limitations often call for frequent interaction with Fund staff and for support through technical assistance and training. The Fund's work also takes into account that LICs are exposed to shocks, dependent on volatile external inflows, and had or have high debt levels.
- The Fund's advice and instruments are adjusted as the macroeconomic issues faced by LICs evolve; future challenges will likely relate to the macroeconomic implications of: the current global economic slowdown, help in dealing with the cost of rising fuel and food prices and aid shocks, and climate change.

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<sup>8</sup> For a critical discussion of some of the issues involved, see Center for Global Development, 2007, *Does the IMF Constrain Health Spending in Poor Countries: Evidence and an Agenda for Action*, Washington, D.C.

### Box 2. The Importance of Macroeconomic Stability for Growth and Poverty Alleviation

**Macroeconomic stability is central to sustained growth and poverty reduction.** This is widely recognized and supported by many years of research and cross-country experience. In addition, LICs experience a higher incidence of shocks than other countries, which have negative effects on long-term growth and poverty reduction; macroeconomic policies can play an important role in dampening output fluctuations. The main elements of macroeconomic stability include:

- **Single-digit Inflation:** inflation above 10 percent is generally considered to pose risks to medium-term growth. At the same time, targeting very low inflation—below, say, 5 percent—may not leave sufficient flexibility to accommodate relative price changes, especially in the wake of adverse supply shocks.<sup>9</sup>
- **Prudent fiscal policy:** The fiscal stance should help ensure macroeconomic stability and debt sustainability, and avoid risks of crowding out.
- **Exchange rates consistent with fundamentals** and efforts to enhance competitiveness to provide appropriate incentives to export sectors.<sup>10</sup>
- **Financial sector stability:** Policies geared to financial stability and deepening can play a major role in fostering investment, expanding income-earning opportunities, and forestalling financial crises, which tend to hurt the poor most.

**Economic growth, in turn, is necessary—though not sufficient—for poverty reduction.** The empirical record shows that reductions in poverty are associated with increases in average incomes.<sup>11</sup> Growth can also improve a range of other (non-income) dimensions of poverty, including most notably health and education outcomes.

**Beyond the indirect effects through growth, the *specific mix of macroeconomic policies and instruments* chosen to achieve macroeconomic stability can have a direct and immediate impact on poverty reduction.** Most notably:

- **Public Financial Management:** Strong PFM systems ensure that resources are tracked, reported, and targeted appropriately, enhancing the efficacy of resources devoted to the poor.
- **Expenditure and revenue policies:** In particular, the composition of spending and its quality has a direct impact on poverty (e.g., through social safety nets) and an indirect effect via growth (through spending on infrastructure and human capital).
- **Monetary policies:** Chronic inflation corresponds to a tax that falls mostly on the poor.

**As shocks tend to hurt the poor disproportionately, macroeconomic policies can help by dampening output fluctuations.** Flexible exchange rate regimes can also help buffer shocks, as can well developed financial systems.

<sup>9</sup> See International Monetary Fund, 2005 “Monetary and Fiscal Policy Design Issues in Low-Income Countries”.

<sup>10</sup> See International Monetary Fund, 2005 “Can IMF Policy Levers Improve Institutions and Lead to Sustained Growth?”.

<sup>11</sup> See, for example, Aart Kraay, *When is Growth Pro-Poor? Cross Country Evidence*, IMF Working Paper 04/7 (March), (Washington: International Monetary Fund).

## B. Policy Advice in Key Areas

11. **The Fund’s work remains centered on helping LICs achieve and maintain macroeconomic and financial stability.** The immediate objectives include single-digit inflation, financial sector stability, policies supportive of export growth and external stability, and debt sustainability. However, the basic messages on the design of prudent fiscal and monetary policies must be adapted to new circumstances, including changes in the nature of financial inflows (Figure 2), debt relief, and the transition to middle-income status.<sup>12</sup> There are common macroeconomic challenges and priorities among various sub-groupings of LICs (Box 3).<sup>13</sup> The classification illustrates the diversity of LICs (Figure 3), and countries may shift among categories over time—indeed, advancing toward middle-income status is a key medium-term objective.

- **Sound fiscal and monetary policies are essential for securing macroeconomic stability and fighting poverty.** The Fund should advise LICs on raising adequate fiscal revenue—in part, to avoid risks of excessive long-run reliance on aid. Budgetary policies should be set in the context of a medium-term macroeconomic framework, with deficits limited by the scope for non-inflationary and sustainable financing. The Fund can also play a major role in improving financial management (PFM) systems. As many LICs have overcome problems of fiscal dominance, monetary policies can be targeted more effectively at maintaining single-digit inflation. The Fund should aim to enhance the transparency and effectiveness of monetary and exchange rate regimes, and assist in the development of more advanced policy frameworks, including inflation targeting. More sophisticated policy approaches will often depend on strengthened economic data compilation.
- **The Fund should help bring all low-income members to the point where all aid can be fully and effectively spent and absorbed in a manner that protects macroeconomic stability.**<sup>14</sup> However, the full use of aid, does not mean that all aid

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<sup>12</sup> Additional discussion of how Fund advice has evolved, including on issues related to fiscal space, wage ceilings, health and education spending, and conditionality, is included in the accompanying background paper.

<sup>13</sup> See International Monetary Fund, 2003 “Role of the Fund in Low-Income Countries Over the Medium-Term”.

<sup>14</sup> See International Monetary Fund, 2007 “Aid Inflows—The Role of the Fund and Operational Issues for Program Design” and International Monetary Fund, 2007 “Fiscal Policy Response to Scaled-Up Aid”. In this context, absorbing means that higher aid is matched by an increase in projected net imports. Related to this, the Fund needs to rely on development partners for assessments of microeconomic absorptive capacity, to help avoid unproductive spending.

is to be used immediately.<sup>15</sup> Given the volatility and unpredictability of aid, the Fund should promote a smooth path of fiscal spending, linked to countries' PRSs.

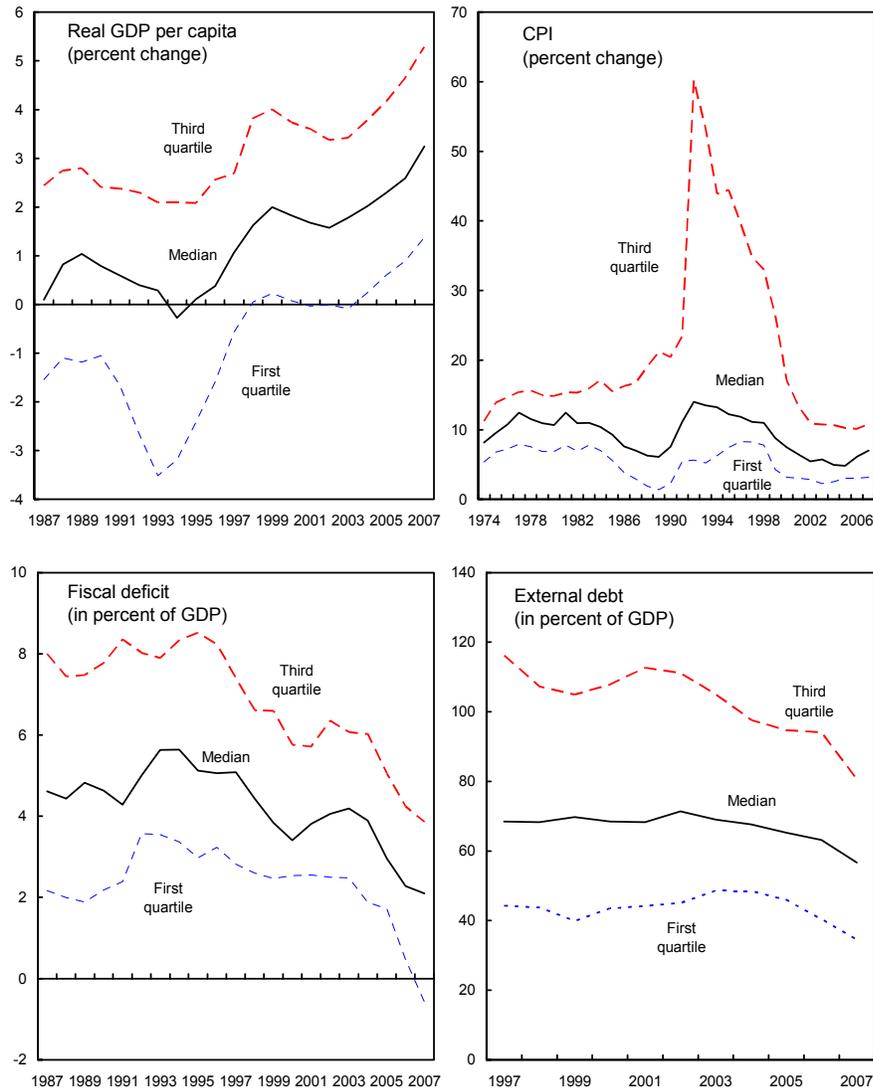
Figure 2. Official and Private Inflows  
percent of GDP



Source: Dorsey, Thomas, Helaway Tadesse, Sukhwinder Singh, and Zuzana Brixiova, 2008, *The Landscape of Capital Flows to Low-Income Countries*, IMF Working Paper 08/51 (February), (Washington: International Monetary Fund).

<sup>15</sup> For contrasting views on the merits and limits of scaling up aid, see Jeffrey Sachs, 2005, *The End of Poverty: Economic Possibilities for our Time*, New York: Penguin Press; William Easterly, 2006, *The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done so Much Ill and so Little Good*, New York: Penguin Press; and Paul Collier, 2007, *The Bottom Billion: Why the Poorest Countries are Failing and What Can Be Done About It*, Oxford University Press.

Figure 3. PRGF-Eligible countries: Dispersion of Selected Economic Indicators 1/ 2/



Source: WEO data.

1/ Moving average of the past five years.

2/ Differences between the quartiles reported in this figure and the weighted averages reported in Figure 1, are due to the relative weights of some PRGF-eligible countries, especially India.

- Helping countries establish a stable, well-regulated, and well-functioning financial system is a central part of the Fund's mandate in all countries.** In the context of LICs, financial sector *stability* and financial sector *deepening* are parallel objectives, which reflect the importance of financial markets for sustained growth. The Fund will help countries establish sound regulatory systems that encourage growth while containing risks. This work needs to be done in partnership with the World Bank, which focuses on the developmental aspects of financial systems. Fund staff should also seek to ensure that the surge in private inflows—in particular through financial sectors—does not expose LICs to undue new risks.

### Box 3: A Typology of LICs and the Tailoring of Policy Advice

**The Fund’s macroeconomic advice keys off country-specific circumstances.** A typology of these circumstances can assist in thinking about the range of problems countries confront.<sup>16</sup> Of course, countries will not always fit neatly into one category and are expected to shift over time.

**Fragile states and post-conflict countries:** *The primary macroeconomic objective of the Fund’s engagement in these countries is to lay the foundations—typically involving the rebuilding of institutions—that permit progress towards macroeconomic stability and restarting growth.* In post-conflict countries, domestic revenues and expenditures (particularly donor-financed capital spending) are often targeted to rise, especially to meet urgent needs resulting from the conflict. Non-post conflict fragile states generally have better initial macroeconomic conditions, but still lack the basic institutions for extending this record and for promoting sustained higher growth and poverty reduction.<sup>17</sup>

**Early stabilizers:** *Advice to early stabilizers generally focuses on ensuring that macroeconomic stability is firmly established and that critical structural impediments are addressed.* An extensive structural reform agenda is likely to be macro-critical, including for improving PFM, debt management, monetary instruments and operations, and foreign exchange markets.

**Mature stabilizers:** *The policy priorities for countries that have achieved macroeconomic consolidation will typically be to ensure that gains from initial successes—such as a sharp increase in official and private capital flows—do not threaten to undo macroeconomic stability.*<sup>18</sup> Fiscal policies may seek to create space for emerging priorities (power, infrastructure), while maintaining debt sustainability (often in the wake of debt relief). Monetary and exchange rate policies will typically need to aim at entrenching single-digit inflation, accommodating monetary deepening, and managing substantial aid flows and rising private flows. Structural reforms often focus on financial sector development, and enhancing transparency and the quality of growth.

**Pre-emerging market countries:** *For countries that are moving toward middle-income status and have market access now or realistic prospects of market access, priorities would shift towards managing the closer integration with global capital markets, ensuring the stability of an increasingly sophisticated financial system, and securing more diversified growth.* The Fund will need to offer advice and technical assistance on putting in place fiscal frameworks, as well as borrowing and debt management strategies that recognize the expanded role of private creditors and domestic financial markets. Other areas of attention are the transition to inflation targeting or similar monetary regimes, the rising significance of short-term private capital flows, and the integrated analysis of financial sector and macroeconomic risks.

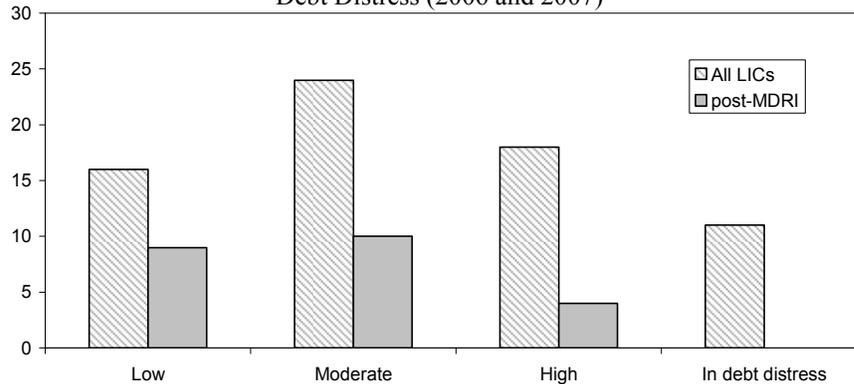
<sup>16</sup> This typology was outlined in International Monetary Fund, 2003 “Role of the Fund in Low-Income Member Countries Over the Medium Term—Issues Paper for Discussion”.

<sup>17</sup> International Monetary Fund, 2008 “The Fund’s Engagement in Fragile States and Post-Conflict Countries—A Review of Experience; Issues and Options”.

<sup>18</sup> International Monetary Fund, 2005 “Review of PRGF Program Design—Overview”.

- **Ensuring public and external debt sustainability remains a core objective.**<sup>19</sup> The strengthened framework for debt sustainability analyses (DSAs) will be particularly important now that an expanding set of creditors is willing and able to provide funds, although often on non-concessional or not fully concessional terms. Even after debt relief, concessional resources remain the most appropriate source of external finance for most LICs, given their needs, vulnerability to shocks, and weak project and debt management capacities (see Figure 4). Fund staff should stand ready to help members deal with emerging debt problems should prevention fail.

Figure 4. Classification of Low-Income Countries by Risk of Debt Distress (2006 and 2007)



Source: IMF, Staff reports issued in 2006 and 2007. Data exclude Zimbabwe.

### III. HOW THE FUND ENGAGES WITH LICs

12. **The Fund uses a range of instruments to provide policy advice and, if needed, balance of payments support.** The Fund provides advice through the Article IV surveillance process, program engagement, and capacity building. Based on policy discussions, the Fund forms a view of country macroeconomic and financial policies that is communicated through staff reports, press releases, and other vehicles such as assessment letters. This section takes stock of recent developments and how they feed into the Fund’s approach for engagement with LICs, and suggests some potential issues for consideration.

#### Surveillance

13. **Surveillance is a vital element of Fund engagement, and is increasingly adopting cross-country and regional perspectives.** Bilateral surveillance remains the main mode of engagement with the majority of LICs that do not have a program relationship with the Fund.

<sup>19</sup> See International Monetary Fund, 2006 “Review of Low-Income Country Debt Sustainability Framework and Implications of the Multilateral Debt Relief Initiative” and International Monetary Fund, 2006 “Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief”.

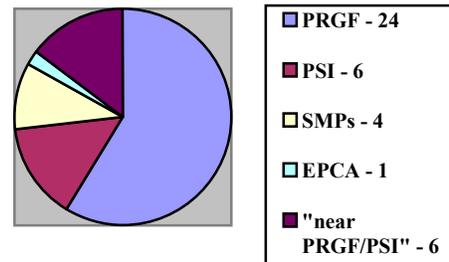
In line with the Fund's refocusing exercise, policy advice will center on its core areas of expertise, enriched by cross-country experience. Already, the Fund has stepped up its regional surveillance—including for LICs—in part, through the regular publication of Regional Economic Outlooks and with the formalization in 2006 of discussions with monetary unions. Advice will also reflect a deeper analysis of the linkages between financial markets and the real economy. In this context, the Fund will bring lessons from emerging markets to those LICs that are starting to access international financial markets.

14. **Surveillance can take into account the particular characteristics of LICs** while remaining focused on external stability. Consistent with the 2007 surveillance decision, the Fund assesses whether a country's exchange rate and domestic economic and financial policies are consistent with the objective of external and domestic stability. In LICs, macroeconomic policies and institutions that support growth and poverty reduction—including through their effect on donor funding—have an impact on macroeconomic, financial, and external stability, and thus should be discussed in surveillance. With regard to the assessment of exchange rates and exchange rate policies under surveillance, the tools for arriving at these judgments are moving beyond indicators traditionally used in the past to utilize more advanced methodologies.<sup>20</sup> To the extent data weaknesses constrain the use of such methodologies, the Fund will help build needed capacity.

### Financial and Policy Support

15. **The Fund will continue to provide subsidized balance of payments support to LICs when needed, tailored to individual country circumstances.**<sup>21</sup> Such financing can help LICs secure and maintain macroeconomic and financial stability, address shocks or ease the adjustment path for LICs with macroeconomic imbalances or where structural impediments hamper growth. LIC needs range from longer-term support under a PRGF to low access PRGFs or intermittent shock financing

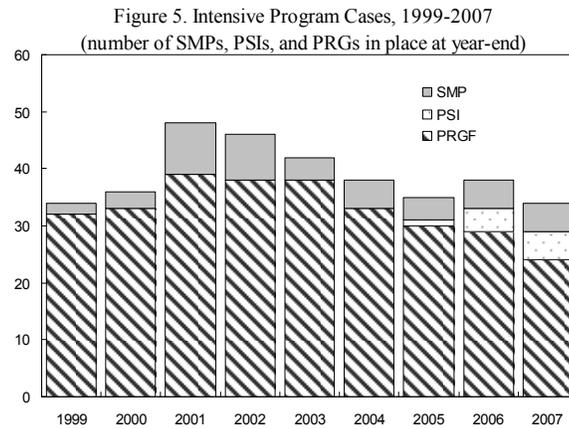
41 Program or "near-program" relationships



<sup>20</sup> For assessments of exchange rates, for example, staff advice for LICs and others is—subject to data availability—making greater use of econometric estimation and the use of the macro balance, external sustainability, and equilibrium REER approaches. Judgments of external stability more broadly are also increasingly being informed by references to: profitability, productivity and unit labor costs in the export sector; market shares; debt sustainability; and FDI prospects.

<sup>21</sup> International Monetary Fund, 2004 “The Acting Chair’s Summing Up—The Role of the Fund in Low-Income Member Countries”.

(Box 4). Providing assistance to LICs on more concessional terms remains appropriate given their needs, vulnerability, and limited debt management capacity.<sup>22</sup> For countries that need to establish, or re-establish, a policy implementation track record before requesting or resuming a financial arrangement, a staff-monitored program (SMP) can be helpful (Figure 5).



### *PRGF lending*

16. **The PRGF remains the primary instrument for Fund financial engagement with LICs seeking support for protracted balance of payments problems and a remaining agenda of economic stabilization and structural reform.** In addition, 18 countries that have not yet reached the HIPC completion point will need to implement PRGF- or EFF-supported economic programs to receive debt relief under the HIPC Initiative and MDRI.

- **PRGF lending will remain anchored by the PRS process, to help ensure country ownership and** promote consistency between the country's macroeconomic framework and its poverty reduction strategy. The PRS would be an appropriate framework to consider alternative macroeconomic scenarios. Further capacity building is important to strengthen the ability of countries to develop and implement realistic and prioritized PRSs with macroeconomic frameworks and debt management strategies consistent with poverty reduction.
- **Program content and conditionality for the PRGF (and for other instruments such as the PSI and ESF) will be guided by the PRS and focus on the Fund's areas of expertise.** Further efforts will be made to streamline the number of

<sup>22</sup> As Fund members, LICs also have the option of drawing on GRA resources including through Stand-by Arrangements (SBAs). While GRA lending is not subsidized, some PRGF-eligible members have opted for SBAs in recent years (e.g., Bolivia, Dominica, Honduras, Nigeria, Pakistan, Papua New Guinea, and Sri Lanka have had SBAs). Reasons for seeking an SBA over a PRGF vary but have included the desire for programs more focused on short-term stabilization.

conditions<sup>23</sup> although conditionality will continue to cover all measures critical for program success. To help ensure greater focus, measures outside the Fund’s core areas that are critical for program success will require strong justification, and a detailed description of assistance in these areas from development partners. Programs will continue to benefit from feedback gained through *ex post* assessments for countries with longer-term program engagement.

#### **Box 4: Modes of Engagement by Low-Income Country Type**

In addition to surveillance-based policy advice for all countries and capacity building for those seeking such assistance, a range of Fund program and financial support instruments is available to help meet the varying policy support and balance of payments needs of low-income members:

**Post-Conflict and Fragile States:** Emergency Post-Conflict Assistance (EPCA) is appropriate for countries that have made sufficient progress for a relatively early move to a PRGF (perhaps within 18 months). Fragile states with somewhat stronger capacity could benefit from a PRGF-supported program. The Fund is currently considering refinements to these policies (see below).

**Early Stabilizers:** PRGF-supported programs would be appropriate for longer-term adjustment measures and for HIPC-eligible countries seeking HIPC/MDRI debt relief. Balance of payments shocks could be addressed through PRGF augmentation or the ESF (for countries without a PRGF).

**Mature Stabilizers:** Low-access PRGFs, PSIs, ESFs would be the most appropriate instruments.

**Pre-Emerging Market Countries:** Although PRGFs would remain an option, countries are increasingly likely to turn to PSIs and PRGF/EFF blends with the ESF and Stand-by Arrangements (SBAs) available to help address specific shocks.

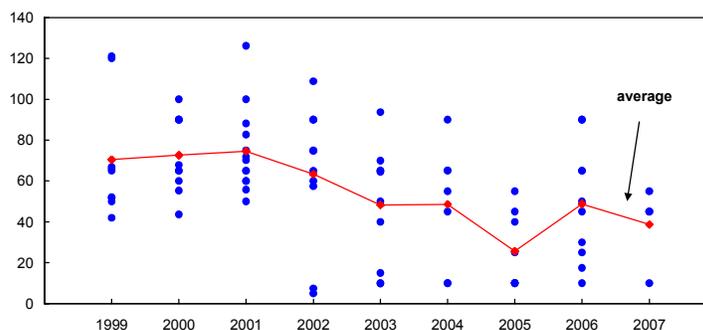
**All Countries:** SBAs are available to help address short-term balance of payments problems, but do not provide subsidized terms. The TIM is available to cushion shocks related to trade liberalization for countries with PRGFs or SBAs while emergency assistance can be used for natural disasters (ENDA).

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<sup>23</sup> International Monetary Fund, 2007 “The Chair’s Summing Up—IEO Evaluation of Structural Conditionality in IMF-Supported Programs”.

- Access under the PRGF will reflect country needs and policy guidelines.** Policy developments in recent years—standardization of low-access PRGFs, establishment of the PSI and a shock financing instrument, and substantial debt relief—may lead over time to more low-access PRGFs and episodic shock financing, although a less benign global environment may lead to higher demand for “regular” access PRGF in the short term (see Figure 6). Significant subsidized assistance for balance of payments needs will remain available to LICs.

Figure 6. Access Level Under New PRGF Arrangements by Year, 1999-2007, in percent of quota



- The PRGF remains open to possible improvements** to meet the changing needs of Fund members.<sup>24</sup>

#### *Policy Support under the PSI*

17. **The PSI was created in 2005 for low-income members that do not need, or want, Fund financial assistance.** Recognizing that a number of LICs were advancing to the point where immediate balance of payments support was not needed, but continued donor flows remained critical to the achievement of poverty reduction objectives, the Fund created the PSI for mature stabilizers in 2005 as part of a package of measures (the MDRI further reduced financing needs and the ESF offered confidence that rapid assistance would be available to PSI countries in the event of a shock).<sup>25</sup> The PSI, which is based on a country’s PRS, offers policy support for an upper-credit tranche quality program, thus signaling the strength of policy performance. There are now five PSIs, and as more LICs consolidate macroeconomic stability, it is likely to increasingly serve as a key vehicle for program engagement. To ensure that the PSI remains well-suited to LIC needs, a review of initial experience is expected in 2008.

<sup>24</sup> Among potential ideas, Cohen and Borensztein have noted the flexible repayment terms offered by “Agence Française de Développement” as a means to help LICs manage financial pressures better in the event of shocks. However, the short amortization schedule of PRGF loans limits the scope for following this approach. See [Daniel Cohen and Eduardo Borensztein, 2008, “Managing Risks in Low-Income Countries: Markets, Multilaterals, & Money,” IMF working paper (forthcoming).]

<sup>25</sup> International Monetary Fund, 2005 “Implementation of the Policy Support Instrument”.

*Facilitating adjustment to shocks*

18. **Helping LICs minimize the economic impact of shocks remains a key role for the Fund.** In addition to advising countries on policies to reduce macroeconomic vulnerabilities and foster resilience to shocks, the Fund will continue to offer subsidized balance of payments assistance:

- For countries with an active PRGF arrangement, an augmentation of access generally provides the most suitable means of support.
- Under the Trade Integration Mechanism (TIM), the Fund can help address balance of payments shortfalls due to trade liberalization undertaken by others. Demand for this facility—which is incorporated into an existing PRGF, PRGF/EFF, or SBA—could increase in the context of forthcoming multilateral trade liberalization.
- Emergency Natural Disaster Assistance (ENDA) provides support in case of events such as floods or hurricanes and, resources permitting, does so on subsidized terms.
- The recently created Exogenous Shocks Facility (ESF) remains available, but modifications will be considered to enhance its usefulness. Established in 2005 to meet a perceived need, particularly for PSI users, the ESF has not been used to date.<sup>26</sup> This reflects in part favorable global economic conditions in recent years that have contributed to strong demand for LIC exports and helped offset higher oil prices for some countries, as well as the availability of the PRGF augmentations. Global conditions may be worsening, and in any event, ESF modifications will be considered. For instance, steps to facilitate more rapid access might be considered and ESF financing could also be linked more closely to the PSI.

*Fragile states*

19. **The Fund is considering refinements to the modalities of its engagement with the fragile states among its LIC members in order to provide support more closely attuned to their specific needs.** The international community, increasingly concerned with state fragility, is attempting to devise an integrated and coordinated approach to engage with them more effectively. While fewer LICs are now in conflict than was the case at many points in recent years, the nature of the Fund’s engagement in post-conflict and fragile states will likely be more intensive than in the past. The Board recently discussed a review of the

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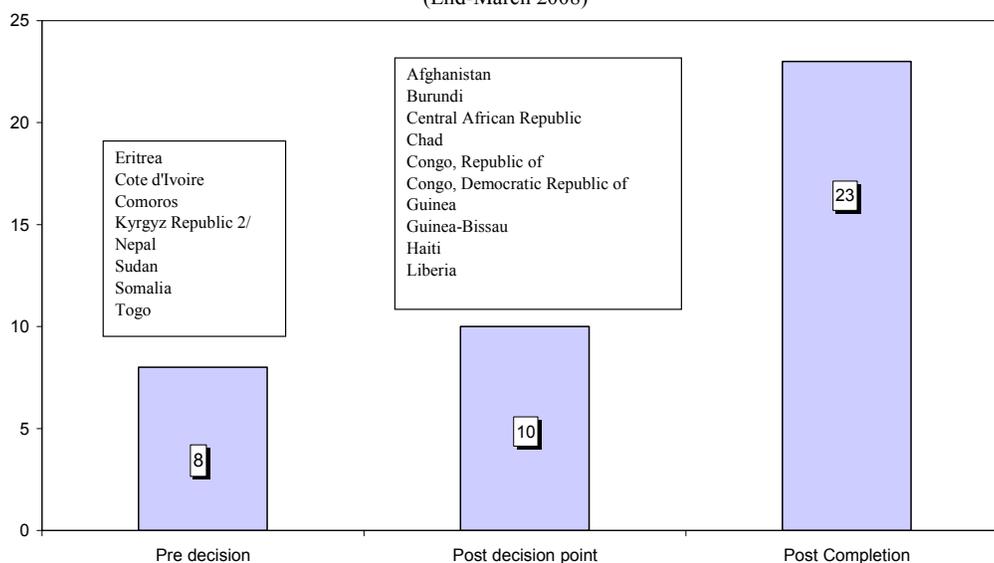
<sup>26</sup> International Monetary Fund, 2005 “Establishment of an Exogenous Shocks Facility Under the Poverty Reduction and Growth Facility Trust”.

Fund's engagement with fragile and post-conflict states,<sup>27</sup> and follow-up work is scheduled for the near term (see below).

### *Debt relief*

20. **The Fund will continue to support the efforts of LICs to ensure debt sustainability and secure debt relief through the HIPC Initiative and MDRI.** The joint Bank-Fund debt sustainability framework (DSF) remains a cornerstone in the formulation of Fund advice, both in surveillance and program contexts. Through HIPC and the MDRI, creditors are forgiving a large share of the debt of qualifying LICs, thereby strengthening debt sustainability and external positions, and creating fiscal space for priority outlays. The Fund alone has delivered approximately US\$6.5 billion in HIPC and MDRI debt relief. While agreement on a debt relief framework is in place, substantial work will still be needed for implementation. Ten countries are between HIPC decision and completion point, while eight are yet to reach decision point (Figure 7). Most of these countries are vulnerable to domestic policy shocks and will require extensive staff engagement. The remaining protracted arrears cases are likely to present resource and policy challenges, as evidenced by recent experience with Liberia.

Figure 7. Low Income Countries by Stage in the HIPC Initiative Process 1/  
(End-March 2008)



1/ Twenty five countries have benefitted from MDRI debt relief, including all those that have reached the HIPC completion point.

2/ The authorities of the Kyrgyz Republic have indicated that they do not wish to avail themselves of HIPC relief.

<sup>27</sup> International Monetary Fund, 2008 "The Fund's Engagement in Fragile States and Post-Conflict Countries—A Review of Experience—Issues and Options".

## Capacity Building

21. **The Fund will continue to help LICs build skills and institutions that support effective macroeconomic management.** The objective of capacity building is to develop the institutional and governance foundations necessary to implement sound economic policies, reduce vulnerability to shocks, and strengthen financial sectors. Capacity building will continue to focus on the Fund’s core areas of expertise, be integrated with surveillance, support implementation of Fund-supported programs, and reflect the evolving needs of individual members. To deliver capacity building most efficiently, there is likely to be greater emphasis on coordination with other donors, measuring effectiveness, using regional centers to provide technical assistance and training,<sup>28</sup> and recovering TA and training costs through additional donor financing and a graduated system of charging according to a member’s per capita income. This will entail the bundling of Fund technical assistance through a menu of topical trust funds and highlighting the link with donor development strategies. At the same time, resource constraints will necessitate some scaling back of Financial Sector Assessment Program (FSAP) work and Reports on the Observance of Standards and Codes (ROSCs).

- **Technical assistance:** The Fund’s technical assistance will focus on tax and expenditure policy and revenue administration, expenditure management, monetary policy, exchange rate regimes, financial sector work with central banks and supervisors in support of financial market development and deepening, and macroeconomic and financial statistics.<sup>29</sup> As LICs advance, more need help on sophisticated techniques for monetary control—for example, inflation targeting—and financial sector supervision.
- **Training** of country officials also will focus on the Fund’s core areas of expertise. To deliver this assistance more efficiently, the Fund will shift shorter courses from headquarters to co-financed locations abroad, introduce charges for courses at headquarters, and seek additional external funding.<sup>30</sup>

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<sup>28</sup> The Fund operates regional technical assistance centers in Asia and the Pacific (PFTAC), Africa (East, West, and Central AFRITACs), the Caribbean (CARTAC), and the Middle East (METAC). The Fund operates the following regional training institutes and programs: the IMF-Singapore Regional Training Institute; the Joint Africa Institute; the Joint China-IMF Training Program; the Joint IMF-Arab Monetary Fund Regional Training Program, the Joint India-IMF Training Program, the Joint Regional Training Center for Latin America, and the Joint Vienna Institute (in Austria).

<sup>29</sup> International Monetary Fund, 2008 “Enhancing the Impact of Fund Technical Assistance”.

<sup>30</sup> International Monetary Fund, 2008 “Training as Part of Capacity Building—Recent Initiatives and Strategic Considerations”.

- **Economic Data:** The Fund will continue its statistical capacity-building work, particularly given serious capacity constraints in many LICs and the importance of high-quality data to economic management. The Fund will continue to promote the General Data Dissemination System (GDDS), and will encourage countries moving toward capital market access to graduate to the Special Data Dissemination Standard (SDDS) given its focus on facilitating capital market access. The World Bank and the Fund will also encourage additional LICs to report quarterly external public debt as part of the recently established Quarterly External Debt database.
- **Standards and codes and transparency:** The Fund will continue to use the standard and codes initiative and related ROSCs that chart country progress to encourage good governance<sup>31</sup> and promote transparency in fiscal as well as monetary and financial policies.<sup>32</sup> Staff actively supports the Extractive Industries Transparency Initiative (EITI).<sup>33</sup> Finally, the Fund’s Safeguards Assessment Policy emphasizes transparency to achieve accountability and help strengthen capacity at central banks.<sup>34</sup>
- **Financial Sector Assessment Program:** The joint Fund-Bank FSAP will continue to help LICs make their financial markets more resilient to shocks, particularly with growing capital market liberalization and increased reliance on portfolio investments.
- **Debt management:** The Fund, working closely with the World Bank and others, is helping LICs develop the capacity to design and implement their own medium-term debt strategies (MTDS). An MTDS aims to identify the size and terms of a prudent borrowing envelope—informed by the DSF—and also covers choices between alternative financing instruments. Complementary efforts concern areas such as debt recording, macroeconomic forecasting and institutional development. Work is also expected to continue in developing LIC-specific risk assessment tools linked to the DSF. A four-year pilot project has been initiated to test this approach and these tools.<sup>35</sup>

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<sup>31</sup> See *Good Governance—the IMF’s Role* at <http://www.imf.org/external/pubs/ft/exrp/govern/govindex.htm>

<sup>32</sup> For the transparency codes and associated documents, see <http://www.imf.org/external/np/fad/trans/index.htm> and <http://www.imf.org/external/np/mae/mft/index.htm>

<sup>33</sup> See <http://www.eitransparency.org/>.

<sup>34</sup> See <http://www.imf.org/external/ns/cs.aspx?id=156> .

<sup>35</sup> See International Monetary Fund, 2007 “Strengthening Debt Management Practices—Lessons from Country Experiences and Issues Going Forward”.

#### IV. COOPERATION AND EXTERNAL COMMUNICATION

22. **Given the multitude of development partners actively assisting LICs, effective cooperation and clear communication are essential.** Reducing overlaps and building on complementarities will improve the efficiency of the global community's efforts.

##### A. Cooperation with Development Partners

23. **The effectiveness of the Fund and development partners depends on two-way cooperation.** If the Fund is to refocus its efforts while remaining effective, it will have to rely more on others. And while collaboration itself requires effort, successful cooperation with development partners should enable the Fund to engage more efficiently in LICs. Particularly relevant are the flows of information, from the Fund to donors on country macroeconomic situations and prospects, and from donors to the Fund on their financial assistance and their assessments of sectoral approaches. Collaboration does not imply donor coordination by the Fund, but, especially for budget support, donors desire a more intensive dialogue with Fund staff and assessments at specific points in the budget calendar.<sup>36</sup> Cooperating in the provision of capacity-building support is also important in enhancing the effectiveness of all TA providers. Interaction during missions is essential as donors empower in-country representatives and the Fund scales back the use of Resident Representatives. However, achieving this objective within the reduced budget envelope for mission work will be challenging and will require effective prioritization, planning, and management of expectations. The Fund also needs to continue developing relationships with new donors and creditors that are playing an increasingly important role in many LICs.<sup>37</sup>

24. **In addition to outreach to donors in the field and participation in PRS and consultative group meetings, a few other specific areas of cooperation are under way:**

- **Collaboration with the World Bank:** Key inputs from the Bank on sectoral policies and other structural reforms will help the Fund provide advice on macroeconomic policies and design effective economic programs (including conditionality). Similarly, the Bank will be expected to seek input on country macroeconomic policies from the Fund. Coordination, including in areas of overlap, will promote the provision of coherent advice with clear lead responsibilities while reducing

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<sup>36</sup> For the most recent paper, see International Monetary Fund, 2007 "The Role of the Fund in the Poverty Reduction Strategy (PRS) Process and Its Collaboration with Donors". Donors' need for stronger collaboration was raised in the IEO report on the Fund and Aid to Africa.

<sup>37</sup> To date, the Fund has engaged at a technical level to seek information about support from new donors and creditors and to promote a shared understanding of the DSF framework. Further higher-level engagement might be considered to enhance coordination on debt-related issues in LICs.

duplication of effort.<sup>38</sup> Better coordination will be supported by the JMAP, which seeks to make best practice on collaboration common practice, including through country level agreements and greater sharing of technical assistance reports and other information. Other key Fund-Bank efforts concern the HIPC and MDR Initiatives, the joint DSF, cooperation on the PRS process, FSAPs, ROSCs, the pilots under the March 2007 initiative for Coordinated Support for Growth Critical Reforms in Africa, and the Integrated Framework under the Aid for Trade Initiative.

- **Outreach to support debt sustainability:** The Fund, often working closely with the Bank, seeks to promote the sustainability of LIC debt. The Fund: (i) is working to strengthen information sharing and coordination among creditors—a critical condition for debt sustainability in LICs; (ii) maintains close contacts with Paris Club creditors, multilateral development banks, and others to ensure that debt relief is provided to remaining HIPCs in an efficient and timely manner; and (iii) has enhanced its contacts with the OECD/DAC and other creditors to exchange information on LICs’ financing needs and debt sustainability prospects. The Fund will continue to encourage creditors to disseminate information on their financial operations in LICs and use DSAs to inform their lending decisions.<sup>39</sup>
- **Aid for Trade:** The Fund will continue to cooperate through Aid for Trade (AFT) activities and the Enhanced Integrated Framework (EIF) to help countries take better advantages of trade opportunities and integrate trade policies into national development strategies.

## **B. Strengthening Communication**

25. **The Fund aims to strengthen communication on its LIC policies to build greater understanding and support.** The institution will aim to articulate more clearly the Fund’s role and relevance in LICs, and its continued commitment to supporting growth and poverty reduction while focusing on its core areas of expertise. Given limited resources, this will involve targeted engagement with development partners, media, parliamentarians, CSOs, and private foundations who have emerged as major donors. Moreover, participation in relevant international organizations’ meetings and seminars should help build support among key constituencies for the Fund’s LIC work. While enhancing web-based communications to disseminate information, more traditional communication tools, such as in-country press briefings, will also be required in many parts of the developing world. The flagship

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<sup>38</sup> Following the division of labor contained in the 1989 Concordat, International Monetary Fund, 1989 “Bank-Fund Collaboration in Assisting Member Countries”.

<sup>39</sup> A number of multilateral and bilateral creditors already use DSAs to guide their lending and grant-allocation decisions, and others are currently developing similar systems.

publications World Economic Outlook and the Regional Economic Outlooks will be disseminated widely to media, parliamentarians, and CSOs in LICs.

26. **Communication must be two-way with the Fund responsive to the concerns of its critics and other interlocutors**, and ready to explain the rationale of its policy recommendations. Missions will be advised to provide adequate opportunity for a debate on the core elements of Fund programs and to discuss policy trade-offs. In light of the Independent Evaluation Office's (IEO) findings that on occasion the Fund's rhetoric on its work in LICs has been disconnected from its policy and practice, the new communications strategy emphasizes the need to ensure full alignment of the Fund's policy, practice, and public pronouncements.

## V. CHALLENGES AHEAD AND WORK PROGRAM

27. **The Fund's role in LICs will continue to evolve in line with its new strategic direction and as LICs themselves grow and face new challenges.** The strategic direction's emphasis on helping countries secure and maintain macroeconomic stability, while focusing on the Fund's core areas of expertise, is reflected in the proposed mission statement (Box 1), which takes into account the specific context of the Fund's LIC members.

28. **The Fund's low-income work needs to reflect both near- and longer-term priorities.** At this juncture, helping countries respond to shocks, such as the recent spikes in food and fuel prices, requires immediate attention. In the medium term, an increasing number of LIC countries have been moving towards middle-income status—indeed, supporting that shift is the ultimate objective of the Fund's work in LICs—and the Fund will tailor its approach accordingly. Other key issues for LICs that help shape where the Fund will need to focus in the future include: policy responses to capital inflows, financial market development and integration, and the opportunities created by the expanding universe of creditors, and associated risks, including to debt sustainability.

29. **As part of the refocusing exercise, the Fund's surveillance, capacity building, and financing instruments will be refined to help ensure effective support for LIC members.** To strengthen low-income work at the Fund, a Low-Income Country Unit is being set up to consider policies and operational practices, enhance cross-country understandings and coordination within the Fund, bring proposals to a revived management-led Committee on Low-Income Countries, and conduct outreach. In seeking to assist LICs, the Fund will also need to improve collaboration with development partners and maintain effectiveness in a more stringent Fund budget environment.

### Strategic Refocusing in a Changing Global Environment

30. **Immediate efforts are focused on helping countries address current shocks.** Following the generally supportive global economic environment for much of the last fifteen years, sharply rising food prices, continued high fuel prices, and risks of economic slowdown

now pose serious challenges. The Fund is reviewing the ESF on an accelerated schedule to enable the Fund to provide more rapid and effective shocks financial assistance. Fund policy advice in response to shocks generally encourages pass-through of permanent changes in world market prices in order to limit price distortions and preserve longer-term fiscal sustainability, while cushioning the impact on the poor through targeted measures. Advice to resource exporters, who benefit from high export prices, seeks to avoid the “resource curse” through sound governance and careful medium-term financial planning. For many LICs, rising inflation may also pose policy challenges in the period ahead.

31. **The planned review of all Fund facilities will provide an opportunity to ensure that LIC instruments are adapted to the changing needs of LIC members** (Box 5). As LICs develop and improve their policies and institutions and as their balance of payments strengthen, including through debt relief, there is likely to be a shift in the form of Fund engagement, with fewer countries requiring medium-term financial support. Policy engagement will be increasingly anchored in PSIs and Article IV surveillance, with financial support likely to focus more on helping countries regain macroeconomic stability, particularly in the wake of shocks—which may become more prevalent as countries integrate into the global economy. In this context, it will be important to assess the Fund’s concessional financing structure and whether LIC needs are being met, so as to eliminate overlaps in the range of current instruments or fill any identified gaps, such as the need for a concessional short-term stabilization instrument.

### Box 5: Work Program on LIC-related Issues

#### *Strengthening LIC-related Instruments:*

**Shocks Financing:** Changes to the Fund's shocks financing capabilities will be proposed shortly to make it easier to provide rapid and effective assistance, and address shortcomings in the ESF. Potential issues include facilitating more rapid assistance, particularly in the context of food price increases, and improving integration with the PSI.

**Facilities Review / PRGF Design:** The planned review of Fund facilities will consider how the PRGF and other instruments fit the needs of LIC members, including whether there is a need for a concessional short-term stabilization instrument for LICs. On the PRGF, possible issues include more flexible repayment schedules to help LICs manage financial pressures in the event of shocks and streamlined reviews.

**PSI:** The upcoming review of initial experience under the PSI will provide a timely opportunity to ensure that the Fund's instruments are meeting the changing needs of low-income members, especially as more LICs are in need of intensive policy engagement rather than financing. Issues likely to be considered include the fixed cycle for reviews and possible use of PSIs by middle-income countries.

**Fragile States:** After an initial Board discussion based on staff's review of the Fund's engagement with fragile and post-conflict states, staff will come back to the Board with a follow-up paper with operational proposals that reflect the Board's views and the results of planned outreach to potential recipients and donors.

**Aid Volatility:** Questions have been posed about whether the Fund might play a role in providing financing to help countries experiencing aid shortfalls.

**Debt Sustainability:** Refinements to Fund advice and instruments for supporting prudent debt management in an increasingly complex financial environment will be discussed near the time of the Annual Meetings.

**Trade:** Work will include assessing the impact of the Doha Round and other trade agreements such as EU Economic Partnership Agreements on LICs.

#### *Refocusing and Strengthening Work Practices:*

**Capacity Building:** Greater prioritization, combined with external fund raising, should help maintain the Fund's effectiveness. A more selective approach to ROSCs and FSAPs will be used, and efficiency will be enhanced further through the use of regional centers for delivering TA and training.

**Debt Relief:** Preliminary HIPC documents will be shortened and financing will need to be identified for the remaining protracted arrears cases.

**Streamlining:** Proposals to (i) eliminate JSANs except for full PRS documents and for PRS documents tied to HIPC decisions and (ii) to streamline mid-year reviews of the PRGF and PSI will be taken up in 2008.

#### *External Engagement:*

**International Cooperation:** The Fund is active in international efforts to help countries deal with high food and fuel prices, and among other events, will participate in the Accra High Level Forum on implementation of the Paris Declaration in September and the UN Conference on Financing for Development in Doha in December to review progress in implementation of the Monterrey Consensus.

32. **Surveillance in LICs will be sharpened as part of broader work in this area.** Efforts to strengthen Fund surveillance, including through implementation of the 2007 decision, will pay due attention to the specific needs of LICs. Capacity building support will be provided to help address data weaknesses and policy advice will be tailored to evolving country circumstances, with the Fund drawing on emerging market experience for those LICs for which market access is an option.

33. **The new financing environment for LICs underscores the continued importance of debt sustainability analysis and advice on external assistance.** The promised aid scaling-up by traditional donors is not materializing across the board, so the Fund will continue to assist countries in managing aid flows, maximizing aid spending and absorption over time, while calling on donors to live up to their commitments. At the same time, many LICs are gaining access to increased private inflows and funds from nontraditional creditors, especially post debt relief. The widening of the donor and investor base—both public and private—is welcome, as it means new financing opportunities for LICs, whose investment needs remain very large. However, this context can make it more challenging to maintain debt sustainability, and the DSA will remain central in countries' efforts to do so.

34. **The Fund will seek to provide capacity building assistance more efficiently.** Capacity building has proven particularly valuable to LICs, and following a recent Board discussion, the Fund will take steps to enhance prioritization, increase external funding, and make greater use of regional centers.

### **Collaboration with Other Institutions**

35. **The Fund's new strategic direction requires an effective and balanced division of labor among international institutions as well as a fluid exchange of information.** Collaboration with the World Bank will be enhanced as the JMAP and pilot initiatives to foster cooperation in a number of African countries are implemented. Enhancing cooperation with partners will require resources, but should be seen as a worthwhile investment, since the Fund will increasingly be able to focus its own efforts while relying on inputs from others. Ensuring efficient support of LICs depends on a clear division of labor among international institutions, and toward that end, the Fund will continue to focus on the macroeconomic and financial policy issues where it has clear responsibility to play the leading role, and will seek to foster consensus on this division of labor.

36. **The Fund will need to address the macroeconomic aspects of emerging global challenges.** The recent food and fuel price shocks, as well as attention to the potential impact of climate change, provide good examples of how the Fund will work with others in the international community. The Fund will focus narrowly on macroeconomic facets such as the fiscal and balance of payments impacts and how to preserve price stability, but will cooperate closely with other key players given the broad nature of the challenges.

## Budgetary Implications

37. **Work on LICs represents a sizeable share of the Fund’s overall budget.** In FY 2007, an estimated 25-30 percent of the Fund’s budget was spent on LIC-related activities. On the basis of the Fund’s key output areas, the largest share of LIC-related spending was allocated to programs and financial support (41 percent),<sup>40</sup> followed by capacity building (29 percent), and bilateral and regional surveillance (25 percent).<sup>41</sup> While there are weaknesses in the database, these ratios appear to be typical of recent years.

38. **Expected trends in the demand for Fund LIC instruments suggest a clear tension given a significant reduction in staff resources.** While there has been a shift from PRGF arrangements to PSIs, the total number of intensive program cases (a category including EPCAs and SMPs) has remained fairly stable, and new requests do not signal an imminent decline. Whereas the number of countries reaching HIPC decision or completion point each year is projected to remain below the earlier peaks, most of the remaining countries are institutionally fragile, and helping them normalize their relations with the international financial community will require extensive staff engagement and creative policy approaches. With relatively constant demand, at least in the medium-term, it will be a challenge to meet LIC needs given a 10–15 percent reduction in staff resources as part of the Fund’s refocusing, and prioritization will be needed.

39. **Nonetheless, the Fund will seek to achieve medium-term resource savings through the refocusing, streamlining, and broader efforts to reduce overlaps within the Fund and among entities involved in LICs.**

- Further sharpening of the Fund’s focus will limit analysis of issues outside its core mandate to those that are macro-critical and can be well justified, including with respect to the work done by other institutions.
- Work related to the HIPC Initiative and MDRI should also be winding down. However, given the expectation of somewhat intensive work on the remaining HIPC Initiative cases, significant savings will only materialize in the medium term.
- New procedures that should also benefit LIC-related work include streamlined internal review procedures, improved automation, and organizational changes involving larger divisions to encourage cross-country synergies.

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<sup>40</sup> The category “programs and financial support” includes SMP, PSI, EPCA, ENDA, and near-program work, in addition to that directly associated with the administration of the PRGF.

<sup>41</sup> The composition of the LIC-related expenditure differs somewhat from that for the Fund as a whole, where the largest allocations were to bilateral/regional monitoring (38 percent), country programs (24 percent) and capacity building (24 percent).

- Other efficiency measures particularly important for LICs include a more selective approach to capacity building, combined with external fund raising;<sup>42</sup> scaling back Joint Staff Advisory Notes (JSANs); streamlining alternate reviews under the PRGF and the PSI; and shortening preliminary HIPC documents (see Box 5).

## VI. ISSUES FOR DISCUSSION

40. Directors may wish to discuss the following issues:
- Do Directors agree with need for continued close engagement with LICs, focused on the Fund's core areas of expertise, as presented in the proposed mission statement?
  - Do Directors agree with the staff's views of the broad architecture of how the Fund's instruments should be used to engage with LICs?
  - In the context of refocusing the Fund's work on LICs, what do Directors see as the priorities for the Fund's work agenda (summarized in Box 5), both for the short and medium term?

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<sup>42</sup> Depending on the outcome of fundraising efforts, there may be a decline in the overall volume of TA provided by the Fund.