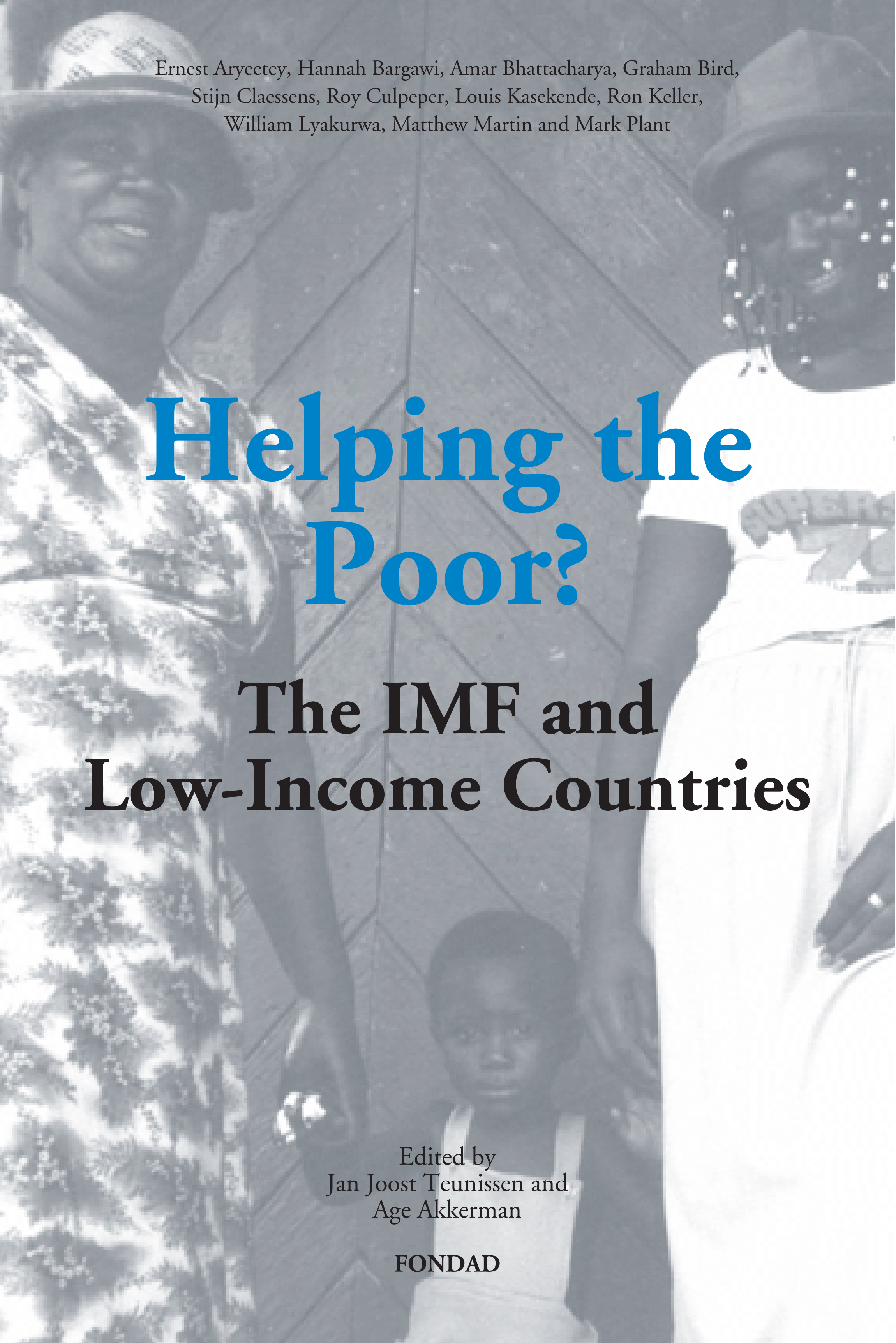

Ernest Aryeetey, Hannah Bargawi, Amar Bhattacharya, Graham Bird,
Stijn Claessens, Roy Culpeper, Louis Kasekende, Ron Keller,
William Lyakurwa, Matthew Martin and Mark Plant

Helping the Poor?

The IMF and Low-Income Countries

Edited by
Jan Joost Teunissen and
Age Akkerman

FONDAD

Helping the Poor? The IMF and Low-Income Countries

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Jan Joost Teunissen
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June, 2005

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William Lyakurwa (1948) is executive director of the African Economic Research Consortium. He joined AERC from the International Trade Centre based in Geneva, Switzerland in 1993, where he held the post of senior trade promotion advisor. Since 1994, he held the positions of director of training and deputy executive director until his appointment to the position of executive director in March 2003.

He has been advisor and consultant to governments, regional bodies, multilateral institutions, international and non-governmental organisations. He has served as chair and member of several policymaking Boards in Tanzania and internationally. He has also served as chair and head of several national committees on trade and capacity building. He has published extensively in local and international journals as well as contributed chapters in books, research and discussion papers.

Matthew Martin (1962) is director of Debt Relief International and Development Finance International, both non-profit organisations which build developing countries' capacities to design and implement strategies for managing external and domestic debt, and external official and private development financing. Previously he worked at the Overseas Development Institute in London, the International Development Centre in Oxford, and the World Bank, and as a consultant to many donors, African governments, international organisations and NGOs. He has co-authored books and articles on debt and development financing.

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Jan Joost Teunissen (1948) is director of FONDAD. He started his career in 1973 as a social scientist and freelance journalist in Chile. Seeing his plan to work in Chile's agrarian reform and rural development aborted by the coup d'état of 11 September 1973, he engaged himself in activities aimed at the return of democracy in Chile. He focused on economic boycott as a political instrument to bring about regime change in Chile and other dictatorships. In his work on international economic and political issues, he forged links with academics, politicians, journalists and high-level policymakers in various parts of the world. In the Netherlands he stimulated discussions on the origins and solutions to the international debt crisis. Supported by economists such as Robert Triffin, Jan Tinbergen, Johannes Witteveen and Jan Pronk he established FONDAD in 1987. He has co-authored books and articles on finance and development issues.

Abbreviations

AAF-SAP	African Alternative Framework to Structural Adjustment Programmes for Socioeconomic Recovery and Transformation
AERC	African Economic Research Consortium
AfDB	African Development Bank
AFRITACs	Africa Regional Technical Assistance Centers (at the International Monetary Fund)
BCEAO	Central Bank of West African States
BWIs	Bretton Woods Institutions
CAFOD	Catholic Agency for Overseas Development
CARTAC	Caribbean Regional Technical Assistance Centre
CBM	credit buy-down mechanism
CDF	Comprehensive Development Framework
CEMAC	Monetary and Economic Community of Central Africa
CFF	Compensatory Financing Facility (of the IMF)
CGIAR	Consultative Group on International Agricultural Research
CPIA	Country Policy and Institutional Assessment (of the World Bank)
DAC	Development Assistance Committee (of the OECD)
DFID	Department for International Development (of the UK)
DSA	debt sustainability analysis
EAC	East African Community
EBRD	European Bank for Reconstruction and Development
ECLAC	Economic Commission for Latin America and the Caribbean (of the UN); (in Spanish CEPAL)
EFF	Extended Fund Facility
EPEP	Economic Policy Empowerment Programme (of EURODAD)
CEPAL	see ECLAC
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
EURODAD	European Network on Debt and Development

FAD	Fund for Development Aid
FDI	foreign direct investment
G-8	Group of Eight (Canada, France, Germany, Italy, Japan, Russia, UK, US)
G-24	Group of Twenty-Four (including 9 African, 8 Latin American and 7 Asian countries)
GDI	gross domestic investment
GDP	gross domestic product
GDS	gross domestic savings
GNI	growth national income
GNP	gross national product
GRA	General Resources Account (of the IMF)
HIPCs	Heavily Indebted Poor Countries
HIPC CBP	Heavily Indebted Poor Countries Debt Strategy and Analysis Capacity Building Programme
HNB	Hatton National Bank (in Sri Lanka)
IBRD	International Bank for Reconstruction and Development (World Bank)
IDA	International Development Association
IEO	Independent Evaluation Office (of the IMF)
IFF	International Finance Facility
IFIs	international financial institutions
IMF	International Monetary Fund
IMMPA	Integrated Macroeconomic Model for Poverty Analysis
JSAs	Joint Staff Assessments (of the IMF and the World Bank)
MIMAP	Micro Impacts of Macroeconomic and Adjustment Policies
MDGs	Millennium Development Goals
MEFMI	Macroeconomic and Financial Management Institute of Eastern and Southern Africa
MGS	imports of goods and services
MIFs	microfinance institutions
NABARD	National Bank for Agriculture and Rural Development (in India)
NBER	National Bureau of Economic Research
NEPAD	New Partnership for Africa's Development
NGO	non-governmental organisation
NPV	net present value (of external public debt)
OAU	Organisation for African Unity
ODA	official development assistance
ODC	Overseas Development Council

OECD	Organisation for Economic Cooperation and Development
OED	Operations Evaluation Department (of the World Bank)
OPEC	Organization of the Petroleum Exporting Countries
PDR	Policy Development and Review Department (of the IMF)
PFPs	Policy Framework Papers (of the IMF)
PRGF	Poverty Reduction and Growth Facility
PRS	Poverty Reduction Strategy
PRSC	Poverty Reduction Support Credit
PRSPs	Poverty Reduction Strategy Papers
PSIA	Poverty and Social Impact Analysis
SAF	Structural Adjustment Facility
SAP	structural adjustment programme
SDR	Special Drawing Right
SDRM	Sovereign Debt Restructuring Mechanism
SFF	Supplementary Financing Facility
SSA	sub-Saharan Africa
UEMOA	West African Economic and Monetary Union
UK	United Kingdom
UN	United Nations
UNAIDS	Joint United Nations Programme on HIV/AIDS
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNECA	United Nations Economic Commission for Africa
UNICEF	United Nations Children's Fund
UNU	United Nations University
US	United States
VAT	value added tax
WAIFEM	West African Institute for Financial and Economic Management
WAMZ	West African Monetary Zone
WHO	World Health Organization
WIDER	World Institute for Development Economics Research
WTO	World Trade Organization

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An Inquiry into the Nature and Causes of Poverty: By Way of Introduction

Jan Joost Teunissen

> *Political economy … proposes two distinct objects; first, to provide a plentiful revenue or subsistence for the people, or, more properly, to enable them to provide such a revenue o subsistence for themselves; and, secondly, to supply the state or commonwealth with a revenue sufficient for the public services. It proposes to enrich both the people and the sovereign.*

The citation above is from Adam Smith's classical study *The Wealth of Nations*. The full title is *An Inquiry into the Nature and Causes of the Wealth of Nations*, but the words preceding the shorthand title are not usually mentioned. This is a pity because they nicely reflect the scientific rigour, curiosity and broad view of Adam Smith's writings – a rigour, curiosity and broadness of view I often miss in today's economic analyses of poverty.

Why do economists tend to inquire so little into "the nature and causes of poverty"? I will try to answer this question by looking, first, at the politics of poverty, second, at the economics of poverty, third, at the recent history of poverty, and fourth, at the likely future state of poverty.

Obviously, I cannot claim any originality of thinking in a bird's eye view of these important issues. And when I base my thoughts on experiences I have gained as a young student participating in agrarian reform processes or as a research-oriented journalist who came in direct contact with poor *and* rich people, I will most likely just repeat what

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others have "discovered" or said before me. There is another reason that I have so little faith in my originality of thinking – as well as that of other social scientists - about poverty. Too often our thoughts are seen as our wisdom and geniality, instead of that of the poor themselves. And too often we, social scientists, are eager to tell the poor what they should do to emerge from poverty, when we should instead trust the capacity of the impoverished to take their fate into their own hands. Do we tell rich people what they should do? Perhaps we should, given Adam Smith's plea for high moral standards and "good behaviour" by the businessmen.

The Politics of Poverty

In my view, a good starting point for an analysis of poverty in a country or region is the notion that poverty is, generally speaking, a social and not an individual phenomenon – even though individual characteristics can explain why one person is rich and another poor in specific cases. Since poverty is a social phenomenon, it is the object of study of social scientists: political scientists, economists, historians, sociologists, cultural anthropologists, social psychologist, psychologists or whoever.

From a political point of view, poverty is, above all, determined by differences in power – both between individuals and groups. Therefore, differences in power are a major part of the political explanation of why some people are rich and others are poor.

Just like poverty, power is also a social phenomenon: a person or group can only be more (or less) powerful vis-à-vis another person or group. Power is not something you possess like a house, a farm, a company or intelligence; power is something you acquire by skills, perseverance, money, luck and/or relationships – the one characteristic often feeding upon the other. As a result, the battle against poverty is largely a question of creating the circumstances that enable an individual or a group to gain power and emerge from poverty on a long-term basis. In the case of a poor small farmer or rural labourer, this can be done by giving him or her access to land, water, fertiliser and credit and making sure he or she will not be forced to sell the land or be deprived from water or credit within a few years. Only then one can expect the poor farmer to grow out of poverty and not fall back into the previous state of deprivation from these valuable and crucial assets necessary for overcoming poverty.

Usually, the creation of enabling circumstances will be the result of both individual and collective actions and, usually, such action will lead to social conflicts – ranging from petitions for better labour conditions and the right to work the land to nation-wide social revolutions or societal transformations. An important characteristic of such struggles is that some people try to improve the situation of the poor by changing the existing power structures while others try to maintain the power structures.

As an observer of political processes in poor areas and countries in various parts of Latin America, Spain, Italy and Portugal, I have noticed that political struggles are often preceded and accompanied by an interesting body of social scientific literature – essays, studies, articles, books, pamphlets, whatever. Quite often, this literature helps political activists (ranging from peasant and union or community leaders to campaigning presidential candidates) in formulating their visions and demands. In doing so, social scientists have had a remarkable impact on the shaping of society. For many political scientists, this may be considered normal; but for most economists it is not – they rather prefer to believe that their analyses are independent from politics. But when it comes to the divide between rich and poor in society, the impact of economists is as, or even more, remarkable than that of political scientists.

The Economics of Poverty

Many economists prefer to *interpret* society rather than *change* or shape it – at least, that is what they claim. In reality, however, economists contribute more than any other social scientists to how society is shaped, particularly in these days of the dominance of economic ideas, practices and ideologies. This puts them in a paradoxical situation. On the one hand, they want their analyses to be independent from society, but on the other hand, they want society to act according to their insights – as they usually believe strongly in the "scientific" character of their analyses. This paradox may also put them in a painful situation. Because, even if they do not feel responsible for the economic policies pursued by governments and companies and argue that it was not them but the policymakers and managers who decided which course they wanted to follow, they cannot prevent attracting the blame as the intellectual masters of the policies pursued. Civilians in many developing countries have accused the IMF for the austerity policies applied by their governments. Or, to give another example I vividly remember:

Milton Friedman was blamed by many observers of Chile's dictatorship (1973-90) for the economic shock therapy applied in Chile after the bloody coup d'état of September 11th, 1973, which brought so much misery and social suffering.

In economic theories about poverty, a fundamental concept is economic growth. That is where the agreement usually ends and the dispute begins because there are almost as many theories of poverty as there are views about how economic growth occurs. To mention a few of the growth theories by their key concept: division of labour (Adam Smith), international trade based on comparative advantage (David Ricardo), protestant ethic (Max Weber), capital accumulation (Robert Solow), innovation and creative destruction (Joseph Schumpeter), free markets (Friedrich von Hayek), "sound" macroeconomic policies (but who determines what is "sound"?), "good" governance (but who determines what is "good"?), well-functioning capital markets (but what does "well-functioning" mean, and isn't a broader definition needed than the usual one?), export diversification, appropriate technology development, flexible labour laws, balanced budgets (except the United States, which is still widely considered a special case which is allowed to escape the rule), low level of foreign debt (again, with the United States dramatically escaping the rule), good industrial policies, and so forth. In brief, there are almost as many economic theories of growth as there are common sense notions of how wealth is created.

Another basic concept in economic thinking is "the market" – often (wrongly) opposed to the state. Most economists strongly believe in the beneficial effects of "free" markets. In practice, however, markets are often less free than imagined and, moreover, less beneficial than believed – or they are so for only certain segments of society. Therefore, it is not surprising that the debate about the role of the market and the state in overcoming poverty still lingers on. Nor is it surprising that in these days of the supremacy of capitalist ideology, most economists defend the superiority of markets over governments. In my view, and that of many others, however, the dichotomy of the market versus the state is wrong. The two should work nicely together.

The History of Poverty

Ever since human beings have joined forces to hunt animals or raise cattle or – jumping to present day – to set up a car or computer company, some people have become rich while others have remained or become poor. Does this mean that poverty is, just like war, a sad state of affairs we cannot do much about? Does history "show" that any effort at alleviating poverty will be in vain and end in frustration?

No, history does not tell us that. It only tells us that, given certain historical experiences and circumstances, the fight against poverty is likely to be difficult.

True, some people are extremely poor, others are less poor and poor people will always remain simply because "we" define them as poor. However, did you ever ask a poor person whether he or she considers him/herself poor? Then you may have noticed that many of those whom we consider poor, don't see themselves that way because they know other people are poorer. Poverty is a relative concept.

Importantly, history tells us that poverty can be reduced and that poor countries can become rich or, at least, richer. Look at the recent history of South Korea! Look at (parts of) China! Look at Mauritius! However, history also tells us that rich countries can become poorer or less rich. Look at Argentina! And history tells us that there are different stages of economic development and different initial conditions – physical, geographical, political – that explain why some countries or regions are better suited for attaining richness than others. Finally, history also tells us that society is shaped by certain political and economic interests. It is possible to identify such interests as well as the initial conditions and stages of development, and they can be put to the scientific test by social scientists, including economists.

In brief, there is no "natural" state of affairs in society, and poverty is certainly not a natural state of affairs, nor is wealth. Both poverty and wealth in a country or a region are the product of natural endowments, human thoughts, and human activities. That is fortunate because it indicates that the fight against poverty is possible and winnable. And it indicates that if capitalism is seen as the sole viable economic model today, it was not considered the only model yesterday. As Europe shows, a social market economy, for example, is possible. There are alternatives; there is no "end of history".

The Future of Poverty

A scientific approach to poverty requires that there is "something", a given object or process that can be studied. Obviously, "the future" of poverty does not provide that "something", unless one believes that theoretical predictions or practical strategies suggested by economists or other social scientist are a "reality" that can be studied scientifically.

Particularly with regard to "the future" social scientists tend to make statements that carry human values, beliefs and interests. They cannot but make value judgments about the future or, at best, predict trends. Therefore, I believe that the future of society (including the future of poverty) does not, or should not, lie in the exclusive hands of economists, sociologists, politicians or any technocrats. It must lie in the hands of all of us – the people of the world. Social scientists, technocrats and politicians have the important task of clarifying what alternative visions and policies are available and on what grounds they think some policies would work better than others. But the actual policies depend on the will of the people, or at least should depend on their will if we take democracy seriously.

Poverty is generally considered something that we, citizens, scientists, policymakers and business people, should be able to reduce substantially if not eradicate completely. The knowledge, physical means and human capacities to overcome poverty are available. So far the main obstacle has been a lack of political will. Fortunately, however, a few years ago consensus was reached that we should aim at at least halving extreme poverty – defined as living on less than one dollar per day – by the year 2015. This goal along with the other targets aimed at improving health, education and other important indicators for the poor are known as the Millennium Development Goals (MDGs) that were agreed upon by the international community.

So, if the future of poverty lies in all our hands, in the collective of mankind so to say, what is the role of economists? That is the question that this book implicitly answers. The economists who have written the chapters that follow make clear what role they and their fellow economists are playing. Before highlighting some of their insightful thoughts, let me first zoom in on Africa, the continent that has already been plagued by poverty for so many years.

Poverty in Africa

When focusing in on Africa, one is immediately confronted with a historical legacy: European countries took possession of Africa and arbitrarily divided the continent according to their interests and preferences. Or, to put it in tougher terms: for many years, Europe has exploited the poor in Africa and has shipped them, helped by Arab traders, overseas as slaves. Until after the Second World War, a large part of Africa was under Europe's rule and in some African countries, colonialism even lasted up to the mid-1970s. And that other system of white man domination, Apartheid, came to an end even more recently – in 1991. It is therefore not surprising that one of the African contributors to this volume, William Lyakurwa, makes this historical legacy the starting point of his chapter when he observes: "Africa's historical experience of slavery and colonialism severely deformed, distorted, disarticulated and underdeveloped the region. This culminated in the marginalisation of the continent in the global capitalist system, with its hostile global market, and was compounded by domestic crises that have over time inhibited growth and development."

This is a useful reminder by William Lyakurwa, professor of economics and executive director of the highly esteemed African Economic Research Consortium (AERC). Indeed, Europe is to blame for the bad starting point of African countries after their independence. Reminding ourselves of this European responsibility puts today's discussions about the development challenges of poor African countries, and the role that the IMF and World Bank can play, in a proper historical perspective.

Two other African economists contributing to this book, Ernest Aryeetey, a Ghanaian professor of economics and Louis Kasekende, deputy governor of Uganda's central bank, stress the deplorable stage of development in which most African countries still find themselves.

Aryeetey observes that despite the significant progress some African states have made over the last few decades in terms of human resource development, industrialisation, global trade, production and institution building, the continent's overall record has been disappointing. "Africa is still considered the most vulnerable, poverty-stricken, debt-distressed, technically backward and marginalised continent," he says. According to Aryeetey, the main development challenge facing Africa now is how to significantly reduce the extent and depth of poverty in the region while transforming the structure of its economies. He believes that making poverty reduction the focus of current development initiatives – as both the IMF and World Bank have been doing since 1999 – is justified "by the extent and depth of poverty in the region and also by the fact that such poverty slows down all manner of social and economic progress."

Kasekende observes that a very large proportion of the population in Africa is living on less than one dollar a day while absolute poverty is on the rise. He observes that most African economies remain very fragile, show little export diversification, and markets are largely dysfunctional. Africa also remains highly vulnerable to climatic shocks and terms of trade shocks. On top of all this, there are the issues of development assistance shortfalls and AIDS. "This is the stark reality that one has to take into consideration when one looks at the role of development assistance, in general, and the role of the IMF and World Bank in particular," says Kasekende.

Amar Bhattacharya, an Indian economist working for more than twenty-five years with World Bank, nuances this sombre picture of Africa. In his chapter, he argues that since the mid-1990s, there has been both an improvement and a differentiation in performance in sub-Saharan Africa. "In the last seven years," he says, "some 12 countries recorded growth rates in excess of 5 percent per annum and some 18 countries had sustained growth in excess of 4 percent per annum. There has been a strong improvement compared to the 1980s in the growth performance of African countries. This is most evident from the increase in investments, which is even more encouraging than the improvement in growth."

Have the IMF and World Bank Failed?

Development assistance shifted in the 1980s from financing investment to promoting policy reform, a reorientation occasioned by the growing belief that developing countries were held back more by poor policies than by lack of finance for investment. However, the reforms of the 1980s and 1990s have not brought the results that were expected. The performance of Africa still does not live up to the expectations of the western donors and the IMF and World Bank, nor does it live up to the hopes of most people in African countries – which is an even more serious problem.

Graham Bird, a long-time observer of IMF policies, explains in his chapter why the recipes of the IMF (and World Bank) have not lived up to the expectations. "Because of the structure of their economies, poor countries face frequent balance of payments difficulties. Low holdings of reserves, little access to private capital and unpredictable aid flows imply that they will be constrained in financing balance of payments deficits. The imperative will then be to achieve rapid adjustment and this in turn is likely to mean compressing aggregate domestic demand; a strategy that will bring with it associated economic and political costs. In principle, the IMF can help by providing liquidity that reduces the need for short-term demand-based adjustment. It can assist with both stabilisation and longer-term adjustment. It is then a matter of how well or how badly the Fund fulfils these functions in practice. Objective examination of the evidence suggests a nuanced conclusion. However, the rhetoric involved in the debate sometimes departs from the reality."

Amar Bhattacharya gives another explanation for the failure of the reform programmes of the IMF and the World Bank. In his view, there are three possible hypotheses. The first is that the strategies suggested by the IMF and World Bank were not fully implemented. The second is that there were important errors in the design of those strategies. And the third is that there were important missing elements. Even though the first hypothesis might be valid, the twin Washington institutions decided to do some self-criticism and developed a new framework for their support to low-income countries in Africa and elsewhere. The framework adopted at the end of 1999 comprised two key elements: country-authored Poverty Reduction Strategy Papers (PRSPs), which were expected to draw on broad-based consultation with key stakeholders, and the Poverty Reduction and Growth Facility (PRGF). The core aim of the PRGF was to arrive at policies that were more clearly focused on economic growth and poverty reduction, and as a result, would enjoy better national ownership. As Bhattacharya and Lyakurwa observe, the underlying principles of the PRSP process were that it would be country-driven and involving broad-based participation; results oriented and focused on outcomes that are pro-poor; comprehensive in recognising the multi-dimensional nature of poverty and the proposed policy response; partnership oriented involving coordinated participation of development partners; and grounded in a long-term perspective for poverty reduction.

Is the New IMF Strategy More Successful?

Has the new IMF strategy been more successful? According to Matthew Martin and Hannah Bargawi, both close followers of IMF policies in Africa, the success is mixed at the most. Even though the IMF "has a very strong capacity to play a long-term role in low-income countries," the amounts of financing provided have not been sufficient, nor have the terms of lending been sufficiently soft. Although the PRGF lending is provided on a longer-term basis and somewhat softer terms, it is still short of what is needed. When it comes to the catalytic role of the IMF in mobilising financing from private sources, Martin and Bargawi are even more critical. "Even though it [the IMF] has clearly facilitated large amounts of debt relief, and helped to mobilise some official financing, its role in promoting private financing has been much less positive."

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

Ron Keller, a high-level development cooperation official in the Netherlands, agrees with most of Martin and Bargawi's criticism of IMF conditionality. "The IMF has moved too far into the governance, transparency, and corruption-related conditions. I am not saying that these are unimportant issues, but in the spirit of division of labour, other institutions – and primarily the recipient – should take these up. … I would call upon our executive directors and the management of the IMF to go back to the original intention of a couple of years ago to simplify conditionality."

Louis Kasekende sees possibilities for enhancing the credibility of the IMF. In his chapter, he begins by illustrating how difficult it is for the IMF to make the right assessment in its programme design by enumerating a whole range of difficulties: "What targets for the monetary anchors are appropriate for inflation control, economic growth and poverty reduction? What level of inflation is appropriate for sustainable growth? Can we talk about fiscal flexibility when most of the spending is committed to civil service, defense, wages and social spending? When we talk about fiscal flexibility and demand management, how can we expect re-adjustments when most of the expenditure is on priority areas or areas that are difficult to cut? … The list of questions is endless and the answers are largely elusive. The chances of getting it wrong are quite high. Maybe this explains the over-optimism reflected in the IMF programmes."

Kasekende suggests some concrete ways in which the IMF could enhance its credibility in programme design. Supporting the idea that the PRSPs should be the basis in programme design, he advocates that efforts be made to make the PRSP itself more realistic and broad enough to encompass the development challenges facing a country. "This leads me [back] to the issue of the role the IMF can play if the PRSP is the basis. The IMF could ease the conditions necessary for absorbing external assistance, especially grants, and the fiscal space required for increasing investments in physical infrastructure. The problem most of the countries face is a tendency to place over-reliance on the private sector to take up investments in physical infrastructure. This rarely happens. Therefore, if you present a very tight programme, you will frustrate the government because the government cannot improve the infrastructure, which is required for supporting private sector-led growth. The IMF could assist governments and provide that fiscal space, so that governments can make investments in the public sector."

So here we are back at the issue of the role of the state. Just like the quote of Adam Smith at the beginning of this chapter asserts, there should be a nice cooperation between the market and the state. The one cannot function without the other.

Kasekende makes more suggestions as to how the IMF might improve its credibility. Let me cite one more. "Another big issue in programme design is the tension between short-term stabilisation and medium to long-term growth. I think this issue will continue to bog our minds; it will also be complicated by the tension between the financing needs for Millennium Development Goals and the objective of obtaining debt sustainability. This is one of the issues that we have been talking about in the World Bank. Once you bring in debt sustainability, especially as both the IMF and the World Bank have proposed it, you end up constraining the resource envelope or the type of resources that countries can assume. For those countries with a very low debt-carrying capacity, you start talking about grants as the only source of financing. … The IMF should be more flexible in programme design and react as problems reveal themselves, as opposed to setting unrealistic monetary and inflation targets as a means to deliver short-term stabilisation requirements. This will push the IMF in the direction of designing programmes on a case-by-case basis. Even though this is something we always talk about, I am bringing it back again: the need for a case-by-case approach."

In his chapter, Mark Plant of the IMF summarises the many problems low-income countries are facing and argues that if there is one thing made clear from all these problems, it is that "the Fund has a role in helping its low-income members confront these problems, many of which are macroeconomic in nature." He does not think the IMF has all the answers. On the contrary, "the answers to these questions also need the expertise of others." After having discussed several of the issues raised by Graham Bird, Matthew Martin and Hannah Bargawi, Mark Plant observes that these problems cannot be solved overnight. For example, low-income countries will continue to be vulnerable to external shocks. Plant endorses proposals that the IMF would help overcome the immediate negative effects of such shocks by disbursing quickly the sums needed. "As its lending is rather expensive, then it can be bought out overtime by donors with more concessional money. This is an idea that the donor community should pursue."

Plant concludes that a "continued discussion with people outside the institution" is needed to get the right solution so that the Fund can play its part in helping its low-income members make progress toward the Millennium Development Goals.

The Washington Consensus, the MDGs and the Financing of Development

In his chapter, Ernest Aryeetey argues that growth in Africa can only be financed if African countries take steps to reduce the risks associated with rural production, stabilise the macroeconomic environment (to ensure that the returns on financial assets are relatively stable and predictable), and initiate policies that reduce the transaction costs of holding financial assets through the development of appropriate institutions, including micro-finance institutions. Aryeetey further argues that faster longer-term growth and development in Africa require increasing foreign direct investment and the inflow of other private capital. According to Aryeetey, the objective should be to make private capital provide 70 percent of external finance in the medium term and 100 percent in the long term. "Africa has to tap private foreign capital in order to raise the productivity levels necessary for sustained increases in living standards. For this, countries will need to take concerted action on many fronts including improving infrastructure, strengthening banking systems, developing capital markets by accelerating the pace of privatisation and broadening the domestic investor base, developing an appropriate regulatory framework and a more liberal investment regime, introducing competitive labour market policies while creating and maintaining institutions for upgrading human capital, reforming the judiciary system and containing corruption."

In his comment on Aryeetey, Roy Culpeper, president of the North-South Institute in Ottawa, says that he is surprised to see that Aryeetey embraces the Washington Consensus, just as most African leaders and economists are doing, since the Washington Consensus has not worked in Latin America and the Latin Americans have moved on, albeit with some uncertainty, beyond the Washington Consensus. "[Aryeetey's] frame of reference for the policy environment is very much that of the Washington Consensus: the need for internal and external reforms, greater openness and liberalisation to the rest of the world, and so forth," says Culpeper.

One explanation for this embrace of the Washington Consensus that I heard from an African economist is that the post-war structuralism and dependency thinking of progressive academics and policymakers was considerably less successful in promoting development in Africa when applied during the 1970s than its Latin American version was from the 1940s and 1950s on. So alternative thinking became more discredited in Africa, and most economists who wanted to be inside the policy debates abandoned it to subscribe to the Washington Consensus, which was "the only game in town" in Africa from the beginning of the 1980s.

Culpeper is also "quite intrigued" by Aryeetey's focus on the target of achieving the Millennium Development Goals and raises the question of whether the MDGs should be the target. "The MDGs are in a sense not adequate as a development target. There are broader and deeper goals such as achieving long-term sustainable growth at rates of 6 to 8 percent and related to that, a process of economic and social transformation which adds up to a much more profound agenda of change. I would even go further to say that the MDGs are at once both too ambitious and not ambitious enough. They are too ambitious in that they may not be achieved by many countries in Africa by 2015. The problem is that the costs of not achieving them may come in the form of disillusionment, accusations of failure and the withdrawal of donors from the development struggle."

Culpeper goes on to argue that the MDGs are neither ambitious enough and that the problems of development will not go away by year 2015. The MDGs address the symptoms of development failure, he observes, whereas the real challenge is to tackle the underlying root causes. "The real challenge is not only to achieve the MDGs up to 2015, but go beyond them to the issues of transformation in the productive structure. In Africa, the discussion must come around to the centrality of agricultural transformation, because how can one presume any progress on the MDGs, most of all in poverty reduction, without a focus on agriculture?" And Culpeper adds: "There has to be pro-poor growth, there has to be quality of growth, otherwise again we will be falling short of what needs to be done."

A New Approach to Debt Sustainability and Policy Reform of Low-Income Countries

In his chapter, Stijn Claessens, who returned to the World Bank at the end of 2004 after a brief hiatus as a professor of economics in Amsterdam, presents a refreshing analysis of and solution to the debt problem of poor countries. In his view, the recurrent debt problems of low-income countries do not so much reflect economic causes but, rather, the failure to reform the international institutional structure for decision-making related to low-income countries' debt, external financing and debt sustainability. "The recurrent nature of the debt problems, the ongoing debates, and the limited and poor resource transfers are but signs of the need for deeper reforms to the institutional framework for dealing with the financing problems of low-income countries." He therefore suggests reforming the design, institutions, and governance of the international system governing low-income countries' debt, financing and debt sustainability. Institutional changes will not be easy, he observes, "and will require answering – implicitly or explicitly – fundamental questions regarding the nature of the governance framework of the international financial system."

William Lyakurwa also believes that the international financial institutions need to adapt their functioning to the needs of poor countries. In his chapter, he argues that the evolution of the role of the Bank and the IMF in helping countries meet their development strategies clearly indicates that the Bretton Woods Institutions should give more attention to the importance of country ownership. There is no single blueprint for policy programmes that will work in all countries, he stresses. "Any country's policy programme must be designed with country ownership to fit that country's specific circumstances."

Lyakurwa observes that the most fundamental component in the success of policy programmes has been domestic political economy factors, implying that the main way of enhancing ownership is by genuinely involving citizens and policymakers in the design and implementation of macroeconomic and structural reforms. In his view, government ownership and political will have a greater influence on the success of reform programmes than the amount of aid flows.

Lyakurwa concludes: "The Bank's and the IMF's future role in low-income countries thus involves a great need to adapt their conditionality to the needs of the low-income countries, to improve capacity building through greater empowerment of the borrowing governments and to base lending decisions on longer-term planning. There is also need to move from stabilisation to more pro-poor macroeconomic frameworks."

Adam Smith would have agreed, I think.

2

The IMF and Poor Countries: Towards a More Fulfilling Relationship

Graham Bird

1 Introduction

Towards the end of the 1990s there appeared to be an emerging consensus that the IMF should discontinue its lending to low-income developing countries. A series of reports claimed that this was an inappropriate role for the Fund to play and that it would be better performed by aid donors or by the World Bank. The institutional comparative advantage of the IMF was claimed to lie elsewhere – largely in dealing with economic and financial emergencies in emerging economies; although even in this role there has also been considerable debate about the Fund's performance.[1] Critics argued that while the Fund was not designed to be, and should not become, a development agency, mission creep had caused it to gradually move in that direction.

The notion that the Fund should not be lending to poor countries would have sat uneasily with the portfolio of IMF lending at the beginning of the 1980s. At that time, the clientele of the Fund almost exclusively comprised low-income countries. Better-off developing

[1] Some critics argued that the Fund became much too heavily involved in designing a wide range of policy (for example, Feldstein, 1998). Others argued that it often misdiagnosed the causes of crises, even in terms of traditional macroeconomic policy instruments and therefore advocated inappropriate reforms. Thus, for example, Stiglitz (2002) forcefully claimed that fiscal contraction was not the correct way of dealing with the East Asian crisis in 1997/98. Still others argued that the Fund had lent far too much to emerging economies, and created both debtor and creditor moral hazard problems.

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countries had been enjoying access to private international capital markets and had preferred to exploit this rather than to borrow from the IMF. It was only after 1982, and in the wake of the largely Latin American Third World debt crisis, that the Fund once again began to lend to some of the highly indebted emerging economies. With the fall of Communism, there was further diversification of IMF lending as economies from Eastern and Central Europe began to use IMF resources.

The path of disengagement from low-income countries neither seemed to be the one favoured by the IMF.[2] Instead, in the mid-1990s, it had been a co-sponsor of the Heavily Indebted Poor Country (HIPC) initiative, through which eligible low-income countries were intended to be able to exit their debt difficulties, and in 1999, it remodelled the facility through which most of its lending to poor countries took place, to become the Poverty Reduction and Growth Facility (PRGF).

Adjacent to the debate about whether the Fund should be lending to poor countries, there is a debate about the effects of IMF-supported programmes on poverty and "the poor". The issue is whether policies endorsed by the IMF have a negative effect on economic growth, on social expenditure and on income distribution. In principle, even if the Fund was to withdraw from lending to low-income countries and was to focus more narrowly on programmes in emerging economies, the question of the Fund's impact on poverty would not go away.[3]

Although this chapter touches on the effects of IMF programmes on poverty, its focus is on the Fund's relationship with low-income countries. In discussing this relationship, the first challenge is to impose some constraints. After all, there is hardly any aspect of the Fund's opera-

[2] This is not to argue that there was a unified view amongst the staff and management of the Fund, some of whom privately expressed concern about the way in which the institution's involvement in poor countries was evolving. However, these disagreements were not made public, except to the extent that some individuals tended to talk about initiatives such as HIPC and the PRGF with muted enthusiasm.

[3] This has been one part of the more general literature dealing with the overall effects of IMF programmes. There is rather more limited research that focuses on programmes under the Fund's concessionary lending windows, which claim to give a higher priority to growth and poverty reduction. Even at a superficial level, issues involved in evaluative studies become complex and not just for methodological reasons. For example, beyond what point are the costs of reducing inflation exceeding the benefits and disadvantaging the poor? Killick (2004a) provides a succinct discussion of this issue.

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tions that could not legitimately be considered as part of this relationship. A list of relevant research topics relating to the IMF could include the following: why do some countries turn to the Fund while others do not; under what economic circumstances do countries demand IMF assistance; in what way does domestic politics exert an influence on the demand for IMF loans; what determines the response of the IMF and to what extent does politics influence it; what factors determine the design of IMF programmes, the blend between financing and adjustment and the nature of adjustment policy; is conditionality stricter for some countries than for others and does strictness relate to the breadth or depth of conditionality; what has been the effect of the Fund's recent policy of "streamlining" conditionality; what factors determine whether programmes are implemented; does the degree of implementation make a difference to macroeconomic outcomes; what are the effects of IMF programmes; is the IMF over-ambitious in setting targets; why do some countries keep coming back to the Fund (prolonged users or recidivists) while others are only temporary users and seem anxious not to repeat the experience; is IMF lending inadequate or excessive; is there a moral hazard problem associated with IMF lending and is it of the debtor or creditor variety; how should the IMF's operations be financed, and are quota-based arrangements satisfactory; is there a significant role for the SDR to play; to what extent should IMF lending be subsidised or should it only be available at penalty rates; does the Fund have an appropriate array of facilities through which to lend, and if not, how should it be reformed; do IMF programmes have a catalytic effect on other financial flows and, if so, to what extent is this associated with the liquidity that the Fund provides or the endorsement of economic reform via conditionality; does the Fund perform a useful signalling and monitoring role; does it possess an appropriate organisational structure or are there issues of governance that need to be addressed, and if so how; what should be the division of labour between the IMF, World Bank and aid agencies? It would not be hard to add to this list. Indeed the hard thing is to stop. But even as it stands, all of these issues have relevance for low-income countries, and many of them could be examined specifically from the viewpoint of low-income countries, raising the question of whether there are differences between low-income member countries and middle-income ones, or even amongst the low-income countries themselves.

Rather than trying to cover all the above topics or to dip whimsically into them, this chapter attempts to address a number of more fundamental issues pertaining to the IMF's relationship with poor countries. The concept of "mission creep" mentioned above has, in the main, been applied to the increase in the Fund's dealings with poor countries and the expansion in IMF conditionality in the 1980s and 1990s associated with structural adjustment. It implies that the relationship has not occurred by design but rather as an *ad hoc* response to circumstances and to myopic "political" factors.[4] According to this view, short-term expediency has dominated purposeful analysis. This could result in a lack of enduring commitment to the role. Just as the Fund argues that programmes are unlikely to succeed unless they are nationally owned, so one might argue that the Fund's relationship with poor countries is unlikely to be successful, or at least as successful as it could be, unless the international community and the Fund fully endorse it. So is there a justification for the Fund to be involved in low-income countries, and if there is, what form should this involvement take? As far as justification goes, while there are certainly those who feel uncomfortable with the idea of the IMF as a development institution or as a conduit for resource transfers from richer to poorer countries, there are relatively few who oppose the IMF's role as a balance of payments institution.[5] Of course, not all countries experiencing payments imbalances need assistance from an international financial institution. The question is therefore whether poor countries encounter balance of payments difficulties, and whether they need the help of an international financial institution such as the IMF in seeking to overcome them.

In dealing with balance of payments disequilibria, policy is likely to involve a blend between external financing and adjustment. Some strategies will be more financing-intensive and others more adjustment-intensive. However, the choice will be subject to different sets of constraints in different countries. Limited access to external financing may force one country to opt for short-term adjustment, while in another the political costs associated with balance of payments correction may impose a constraint on how far an incumbent government will

[4] It is difficult to imagine that it was purely a coincidence that the HIPC was enhanced and the Enhanced Structural Adjustment Facility (ESAF) remodelled in the run up to the UN Millennium Summit. Similarly, there was a "millennium rush" to achieve the target of countries involvement in HIPC (Killick, 2004b).

[5] There is of course the argument made by some critics of the Fund that with freely flexible exchange rates and the free international movement of private capital the Fund is no longer needed as a balance of payments agency. They argue that via creditor moral hazard the Fund's existence has destabilised the international financial system. For a critical review of this argument see, for example, Bird (2001a).

pursue adjustment. Of course, some countries may be more constrained both in terms of financing and adjustment. For them there will simply be fewer options when it comes to balance of payments strategy. There will be less policy flexibility. What is the optimal blend between financing and adjustment for low-income countries? How constrained is their choice? And, to the extent that these constraints force them to turn to the IMF, do the lending and adjustment policies favoured by the Fund allow them to adopt a superior balance of payments strategy? These are the questions this chapter considers.[6]

The chapter is organised in the following way. Section 2 provides a brief empirical summary of the extent of poor countries' balance of payments problems and their dealings with the IMF. It shows how many resources they have drawn from the Fund and under what facilities; it also shows how many poor countries have made prolonged use of IMF resources. Section 3 builds on this to examine the nature of the balance of payments problems faced by poor countries, and the relevance of balance of payments theory in explaining them. It also investigates conceptually the policy options available to poor countries. Section 4 examines, in broad terms, ways in which the IMF might assist poor countries in dealing with their balance of payments problems. To defend a role for the Fund, it has to be the case that balance of payments policy with the IMF is better than balance of payments policy without it. Having discussed the potential role of the IMF in poor countries, Section 5 investigates the extent to which current operations and instruments allow it, or encourage it, to perform this role. Section 6 offers some concluding remarks, but also provides an opportunity to raise other related issues that have not been covered in the main body of the chapter.

At the outset, however, it is appropriate to note the excessive degree of generalisation and aggregation that will permeate the discussion that follows. The economic and political circumstances in low-income countries differ widely. The Fund is frequently criticised for acting as if one size fits all. Accentuating the differences between emerging economies

[6] In this way, the chapter circumvents some of the currently popular discussion of the IMF's role as a development institution. For an illustration of this discussion, compare the contrasting views of Kenneth Rogoff (2004), who advocates discontinuing the Fund's lending role in developing countries, with those of Jeffrey Sachs (2004) who argues that, in the design of its programmes, the Fund should pay relatively less attention to financial variables, such as monetary growth and inflation, and relatively more to development related variables, such as per capita income, life expectancy and morbidity.

and low-income countries is certainly necessary but hardly sufficient to guarantee the institutional flexibility that might maximise the Fund's effectiveness in poor countries.

2 Poor Countries' Balance of Payments Problems and the IMF: A Selective Empirical Background

Part of the problem in discussing the IMF's relationship with low-income countries is indeed their diversity. Some exhibit persistent current account balance of payments deficits, but not all. Many turn to the IMF for financial support in seeking to deal with their balance of payments problems, but not all. Of those that turn to the IMF, some become prolonged users of IMF resources, but not all. Many hold relatively low levels of international resources, but not all. Most do not have significant access to private capital markets, but some do. Most receive foreign aid in one form or another, but their degree of reliance on it varies. Similarly, degrees of external indebtedness vary. Generalisation therefore runs the risk of becoming scientifically unsound. Identifying the characteristics of a "typical" low-income country risks becoming a caricature. This, having been said, some broad statistical picture does provide a useful backdrop to what follows. The data in Table 1 imply that, relative to other country groupings, poor countries tend to experience fairly persistent current account deficits. But is this misleading? A detailed analysis of the behaviour of current account imbalances over the period 1970-2001 has recently been undertaken by Edwards (2003). Unfortunately, from our point of view he conducts his analysis on a regional basis rather than on the basis of income per capita. His Asia region therefore includes middle-income emerging economies as well as low-income developing countries. It is his African region that includes the greatest concentration of poor countries. His results show that, as a percentage of GDP, African countries have tended to have the highest mean current account deficit over 1970-2001. However, only 7 of the 49 African countries are *persistent* "high-deficit" countries. This implies that poor countries encounter relatively severe current account balance of payments difficulties but that deficits are usually reversed quite rapidly either, one supposes, as a consequence of beneficial shocks neutralising negative ones, or as a result of induced policy responses that are designed to offset the effects of negative external shocks or more persistent adverse trade effects on the balance of payments.

Table 1 Incidence of Current Account Balance of Payments Deficits
(Current Account Balance in billions of dollars)

	Low-Income Countries[a]	Middle-Income Countries[b]	High-Income Countries[c]
1980	-9.0	9.7	-79.4
1981	-24.1	-32.8	-39.1
1982	-23.5	-47.9	-24.7
1983	-18.7	-46.7	-18.8
1984	-13.3	-36.8	-46.1
1985	-13.3	-34.1	-46.1
1986	-19.4	-54.3	-13.3
1987	-19.4	-23.9	-37.7
1988	-20.0	-31.6	-32.0
1989	-24.7	-28.8	-63.4
1990	-21.0	-10.3	-87.0
1991	-21.2	-56.3	-29.6
1992	-19.9	-64.2	-23.9
1993	-20.3	-108.3	59.0
1994	-15.9	-68.6	19.1
1995	-24.3	-75.7	51.5
1996	-23.0	-73.1	38.5
1997	-18.7	-73.1	90.2
1998	-28.0	-86.0	38.1
1999	-21.0	-2.6	-102.2
2000	-7.9	64.5	-246.3
2001	-10.6	28.3	-206.7
2002	-6.4	77.9	-193.3
2003	-7.4	110.6	-241.9

Notes:
[a] GNI per capita $765 or less in 2003.
[b] GNI per capita between $765 and $9,385 in 2003.
[c] GNI per capita $9,386 or more in 2003.
Source: IMF, *World Economic Outlook Database*, April 2004.

Table 2 Total Reserves in Months of Imports[a]

	Low-Income Countries	Middle-Income Countries	High-Income Countries
1980	6	7	6
1981	4	5	4
1982	4	5	5
1983	4	6	5
1984	4	5	4
1985	4	6	5
1986	5	6	5
1987	5	6	6
1988	4	5	5
1989	3	5	4
1990	3	6	4
1991	3	6	4
1992	3	5	4
1993	4	6	4
1994	6	6	4
1995	4	6	4
1996	4	6	4
1997	5	6	4
1998	5	7	4
1999	5	7	5
2000	5	5	5
2001	6	6	6
2002	8	7	7
2003	10	8	9

Note:
[a] Total reserves comprise holdings of monetary gold, SDRs, the reserve position of members in the IMF, and holdings of foreign exchange under the control of monetary authorities. The gold component of these reserves is valued at year-end (December 31) London prices. This item shows reserves expressed in terms of the number of months of imports of goods and services which could be paid for.
Source:
World Bank, *Global Development Finance*; IMF, *International Financial Statistics*.

Indeed, without access to external finance, countries are, in principle, forced to eradicate deficits. For this reason, data on current account deficits are not a good measure of payments problems. A sufficiently strict demand deflationary policy may reduce the level of imports to such a degree that a trade deficit is eliminated or a surplus created. But this is not necessarily a signal of a healthy balance of payments since, at the same time, economic growth may have been curtailed. Regenerating growth could then lead to a re-emergence of a current account deficit. The balance of payments deficit is in effect being suppressed; and the balance of payments problem is being reflected by low economic growth rather than by a current account deficit. Growth in productive potential, which enables exports to be expanded and imports to be reduced may, of course, strengthen the current account.

Faced with temporary negative shocks countries may, in principle, deplete international reserves which are, after all, held as an inventory against trade instability and other external shocks. But Table 2 suggests that, relative to other country groupings, low-income countries hold low reserves. What is the logic here? It is a matter of balancing benefits and costs. While their vulnerability to trade instability suggests that low-income countries should hold relatively large reserves in order to stabilise national income, their relative poverty suggests that they should avoid the high opportunity cost of holding them. Holding owned reserves may therefore be a relatively inefficient way of meeting the liquidity needs of low-income countries. It may be preferable to have access to credit as and when it is needed.

The combination of balance of payments problems, low reserve holdings and, as Table 3 suggests, relatively limited access to private international capital is reflected in the use of IMF resources by low-income countries that is shown in Table 4. Over 1991-2002 poor countries accounted for the largest proportion of IMF arrangements. They have also accounted for a large proportion of the prolonged users of IMF resources (see Table 5). There are a number of issues here that are worthy of detailed investigation. What determines whether low-income countries borrow from the IMF? What influences their demand for credits and the Fund's willingness to supply them? What are the characteristics of prolonged users of IMF resources, and are those low-income countries with persistent deficits also prolonged users? Interesting as these questions are, we shall not explore them in detail, but will make do with a few general observations.

Table 3 Private Capital Flows to Low- and Middle-Income Countries[a]
(in millions of dollars)

	Low-Income Countries	Middle-Income Countries
1970	951	7,483
1971	1,391	5,198
1972	1,757	7,787
1973	2,054	9,817
1974	2,576	12,087
1975	4,229	21,993
1976	3,355	21,384
1977	3,454	28,134
1978	5,175	34,821
1979	4,954	41,708
1980	6,571	41,258
1981	7,644	61,992
1982	9,766	55,195
1983	8,225	32,741
1984	4,758	34,502
1985	4,363	23,493
1986	5,268	18,810
1987	6,495	21,039
1988	9,097	28,296
1989	8,922	27,124
1990	6,820	36,872
1991	8,337	47,465
1992	10,347	83,145
1993	11,223	147,904
1994	20,065	147,153
1995	20,049	156,294
1996	30,873	211,363
1997	25,464	252,396
1998	7,539	261,637
1999	3,008	213,785
2000	4,741	175,260
2001	6,473	167,698
2002	7,151	146,680

Note:
[a] Private capital flows, net total; consist of private debt and non-debt flows. Private debt flows include commercial bank lending, bonds, and other private credits; non-debt private flows are foreign direct investment and portfolio equity investment.
Source: World Bank, *Global Development Finance.*

Table 4 IMF Arrangements in Effect during Financial Year ended April 30, 1991-2002
(in number of arrangements and millions of SDRs)

	Stand-By	EFF	SAF	PRGF	Total
	Number of Arrangements as of April 30				
1991	14	5	12	14	45
1992	22	7	8	16	53
1993	15	6	4	20	45
1994	16	6	3	22	47
1995	19	9	1	27	56
1996	21	7	1	28	57
1997	14	11		35	60
1998	14	13		33	60
1999	9	12		35	56
2000	16	11		31	58
2001	25	12		43	80
2002	26	8		35	69
	Amounts Committed Under Arrangements as of April 30				
1991	2,703	9,597	539	1,813	14,652
1992	4,833	12,159	101	2,111	19,203
1993	4,490	8,569	83	2,137	15,279
1994	1,131	4,504	80	2,713	8,428
1995	13,19	6,840	49	3,306	23,385
1996	14,963	9,390	182	3,383	27,918
1997	3,764	10,184		4,048	17,996
1998	28,323	12,336		4,410	45,069
1999	32,747	11,401		4,186	48,334
2000	45,606	9,798		3,516	58,921
2001	61,305	9,789		4,576	75,670
2002	74,344	8,697		4,201	87,242

Source: IMF, *Annual Report 2003,* IMF, Washington D.C.

There have been many studies over the years that have examined the economic circumstances in which countries seek assistance from the IMF, and the economic characteristics of those that do. Although not uniquely so, the characteristics are reasonably descriptive of low-income countries. Further research into the prolonged use of IMF expansionary demand management policies – particularly in the form of monetary expansion – do not appear as a particular feature of prolonged users or indeed users in general. More recent research has examined the extent to which both the demand and supply of IMF credits are tempered by political and, in some cases, institutional factors.[7] Some governments may find borrowing from the Fund (and the implied conditionality and loss of sovereignty) particularly unpalatable. Other governments may actively seek the Fund's endorsement as a way of strengthening their position vis-à-vis opposition groups.[8] The Fund may rule some countries as ineligible to borrow because they are in arrears. Or the Fund's principal shareholders may favour some potential borrowers, and disfavour others for a series of strategic and commercial reasons.

Are there political features on either the demand or the supply side that uniquely characterise low-income countries? Do they experience higher levels of political instability and conflict; are they less democratic? Perhaps political opposition to involving the Fund will be less strident; there may be an aura of resignation to the Fund's involvement. Similarly, the relevance of low-income countries to the commercial interests of advanced economies – though not necessarily their military interests – may tend to be less, and economic crises in poor countries

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[7] To some extent, early research captured this by examining the size of government consumption, but recent studies have more explicitly set out to investigate the effect of political factors – in particular US influence – on IMF lending. Political factors may, of course, affect the likelihood that a government will turn to the Fund for assistance as well as the likelihood of the Fund responding positively (Bird and Rowlands, 2004b). Politics also affect the amount of lending (Oatley, 2002) and the nature of conditionality (Dreher and Jensen, 2003). The empirical literature suggests that prolonged users of IMF resources exhibit higher levels of corruption and political instability and a more rigid structure of government expenditure, which makes adjustment more difficult.

[8] See Vreeland (2003) for a detailed articulation of this view. Theoretical contributions that emphasise the role of IMF conditionality in enabling governments to deal with opposition groups or veto players include Drazen (2002) and Mayer and Mourmouras (2002).

may represent less of an immediate and direct threat to international financial stability.[9] But here we are beginning to move from evidence to conjecture. In the context of this chapter the relevant empirical point is that, in general, low-income countries have persistently encountered balance of payments problems that have frequently pushed them towards the IMF. In spite of the Fund's infusion of liquidity, they have often experienced a reasonably rapid reversal in their balance of payments. If this is a fair representation of the facts, does it imply that the Fund has been playing an important and beneficial role in allowing low-income countries to follow optimal balance of payments strategies or does it imply that the Fund is failing in this role?

3 Balance of Payments Policy Options: Some Basic Analysis

The previous section shows that, as a group, low-income countries have encountered relatively frequent current account balance of payments deficits and that they have often made use of IMF resources. Recent theory views current account deficits as the consequence of inter-temporal consumption smoothing. Following on from conventional national accounting identities, deficits are presented as reflecting deficient saving relative to investment. Other things being constant, an increase in saving is then anticipated to lead to a broadly equivalent "improvement" in the current account. That empirically this does not seem to happen, has resulted in additional theoretical and empirical investigation designed to see whether the basic inter-temporal model may be salvaged.

However, even proponents of this approach accept that it is of relatively limited relevance for emerging economies and perhaps even less relevant for developing countries.[10] There are the ubiquitous

[9] Some poor countries may be more likely to be perceived as being economically significant as suppliers of particular primary products than as potential markets for the exports of advanced economies.

[10] The presentation of the current account in an inter-temporal framework is often credited to Sachs (1981). It formed an underlying theme in the standard text by Obstfeld and Rogoff (1996). More recent contributions that extend the basic analysis in a portfolio context include Kraay and Ventura (2000, 2002) and Ventura (2003). In similar vein, see Edwards (2002). However, models that emphasise changes in portfolios as a reaction to changing perceptions of risk and adjustment costs in investment, are probably not as relevant in the context of low-income countries, where capital inflows that mirror current account deficits take the form of aid.

problems of satisfactorily explaining saving and investment, but there is also greater uncertainty about the future, consequent upon the vulnerability to shocks, and the more binding nature of financing constraints that are encountered in low-income countries. As a result, current account deficits, normalised for country size, will become unsustainable and problematic in poor countries before they would in advanced economies.

Prior to the vogue for the inter-temporal consumption-smoothing model, the current account balance of payments was traditionally analysed using absorption, monetary and structural approaches. Indeed, the saving-investment approach is derived from the absorption approach. To a large degree, these approaches may be integrated within a Mundell-Fleming (IS-LM-BP) framework. Current account deficits (or, indeed, overall balance of payments deficits) can then be represented as the consequence of excessive domestic consumption, fiscal deficits and monetary expansion, as well as structural factors relating to the nature of domestic production and exports, the pattern of trade, and domestic productivity and efficiency.

Each of these explanations probably has a part of play in explaining current account deficits in low-income countries. Certainly, monetised fiscal deficits are not uncommon in poor countries. But a key feature of countries in an early stage of development is their low level of economic diversification. If primary products exhibit a relatively low-income elasticity of demand, and if poor countries have a high degree of export concentration on them, they will experience a secular weakening in their current accounts. With a low price elasticity of demand, export success in terms of volume may fail to translate into success in terms of export revenue. Superimposed on an adverse movement in the terms of trade, there may also be significant export instability that makes balance of payments management yet more challenging.[11] The difficulty may be as much associated with export excesses as with export shortfalls.

How can low-income countries respond to the current account balance of payments deficits they encounter? One possibility is that the response comes from elsewhere in as much as aid inflows to some extent cover trade deficits, making them more sustainable. However, there

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[11] As noted earlier, studies of the prolonged use of IMF resources have identified these structural characteristics as being significant determinants.

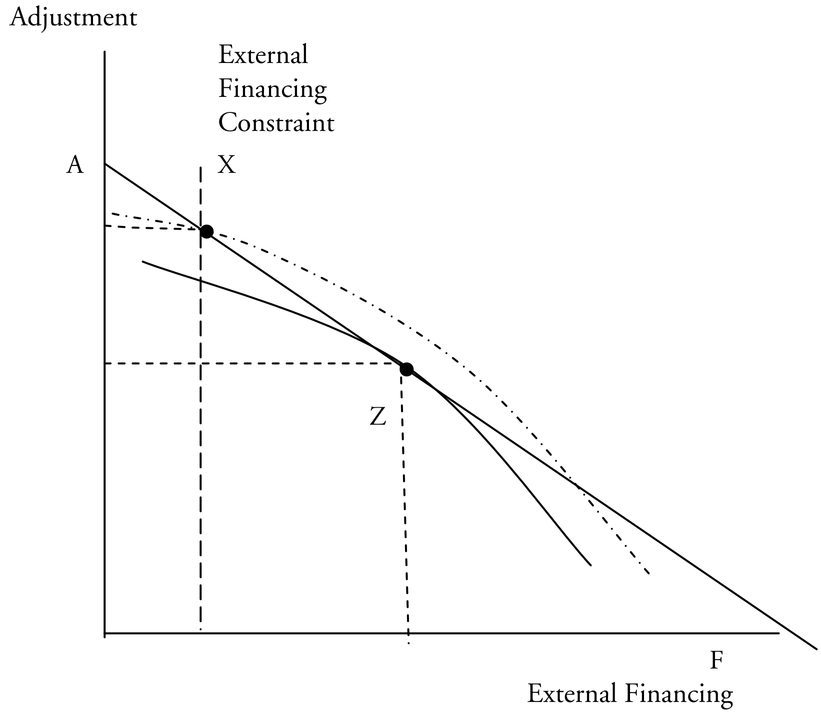
may be secular declines in aid flows, and aid may also be unstable.[12] More generally, governments, in effect, have to make a choice about the extent to which they attempt to correct trade imbalances or finance them. Beyond this, they then have to choose the most appropriate means of adjustment and method of financing.

In principle, the choice between adjustment and financing depends first on whether the deficit is temporary or permanent, second on the relative costs of adjustment and financing, and third on the social time preference rate. A financing-intensive strategy seems most appropriate where deficits are temporary, where the cost of financing is low relative to that of adjustment, and where there is a high social discount rate. The choice is illustrated in Figure 1, which shows consumption choices over two periods. The intercept A on the vertical axis illustrates full first period (short-term) adjustment, which is assumed to involve a contemporary consumption sacrifice. Intercept F on the horizontal axis involves short-term (first period) financing. This enables the current sacrifice to be avoided but involves incurring a larger future (second period) sacrifice when loans have to be repaid with interest. Governments then have to choose the optimum point on the AF trade-off. This depends on their preferences as between contemporary and future consumption – the idea of smoothing is relevant here. The optimum combination of adjustment and financing will occur where the marginal rate of substitution between current and future consumption sacrifices equals the marginal rate of transformation between them (point Z in Figure 1). This optimum will be affected by the slope of AF reflecting the relative costs of adjustment and financing and the slope of the community (governmental) indifference curves in Figure 1, reflecting the country's preferences.

Given this simple conceptual framework, a number of assumptions about low-income countries may be made. Assumption 1 is that short-term (i.e. rapid) adjustment involves a relatively high cost. This could be the consequence of a relatively low degree of economic flexibility and low demand and supply elasticities. It could also be related to relatively low marginal propensities to import and the strategic developmental importance of imports. Assumption 2 is that there will be a high discount rate favouring future as opposed to current sacrifices in consumption – there is a preference for current over future consumption.

[12] The decline in aid flows during the 1990s has been widely discussed. Recent studies have emphasised the volatility and unpredictability of aid.

Figure 1 The Choice of Balance of Payments Policy



This preference, combined with a diminishing marginal productivity of capital, may explain why domestic saving falls short of investment in low-income countries and therefore why current account deficits appear in the first place. Taken together, this implies that low-income countries will prefer a balance of payments strategy that involves relatively large current financing and more gradual adjustment, rather than rapid adjustment and little financing. However, their choice will be constrained. With little access to private capital markets, relatively low holdings of international reserves and with only relatively modest inflows of aid that will not be increased in the short term, governments may be forced to select what they perceive as a sub-optimal strategy, such as point X in Figure 1.

Of course, there are problems in defining an "optimal" balance of payments policy. Can this be done technically on the basis of economic considerations alone, or does it need to incorporate political economy

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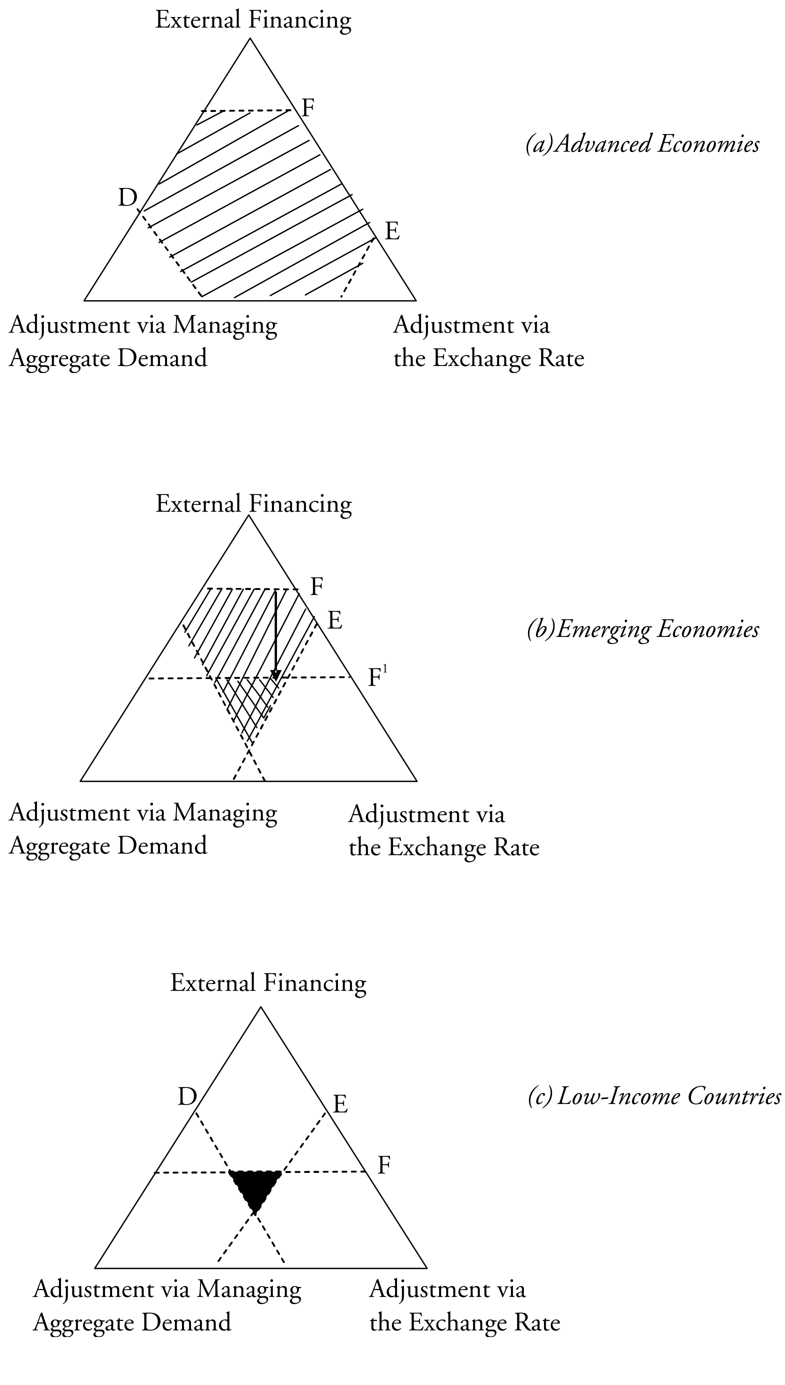
factors? A technically superior strategy, may, in effect, turn out to be redundant if it involves political costs that prove unacceptable. Furthermore, a strategy perceived as superior by one government in isolation may be globally inferior when externalities are taken into account. For example, a beggar-my-neighbour strategy may be deemed globally undesirable. There is a growing literature on the political economy of policy reform and this can be applied to balance of payments policy as much as to other areas of policy. With regard to Figure 1, while point Z will represent the government's preferred policy mix, the government may be self-serving. Point Z will not necessarily represent the best policy mix from either the broader national or international perspective.

The general observation that in choosing a balance of payments strategy poor countries may be more constrained and have less flexibility than other countries may be conceptually illustrated by using a figure originally designed by Cooper (1968). The vertices of Figure 2 show three alternative ways of responding to a current account balance of payments deficit; financing, adjustment based on the exchange rate, and adjustment based on managing domestic aggregate demand. However, there may be economic and political constraints on the extent to which each of these may be used, shown by lines F, E and D. These delineate an area of flexibility in terms of the design of balance of payments policy for advanced, emerging and low-income countries. For advanced economies, there is a relatively large area of flexibility and these countries can exploit it in a way that enables them to avoid borrowing from the IMF. For emerging economies, this may also be true for much of the time. However, in the midst of a crisis, the financing constraint becomes more binding and the area of policy discretion is sharply reduced, such that they may need to turn to the IMF for financial assistance (as shown in Figure 2b).

For low-income countries shown in Figure 2c, there is a persistently binding financial constraint, and there may be economic and political factors that more sharply militate against demand compression or exchange rate devaluation. The area of balance of payments policy flexibility is therefore much smaller and these countries are more likely to regularly seek assistance from the IMF. Structural adjustment is not directly shown by the Figure but, given its relatively long-term nature, will be constrained by a lack of external finance. Additional financing to some extent allows structural adjustment to substitute for adjustment based on managing aggregate domestic demand.

Figure 2 Balance of Payments Policy Options



4 Where Does the IMF Fit In: Is There a Role for the Fund?

What is the role of the IMF? Can it improve balance of payments policy in low-income countries? In the context of Figure 2, it can increase the area of balance of payments policy flexibility. In the context of Figure 1, it can relax the external financing constraint and allow adjustment to occur more gradually, enabling policies closer to the optimum combination of current adjustment and financing. The Fund can help fill the gap in external financing that would otherwise be left by private capital and by foreign aid.

However, where the government's preference is dominated by short-term political considerations – such as the desire to avoid all adjustment in the run up to an election – or where it is globally inferior, the Fund may play a positive role in encouraging an alternative strategy. In short, the Fund can play both a financing and adjustment role. Moreover, the roles are inter-related.

The Fund's involvement implies a direct impact on financing, since it makes its own resources available to borrowing countries. But it may also exert a catalytic effect through its impact on other sources of external financing. Its overall impact on external financing may, therefore, be greater than its own lending. The mechanics of the catalytic effect can operate via relieving illiquidity, and via the conditionality that the Fund attaches to its loans which, in principle, might signal better economic policy and performance and greater government commitment.

There is a growing literature on catalysis covering both the theory behind it and the empirical evidence concerning its existence.[13] As far as low-income countries are concerned, however, private capital inflows are relatively modest and seem unlikely to be galvanised by the existence of IMF programmes; this is largely supported by the empirical evidence. For them, the connection with aid inflows will be more important. But here it seems likely that the positive association between IMF programmes and aid flows found in some empirical studies reflects coordination, or concerted lending, rather than conventional catalysis whereby an agreement with the Fund independently stimulates aid donors to give more aid. The strength of the association will, in turn, depend on the complex political economy of aid; for

[13] Examples include Bird and Rowlands (1997, 2002, 2004), Morris and Shin (2003), and Mody and Savaria (2003). The literature is fully reviewed in Cottarelli and Giannini (2003).

example, what is the objective function of aid donors and does it match that of the Fund? What is the nature of the relationship between aid donors and the IMF? For example, are they independent actors or is there a principal–agent relationship, and if so which is which? A fundamental issue remains whether IMF lending and bilateral aid flows are substitutes or complements; and whether IMF programmes lead to a tapering out of aid.

With regards to private capital, the evidence implies that the IMF often becomes involved in lending at times when private capital is leaving or other creditors are reluctant to roll over maturing debt. However, in the case of official flows there is evidence to suggest a complementary relationship within the context of contemporary programmes (Bird and Rowlands, 2002a; Powell, 2003). Collier and Gunning (1999) have argued that by setting fiscal targets exclusive of aid, IMF programmes create disincentives for donors to provide future aid, with the result that it tapers out, particularly perhaps in countries that are successful in achieving fiscal targets. There will then be a form of adverse selection in the allocation of aid. For a critical assessment of this view, see Bird and Mosley (2003) and IEO (2003).

For rather different reasons, some critics have argued that debt relief, supported by the IMF under the auspices of HIPC, has redirected global financial assistance amongst developing countries in an undesirable way (Ranis and Stewart, 2002; Bird and Milne, 2003). The relationship between aid and IMF lending may of course be quite complex. Following a detailed study of IMF lending to African economies, Stone (2003) claims that politics dominates. African economies that have the support of a powerful G-7 country (such as the UK or France) because of their former colonial status may not only receive aid, but are also more likely to receive loans from the IMF. They are, however, less likely to implement programmes completely, since, although the failure to implement may incur a short-term penalty in terms of not receiving the full amount of the loan, the countries will experience little difficulty in negotiating replacement programmes. Aid is then associated with IMF lending because both are associated with the political preferences of powerful advanced countries. Low-income countries that do not have the same degree of political support may not only receive less aid but also less financial assistance from the IMF. When agreeing a programme, however, they may also be treated differently should they fail to complete it. For this reason, Stone claims that their implementation record is better.

The provision of finance, either directly or indirectly via catalysis, will, as noted above, have implications for adjustment. By permitting short-term adjustment costs to be reduced, the Fund aims to act in accordance with its Articles of Agreement that require it to enable member countries to avoid measures destructive of national and international prosperity. But the potential danger is that governments may seek to reduce adjustment excessively or avoid it altogether; there may be so-called debtor moral hazard. In part, the purpose of IMF conditionality is to police this form of moral hazard and to prevent countries from squandering the resources borrowed from the Fund. The IMF therefore opts to exert a direct influence over adjustment policy as well as an indirect one via its provision of financial assistance. There will be a socially optimum adjustment path that involves neither 100 percent nor zero percent short-term adjustment. Can the IMF help countries find and then keep to this path?

The basic adjustment policy dilemma may be easily illustrated by the simplest of all open economy frameworks where:

$$X - M = Y - [C + I + G]$$

with X = exports, M = imports, Y = aggregate domestic output, C = consumption, I = investment and G = government expenditure. To strengthen the current account, either Y must increase or [C + I + G] must fall. Although a preferable strategy, it may take time to increase Y and this may, in any case, require a near-term increase in I and the capital component of G. If, however, the current account deficit needs to be eliminated quickly then C and the current component of G will have to fall to protect capital accumulation. But such cuts will encounter domestic political resistance. IMF lending provides time to cushion adjustment; but the time needs to be used productively. There have to be appropriate policies to influence both Y and [C + I + G]. The key question then is the extent to which the IMF's involvement via conditionality helps to put in place and to carry through the appropriate demand side and supply side policies.

Matters would be relatively clear-cut if there were well defined correct and incorrect policies relating to macroeconomic stability, microeconomic efficiency and openness, and if the IMF knew and supported the correct ones while governments either did not know the correct ones or simply chose to ignore them and implement the incorrect ones. Unfortunately, things are much more complex than this, and it is this complexity that is at the heart of much of the debate surrounding the IMF's involvement in both developing and emerging economies.

To some extent there is a *prima facia* argument that referral to the Fund indicates that governments have made mistakes and not pursued the correct policies. But another feature of low-income countries is their vulnerability to shocks that may adversely affect the current account and the fiscal balance. A bad harvest, or a fall in export prices may reduce both export revenue and tax revenue. Or, where sovereign debt is denominated in US dollars, an increase in world interest rates or an appreciation in the US dollar will lead to an increase in government expenditure expressed in domestic currency. Apart from such exogenous shocks, it may also be the case that the characteristics typically found in developing countries make it more of a challenge to conduct macroeconomic management. It may be more difficult to control government expenditure, to increase tax revenue, to avoid monetising fiscal deficits, to control the supply of money and to pursue inflation targeting. Exchange rate depreciation may also be less effective if the inflation it induces impedes its relative price effect, if foreign trade price elasticities are relatively low, and if its distributional consequences create severe political problems.[14]

But at least there is a reasonable degree of scientific consensus surrounding the design of key elements of macroeconomic policy. Large fiscal deficits, either when they are monetised or when they result in the accumulation of large amounts of short-term external debt, are likely to cause problems.[15] Similarly, the counter-inflationary effects of overvalued exchange rates are unlikely to offer sufficient compensation for the erosion of international competitiveness and the expectations of devaluation to which they lead. Again, the fact that countries are turning to the Fund suggests that governments may have paid insufficient attention to the balance of payments constraint, or may have in effect accepted that their exposure to external shocks will make it likely that they will periodically need to turn to the IMF. Countries seek Fund assistance when their balance of payments has become

[14] Bird (2004a) provides a fuller discussion of these issues and the implications for the design of PRGF programmes.

[15] However, the effects of fiscal deficits on other variables will depend on the circumstances in which the deficits occur. For a detailed discussion of the effects of fiscal deficits in developing countries, see, for example, Easterly and Schmidt-Hebbel (1993).

unsustainable and a policy priority must therefore be to create or recreate sustainability. Managing aggregate demand has a part to play in achieving and continuing to achieve this objective, but it is unlikely to be the whole story. Again, the evidence cited earlier in this chapter suggests that it is not purely and simply macroeconomic mismanagement that leads poor countries to turn to the IMF. There will also be structural problems.

Policy prescriptions relating to structural adjustment and the supply side, however, draw on less secure analytical foundations. There is less consensus on the causes of economic growth and the effects of openness, with the consequence that there is more debate and disagreement about what policies will increase aggregate supply in the long run. What is the appropriate role of the state? To what extent will privatisation stimulate growth? Which elements of government expenditure show the biggest return in terms of economic growth? What is the impact of openness and trade liberalisation on growth? What is the connection between financial liberalisation and growth? In what order should policies of economic liberalisation be sequenced? On supply-side issues, it is therefore more difficult for the IMF to advocate a specific evidence-based set of policies.[16] What is perhaps more certain is that economic growth may be interrupted by the exogenous shocks to which low-income countries are vulnerable (Easterly *et al.*, 1993; Winters, 2004).

What general messages does the above discussion contain for the IMF's involvement in poor countries? First, it is reasonable that IMF conditionality should establish a broad macroeconomic framework that seeks to avoid macroeconomic disequilibrium arising from excess aggregate demand. Second, while stabilisation may almost unavoidably imply a measure of short-term demand compression, it is also reasonable that the Fund should seek to minimise the costs associated with this by seeking to spread out the adjustment period. Third, emphasis should therefore be placed on adjustment with growth. However, given the lack of scientific consensus about the causes of growth, member countries need to be encouraged to formulate their own development strategies that the IMF can then endorse, monitor

[16] Temple (1999) provides a reasonably up to date survey of the recent literature on economic growth; but also see Easterly and Levine (2001, 2002), Rodrik (1999, 2000), Rodrik *et al.* (2002), and Sachs (2001). Winters (2004) reviews the available empirical evidence on the relationship between trade liberalisation and growth and reaches a largely positive conclusion.

and support (or choose not to endorse). This will probably involve encouraging countries to strengthen their institutions. Fourth, the Fund should also attempt to minimise the disruptive effects of external shocks on strategies to which it has given its approval. An implication of this is that the Fund needs to provide adequate finance in support of something more than a short-run adjustment strategy, unless it can effectively mobilise other sources of capital. At the same time and fifth, the danger needs to be avoided that increased borrowing from the IMF or elsewhere leads countries to accumulate unsustainable levels of external debt. This implies that loans need to be at highly concessionary rates or take the form of grants. Finally, the Fund can assist low-income countries significantly, but indirectly, by helping to create a conducive global economic environment, with sustained economic growth and improved market access in advanced economies. But if these are the messages being transmitted, how well have they been received by the IMF?

5 How Well Does the IMF Play Its Role?

Critics argue that the Fund does not play its role in developing countries at all well. What have been the key arguments in their case? Of course, not all critics subscribe to the same list of arguments. The following is a generic list, although at least one specific example of each argument is cited from the literature. Briefly, critics claim that IMF programmes and the conditionality they embody do not work, either because they are badly designed or because they are not fully implemented (Killick, 2004a and 2004b; Collier *et al.*, 1997). They claim that IMF programmes have a negative effect on economic growth and on income distribution. They claim that programmes fail to generate a catalytic effect on private capital flows and that the failure to sustain any improvement in the balance of payments results in countries becoming IMF recidivists (Bird and Rowlands, 2002a; Bird, 2001d). They argue that structural adjustment programmes, or even a sequence of them, have not resulted in improvements in economic performance (Easterly, 2002). They argue that IMF programmes lead to a tapering out of aid (Collier and Gunning, 1999). They argue that the Fund exhibits serial over-optimism in terms of economic growth, investment, fiscal correction and export growth, such that short-term adjustment has to be greater than envisaged at the outset of programmes (IEO, 2003; Bird, 2004c).

At the same time, they argue that IMF lending leads to creditor moral hazard, with the prospect of such lending reducing perceived risks and encouraging over-lending by capital markets that then culminates in crises (IFIAC, 2000). They argue that IMF lending is, in any case, politically motivated (Feldstein, 1998; IFIAC, 2000; Sachs, 2004). They argue that the wider participation designed to encourage ownership has been largely cosmetic and has not worked, and that reduced IMF conditionality via streamlining has merely been replaced by additional conditionality from the World Bank or aid donors (Killick, 2004a).

Each of these claims can be the subject of legitimate, and often quite lengthy, debate. There is a large and growing literature on all of them, dealing with both the underlying analytics and the empirical evidence. This is reviewed in Bird (2003). Counter-arguments can also be assembled. From the viewpoint of low-income countries, these could include the following. First, given the deep-seated problems they face, it is unrealistic to expect involvement by the IMF to transform the economic situation in poor countries in the short term. Second, given the circumstances in which countries turn to the IMF and the need to eliminate macroeconomic disequilibrium, it may also be unrealistic to assume that aggregate demand deflation can be avoided unless substantial aid flows can be generated; there is likely to be an adverse short-run effect on investment and growth. Third, the catalytic effect on private capital flows is never likely to be a significant factor in the case of low-income countries; IMF programmes do however encourage effective foreign aid by seeking to combine it with sound economic policy. Fourth, creditor moral hazard is unlikely to be relevant for low-income countries. Fifth, policies designed to strengthen ownership and streamline conditionality provide evidence that the Fund is moving in an appropriate direction. And sixth, there is at least some evidence to suggest that, under the umbrella of the PRGF, these policies are having some beneficial effects on economic growth and poverty reduction (see, for example, IEO, 2004).

To cut a very long story very short, the evidence seems to suggest that the IMF's performance of its role in poor countries should objectively receive mixed reviews. If this is a reasonable assessment of the evidence, it implies two things. First, it may be unwise for the Fund to disengage from its relationship with low-income countries, unless there are fairly compelling reasons to believe that the Fund's role could be better played by other agencies such as the World Bank or aid donors. Would low-income countries be better off without the IMF?

The operations of the World Bank and aid donors have not escaped criticism. World Bank policy-based lending has been subjected to criticisms relating to its design, implementation and effectiveness (see, for example, Mosley *et al.*, 1991). Similarly foreign aid also has its fair share of critics (for example, Easterly, 2002a). Certainly, there could be as many debates about the role of the World Bank and aid in low-income countries as there are about the IMF.

A second implication is that rather than discontinuing its role in poor countries the Fund should be seeking to strengthen it. How could it do better? Answering this question could involve detailed analyses of the PRGF and the post-HIPC era, as well as collaboration between the IMF and the World Bank, and much of the recent material being produced by the IMF takes this approach (IMF, 2004a and 2004b). The following section adopts a rather different one and examines some of the broader policy implications of the analysis contained in Section 3.

6 Strengthening the Fund's Role: The Issues and Options

In looking to establish a more fulfilling relationship between the IMF and poor countries within the context of the balance of payments problems they encounter, policy reform might usefully focus on a number of areas and issues. Here we consider the provision of external finance; adjustment, conditionality and the design of IMF programmes; the implementation of programmes and their vulnerability to external shocks; and selectivity. Many of the points made could apply to the Fund's dealings with all its "client" countries and not just to low-income countries. The list of issues is not comprehensive.

6.1 Financing

By engineering additional external financing, poor countries would be able to substitute further out of short-term demand-based adjustment and further into longer-term supply-based adjustment. They would be able to place greater emphasis on structural adjustment, and on strengthening the real economy. This is not to advocate short-run macroeconomic profligacy. Poor countries need to pay due regard to avoiding fiscal and monetary excesses and currency overvaluation. But, at the same time, having reached a point where macroeconomic policy is "sound", national prosperity will not be served by seeking adjustment through the heavy compression of aggregate demand. Longer-term improvements on the supply side of the economy may also raise the efficiency of future short-term stabilisation policy. Foreign trade price elasticities may be increased, making exchange rate policy more effective. Tax reform may make it easier to control tax revenue, and financial reform may allow indirect instruments of monetary policy to replace direct controls.

The potential dangers associated with additional external financing are debtor moral hazard, and the accumulation of unsustainable levels of external debt. The first of these may be constrained by effective conditionality; it is therefore important that conditionality is appropriately designed (see below). The second requires that lending is at a sufficiently concessionary rate, so that the risks of future debt problems are minimised.

With these dangers taken into account, the question then relates to the *instruments* through which additional financing is to be orchestrated. In principle, there are a number of possibilities, although few are particularly novel. Some would involve more direct lending by the IMF. These could take place via the General Resources Account, but with subsidies introduced to reduce the cost to poor countries, or through the concessionary PRGF. There is also the long-standing notion of making additional allocations of SDRs to low-income countries. There are technical problems with each of these that would need to be addressed. And each raises its own group of issues.

For example, would the resources of the General Resources Account be adequate to meet additional demands from low-income countries and, if not, how could the resources be increased? In fact, although the IMF has many arrangements with poor countries, the resources involved remain small relative to those with large emerging economies. The Fund's resources could, in principle, be raised via further increases in quotas. Or extra general resources could be made available for poor countries if emerging economies developed their own regional financing agreements – there is the idea of an Asian Monetary Fund for example, or if the Fund borrowed directly from private capital markets to finance some of its emergency lending to emerging economies. Expanding or enhancing the PRGF could be achieved by increasing direct subscriptions to the Trust Fund or by the IMF continuing to sell off its remaining stock of gold; although gold sales involve their own problems.[17] Moreover, why would donor countries wish to channel aid through the PRGF? This would have to offer them some advantage. A blanket allocation of SDRs to low-income countries would not distinguish between those that would have borrowed from the IMF and those that would not. Moreover, as things stand, the SDRs would be unconditional. Certainly, the SDR facility could be used as a means of providing financial assistance to low-income countries, but to choose to modify it to fulfil this function means that advanced (donor) countries would again have to see some advantage in providing aid in this way. After all, an allocation of SDRs to poor countries that then use them to finance current account deficits would still involve a transfer of real resources from advanced economies.[18]

An alternative approach would not call on the Fund to be involved with direct lending to poor countries at all. This approach would have the IMF negotiating conditionality and monitoring implementation but not providing its own resources. Instead, it would be the aid agencies that would provide the money. There would then be a clearer division of labour between the IMF and aid agencies. Such a change, if taken to extremes, would be strategically significant since it would mean that the Fund would not be contributing directly to alleviating liquidity problems. A counter view is that the IMF should focus more strongly on encouraging private sector involvement in emerging economies without lending so much itself, and should concentrate more of its own lending on low-income countries where the chances of PSI are much more restricted and aid has been unpredictable.

Political realities would seem to make some of the above options less likely than others. The more improbable ones include additional SDR allocations to low-income countries and the complete discontinuation of IMF lending to poor countries. The more probable ones include the further refinement of the PRGF, the subsidisation of drawings under GRA facilities and closer coordination between the IMF and aid donors.

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[17] Any plan involving the depletion of the Fund's remaining stock of gold would need to address the concern that gold sales will depress the global price of gold and that this could have disadvantages for countries that produce gold or have significant gold holdings. For recent discussions of varieties of this proposal, see Birdsall and Williamson (2002) and Sanford (2004).

[18] The governments of donor countries could see some political advantage in providing extra financial assistance via the less transparent form of SDRs, if they believed that extra aid was appropriate but also that providing it in conventional ways would encounter domestic political opposition.

6.2 Adjustment, Conditionality and Design of IMF Programmes

There are a number of elements to reforming the IMF's adjustment role in low-income countries that lead on from the analytical discussion earlier in this chapter. Again, they all merit much further discussion than they receive here. First, while conditionality is legitimate in mitigating debtor moral hazard and in seeking to catalyse foreign aid, it needs to be appropriate in its design. Excessive conditionality may be counter-productive; there may be a conditionality Laffer curve (Bird, 2001c). On these grounds, a minimalist approach to conditionality would appear to be more appropriate. Mandatory conditions might be limited to policies that affect a country's ability to repay its debts to the Fund and to avoid falling into arrears; they should be based on the areas of broad economic consensus surrounding macroeconomic stabilisation. In the areas of economic growth and poverty, where there is much less consensus, governments should be granted as much discretion as possible. The Fund could make recommendations but should not impose these as performance criteria; at least not until reasonable alternative policies selected by governments had been shown not to work.

Greater temporal flexibility in the design and implementation of conditionality could also be introduced via "floating tranches" with Fund finance being linked to the implementation of reform. Offering governments greater discretion does not mean abandoning conditionality. The Fund would still monitor performance, and its support would remain conditional on governments pursuing the strategies agreed with the Fund. But structural conditionality would be more fully self-designed. This approach would also encourage poor countries to build up their own capacity to design long-term balance of payments strategies and to establish the necessary institutional arrangements for long-run economic success; contemporary research suggests that institutional weakness has negative effects on economic growth.[19]

[19] There is a large and growing literature involving empirical studies of growth. Is growth affected by geography or institutions? On this see, for example, Easterly and Levine (2001 and 2002), Rodrik (1999), Rodrik *et al.* (2002) and Sachs (2001). To what extent is it the Fund's role to seek to change domestic economic institutions? Are they political institutions or do they cover the institutional mechanisms for collecting taxes and the degree of central bank independence? Some may argue that the IMF is not in a strong position to preach democracy when its own governance is not particularly democratic.

In this context, the Fund's decision to "streamline" conditionality at the beginning of the 2000s is a movement in the right direction. Whilst retaining macroeconomic conditionality, streamlining involves reducing the content of structural conditionality and reversing the trend of the late 1980s and 1990s. The stated intention is to retain structural conditions only where they are needed to facilitate the attainment of macro conditions. It may still be premature to evaluate the success of streamlining. Certainly, some critics have argued that although the number of performance criteria in IMF programmes has fallen, the "depth" of conditionality has not changed. Moreover, they claim that IMF conditionality has simply been replaced by World Bank conditionality so that the degree of overall conditionality faced by poor countries has not been reduced and may even have increased (Killick, 2004a and 2004b). In addition, if external financing remains inadequate, this effectively constrains structural adjustment whoever designs it. The speed of adjustment itself then has to adjust to be consistent with the amount of financing.

In connection with this, streamlining does not seem to have been accompanied by a reduced tendency for the Fund to be over-ambitious. IMF programmes still seem to set unrealistic targets in terms of economic growth, export growth, and fiscal adjustment as well as the amount of outside financing. They also seem to be over-ambitious in terms of how long it takes to bring about institutional changes such as the reform of tax administration. As a consequence, they tend to underestimate the amount of IMF support required or the extent to which short-term adjustment will be needed. While there may be political explanations as to why over-ambition helps in reaching initial agreement, it does little to foster the success of programmes once they have been initiated, and may indeed work against implementation.

6.3 The Implementation of IMF Programmes

The relatively poor record of implementation has been another feature of IMF programmes that has recently received both theoretical and empirical attention. From a policy point of view, the Fund has attributed poor implementation to a lack of national ownership. The broader participatory process incorporated into the reformed PRGF has been intended to strengthen ownership and thereby improve implementation.

But will it work? A range of issues arises.[20] What factors influence implementation? To what extent do initial conditions, the amount of IMF financing and the existence of external shocks play a role? If implementation depends on "political economy" factors, what are they? To what extent is it simply the existence of powerful opposition groups that sabotage programmes or are there in fact a myriad of relevant political factors? Is ownership an operational concept? Can implementation be encouraged even in the absence of strong ownership? Is conditionality fundamentally inconsistent with ownership or is it an effective mechanism for dealing with "veto players"? Indeed, can conditionality be used to foster ownership? Does broader participation in negotiating programmes lead to stronger ownership and better implementation or does this depend on the type of participation? Should the Fund, in any case, be consulting with groups outside the government? Should the probability of implementation be factored into decisions about alternative programmes?

There is much to examine and debate here, but a few underlying principles could help to direct reform while research attempts to improve our understanding of the above issues. There is little point in designing programmes if their implementation is a matter of indifference. Incentives should therefore be arranged to encourage implementation. Incentives can be both positive and negative. Thus, countries can be rewarded for implementing programmes by the amount of finance they receive. Similarly, they can be penalised for poor implementation by impaired access to future finance from the Fund – and not just in the context of contemporary programmes.

To some extent, the prolonged use of IMF resources by low-income countries may reflect a moral hazard problem in as much as new programmes are not prejudiced by a prior record of poor implementation.

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[20] Literature on implementation and ownership includes Bird (2002a and 2004b), Bird and Willett (2004), Boughton and Mourmouras (2002), Drazen (2002), Drazen and Isard (2004), Dreher (2002), Ivanova *et al.* (2003), Joyce (2003), Khan and Sharma (2001), Killick (1998), Mayer and Mourmouras (2002), Mecagni (1999), Mussa and Savastano (2000). Although the questions are relevant to the Fund's dealings with all its members, they are certainly important in the context of low-income countries where the persistent use of IMF resources could, in principle, reflect poor implementation. What little evidence is available, however, suggests that poor implementation is not a feature that distinguishes low-income countries from other users of IMF resources (IEO, 2002). It is a general problem.

Policy needs to address this.[21] At the same time, prolonged use may reflect the severity of the problems that low-income countries face and these need to be accommodated within IMF programmes. Poor implementation may not just reflect policy backsliding by governments. It may be caused by external shocks that are beyond a government's control. The implication is that programmes need to incorporate contingency provisions that shockproof them. The issue is then whether the Fund's current institutional arrangements in the form of the Compensatory Financing Facility and the use of waivers and modifications provide adequate shock-proofing.

6.4 Dealing with External Shocks

Low-income countries exhibit a relatively high degree of export concentration on commodities whose price in world markets is often unstable. At the same time, where the price is denominated in US dollars, variations in the price of the dollar may be another factor in determining how the international purchasing power of a specific volume of exports may change. Weak terms of trade contribute to a country's decision to turn to the IMF, and export shortfalls make it more difficult to achieve targets and implement agreed programmes. Even positive shocks – export excesses – may have macroeconomically destabilising consequences via Dutch disease effects or by enticing governments to relax macroeconomic discipline. On top of this, the empirical growth literature shows how external shocks disrupt economic growth. It is in this respect that low-income countries may experience "bad luck" rather than simply bad policy.

Can the IMF help poor countries deal with their bad luck or, indeed, help them to improve their luck? One response is for countries to use the additional revenue from export excesses to build up reserves that can then be decumulated when there are export shortfalls. After the Asian crisis in 1997-1998 the IMF encouraged countries to accumulate reserves as

[21] Poor implementation undermines the credibility and signalling effect of programmes (Bird, 2002b). As noted earlier, Stone (2003) claims that the evidence from Africa confirms that the expected probability of being able to secure a replacement programme affects the extent to which contemporary programmes are implemented. The IEO report on prolonged use (IEO, 2002) suggests that the structure of incentives affecting implementation needs to be addressed. A proposal from the IEO to increase the rate of interest on loans in replacement programmes was not supported by the Fund's Executive Board.

a way of minimising their vulnerability to future crises – although this advice was largely aimed at emerging economies and according to some observers may have been taken too far. The underlying issue here relates to optimum reserve holdings. For low-income countries, the opportunity cost of holding reserves will be high. Export revenue may be used more productively than by being accumulated in the form of reserves.[22] For low-income countries therefore, it may be better to facilitate their access to liquidity when a shock occurs rather than for them to take out expensive "insurance" against shocks that may not happen. Insurance is a luxury good that poor countries may not be able to afford. The IMF has a facility – the Compensatory Financing Facility – that was designed initially for just such a purpose. The CFF faced technical challenges in establishing the size of shortfalls, the extent to which they were temporary, and in distinguishing between export shortfalls that were beyond the control of the country concerned and those that were not. The facility has had a chequered history. In the mid-1970s, it involved low conditionality and was heavily used. After the early 1980s, however its conditionality was in effect raised and its use since then has fallen dramatically. It has been reformed on more than one occasion, but its future remains uncertain (IMF, 2004a).

Whilst recognising that the devil may be in the detail, it is surely appropriate that the Fund should seek to have within its array of lending facilities one that permits countries that are pursuing well managed and coherent economic policies outside the auspices of IMF programmes to gain access to quick disbursing financial assistance in the event of temporary adverse shocks. The purpose is to ensure that short-term illiquidity does not threaten long-term growth and development.

For those countries contemporaneously under IMF programmes, the need is to effectively incorporate a contingency component to cover temporary external shocks. For positive shocks that lead to formal programmes being discontinued, the Fund needs to seek ways of encouraging countries to continue to pursue sound policies that will enhance their access to foreign aid and their chances of sustaining economic growth. This could be in the form of monitoring economic policy and performance outside of a programme (see IMF, 2004a, for a discussion of such proposals). For negative shocks that mean that initial targets are no longer feasible, the Fund currently relies on modifications to existing

[22] The opportunities for hedging against future movements in commodity prices and indeed exchange rates may also be more limited.

programmes or waivers or replacement programmes. The shocks are dealt with *ex post*. In practical terms the flexibility that is thereby permitted has probably been beneficial (Mussa and Savastano, 2000), but there may be better ways of handling matters. It was earlier suggested that IMF targets tend to be over-ambitious (Baqir *et al.*, 2003; Atoian *et al.*, 2003). In any event, there will be uncertainties surrounding projections. Since the vulnerability to shocks can be anticipated, programmes could be subjected to detailed stress tests. In addition to agreeing to one particular programme, shadow programmes could simultaneously be agreed that would cover a range of eventualities. These would allow the fundamentals of an agreed economic strategy to be protected from the consequences of short-term illiquidity. If what initially appeared to be a short-term export shortfall transpired to be a longer-term trend movement then subsequent programmes would need to address this. Indeed, turning to the longer term, the Fund could play a role in seeking to ensure that exchange rate policy and fiscal and financial policy did not discriminate against export diversification, which could minimise the future vulnerability of the overall balance of payments to shocks affecting individual exports. In this way and in cooperation with the World Bank, the Fund could improve the "luck" of low-income countries. Moreover, by encouraging appropriate economic and institutional reform the Fund could help countries to handle shocks without creating the political instability that then negatively affects economic growth.

6.5 Selectivity

While some critics have suggested that the Fund should not be lending to poor countries at all, others have argued for greater selectivity. The argument here is that a perception of overall failure is created by the Fund negotiating programmes where there is little chance of success either in terms of implementation or economic performance. Scarce IMF resources are therefore not being used efficiently. If analysis of past programmes enables the factors determining implementation to be identified, then the probability of success may be calculated *ex ante* by examining these factors. According to this view, the Fund should focus its own resources where there is a good chance of success. In other cases, it should not lend its own resources but should instead concentrate on trying to help create the circumstances in which conventional programmes may eventually be endorsed. Through providing advice on economic policy and by monitoring progress, the Fund could then encourage aid donors to provide financial support, although ultimately this could be basically humanitarian in nature.

The idea of selectivity builds on the notion that there is an important distinction between IMF lending and foreign aid. Should the IMF be allocating its resources in such a way as to maximise some notion of "return". If so, at the margin it may well be sensible to redirect its lending away from countries where the prospects of success are low, to others where they are higher. The difficulty is in applying this basic principle. While it may be possible to identify some countries where political instability and conflict is so pronounced that the environment in which an IMF programme may be negotiated and implemented is absent, there will be other cases where any judgment is more nuanced, Applying a policy of selectivity to any great extent will require a better understanding than currently exists of the circumstances in which programmes are and are not successful. The existing analytical and empirical research on implementation is still quite rudimentary, and it is still by no means firmly established that eventual success in terms of outcomes is strongly and positively associated with implementation – although there are indications that point in this direction.[23]

7 Concluding Remarks

Although it has attracted recent attention in association with the setting of the Millennium Development Goals and concerns that globalisation may not have conferred benefit on developing countries, the question of the relationship between poor countries and the international monetary system in general and the IMF in particular has in fact been under examination for many years.

The issues involved and the literature discussing them were sufficient to warrant at least two surveys in the 1970s (Helleiner, 1974; Maynard

[23] Mosley *et al.* (2003) mount a strong attack on the notion of greater selectivity in the context of World Bank lending. They take issue with studies that claim to have discovered a link between the completion of programmes and domestic political variables, and argue that their own empirical work – based so they maintain on superior data and econometric techniques – fails to find such a relationship. According to them, objective grounds for selectivity therefore do not exist. Indeed, they argue that factors influencing implementation are ones upon which the international financial institutions can themselves exert an effect.

and Bird, 1975). Many of the issues remain fundamentally unchanged (see, for example, Bird, 1978; Helleiner, 1983; Williamson, 1983). The role of economics as a discipline is to clarify these issues, analyse them and collect relevant empirical evidence. From this, the policy options may then be laid out, with their attendant advantages and disadvantages.

However, the people who make the decisions may remain unpersuaded by the economic arguments or may even make policy decisions in spite of them. They are likely to be influenced by politics. Of course, where the economics is unclear, there is a scientific vacuum that politics tends to fill. Indeed policy decisions based on political considerations may move ahead of the related economic analysis. Anxious to get things done, and frustrated by what they see as lack of progress, some economists have opted to become advocates for policy change.

In the context of the IMF's relationship with developing countries, many of the important economic questions remain unanswered or at least not fully answered. They relate both to fundamental issues such as the determinants of economic growth and poverty, as well as to aspects of the IMF's operations, such as the effects of IMF programmes. Indeed economics, on its own, may be incapable of providing complete answers to these questions. For example, in looking at the "life-cycle" of IMF programmes political economy variables are likely to exert an influence at each stage. Certainly, within the context of the IMF's operations politics plays a central role. It strikes at the core of the institution affecting its governance and the quotas that are the "building blocks" of its operations. Meanwhile, highly reputable economists have reached opposing views about the Fund's relationship with developing countries. Even on issues where an academic consensus of sorts emerges, politics may block reform, such as with the proposal for a Sovereign Debt Restructuring Mechanism (SDRM). On other issues, politics may accelerate reform, such as perhaps with the enhanced HIPC or the PRGF.

So where does this leave us? If it seems to imply that the issues are highly complex, that our understanding of them is still limited, that there is a potentially explosive combination of economics and politics, and that there are no easy answers, then it is because this is exactly what the situation is. But at the same time, the absence of easy answers is not an argument for policy inaction. It is a matter of learning by doing, trying to avoid doing harm, and gradually evolving towards a better outcome.

This chapter examines some of the broad principles underlying the

IMF's relationship with low-income countries. However, it avoids the contentious question of IMF governance, a source of considerable disquiet to developing countries (see, for example, Kelkar *et al.*, 2004). Because of the structure of their economies, poor countries face frequent balance of payments difficulties. Low holdings of reserves, little access to private capital and unpredictable aid flows imply that they will be constrained in financing balance of payments deficits. The imperative will then be to achieve rapid adjustment and this in turn is likely to mean compressing aggregate domestic demand; a strategy that will bring with it associated economic and political costs. In principle, the IMF can help by providing liquidity that reduces the need for short-term demand-based adjustment. It can assist with both stabilisation and longer-term adjustment. It is then a matter of how well or how badly the Fund fulfils these functions in practice. Objective examination of the evidence suggests a nuanced conclusion. However, the rhetoric involved in the debate sometimes departs from the reality. Moreover, largely unhelpful questions have been pursued such as whether the IMF has become a development institution, when the distinction between long-term balance of payments policy and development policy is sufficiently obscure to make such classification itself unclear.

The IEO has encouraged the Fund to pay more attention to the impact of alternative macroeconomic policies on poverty and social cohesion so that restoring macroeconomic equilibrium imposes minimum social (and political) costs (IEO, 2003).

With a strong commitment to assisting poor countries in dealing with their short-term balance of payments problems and strengthening their balance of payments in the long run in ways that do not damage, and may facilitate, economic growth and development, there are numerous policy options that can be considered. These cover external financing, adjustment and conditionality, the implementation of programmes, coping with external shocks and selectivity. These options have been examined in this chapter. Currently, however, the policy discussion within the IMF seems to be focusing more narrowly on the past performance and future direction of the PRGF, the concessionary window through which the IMF lends to poor countries. Although the discussion raises important issues and although seeking to improve the PRGF is important, the flavour of the internal discussion does seem to suggest an approach that starts out with assumptions about the amount of financing likely to be available and then turns to how this can be best used, rather than starting out by considering the policies most likely to encourage growth, development and long-term balance of payments sustainability and then turning to the amount of external financing and the design of conditionality required to support these policies. The signal is still sometimes transmitted that neither its staff and management nor its principal shareholders are firmly and universally committed to a role for the IMF in poor countries. Without such commitment, or to put it another way, without ownership of this role, it is unlikely that the Fund's full potential to assist poor countries will be fully exploited. Even with it, the path towards a more fulfilling relationship will remain long and arduous.

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3

Enhancing the Credibility of the IMF

Louis Kasekende

I agree with Graham Bird that these issues of the role of the IMF in low-income countries have been with us for a long time. You may recall the shift in the 1970s and 1980s from structural adjustment to the Enhanced Structural Adjustment Facility (ESAF), which was an attempt to focus more on the persistent problems rather than the short-term interventions that where typical for the traditional stand-by arrangements. From 1986 to 1993, 15 countries in Africa had ESAF programmes. Over the years, the IMF has compiled a list of lessons learned. These culminated in placing poverty at the centre of reform programmes in the Poverty Reduction Growth Facility (PRGF).

I believe there is a role for the IMF in the low-income countries. I do not support the extreme view that the problems in developing countries should be dealt with by the World Bank alone. This is partly because of my own experience in Uganda. Our main challenge is finding the proper instruments.

Programme Design: The Chances of Getting it Wrong

Africa presents major challenges to the development world. One is that a number of the African countries are unlikely to meet the Millennium Development Goals. A large proportion of the population lives on less than one dollar a day, and absolute poverty is on the rise. The economies remain very fragile; there is little export diversification, exports remain concentrated on primary commodities, and markets are largely dysfunctional. Africa also remains highly vulnerable to climatic and terms of trade shocks. Then we have issues of aid shortfalls, not to mention AIDS. This is the stark reality that one has to consider when looking at the role

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of the IMF in low-income countries. The question is whether it is realistic to talk of counter-cyclical lending by the IMF, given these stark realities, or is it more realistic to talk about *constraints* to growth.

Let me start with the programme design. I agree with Graham Bird that the circumstances are very complex, and the complexity is at the heart of the debate surrounding IMF's involvement. Given the stark realities I just described, the first issue is what assumptions can one make if we are going to design a programme. What is the appropriate relationship between the fiscal deficit and the rate of inflation? What is the acceptable level of a deficit that can be financed sustainably? Graham says that there is agreement on some of these issues, but my experience working at the central bank suggests that many of these questions have no easy answers.

We are restraining governments in the domestic market, especially the government's borrowing from the domestic markets, without freeing up resources for the private sector. It is assumed that once you restrain the government's expenditures, commercial banks would be awash with the resources and will start lending to the private sector. But the reality in most cases is very different from that.

What targets for the monetary anchors are appropriate for inflation control, economic growth and poverty reduction? What level of inflation is appropriate for sustainable growth? Can we talk about fiscal flexibility when most of the spending is committed to civil service, defense, wages and social spending? When we talk about fiscal flexibility and demand management, how can we expect re-adjustments when most of the expenditure is on priority areas or areas that are difficult to cut? Just as Graham Bird's chapter shows, the list of questions is endless and the answers are largely elusive.

The chances of getting it wrong are quite high. Maybe this explains the over-optimism reflected in the IMF programmes. Graham mentioned that over-optimism might lead to under-financing the programmes, but I think part of the over-optimism results from the extreme difficulty of getting the correct answers to a number of these questions.

There is also the issue of countries agreeing to sub-optimal policies because their objective is just acquiring the resources. They want to reach an agreement quickly with the IMF so that they receive financial resources from the multilateral development banks and the bilateral donors. There are incentives on both sides that make the outcome of programmes highly unpredictable.

Programme Design: The Need for Realism and Flexibility

I recognise that the IMF makes an effort to present fully funded programmes. The IMF staff attempts to make realistic assumptions about export growth, fiscal expenditures, economic growth and aid delivery. Nonetheless, there is a call for more realism and more flexibility in programme design. In my view, however, the realism should come, first of all, from more commitment to the programmes by the countries themselves.

I support the idea that the PRSPs should be the basis in programme design. I do not think that we shall get to a point where attaining the Millennium Development Goals and all of the objectives as defined in the PRSPs will fully drive the IMF programmes. I think that is stretching our expectations too far. But what I am talking about is making sure that the IMF uses the PRSPs as a way of strengthening ownership by the countries themselves.

If we are going to use the PRSP, efforts should be made to make the PRSP itself more realistic and broad enough to encompass the development challenges facing a country.

This leads me back to the issue of the role the IMF can play if the PRSP is the basis. The IMF could ease the conditions necessary for absorbing external assistance, especially grants, and the fiscal space required for increasing investments in physical infrastructure.

The problem most of the countries face is a tendency to place overreliance on the private sector to take up investments in physical infrastructure. This rarely happens. Therefore, if you present a very tight programme, you will frustrate the government because the government cannot improve the infrastructure, which is required for supporting private sector-led growth. The IMF could assist governments and provide that fiscal space, so that governments can make investments in the public sector.

There is a debate, mainly in the Latin American countries, where profitable public corporations can be taken out of the budget and can even borrow directly in the market. Instruments like this, which are innovative, may be required for even the low-income countries.

Another big issue in programme design is the tension between short-term stabilisation and medium to long-term growth. I think this issue will continue to bog our minds; it will also be complicated by the tension between the financing needs for Millennium Development Goals and the objective of obtaining debt sustainability. This is one of the issues that we have been talking about in the World Bank. Once you bring in debt sustainability, especially as both the IMF and the World Bank have proposed it, you end up constraining the resource envelope or the type of resources that countries can assume. For those countries with a very low debt-carrying capacity, you start talking about grants as the only source of financing.

Given the weaknesses in the economic relationships that I have pointed out, the IMF should be more flexible in programme design and react as problems reveal themselves, as opposed to setting unrealistic monetary and inflation targets as a means to deliver short-term stabilisation. This will push the IMF in the direction of designing programmes on a case-by-case basis. Even though this is something we always talk about, I am bringing it back again: the need for a case-by-case approach.

Programmes should recognise ownership and political realities. Many times governments delay programmes, especially in areas of privatisation and the opening to foreign participation, because of politics. If you do not recognise this in the design, you might include items in the programme that the countries will never implement.

Then there are cases where governments want to use the IMF as a scapegoat, I think the IMF should exploit that because it is the government that wants to go ahead and implement a certain policy.

The Signaling Role of the IMF

Let me turn to low-income countries under stress, and post-conflict countries. I see a strong role for the IMF in these countries because in most cases, they lack credibility. Take those countries that are just getting out of a war: Liberia, Angola, and Uganda in 1986. There is a need for some sort of seal of approval for these countries to re-engage with the international community. There is a need to reassure the creditors that external financing or debt relief will be used productively.

This takes me to the issue of the signaling role. I have to sound a word of caution on this particular issue because there are times when bilateral donors end up withholding assistance during programme implementation because of protracted negotiations of a country with the IMF. Malawi comes to mind, as does Zambia where aid was suspended. It tends to introduce unwelcome volatility in aid delivery, especially if derailment is on short-term benchmarks. Aid that is supposed to support a country in the medium and longer-term projects is withheld. It complicates macroeconomic management given that there is little fiscal flexibility in most of these countries. They cannot cut wages; they cannot cut defense, and they cannot cut social spending. Therefore, you end up with countries accumulating a huge domestic debt and by the time you re-engage, you have an additional problem of a huge domestic debt. That is one of the issues that we are dealing with in some countries, specifically in Malawi.

This is not to say that we should weaken selectivity between the good and the poor performers or between poor and sound economic policies. But I would encourage bilateral donors to make more independent judgment as to whether to withdraw aid, especially during programme implementation. Something serious must occur before aid is withdrawn. Countries need more predictable aid rather than suspension of donor disbursements as soon as the IMF signals that that there are problems in the negotiations.

Signaling also plays a role for two other categories of countries. First, you have the countries that are prolonged users of Fund resources, who wish to graduate from the PRGF and still require some signaling role by the IMF. We can find ways of using enhanced surveillance for such countries. The monitoring of the performance of such countries again starts with setting benchmarks plus providing an endorsement that may be required by the market or the creditors. Second, there are countries that are not in the category of prolonged users of Fund resources, like Nigeria, who wish to design their own programme but need an endorsement by the IMF to be able to proceed with debt rescheduling in the Paris Club. The Paris Club should accept such an endorsement and proceed with debt restructuring.

Conditionality and Improving Programme Consistency

Streamlining conditionality and improving programme consistency among donors has been talked about a lot and it is therefore disappointing that it has not yet fully materialised. The proliferation of conditions in recent years in areas of governance, transparency and anticorruption measures is equally disappointing. In view of my earlier argument in favour of PRSPs as a central document to inform programmes, I support those who argue that Fund recommendations should not be performance criteria. Client countries should be allowed to design benchmarks that can be used to monitor the implementation of PRSPs. Such benchmarks would then be a sort of performance criteria for agreed programmes and surveillance.

The last set of issues has to do with programme consistency. A large number of distortions and tensions emerge during the implementation of programmes. There are tensions between short-term stabilisation, on the one hand, and debt sustainability in the medium and long-term development requirements, on the other. In an effort to reach the HIPC completion point, some countries forgo access to the much-needed long-term resources, including concessional resources. This is the case of Ethiopia and Rwanda. There are also countries that have fully liberalised their financial sector but have yet to enjoy benefits in the form of competitive pricing of financial instruments, i.e. Uganda and Tanzania. Real interest rates in double-digit figures are common in Africa in general and constrain access to long-term resources by the private sector. Moreover, there is the complex issue of the domestic debt problem, which is undermining fiscal sustainability. So there are quite a number of problems and the IMF and the World Bank should jointly apply their intellectual capacity to analyse these tensions and distortions in terms of their role in developing countries.

I appeal to the IMF and the World Bank to work together to analyse the tensions and distortions in the macroeconomic framework as PRSPs are implemented. One important issue is exchange rates because countries that have been recipients of aid are now faced with appreciating currencies that constrain export diversification.

Equally important is the guidance to client countries in dealing with booms and busts. I was in the research department of the central bank of Uganda when we had a boom, a coffee boom, in 1994, and we received conflicting advice from the World Bank and the IMF. The World Bank wanted us to pass all of the benefits to the farmers since they are good managers of these windfall receipts, while the IMF wanted us to build up reserves during this period by maintaining a very tight budget. To enhance their credibility, the IMF and the World Bank should develop one common view on how to deal with booms and busts. Client countries have limited intellectual capacity to process such conflicting information from the two institutions.

There is one point in Graham's chapter that I disagree with. He says that insurance is a luxury good that poor countries may not be able to afford. I disagree. There is room for insurance to deal with terms of trade shocks. Work has been done on this issue, especially by the World Bank, and the results of the pilot projects need to be shared more widely with the countries.

4

A Changing Role for the IMF in Low-Income Countries

Matthew Martin and Hannah Bargawi[1]

1 Introduction

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

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

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

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

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

2 The IMF's Lending Role

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

2.1 The Concessionality of IMF Lending

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

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

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

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

Therefore, we recommend that the grant element in IMF programmes should be increased to 35 percent minimum, and preferably to 50 percent for the poorest and most debt vulnerable countries. This is affordable within the Fund's current resources. It is not an overextension of the Fund's role in development financing. Also, the maturity period of loans could be extended by, for example, 5 years. Currently, PRGF countries are borrowing for 10 years, with grace periods of 10 years, which virtually means borrowing for 20 years. Some have suggested that any greater concessionality would transform the Fund into a development financing agency – but the Fund is already a long-term lender (the IEO, 2004 has argued that PRGF funding is already tantamount to development financing) and a 5-year increase in the maturity period would not mean a major change in its status.

2.2 The Scale of IMF Lending

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

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

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

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

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

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

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

How Can This Lending Be Funded?

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

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

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

2.3 External Shocks

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

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

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

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

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

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

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

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

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

2.4 Relationship Between Lending and Programmes

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

The need for IMF funding depends, most of all, on the status of the low-income country. As suggested by the Fund (2003b and 2004c), three groups of countries can be distinguished: "pre-stabilisation" countries, "early stabilisers", and "mature post-stabilisers". Fund resources would be essential for "pre-stabilisation" countries[5] that are just embarking on programmes to stabilise their economies, and sometimes emerging from conflict or other disaster, to contribute to gap-filling where the commitment of other financiers to fungible support is limited. However, as discussed above, Fund lending would need to be highly concessional. Fund resources might continue to be important for "early stabilisers", requiring current PRGF access limits or norms to be used, with higher access levels for countries emerging from arrears or emergency assistance, and reduced levels for successor arrangements, falling to 10 percent of quota as soon as they reach indicators of "mature post-stabilisation" status.[6] And Fund lending could be abandoned altogether for "mature post-stabilisers", since other lenders and donors can provide the needed concessional finance to replace Fund lending. Additional resources could be made available to combat exogenous shocks or fulfil sudden unexpected financing needs, for all three groups. However, all such resources should be given on PRGF terms to avoid putting at risk the debt sustainability of the recipient countries.

3 The IMF's Catalytic Role

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

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

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

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

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

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

3.1 Official Development Finance

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

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

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

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

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

behind programme projections.[10]

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

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

3.2 Private Sector Finance

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

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

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

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

3.3 Debt Relief

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

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

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

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

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

3.4 Impact on the Stability of Financial Flows

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

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

3.5 Improving the IMF's Catalytic Role

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

How can the IMF's catalytic role for official financing and private financing be improved? For official financing, first, the Fund should base its signal on better analysis. IMF views on the macroeconomic desirability of aid should be discussed more openly with governments and donors, based on detailed country-specific analysis, led by the low-income country government with assistance from independent analysts. Where firm evidence of negative effects is unavailable, the presumption should be that higher aid will have a positive effect on development. Low-income country governments should also analyse their absorptive capacity and MDG spending costs, to show a case for aid beyond gap-filling, and for measures to build their aid management capacity. These findings should then be integrated with the macro framework, to ensure that it allows the MDGs to be funded. IMF projections of official flows should take maximum advantage of global aid trends and quality improvements such as increased grants and higher budget support. The IMF should play an even more active role, together with UNDP and the World Bank, in presenting systematic assessments of the degree to which donors are supporting PRSPs and providing funding in a balanced way linked to country progress, and of when shortfalls are derailing programmes, at a country or global level (see also IEO, 2004; Trocaire, 2004).[13]

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

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

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

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

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

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

4 IMF Programme Design

4.1 Macroeconomic Flexibility

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

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

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

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

Growth-Maximising Inflation Rates

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

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

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

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

Fiscal Deficits

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

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

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

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

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

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

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

Reserves

Another possible target for stabilisation, in order to provide countries

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

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

Pre-Stabilisers, Early Stabilisers and Post-Stabilisers

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

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

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

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

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

Flexibility in Stabilisation Targets?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Finally, how does the IMF fare with the fourth possibility for more flexibility: allowing waivers if intent to stabilise is clear and if programme results are still within the ranges suggested as "sufficiently stable"? Again, evidence of flexibility is limited. We have found that for a sample of 63 programmes, 30 have had interruptions, and 16 have broken down irreversibly. This appears to mark a slightly higher success rate than previous analyses of ESAFs and PRGFs (Ivanova *et al.*, 2003; Killick, 2004). The IEO also finds a slightly higher level of programme compliance under PRGF than ESAF, but no significant difference in disbursement percentages or frequency of interruptions. According to HIPC Ministerial Network (2002 and 2003), this reflects the streamlining of structural conditionalities, which has reduced the need for waivers,[23] but is being somewhat offset by *less* flexibility on macroeconomic stabilisation conditions, so that even with adjusters built into programmes, they still fail (Fund staff indicate that there have been numerous instances of *de facto* flexibility). In addition, HIPC Ministerial Network cite delay or suspension of IMF programmes as one of the biggest causes of aid volatility.

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

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

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

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

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

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

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

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

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

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

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

- Targeted GDP growth and anti-poverty spending should not be below the levels seen as necessary to attain the "costable" MDGs unless financing is absent and it is demonstrated why the targeted budget deficit cannot be increased.[25]

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

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

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

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

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

4.2 Structural Conditionalities

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

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

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

What Has the IMF Achieved in Streamlining Structural Conditionalities?

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

What More Could the Fund Do to Streamline Structural Conditionalities?

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

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

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

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

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

A few other measures are needed:

- There needs to be a renewed push to streamline all structural conditions, to reverse the recent increase in structural conditions. This would include cutting prior actions and performance criteria to an average total of three per programme and structural benchmarks to three or less.

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

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

4.3 Alternative Scenarios for Results

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

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

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

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

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

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

How Can the IMF Project Realistic Scenarios and Overcome Shocks?

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

First, by making its baseline scenarios more realistic. This would involve relating all projections more closely to recent trends, and including in them simulations of the scale, frequency and probability of climatic shocks, commodity price volatility and aid shortfalls based on the last 10-20 years of national experience – as well as the impact of new variables such as HIV-AIDS. Use of volatility and probability forecasting techniques would make this relatively straightforward, though it would require more analysis of the scale, frequency and macro impact of shocks for each country.[34] Second, by extending the analysis of the impact of shocks through to their effects on poverty reduction (this would require more complex techniques and more time). Third, it is essential that all scenarios in Fund programmes begin by aiming to attain the MDGs and PRSP national goals. PRGFs should strive to attain the MDGs in their forecasts even in the baseline scenarios. Recent IMF papers on PRGF alignment with PRSPs and World Bank/IMF papers on PRSPs have suggested that baseline scenarios could abandon the MDGs and leave them as "aspirational goals" for an accelerated scenario which might not be financeable. However, only in conditions where the baseline scenario was unable to reconcile potential shocks with attaining the MDGs, would each PRSP and PRGF contain an accelerated scenario. Such a scenario would show how, in spite of the shocks, more financing and more policy effort by governments, including measures to reduce vulnerability to shocks, could attain the MDGs. Financing would therefore preferably be committed up front on a contingent basis so as to be available immediately when any "shock" materialises, and included in baseline scenarios through contingency allowances in the budget and reserves.

4.4 Poverty, Social and Distributional Aspects

To What Degree Are PRGFs Taking Into Account Poverty Aspects?

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

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

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

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

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

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

How Can the Fund Better Link PRGFs with PRSPs?

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

Poverty Reduction and Distributional Effects of Policy Alternatives

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

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

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

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

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

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

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

5 The IMF's Way of Doing Business

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

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

5.1 From Conditionality to Ownership

The most fundamental component in success of Fund programmes has been domestic political-economy factors (IMF, 2001a and 2001b; Killick, 2004; Ivanova *et al.*, 2003; Thomas, 2003). The main ways that the Fund can increase ownership are therefore *not* through public training or education, but by allowing genuine participation in designing and implementing macroeconomic and structural reforms, by streamlining structural conditionality much more dramatically, and by undertaking more rigorous programme projections and encouraging country-led PSIA. For that reason, many these days prefer to talk of encouraging country "leadership" rather than ownership.

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

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

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

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

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

One of the advantages of prolonged use of IMF resources in some countries – those with political "ownership" – has been a gradual but very considerable transfer of economic management skills, through a combination of dialogue with missions, training and technical assistance (IEO, 2002). Particularly where combined with initial independent advisory and capacity-building support, more in-depth institutional change and more comprehensive training programmes, this has allowed various countries to reach the point where they have considerable capacity to design and implement their own programmes (e.g. Rwanda, Uganda, and Tanzania). However, much depends on the degree to which the IFIs are prepared to listen to the ideas developed by the countries. Where the Fund has failed to change its negotiating behaviour (Killick, 2002, sees this as the usual experience) ownership has not increased. Indeed, in part prolonged use has reflected low "ownership" and failure to implement reforms.

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

What More Can the Fund Do to Improve Country Ownership?

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

5.2 From Technical Assistance to Capacity Building

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

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

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

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

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

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

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

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

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

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

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

What More Can the Fund Do to Increase Country Capacity?

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

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

The Fund should assess all of its technical assistance and training interventions more systematically for their long-term capacity-building impact, and as part of country-led strategic frameworks for macroeconomic capacity building, and conduct more long-term capacity-building interventions in low-income countries.

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

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

5.3 From Negotiation to Participation

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

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

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

Various NGOs have suggested mechanisms through which PRGF programmes themselves could be designed in a more participatory way (Oxfam, 2003; Trocaire, 2004) – as Trocaire puts it, "opening up PRGF negotiations to a multistakeholder process". This end-goal would involve roughly a 12-month cycle for designing a new 3-year PRGF, and a comprehensive review of each existing PRGF. Draft PRGFs or briefing papers would be released publicly, and the IMF would debate its macroeconomic forecasts (including alternative scenarios) and measures in the macroeconomic working group of the PRSP. Others have suggested less radical steps. For example, IEO (2004) has proposed that the IMF produce a note on key macroeconomic issues and targets, and that this rather than the full PRGF would be the subject of the consultation. Another possibility would be for all Article IV documents to be released in this way. Perhaps most feasibly, it has been suggested that the IMF would join the donor budget support group and participate in the joint policy matrix (itself taken from the PRSP) negotiations of any multi-donor framework, between government and donors. Once these were finished, it would then select a few key conditions from the matrix and use them as the basis for its PRGF.

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

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

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

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

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

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

6.1 Capacity and Competence for a Long-Term Role?

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

The Fund's catalytic role through its seal of approval has been less clearly successful. Even though it has clearly facilitated large amounts of debt relief, and helped to mobilise some official financing, its role in promoting private financing has been much less positive. PRGF linked to PRSP and HIPC has probably enhanced this catalytic role somewhat. Most Board members seem to believe that the Fund needs to continue to play a "seal of approval" role, but there is no reason why this needs to continue to be through a lending role for "mature-post-stabilisers".

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

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

Future Role of the Fund

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

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

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

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

6.2 Organisational and Procedural Changes

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

- Most fundamentally, far more staff resources need to be allocated to low-income countries, which accounted for more than 75 percent of Fund lending programmes, but received only 11.5 percent of administrative funds in 2003. This applies not only to area departments, but also to units of other departments that work on low-income countries. Some IMF departments (Africa, Policy Development and Review Department (PDR) have already begun to change in these directions, but most have not gone very far. Among these would be: (i) reinforcing the Fund's capacity in the Official Financing Operations Division of PDR, to analyse and mobilise official financing; (ii) reinforcing the Fund's capacity to participate in *country-led* PSIA, to conduct more flexible analysis of macro-economic frameworks and of the impact of aid on the economy, and to make more realistic but MDG-oriented projections (much of which would be designed in FAD); and (iii) decentralising Fund mission chiefs and staff to the countries themselves, to bring them closer to country discussions.

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

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

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5

No Agreement Yet on the Fund's Role: By Way of Comment on Graham Bird and Matthew Martin

Mark Plant[1]

Graham Bird's chapter and Matthew Martin and Hannah Bargawi's chapter bring forward the complex nature of the problems that the international community is confronting in considering the role of the International Monetary Fund in low-income countries. The Fund's Executive Board, management and staff have been grappling with these problems for some time now – and, while there are areas of emerging consensus, some difficult choices face the Fund in deciding how it can best support low-income countries.

First, there is a set of problems that surround the economic analysis that underpins the Fund's work in low-income countries. How does the Fund view the determinants of growth? Where are the links between growth and poverty? What is the nature of economic shocks in these low-income countries? What is the impact of aid on the macroeconomics of a low-income country? What is the right level of reserves? These are all questions that the academic community struggles with at a theoretical level, and ones that the country authorities and the Fund's missions must confront on a practical level on a daily basis.

Second, there are questions of the political economy of IMF support to low-income countries. One set of issues surrounds how the international community will use the Fund as an instrument to assist both

[1] The views expressed herein are those of the author and should not be interpreted as those of the International Monetary Fund.

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developed and developing countries in their work towards achieving the Millennium Development Goals. Another centres on political economy at the national level: how can the IMF engage with governments and the citizens of its member countries so as to facilitate the implementation of good policies? If the Fund is to help the country design sound economic policies, how much do Fund missions need to understand the political context of economic decisionmaking? And there are important issues about what is ownership and who takes responsibility for the policies that are being implemented; for example, should the Fund let itself be used as a scapegoat by authorities who realise the need for deep reform but fear its political consequences.

There is third set of issues about resources and accountability. How much money should the IMF have at its disposal to lend to low-income countries? How are the decisions made to support a particular country and a particular country's reform? With limited resources, there are of course tensions between the desire to provide sufficient funding to low-income countries for their poverty reduction efforts and the desire to ensure the policies and programmes they are implementing are in fact supported by the country, effective and a good use of the international community's financial good will. Closely related to this is the issue of responsibilities and incentives – of donors, of country authorities, of the IMF's Board, management and staff, all of which overlap and are quite intertwined.

All three sets of questions are closely related to how and what the IMF contributes to a country's Poverty Reduction Strategy (PRS). Much criticism has been levied at the Fund for not integrating its operations fully into the PRS process. But this is easier said than done. Policy reforms that provide the macroeconomic and institutional framework for long-term sustainable growth often require very difficult short-term choices among competing interests. Thus, the Fund finds itself necessarily embroiled in the political economy of reform – something that many PRS have side-stepped by not constraining policies within a macroeconomic or budgetary framework.

While it would be convenient to consider each of these issues separately, the Bird and Martin/Bargawi chapters rightly wrap them together. While this could be a frustrating experience for the reader, it mirrors the complex task taken on by the Fund when it was asked to define its role in low-income countries more clearly. There is no monolithic Fund view on these issues, as evidenced by various press information notices that reflect recent Executive Board discussions of these issues.

In the remainder of this comment then, I will consider some efforts we are making to address the issues raised by the Bird and Martin papers, without trying to come to grips with all the various questions raised. For organisation's sake, the presentation will divide our work into three pieces, recognising that such a taxonomy belies their interaction. The first function is that of policy advice, the second monitoring and the third financial assistance. The other important aspect of the Fund's work is capacity building, or technical assistance, which would be a paper unto itself, so it will be left aside in this comment.

The Policy Advice of the IMF

Some have raised the question as to whether the IMF should be involved in development. In this regard, it is a red herring to talk about whether the IMF is a development institution. As Bird points out, our developing country members have the right to ask for the Fund's advice and the institution has a responsibility to help them confront their macroeconomic problems. As their macroeconomic problems revolve around their development, the Fund is necessarily involved in development.

The critical questions centre around the extent of the Fund's involvement. How is the Fund's expertise and comparative advantage delineated in an international effort that has many participants? Can a bright line be clearly drawn separating macroeconomic problems and microeconomic challenges in these countries? How much does the Fund have to understand the microeconomics of development to give sound macroeconomic advice? What interactions are needed with other development partners, especially the World Bank, to ensure a coherent policy framework for development?

A few examples can make these problems more concrete.

First, institutions. Increasingly the development literature focuses on the need for good institutions for durable economic growth. The Fund has expertise in establishing the policies needed to make macroeconomic institutions work well – institutions such as central banks, financial regulatory bodies and budgetary systems. We have considerable experience in establishing these bodies, regulating them and ensuring they work in a coordinated fashion. But the sound functioning of a financial system also depends on having a well-functioning legal system, including judicial and regulatory enforcement. Property

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rights need to be well established and the notion of collateral, especially that based on land ownership, must be functional. These are areas where the Fund has limited, if any, expertise. So, what do Fund experts have to know about these other institutions to formulate their own policy advice? Can sets of reforms move forward in parallel or is there a needed sequencing? How can the country make these decisions in the face of perhaps differing advice from various institutions?

Perhaps more central to the Fund's core areas is the problem of exogenous economic shocks. The literature shows that shocks occur more frequently in developing countries and, as these countries are less diversified, shocks tend to have a deeper economic impact and be longer lasting. While the Fund can provide financing to mitigate the impact of a shock, what economic reforms are needed both *ex ante* and *ex post* to deal with frequent and deep shocks? Does the Fund's promise of provision of assistance undermine other development partners' efforts to have countries put in place the physical infrastructure and human capital needed to lessen the impact of shocks? How temporary is, say, a terms-of-trade shock and, if viewed as permanent, how fast can the country adjust? These questions all have both macroeconomic and microeconomic aspects.

There are also macroeconomic challenges to utilising the large levels of aid that will be forthcoming when the Monterrey commitments of developed countries are realised. But here, too, the macroeconomic effects can depend on the microeconomics of the use of aid. First and foremost, aid absorption is a microeconomic problem – how much can be physically produced as aid flows in. But as aid scales up, domestic resources can start to get diverted from other productive uses. Is this good or bad? Will it result in a real appreciation of the currency and thus dampen the export sector – the so-called Dutch disease problems? What are the implications for the budget over the medium term of substantial investment in schools and health clinics in the next few years? Does aid dismantle a country's capacity to raise domestic revenue?

Another set of issues surrounds giving the countries the needed fiscal space to make progress toward the MDGs without undermining fiscal and debt sustainability. While more aid can give countries this room, there are questions as to the appropriate size of the government sector in the short- and long-term? What fiscal obligations is today's spending setting for the future? How do you go about forecasting and thinking about the amount of fiscal space that is needed when you have countries that are inherently more volatile given their sensitivity to shocks?

What does debt sustainability mean in these countries, where projections of GDP growth, export growth and the external environment are inherently uncertain? How does financing by domestic debt financing differ than that from external debt?

The Fund does not have answers to all of these questions and we are actively pursuing an agenda to bring some ideas to the international discussion. In mid-July, 2005, we expect to discuss some issues surrounding the macroeconomic design of programmes we support under our Poverty Reduction and Growth Facility (PRGF).

One thing is made clear from just raising these questions – the Fund has a role in helping its low-income members confront these problems, many of which are macroeconomic in nature. But the answers to them also need the expertise of others and answering them poses a coordination problem for the international community – who does what to ensure low-income countries get the advice they need. Can each institution "do its own thing" or is a concerted effort needed to ensure policies intermesh?

The Monitoring Role of the IMF

The monitoring role of the IMF is to help the global community understand the systemic impact of individual countries' macroeconomic policies on the world economy and guard against any harmful effects. Some say that this function is inherently limited in poor countries because, even taken as a group, their systemic impact is virtually nil. This is a rather limited and short-term view and, in fact, the Fund views the monitoring function as critical within the small countries, as there is limited expertise and attention trained on them. The Fund provides the country some outside perspective on its economic policies and the international community information that would not otherwise be available.

But one particular aspect of our monitoring function has come to the forefront in the discussion of the role of the Fund in low-income countries – that of sending signals to donors about the quality of a country's economic policies. The Fund has often played the role of "gatekeeper" for international aid – without a Fund stamp of approval, donors have decreased or stopped their aid flows. With aid flows increasing and the focus of aid moving more and more to general budgetary support (rather than project aid), donors are reconsidering how to use Fund monitoring. Three concerns are important. The first is that of volatility – an on/off signal from the Fund can exacerbate already volatile donor flows of aid. The second is one of financial need – with higher levels of donor support, the Fund's financial support (which is in the form of concessional, but relatively more expensive loans) is needed less and less. Third, certain countries want to signal their emergence as macroeconomically stable economies through some independence from Fund support.

So how can the Fund provide better monitoring in the context of the joint international effort to meet the MDGs. The Bird and Martin papers struggle with the Fund's signaling role and offer some suggestions. Let me give a bit of perspective from inside the institution.

While our surveillance work – through our annual Article IV discussions – can provide information about the country's economic situation, often times low-income countries and their partners want more frequent or more structured feedback. In some instances, countries have formulated their own programmes and the Fund has given its opinion of both the quality of the programme and whether the country is living up to what it has said it will do. But this has resulted in confusion too – does the Fund endorse the policy programme or not? Would it lend to the country if so desired or not? Can policy quality really be calibrated? These are all questions that we are dealing with on a day-to-day basis. The Fund's latest biennial surveillance review offers some answers, but there is a certain amount of learning by doing going on as well.

We have a specific effort to look at how we can send signals outside of a programme that provides financial support and still meet countries' and donors' demands for a structured arrangement with the Fund. In August 2004, the Fund's Board considered the outline of what we dubbed a "Policy Monitoring Arrangement" – essentially a stand-by arrangement, or PRGF arrangement, endorsed by the Board but without any money being lent. The Board underscored various problems and the reactions were wide-ranging. Some felt that such an arrangement would be too demanding in terms of the implicit conditionality – thus belying any sense of graduation. Others felt that, without money attached, the quality of the policy content would be eroded and it would be seen as a weak, rather than strong signal. Many raised issues about the standards to be used in entering into such an arrangement with countries. So we have gone back to the drawing board and expect to present a modified version to the Board sometime in mid-2005.

The Financing Role of the IMF

The final set of issues to be raised is the circumstances under which the Fund should in fact lend money. While money gives a signal, the Fund's financial support should be needed, given scarce financial resources available. So what criteria are used for giving loans? When countries draw money under a Stand-By arrangement, the criteria is that there should be an immediate balance of payments need. Whereas, under the PRGF, the criteria is that there should be a long-term balance of payments problem.

Now, that seems to many like semantic niggling, but it is not. The differentiation underscores that for a short-term loan you have to have a very specific need that can be remedied relatively quickly; for a longer-term loan, the need is chronic and the solutions are of a longer duration.

In the context of the effort to meet the MDGs, the question then becomes what is the right criteria in countries like Tanzania, Ethiopia or Rwanda, where donors have provided substantial financial resources, and are likely to continue to do so for at least the next ten years. There is no real balance of payments need but the very fact that so much aid is being disbursed indicates that there is a set of economic problems that need to be addressed over the next 10-20 years. Should the Fund be lending to such countries? Bird's reflections about the nature of balance of payments problems are important in this regard. It is worth noting that the Fund does not provide budget support, but instead help to ensure the country has the necessary amount of reserves to finance its balance of payments, without resorting to severe financial and economic adjustment. And so it brings us back those questions of what is the right level of reserves in poor countries, where the social and humanitarian needs are pressing and the vulnerability to shocks is great?

Closely related to the issues of financial need are the questions Martin raises regarding what conditions the Fund places on its loans. The Fund has recently completed a review of its conditionality, which shows that we have focused our conditions increasingly on our areas of expertise, yet there remains some work to be done. The review underscores the need for our financial assistance to support country reforms, not to buy them. Thus conditionality should support government-owned reform efforts and should not result in micromanagement from afar.

Some other ideas have surfaced regarding the Fund's financing role. For example, given the vulnerability of low-income countries to shocks, some have argued that the Fund should disburse quickly in the case of a shock. As its lending is rather expensive, then it can be bought out overtime by donors with more concessional money. This is an idea that the donor community should pursue. There is also a good deal of discussion about using non-concessional Fund money for low-income countries. This is not a good idea given the structure of the Fund's financing, which clearly separates concessional and non-concessional resources – the former being held off the institution's balance sheet in a separate trust funds.

Bird and Martin also raise the issue of revolving nature of the PRGF. Is it best to have the facility replenish itself and how might this be accomplished? While the financial details can be quite complex, the fundamental question comes back to the nature of the Fund as a development partner. Martin also raises the issue of the concessionality of Fund lending, suggesting it be made more concessional by lengthening the maturity. Can the Fund see itself in its traditional role as a short-term lender if it has loans with maturity of 20 years? If not, is it appropriate to change its role and make it a long-term lender. The emerging consensus in the international community is against such a change – focusing the Fund's efforts in the development area on macroeconomic advice and lending for shocks.

Conclusion

So where is the Fund going with all this? Clearly the issues are complex and do not lend themselves to an easy consensus. Issues of economic substance intersect with issues of bureaucratic process. Resource constraints – both human and financial – are binding. And the Fund is not the only actor in this play.

We have a considerable work programme before us well into 2005. For the UN Millennium Summit+5 in September, we hope to have clarity on some of the issues raised by Bird and Martin. But these are not problems solved overnight and continued discussion with people outside the institution will give us the needed perspective we need to get the right solution so that the Fund can play its part in helping its low-income members make progress toward the Millennium Development Goals.

6

The Dynamics of Donors, Recipient Countries and the IMF

Ron Keller

The discussion on the role of the IMF in relation to low-income countries is closely linked to how donors and recipients behave. As donors, we have to better organise, harmonise, coordinate, avoid overlap, do away with inefficiencies, and try to move from projects to programmes so that we have a more aggregate longer-term vision on development programmes. We need to link with MDGs and move toward a programmatic role. Linking to institutions and budgetary processes in developing countries also means that we move closer to the World Bank and particularly to the IMF. The relationship between donors and the IMF is a very important one, and they do not meet often enough. There is still a distance between the two worlds, which is very unproductive because we are moving toward the same agenda, and we are actually partners.

Let me briefly go through the various issues of Matthew's chapter. First, the need for concessionality will increasingly be determined by the so-called debt sustainability analysis. The IMF's resources are not cost-free – they are not grants. I agree that the IMF should not become a grant-based institution. As a starting point, the IMF should bring resources through its programmes. In selected cases, there might be an issue of concessionality or the lack of concessionality with bringing in more IMF resources. At the same time, there should not be two Funds; there should not be an IMF for the low-income countries and one for the rest. And while the balance of payment needs and the concessionality needs might differ, the development partners can play a role as co-financing partners here. This means that the IMF should preferably use

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its general account resources and should not finance its programmes in low-income countries from separate budgets or bilateral resources.

Second, I understand Matthew's points that the IMF should be more forward-looking in factoring-in external shocks. But, when Matthew says the IMF should improve its macroeconomic forecasts to avoid shocks, I am very sceptical. I do not think that, apart maybe from some business cycles, many shocks can be foreseen.

Third, the relationship between lending and programmes is a key issue. I take as a starting point the fact that the IMF supplies resources with its programmes, for various reasons. No stick without a carrot. The low-income countries need a vast influx of resources: grants and non-grant resources, see, for example, Jeff Sachs' report on MDGs. Any dollar or any SDR that the IMF brings in is badly needed in many countries. Does this mean that the concessionality issue is at stake? No. We have to provide for concessionality and grants through other means than the IMF.

Fourth, in terms of the IMF's catalytic role, Matthew clearly indicates the various roles that the IMF is playing. The IMF is a strong catalyst for donor resources – also in low-income countries, but not so much for private sector flows. But this last element does not necessarily demonstrate that the catalytic role of the IMF is weak or that it could be stronger because private sector capital flows, unfortunately, react to more than macroeconomic stability – certainly in the low-income countries. Private sector flows also react to the overall business climate, investment climate, and political stability. The enabling environment for private sector flows goes beyond macroeconomic stability.

This does not mean that the catalytic role of the IMF is too weak or should be enhanced in terms of attracting increased private sector flows because then you fall victim to the other issue that Matthew rightly criticised, that the IMF goes too far in the direction of structural governance and micro issues. The IMF should refrain from doing this. But I would provocatively say that there is a strong lack of cross-conditionality. There needs to be far stronger cross-conditionality across the whole set of players. The IMF should also respond to World Bank and donor conditions and agreements.

There are many issues related to implementation and the political will to implement agreements. We need to step up our efforts and say: we have an agreement, you should do this, I should do that, and if one of us does not deliver, there are going to be consequences. We are often far too polite and cautious in addressing these peer pressure issues.

When donors are moving to budget support and budgetary adjustment in a recipient country, then obviously the IMF, the World Bank and donors face the same difficulties and problems. In order to get out of this, it would help tremendously if the donor community, including the IMF, would speak with one voice and address the issue with the recipient country concerned in a coherent and harmonised manner.

Fifth, programme design and implementation. Matthew finds the PRGF programmes, on average, too restrictive. I would advise caution before signaling that they could be looser, that they could be based more on outcome needs. I would be very cautious because – this is probably my Treasury background – I adhere strongly to the need for balance of payments and budgetary sustainability.

A more fundamental issue of Matthew's chapter is that all programmes, IMF programmes as well as countries' own programmes, should focus more on outcomes and MDGs, and include this in s. The IMF needs to step-up its efforts to think more in terms of MDGs and what is needed to bring those MDGs about, certainly in countries where the IMF has a long-term engagement. Whether they like it or not, the Fund has to try to incorporate the MDG agenda into its programmes. But the IMF cannot do it alone and we cannot push the IMF into a scenario in which the needs are dominant and the availability of resources, including domestic resources, are totally neglected. We have to find a middle ground here.

Sixth, I basically agree with all of Matthew's points on structural conditionality. The IMF has moved too far into the governance, transparency, and corruption-related conditions. I am not saying that these are unimportant issues, but in the spirit of division of labour, other institutions – and primarily the recipient – should take these up. The fact that as far as Matthew's research is concerned, after the drive towards simplification, conditionality has recently been further tightened and further complicated is a disappointing one. If this is true, I would call upon our executive directors and the management of the IMF to go back to the original intention of a couple of years ago to simplify conditionality. I do not know if it was a deliberate decision of the IMF's management or whether it just slipped in because of the 30 percent of staff who do business as usual. But if it is a conscious decision, I am disappointed by it because the IMF was on the right track in simplifying and tailoring conditionality.

Let me briefly turn to alternative scenarios. As donors, we often preach that we need more alternative scenarios. If Matthew means more flexibility in conditionality, I would disagree. But if you say: let's have more alternative scenarios on the table for all of the partners involved, then I agree. But once you are operating in a set of agreements, i.e. a certain set of understandings on policy decisions and financing, I would not call for more flexibility but call for adhering to the agreements as much as possible. But alternative scenarios have been called for by many of us for many years. This is not something that the IMF should take on its shoulder alone. It is a wider responsibility that all of us face. Certainly, when it comes to MDG programming, all of us, including the IMF, but also my own institution, need to do a better job. One would expect the recipients countries themselves, to play an active role in pressing for alternative scenarios before somebody else in Washington or The Hague decides for them.

Regarding how the IMF is doing business, it is extremely important for the IMF to move as quickly as possible into strengthening the local representations, into having not only more staff there, but also having a sincere dialogue there. The whole impression of IMF missions flying in and out, and not even touching base with the major donors or the World Bank representative looks very bad – and is very bad. The Fund officers on site should have full responsibility for engaging in country-specific discussion. This is also why technical assistance should stay with the IMF but delivered on site. Having a real role to play as a partner on the ground is very important. If it costs more, so be it; the IMF should then step up its resources or reallocate resources, as Matthew rightly indicated. The Fund can no longer work from Washington through in-flying missions alone. Instead, the Fund should be working from local offices on a continuous basis and with a strong delegated authority.

Finally, as I said in the beginning, we talked about the IMF, but we could also have talked about donor behaviour or World Bank behaviour in these developing countries. One thing is certain: we need to work far more closely together, as Matthew said. Ultimately, we have the basic instrument, the PRSPs, in place, and most of us now have offices and we have decentralised ourselves so that all of our colleagues are on site. But there are still too few meetings where all partners, including NGOs, sit at one table and discuss the situation as well as make concrete agreements and arrangements on how to develop this longer-term agenda. And here I can only say that while there has been a lot of preaching, a lot of commitments and intentions have not been met because the commitments and agreements were not firm enough.

7

Institutional Changes to Prevent the Recurrence of Debt Problems

Stijn Claessens

1 Introduction

While many initiatives have been adopted and implemented over the past two decades, low-income countries have recurrent debt problems. We argue that this does not just reflect economic causes. Rather, the recurrence reflects the failure to reform the international institutional structure for decisionmaking related to low-income countries' debt, external financing and debt sustainability. Applying the framework of Claessens and Underhill (2005), we develop some options to build sustainable financing structures for the low-income countries that are largely dependent on official development assistance. The options concern institutional changes, policy changes and financial policy changes.

Persistent debt problems of the low-income developing countries have led to repeated debt restructuring and debt relief initiatives since the early 1980s. The list of initiatives is long, with the Highly Indebted Poor Countries (HIPC) being the latest. The large number of initiatives highlights that the underlying causes of the debt problem have often not been addressed. Many other symptoms exist to suggest continued deeper causes behind the low-income countries' debt problems. Although debt has been reduced under HIPC for many low-income countries, some countries still suffer from a debt overhang. Other countries risk a recurrence of debt problems when new external financing is being provided on inappropriate terms. There are furthermore ongoing debates on whether the right approaches for debt relief are being used,

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on the modalities of financing for low-income countries, particularly the mix between grants and loans, and on the appropriate analytical and empirical approaches to determine countries' debt sustainability. More generally, there is a strong perception of a poor match between countries' development financing needs and the availability and forms of public capital and much disappointment and scepticism among policy-makers and citizens worldwide on the contribution of the international financial system to global development.

The recurrent nature of the debt problems, the ongoing debates, and the limited and poor resource transfers are but signs of the need for deeper reforms to the institutional framework for dealing with the financing problems of low-income countries. Fundamentally, the design, institutions, and governance of the international system governing low-income countries' debt, financing and debt sustainability remain very similar to those of a few decades ago. We argue that the lack of institutional changes greatly contributed to the recurrence of debt problems. Institutional changes to avoid a recurrence will not be easy, though, and will require answering fundamental questions regarding the nature of the governance framework of the international financial system.

Claessens and Underhill (2005)[1] develop an analytical framework that lays out the general elements to be addressed when rethinking the governance mechanisms of the international financial system. They develop a framework for analysing the tensions between the achievement of global and national development objectives in a world of fragmented governance, multiple institutions, accelerated financial integration and increased private sector roles. Many of the issues on the design of the international financial system also arise when it comes to dealing with the external financing of low-income countries. This chapter therefore tries to apply the framework to the current issue of the debt overhang and maintenance of debt sustainability in low-income countries.

Much of the debt of low-income countries originates from official sources and the debt problems can in large part be attributed to uncoordinated lending associated with a poorly functioning international institutional framework. The focus needs thus be on the rules and institutions governing resource transfers to low-income countries. The HIPC-initiative also involves important institutional design issues.

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[1] See also Claessens (2002), Underhill (2003) and Underhill and Zhang (2003).

Going forward, to assure that debt burdens remain sustainable, there is a need to coordinate on the appropriate amounts and terms of new (debt) financing. Again, it is the institutional design that will importantly affect the outcomes.

This chapter makes a number of suggestions how institutional coordination on resource transfers to low-income countries can best be organised, taking into account the divergent interests of multilateral and bilateral organisations. Different options for more prudent and coordinated lending are explored and analogues to other coordination problems are investigated.

The chapter is organised as follows. Section 2 explores the nature of the debt problem of low-income countries. Section 3 develops options concerning institutional changes. Policy change options are addressed in Section 4 and financial policy changes in Section 5. Section 6 concludes.

2 The Nature of the Debt Problems of Low-Income Countries

The debt problems of low-income countries has backward-looking aspects (what caused the debt build-up), current aspects (how to deal with the current debt problems), and forward-looking aspects (how to assure sustainable debt structures). We analyse these three aspects from the perspective of the design of the international financial system (for analysis of other, economic aspects, we refer to the assessments done by multilaterals, e.g. World Bank/IMF 2004).

The main starting point is that much of origin of the debt problems of the low-income countries (or for that matter more generally, international debt and financing problems) centres on international coordination problems. Put differently, it is hard to explain the debt and financing problems of the low-income countries in the context of a single, (altruistic) lender or donor, without any moral hazard of possibly bailouts. Such a lender would presumably have lent prudently and avoided excessive debt build-ups. Even if a country's external debt had become unsustainable nevertheless, for example, because of adverse shocks, such a lender would presumably have taken the correct actions in terms of restructuring or reducing the debt, such that perverse impact on the country would be avoided.

That single lender model does not describe reality, however. Indeed, Birdsall, Claessens and Diwan (2003), show that much of the debt problems of low-income countries are due to uncoordinated lending, with continuing loans in the face of ever-increasing debt burdens, especially to multilateral lenders. And they show that the debt build-up undermined the willingness and ability of donors to exercise selectively with respect to the quality of policies being pursued by the countries. More generally, it is hard to explain the recurrence of debt problems without reference to the underlying institutional environment for resource transfers to low-income countries. By implication, there are lessons from studying empirically the behaviour of resource transfers in the past as to what aspects of the institutional environment have mattered most.

The current debt problems are being addressed under the HIPC-initiative, already requiring increased coordination and burden sharing among creditors. The current round of official debt reduction, although associated with large transaction costs and introducing much uncertainty, can help clarify the implicit governance of the international financial system. In particular, the process informs us on the implicit objectives and bargaining strengths of the various participants, strengths that will also affect the process going forward. Altruistic objectives of many donors, for example, can weaken their positions in terms of recovery on debts relative to those more commercially oriented creditors. As we observe already, some donors are willing to buy out other creditors, as they are more eager to get on with the "development business" (which can be for good reasons, as when they care more about poverty and development, or because of less good reasons, as when they have mandates to disburse funds (more) easily without regard for policy). More generally, the processes followed and the outcomes are affected by the institutional setup, and as such there are lessons on how to reform the system to improve on outcomes.

Going forward, it is likely that external financing for low-income countries will mostly take the form of grants, and as such need not lead as easily to a renewed official debt crisis (although development and growth are, of course, not assured). However, since there will be some new debt financing from the official sector, mostly concessional loans, new debt problems cannot be excluded. Furthermore, the countries can always try to borrow from the private sector, especially when their headroom is enlarged through official debt reduction. To assure that debt burdens remain sustainable and to avoid new debt problems, one of the key issues has been a country's maximum level of debt that is sustainable.

To determine sustainable debt levels, a framework has been adopted, taking into account among others, the country's economic and institutional characteristics.[2] Within this limit, the issue has been to agree on the appropriate amounts and terms (degree of concessionality and maturity) under which such assistance is to take place, and to achieve some coordination vis-à-vis any private creditors lending to governments (and possibly even for private to private lending). The question is how to organise institutional coordination on resource transfers to low-income countries, taking the divergent interests of multilateral and bilateral organisations into account. Again, many of these are questions of institutional design.

Jointly, the lessons from the build-up of the debt in the past, the current round of debt reduction and the emerging framework for assessing debt sustainability and new development financing can teach us valuable lessons to improve institutional structures. While empirical approaches are still few and complete conceptual frameworks still lacking, different options for more prudent and coordinated lending should nevertheless be explored and analogues to other coordination problems investigated. We classify these options under institutional changes, policy changes and financial policy changes.

3 Institutional Changes

The analytical framework identified in Claessens and Underhill (2005) suggests many institutional changes that can improve the external financing process for low-income countries. One option for institutional change is more transparency in the decisionmaking process among official donors and creditors and more disclosure on actual outcomes.

[2] The new framework in Claessens and Underhill (2005) is based on current financing structures not to imply a breach of maximum (NPV) debt to GDP ratios that differ by countries' institutional capacity. Within that maximum, donors and creditors have to coordinate on a country basis on a mix of aid grants and debt financing and the terms of the debt financing. There are many questions here. What to do with the international financial institutions such as the IMF that only lend (and on less concessional terms than other creditors do)? Since it is largely an *ex ante* framework, it does not stipulate what to do *ex post*, i.e. if the country gets hit by a shock and debt ceilings are breached. How to balance project and programme support (e.g. a project may have a very high rate of return and be financeable with debt, yet the overall limits may be breached)? What is the desired path of debt burdens towards these maximums, particularly if the country has just received debt relief? Only some of these questions are addressed.

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More transparency could highlight to outsiders (including NGOs, researchers, parliaments, taxpayers in donor countries and citizens in low-income countries) and even to insiders any flaws in the processes, false tradeoffs, looming unsustainable financing structures, etc. This transparency could include more and better disclosure of the minutes of IMF and World Bank decisions and of the Paris Club meetings, more disclosure on outcomes in terms of actual debt relief and new financing, and more clarity on debt sustainability outcomes.

This increased transparency will put pressures for change. It is difficult to predict, however, what direction and form these pressures will take and what their outcome might be. Unsound private sector lending can perhaps be discouraged by more clarity on debt burden, but whether there are pressures that restrain official lenders sufficiently is unclear. After all, many of the problems have been known for a long time, yet governments have made few changes. There is equal scope that the increased transparency invites new constituencies to voice their opinion and be heard in ways that may not aid to the quality of the process.

A second option would be changes in the decisionmaking processes. One aspect here is addressing the severe conflicts of interests that exist in the official financing business, in particular the joint roles of the World Bank and the IMF as creditors, development agencies and assessors of the quality of the adjustment programmes. These conflicts of interests seem to have played a role in the debt build-up, as World Bank and IMF were perhaps too eager to approve programmes allowing other donors to disburse. In turn, the international financial institutions were willing to approve weak programmes since they had to defend their own loans against the risk of default by the country, defaults that would have been quite costly as it meant both financial costs and a loss of reputational capital for these institutions. Addressing these conflicts of interests calls for a greater separation of functions, although it is hard to conceive how this may be done. While separation could involve an independent, third party assessment of the country's debt sustainability, how to assure a high quality and credible assessment without a close involvement including a lending role is not obvious. After all, part of the information value these institutions provide is derived from their close lending relationships. Nevertheless, the existence of independent evaluation agencies in other financial markets, such as rating agencies, suggests that it is not impossible.

A second, and related, aspect of the decisionmaking processes is the coordination among the various forums involved in external financing for low-income countries. There are quite a few actors, the Paris Club, the IMF, the World Bank, and others, each of which have different sets of stakeholders, or at least with different influences. More and better coordination could involve changes in procedures. For example, IMF approval of the macroeconomic content of a programme could be provided independently of IMF's own lending. It could even involve IMF approval on a regular basis without any relationship to a programme, as has been contemplated and as will become more routine when IMF lending will become less important. It could also mean changes in formal approval procedures. For example, approvals in the Paris Club, the IMF, the World Bank on programmes, lending and debt relief could be done jointly, to avoid unnecessary coordination issues.

A third aspect of the decisionmaking processes concerns the individual voting processes in each forum. These could be revised, possibly combined with more disclosure. To date unanimity has been the norm, but this might lead to worse outcomes compared to qualified decisionmaking. Many forms of qualified decisionmaking are possible, including majority, double majority, supra-majority, votes in proportion to financial stakes, like in creditor committees for debt restructuring and bankruptcies, or some combination of these voting systems depending on the exact issue at stake. More formal voting and revealing the votes could change incentives, although much of this will be at the margin, as international financial decisionmaking likely will continue to be dictated by implicit contracts. Disclosing the voting records could force more accountability, although again it will be hard to predict what the outcome thereof might be.

4 Policy Changes

As noted, many of the issues on the external financing of low-income countries centre on poor coordination among creditors and donors. Besides institutional changes, changes in policies could perhaps help coordination, provided of course that these changes in policy are credible, which in turn may require institutional changes. One policy that achieves by definition more coordination is reducing discretion among creditors and donors. Linking the debt ceilings to the country's institutional environment, for example, as is proposed under the new debt sustainability framework, helps reduce discretion in lending. That policy change though only covers some part of official development assistance, since the ceilings are only limits on aggregate debt burdens and within this framework the aid allocation across countries is still free. Given the (revealed) sub-optimality of aid allocation decisions, continued aid to bad performing or institutionally weak countries can thus not be excluded. There may be other reforms needed as well for better aid allocation, which, if implemented, would help improve debt sustainability by enhancing countries' growth prospects.

One option along these lines is introducing more formal rules in the aid allocation that reward good policies and penalise bad policies. This is the idea behind the Millennium Challenge Account according to which at least some part of US aid will be allocated based on (independent) assessments of countries' institutional environments. Also, the International Development Association (IDA) and some other donors already use indicators like the World Bank's Country Policy and Institutional Assessment (CPIA), although these are more subjective. An obvious option would be to extend the rules also to other donors for their aid allocation, or at least for part of their aid budgets. By making aid allocation more explicitly a function of countries' institutional environment and capacity to absorb external financing productively, the degrees of freedom of donors would be reduced and thereby aid allocation could improve. Over time, as country's prospects improve, the debt limits could in turn be relaxed.

There are costs to this more formal approach, though. For one, the approach prescribes implicitly a certain development model, as countries will be judged according to some template. It also implies a form of conditionality. On both aspects, there is much evidence accumulating that these are not the best ways to go. As pointed out by many recently (e.g. Rodrik, 2003), the path taken to development has varied greatly among successful countries. And there is much evidence that ownership by the country, rather than conditionality, has been critical to successful reform and growth. Furthermore, there are many questions on the specific measures used. There are many subjective elements in the indexes proposed, for example, introducing not only noise, but also maybe pro-cyclical biases when well-performing countries are rated higher and low-performing lower, even when there are no structural differences. This would mean that those countries most critically in need of assistance and undertaking reform, yet not showing positive outcomes, would be hurt. Approaches could be designed that preserve the reduced discretion among lenders and donors, yet allow for country differentiation and country ownership.

These include peer-based reviews (such as in NEPAD), the country setting its own benchmarks against which it would be assessed, and a process of a country commenting on its own (lack) of achievement of certain benchmarks.

Even with debt limits and better coordination in terms of aid allocation, an external or internal shock may still hit a country and its debt then needs to be reduced. A policy change would be to use in such cases a more formal restructuring or "bankruptcy" regime, which would have effects *ex post*. Here, one can design *ex ante* rules as to how debts will be reduced in specific circumstances. For example, there could be automatic reduction in debt or debt service ("haircuts") for all or a subset of creditors. Seniority rules and other loss-sharing rules could be invoked, granting more value to some creditors. There could be rules set on how the restructuring process needs to be conducted, including on what voting rules to follow for approval of restructuring plans, the deadlines for submission of proposals, the rules, if any, for cram downs on recalcitrant creditors, and what role, if any, of a third-party arbiter. These and other issues are similar to those that present themselves in domestic restructuring and bankruptcy regimes, thus providing experiences from which to draw. Some of these rules already exist in the international financial system, either implicitly or explicitly, but these could be formalised, improved or extended.

One very specific restructuring rule, which would be quite draconian, could be that debt relief is to be granted automatically if debt exceeds the threshold set under the debt sustainability framework. Furthermore, the degree of relief by each creditor could be made inversely related to the commercial degree of its terms (i.e. the lower the degree of concessionality, the more debt reduction would be required). This and other rules could be introduced by simple agreement among donors (in general or on a country-by-country basis, say following a debt relief operation) or be introduced in the form of official IMF, World Bank or Paris Club policy statements.[3] These rules, if made credible, might affect individual creditor behaviour *ex ante* sufficiently to avoid or at

[3] One model to follow is using the so-called London rules that have been used in the UK for dealing with domestic debt restructuring. Note that many of these issues have already been discussed in the Sovereign Debt Restructuring Mechanism (SDRM), a statuary-based approach, necessary because of the multitude of debtors. The difference in the context of official debts would be that changes can be introduced in a contractual way, e.g. all creditors sign on to some rules *ex ante*, rather than a formal, judicial/statuary mechanism.

least reduce the occurrence of crises due to uncoordinated lending, and would surely make the *ex post* resolution simpler.

5 Financial Policy Changes

Besides policy changes, there has been much discussion recently on changes in the modalities of lending and official development assistance to low-income countries. Clearly, increased concessional lending, even moving to grants only, will reduce the likelihood of debt problems. Improved risk management can help mitigate the impact of external shocks of debt burdens. Financial engineering and use of markets can also help deal with debt overhang problems and sustainability issues.

Financial engineering and market-based mechanisms that facilitate greater coordination among creditors with heterogeneous constraints and preferences are not unique in international finance. During the debt crisis of the mid-1980s, one model to achieve quicker coordination was a menu of debt and debt service reduction options. This allowed creditors with different tax, regulation and other constraints, including their own capital adequacy, to choose options that best matched both the creditors' and the debtor's interests. Options were similar, but not identical in terms of debt reduction equivalent. Official creditors today also differ, for example, in terms of the degree of concessionality on new financing, varying from some 34 percent to 63 percent (World Bank, 2004, Table 3). More generally, private and official creditors have heterogeneous preferences for financing firms, projects and countries, leading to complex financial structures that nevertheless can be optimal *ex ante*.

In the context of the debt problems of the low-income countries, a menu of options is already being used, although not to the same degree as commercial banks did for the middle-income countries in the 1980s. One option used is the credit buy-down mechanism (CBM) where, instead of receiving principal and interest payments from a borrower, the creditor receives the present value of these flows from another donor, effectively turning the loan into a grant for the borrowing country. It is used to increase the grant element of already contracted multilateral debt, but essentially plays on differences in creditor preferences and opinions. These and other instruments have already been suggested to be used on wider scale. This expansion could include donors buying debt from other official creditors in a type of secondary market or through an auction type process (e.g. in the context of a debt relief operation donors could be asked to provide bids for the right to buy up official debt). The price determination will also provide for a measure of donor preferences.

In the context of the debt sustainability, that is on a forward-looking basis, financial policy mechanisms could also be found to deal with donors' preferences. One option could be aimed at dealing with those altruistic creditors that cannot bind themselves not to bail out in case the country does misbehave or if shocks happen. Here the analysis by Cordella, Dell'Ariccia, and Kletzer (2002) provides for a useful framework. They present a model of conditional aid as an implicit contract between altruistic donors (concerned about the consumption of the poor), and recipient government representing the interests of the well-offs. It explains why donors who are also debt-holders keep providing aid without granting debt relief. With debt relief the recipient government would regain access to private credit markets, but the possession of the funds would give the government an incentive to meet the needs of its most powerful citizens, which generally are not the poor.

In their model, the private debt market is suboptimal from the country's overall welfare point of view. This is because the government cannot commit not to borrow for socially undesirable purposes – since the borrowing group (the enfranchised) does not represent the whole country welfare – and the donors cannot commit not to bail out the country – since donors have altruistic objectives, for example, they care about the disenfranchised, i.e. the poor.

The model shows that donors can benefit from becoming creditors, not (just) providing grants but also debt financing, as official debt can lock the debtor out of the private credit market. By locking the country out of the private credit market, donors can, by a mixture of *ex ante* debt relief and aid grants, still achieve their desired outcome, i.e. poverty reduction or other objectives aimed at the disenfranchised.

The model is useful and has some similarities to situations with various official lenders lending at different degrees of concessionality. The model can be interpreted, for example, as a situation where one official creditor (the more private type) extends mainly non-concessional debt. Given the pre-commitment problems of donors, it can be efficient to let this lender (the "IMF" or "World Bank") extend more debt, in the extreme until the country's debt limit, which would lock the country out of the other official debt market (as well as the private market), forcing other lenders to provide only grants.

It still leaves some need for coordination among creditors, as the one creditor would face a high risk of default and might need to be compensated for the *ex post* debt relief it has to grant in some circumstances. The current approach is to let other donors "incur the bill" as they care more about the country in terms of final outcomes, but that is *ex post* very costly as it involves complex negotiations. One institutional, *ex ante* based solution could be notional risk provisioning: creditors willing to provide financing need to "deposit" some fraction of resources in a general account as insurance for the main lender against bad risks or policy underperformance. If any official lender worries about risks less than others do, they ought to be willing (or forced) to provide more financing upfront including the deposit or otherwise pay a higher price.

This model of coordination could also involve a menu, even with a market-based auction process. A neutral third party could set lending ceilings, and the right to provide non-grant resources within these limits could be "auctioned off," with the "price" being the degree to which lenders or donors would be willing to contribute to a collective provision fund. Regardless, there would need to be specific rules on how funds are to be made available in cases of default. It also still leaves the issue on how to set the annual lending and aid ceilings in line with absorptive capacity and the final sustainability of debt burdens, but that is necessary to resolve regardless of the approach chosen. And it assumes of course that the supply of concessional resources exceeds the financing ceilings. The key to any of these proposals is that the rules are agreed upon *ex ante*, rather than having slow, extended debt-restructuring negotiations with most of the costs imposed on the debtor country.[4]

6 Conclusion

This chapter has argued that the debt problem of the low-income countries represents the outcome of institutional weaknesses. It has put

[4] *Ex post*, the current HIPC debt reduction also entails burden-sharing, where the costs of debt reduction for the IMF and World Bank, which can be argued to be currently the debt providers limiting the ability of other lenders to provide debt financing, are being paid for by donors. The difference with the proposed approach is twofold: it is aimed at the core of the problem, the uncoordinated lending, rather than the financing of debt relief; and the mechanisms are agreed upon *ex ante*, and thereby more efficient as there is no *ex post* bargaining.

forward some options for reform, involving institutional changes, policy changes and financial policy changes. None of the options proposed deals with all the problems surrounding official development assistance, and some of the options create their own problems. Much more work is needed to analyse these and other options. The point of presenting the reform options here rather is to suggest that changes can be made to the overall institutional environment that over time can address the current debt problems and, most importantly, can help prevent the recurrence of debt problems.

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8

Sub-Saharan African Countries' Development Strategies: The Role of The Bretton Woods Institutions

William Lyakurwa

1 Introduction

Africa's historical experience of slavery and colonialism left the economies of the region severely deformed, distorted, disarticulated and underdeveloped. This culminated in the marginalisation of the continent in the global capitalist system, with its hostile global market, and was compounded by domestic crises that have over time inhibited growth and development. Despite the significant progress some African states have made in terms of human resource development, industrialisation, global trade, production and institution building, the continent's overall record has been disappointing. Africa is considered the most vulnerable, poverty-stricken, debt-distressed, technically backward and marginalised continent. Among the existing conditions in Africa are wars, poverty, collapsed states and failed economic reforms.

Immediately after gaining independence from the colonialists in the 1960s and early 1970s, African economies showed remarkable economic performance, with an average GDP growth rate of about 5.7 percent. The trend was reversed from the mid-1970s, following several shocks such as the oil crises, droughts and civil wars. Initiatives were soon launched at national, regional and international levels to try to solve the problems. This study seeks to give an overview of such efforts, and mainly addresses the role of the Bretton Woods Institutions in shaping African development strategies. The chapter is organised as follows:

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The next section looks at Africa's economic performance over the period 1965-2002 and highlights the origin of the African crisis and regional attempts to solve the crisis. Section 3 analyses the role of the Bretton Woods Institutions in supporting Africa's development strategies. Notable support has been through project lending, the Trust Fund, Extended Fund Facility, structural adjustment programmes, Poverty Reduction Strategy Papers (PRSPs) and development lending. Section 4 gives an overview of various perspectives on what constitutes national ownership of reform programmes, and also highlights the major ways in which national ownership can be enhanced. The last section gives the conclusions of the chapter.

2 Africa's Economic Performance

Immediately after independence, and until the early 1970s, African economic performance showed considerable promise. Real GDP growth rate averaged 5.7 percent in the early years, and all macroeconomic indicators suggested a positive outlook (Table 1). Most African countries (e.g. Botswana, Congo, Gabon, Kenya, Nigeria, Rwanda, Swaziland, Zimbabwe, etc.) had growth rates of above 7 percent per annum.

The period after the first oil shock witnessed a major deceleration in growth in the world economy, with average growth rate for Africa declining to 3.5 percent over 1974-1979 (AfDB, 1995). Following the second oil shock (1981-1985) there were massive declines in many macroeconomic variables, partly because these economies were not well prepared to absorb the severe external shocks. The combined effects of massive external shocks occasioned by the oil crises and generalised price increases, along with domestic production difficulties, caused large current account deficits for many countries. Although a few countries enjoyed commodity booms in 1976 and 1977, the current account deficits persisted. Also, widespread depression resulted in historically low primary commodity prices, with constant or increasing import prices, which led to large increases in prices after 1979. Many countries saw this problem as temporary and therefore responded by borrowing from the international capital market instead of stabilising the market. This was the origin of Africa's debt problem. The period 1980-1985, characterised by the second oil shock, global economic recession, high international interest rates and abrupt cut-offs in external financing, marked the beginning of the steep economic decline

Table 1 Africa's Economic Performance, 1965-2002
(yearly average growth rates)

	1965-73	1974-79	1980-85	1986-93	1990-94	1995-98	1999-02
GDP	5.7	3.5	1.8	2.5	1.9	3.6	3.2
GDP per capita	3	0.7	-1.1	-0.5	-1.1	0.8	0.8
Investment	9.6	6.9	-4.8	1.2	0.8	19.9	20.0
Exports	8.2	2.6	0.4	3	0.6	6.6	2.1
Imports	7.4	6.2	-2.4	-0.7	0.4	6.6	2.2

Source: African Development Bank (1995, 1999 and 2003).

for Africa. The 1980s have been termed the "lost" development decade for Africa, as reflected by weak growth in the productive sectors, poor export performance, mounting debt, deteriorating social conditions, environmental degradation and the increasing decay of institutional capacity (World Bank, 1989, as quoted by Cheru, 1992).

Most African economies stagnated during the period 1990-1994, a period that was also characterised by very low investment and export growth rates. By the late 1990s the economy started recovering, with the average growth rate increasing to 3.6 percent in 1995-1998 but registering a period average of 3.2 percent for 1999-2002. Income per capita also recorded a positive average during the period 1995-1998 and 1999-2002. This recovery was partly driven by the significant progress made in achieving greater macroeconomic stability, and by improved resource allocation through the implementation of macro-economic policy and structural reforms in most countries (AfDB, 1999). Other factors were better prices for African exports, increased development aid to Africa after the launch of the New Partnership for Africa's Development (NEPAD), and the restoration of peace in some parts of the continent such as Angola and West Africa. The improved economic growth rate was achieved despite the weak growth in the world economy and despite continued structural and political constraints to improved performance in some sub-Saharan African (SSA) countries. The slight deterioration in growth during 1999-2002, on the other hand, was mainly driven by both external factors and worsening domestic conditions. African export prices remained depressed during the period, and the effects of 11 September 2001 lingered. Deterioration in economic fundamentals as well as drought in Eastern and Southern Africa contributed to the dampening of growth in Africa.

Attempts to analyse causes of the crisis identified domestic policy failures as the main culprit (AfDB, 1995). However, the Berg Report (World Bank, 1981) demonstrated that external factors such as rising interest rates and deteriorating terms of trade contributed considerably to the economic crisis. Other stakeholders found various other reasons for the crisis, among them: the weak and non-hegemonic nature of the state; corrupt, dependent and weak nature of the dominant elites; inefficiency and ineffectiveness of the bureaucracy; weak nature of African markets; technological backwardness; dependence on foreign capital; mismanagement and poor planning; and inability to set up effective regional integration schemes. Policies of africanisation, indigenisation, nationalisation, import substitution, joint ventures, stabilisation and structural adjustment have had a very limited effect on the quality of life, degree of political stability, and the ability of the state to build supremacy, construct national projects or meet the basic needs of the vast majority of the people (Ihonvbere, 1996).

What therefore has been the response of both regional and international communities to the African crisis? In several ways, Africa has been a laboratory for economic or even political experiments, which, as the current situation clearly shows, have not produced the desired results (Ihonvbere, 1996). Several measures were taken at national levels to solve the crisis. Kenya, for example, after a crisis mainly occasioned by the oil shock, commodity booms and the break-up of the East African Community, embraced a change in the policy direction, which was incorporated into the 1979 Development Plan and various working party papers and sessional papers. Structural adjustment programmes were introduced in 1979, with the main objectives of restoring macroeconomic stability after the disruptions of the 1970s (mainly the oil shocks); reviving economic growth through increased resource mobilisation; and using resources more efficiently. Tanzania also initiated efforts to restore balance in the economy after a balance of payments crisis in 1970-71 and another severe balance of payments crisis and food shortage in 1974-75; one notable reform effort was the Economic Recovery Programme of 1986-1989.

Several measures were also carried out at the regional level in an attempt to solve some of the problems. In 1980, for example, the Organization of African Unity (OAU) came up with the first comprehensive response to the deepening economic crisis in the Lagos Plan of Action for the Economic Development of Africa, 1980-2000 (LPA) as a blueprint for the socioeconomic transformation of the continent. This strategy was abandoned in 1986 and Africa's Priority Programme for

Economic Recovery, 1986-1990 (APPER) was adopted under the Berg report (World Bank, 1981) with heavy reliance on foreign assistance. Other responses were the 1987 Abuja International Conference on the Challenge of Economic Recovery and Accelerated Development in Africa; the 1987 Africa's Common Position on External Debt; the 1988 Khartoum International Conference on the Human Dimensions of Africa's Economic Recovery and Development; and the 1989 African Alternative Framework to Structural Adjustment Programmes for Socio-economic Recovery and Transformation (AAF-SAP). The common position on external debt addressed the need for external debt relief, while the AAF-SAP directly responded to World Bank and International Monetary Fund (IMF) policies by emphasising the specifications of the continent, the structural characteristics of African economies and the place of the individual in the development process (Ihonvbere, 1996). This was the first continental challenge to the World Bank and Western donors on their orthodox prescriptions about the African crisis.

In 1990, The United Nations Economic Commission for Africa (UNECA), with support from the UN, non-government organisations and the OAU, came up with the African Charter for Popular Participation in Development and Transformation, which outlined the ways in which the Lagos Plan, the AAF-SAP, and the World Bank position on democratisation, empowerment and the protection of the poor in periods of adjustment and transformation could be put into operation. The charter pointed to the fact that Africa's crisis was more political than economic, and argued that development must revolve around NGOs, the people, and organisations and communities rather than being an affair of donors, the elites and bureaucrats.

In 1991, African leaders prepared and endorsed the Kampala Document, which emphasised the role played by erosion of security and stability in Africa as an impediment to economic growth and regional integration. During the same year, the OAU summit met in Abuja where African leaders ratified the treaty establishing the African Economic Community, which was to culminate in a common monetary union, a common market and the election of a pan-African parliament by 2025.

3 The Role of the Bretton Woods Institutions

What has been the role of the Bretton Woods Institutions (BWIs) in low-income countries? Since establishment, the resources of the Bank and the Fund have been made available to member countries mainly for two purposes. First, the funds have been meant to compensate for short-term balance of payments problems, which have mainly arisen from a fall in export earnings, a rise in foreign exchange or a rise in import requirements. Second, they have also been meant to provide interim support for longer-term balance of payments problems while adjustment measures were being implemented to counter the shocks. It is agreed that the role of the IMF and the World Bank in low-income countries has evolved over time, from the inception of project lending by the Bank in the 1950s to the current development policy lending. The following sections present a chronology of the Bank and Fund programmes in low-income countries.

3.1 Project Lending

Project lending was the Bank's lending programme; it was initiated in the 1960s to target specific sectors of economies. The programme marked a deviation from the approach taken in the 1950s that emphasised infrastructure development such as roads and railways, telecommunications, ports, and power facilities. The programme on project lending emphasised direct lending for the productive sectors of industry and agriculture in the 1960s, and for socioeconomic sectors of education and health in the 1970s. The emphasis of the development strategies was therefore changed to focus more on investments that could directly affect the well-being of the masses of poor people in developing countries by making them more productive and by integrating them as active partners in the development process. Host countries initiated projects, but the Bank carried out an assessment of the feasibility of the projects. The Bank's major justification for project lending stemmed from the emphasis on capital investment given in the literature on economic development in the 1940s, 1950s and 1960s, which implied that the rate of economic growth was considered as a function of the rate of growth of the capital stock (Please, 1984). The capital stock, on the other hand, was assumed to be determined by the domestic and foreign savings available for financing of investment. Unlike the Bank, the Fund provided assistance entirely in support of policy change.

The weakness of conventional project lending by the Bank in monitoring and disciplining policy reform was apparent. Most of the projects failed and the Bank blamed the countries for poor project feasibility. It should be noted, however, that most of the time the Bank teams that assessed these projects were not familiar with the local conditions, whether institutional setting, supply chains or political environment. One audit report stated that "on the basis of experience, it would be reasonable to conclude that individual projects in general were inefficient instruments for inducing policy change" (Please, 1984, p. 27).

In the 1970s, the importance of policy and broad institutional issues became obvious. It was therefore recognised that for developing countries to achieve their development objectives more fully, there was an urgent need for external development assistance to be provided within a framework of policies and institutions that would utilise such resources effectively. This was the beginning of a change in the Bank's role in development towards assistance in adjustment of policies and institutional arrangements to ensure rapid growth and poverty reduction in developing countries.

3.2 The Trust Fund and the Extended Fund Facility

The idea of a concessional or "soft loan" window for the IMF originated with the Oil Facility Subsidy Account in 1975, which was followed by the Trust Fund in 1976. The Trust Fund was administered by the IMF from 1976 through 1980. The money was lent to 55 low-income countries at an interest rate of 0.5 percent per year, with the principal to be repaid in instalments beginning after five and one-half years and ending after ten years. Initial loans were made in January 1977, and the last ones in February 1981, with significant reflows of cash into the Trust Fund beginning in July 1982 and expected to conclude in February 1991. Loans from the Trust Fund were subject to only first-tranche conditionality, which implied that an eligible member country was required to prove that it faced a balance of payments problem and to demonstrate that it was making a reasonable effort to correct it. Nearly all countries that were eligible on the basis of having low per capita income borrowed their share of available funds. By the time the Trust Fund was exhausted, the idea of making even concessional loans conditional on specific policy commitments was becoming more widely accepted.

The Extended Fund Facility (EFF) was established at almost the same time as the Trust Fund, and was intended to help countries carry out "comprehensive programmes that included policies of the scope and character required to correct structural imbalances in production, trade and prices". EFF credits were meant to have longer maturities and the interest rate was to be the same as the market related rate that was being charged on ordinary stand-by arrangements. This arrangement was also meant to provide a blend of financing available to low-income countries, including conditional stand-by or extended arrangements at regular rates and low-conditionality loans at concessional rates.

Low-income countries, many of them newly independent and most of them needing to import oil to fuel economic growth, faced a cruel economic environment in the 1970s. By 1980, the funds of the Trust Fund were all committed and the situation was not improving, prompting the realisation that the transition would take much longer, and more sustained commitment was needed from donors and creditors. During the same period, the IMF was grappling with the effects of extraordinary high world interest rates. The Supplementary Financing Facility (SFF; 1979-1981), which was also an oil facility, was financed with money borrowed by the IMF at market interest rates, and the IMF's credit interest rate was matched to the cost of borrowing. In 1979, the rate of interest on SFF funds was over 10 percent, as compared with the standard IMF rate of 5.25 percent. Low-income countries could not afford to borrow at those rates, which led to the need for the IMF to subsidise the SFF interest rates. Given that the Trust Fund's reflows were to peak in 1986, the IMF had basically three options: to renew the Trust Fund and channel payments back into it for new concessional lending; to convert the outstanding loans into grants; or to liquidate the Trust Fund and transfer reflows into the Special Disbursement Account. Conversion of loans into grants was dismissed because of the potential for moral hazard problems in future lending. A plan was developed that included setting up a subsidy account that was to be used to reduce interest charges on IMF credits financed by SFF by up to 3 percentage points only for low-income countries. Once the bulk of the Trust Fund repayments began to flow in, pressure began to mount for a new and more substantial means of helping low-income countries.

In reviewing the limitations of the Trust Fund, IMF staff argued that easy access to loans with low conditionality combined with a general deterioration in the external environment that borrowers faced had enabled financing to prevail over adjustment (IMF, 1985). Consequently, many countries were in worse straits at the end of the availability of the Trust Fund loans than at the beginning. Countries had been asked to develop medium-term strategies, on the assumption

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that the global economy would improve. The review had been too limited to be effective.

3.3 Structural Adjustment Programmes and Stabilisation Policies

The urgency of policy reform and the limited effectiveness of project lending, combined with policy dialogue for supporting and monitoring policy reform, led to the introduction of structural adjustment in the 1980s. The late 1970s and early 1980s were characterised by global recession, rising oil prices, staggering amounts of debt and mounting balance of payments problems, which hindered SSA countries' ability to grow and develop. International agencies like the World Bank and the IMF, along with the United States Agency for International Development (USAID), were instrumental in the initiation of economic reform and privatisation in Africa. The World Bank, through its structural adjustment policies, continued to emphasise growth through allocation efficiency and greater reliance on markets. The IMF, also through its stabilisation programme, put pressure on African countries to reduce the role of the public sector.

The idea of creating a replacement for the defunct Trust Fund had widespread support in 1985, but consensus had to be reached on which countries would be eligible to borrow on concessional terms, the conditions to be imposed and what the role of World Bank would be. The Structural Adjustment Facility (SAF) was formally created on 26 March 1986. The Facility was small compared with the Trust Fund, with the IMF's general resources, and with the financing needs of low-income countries. Conditionality for SAF loans was applied similarly to the IMF's extended (EFF) arrangements, with a few key differences. As with EFF programmes, countries were expected to formulate a medium-term policy framework, but the policy framework paper (PFP) process required the report to be drafted by both the member country and World Bank representatives. Loan approval was to be conditional on the specification of a detailed set of policy commitments, but the country was given a greater benefit of doubt on its willingness and ability to carry out those commitments than it would have with a conventional upper-tranche arrangement.

The Enhanced Structural Adjustment Facility (ESAF) was created in 1987 to support programmes of low-income developing countries that intended to strengthen substantially and in a sustainable manner their balance of payments position and to foster growth. ESAF loans were to be disbursed semi-annually and were to be subject to performance criteria on both structural policies and macroeconomic performance. ESAF lending activity began with a loan to Malawi on 15 July 1988. Although only a handful of loans was to be approved each year, the new ESAF quickly overtook the SAF as the IMF's main window for concessional loans. By this time, the IMF was ready to abandon the practice of providing parallel financing for low-income countries through both its general resources and its concessional lending facilities. ESAF succeeded SAF because it was a much larger injection of IMF support in the 1990s.

In the 1980s and 1990s, almost all SSA countries adopted major policy reforms under the World Bank or the IMF, which set the parameters for policy change in Africa, although the extent to which particular countries consistently followed the reform package differed from country to country. The IMF's stabilisation policies were mainly aimed at reduction of short-term disequilibrium, especially budget deficits, balance of payments deficits and inflation, while the Bank's structural adjustment policies were geared towards orienting the structure of the economy towards greater efficiency in the medium term.

Three categories of policies formed part of almost every IMF programme: demand restraint; switching policies; and policies related to long-term supply or efficiency. The aim of demand restraint policies was to curtail expenditure on imports and release resources for exports. Major policy instruments included: reduction in government expenditure and budget deficit; controls over money supply and credit creation; and policies to cut real wages. Switching policies intended to shifting resources from non-tradables to tradables by changing incentives. Policy instruments included: devaluation and exchange rate unification; changes in domestic prices especially in agriculture; and wage control. On the other hand, long-term supply policies were for raising the long-term efficiency of the economy by securing a more market-oriented economy subject to fewer restrictions and less segmentation. Reforms included trade liberalisation, along with financial and price reforms.

World Bank policies were also strongly market-oriented, and like those of the IMF, stressed monetary and fiscal orthodoxy, appropriate real exchange rates, positive real interest rates, and liberal approaches on the external account (Helleiner, 1988, as quoted by Stewart *et al.*, 1994). Categorisation of Bank policies suggests four major elements:

- Mobilisation of domestic resources through fiscal, monetary and credit policies, and improved financial performance of public enterprises.

- Improvements to the efficiency of resource use throughout the economy. Measures in the public sector included reform and privatisation, while measures in the private sector included price decontrol, reduced subsidies, competition from imports, credit reform and encouragement to foreign direct investment.
- Trade policies, which entailed liberalisation, with reduction and removal of import quotas, improved export incentives, and some institutional reforms to support exports.
- Institutional reforms, which aimed at strengthening the capacity of the public sector and increasing the efficiency of public enterprises and also improved institutions to support the productive sectors.

The World Bank released the report *Accelerated Development in Sub-Saharan Africa: An Agenda for Action*, popularly known as the Berg report (World Bank, 1981), a few months after the OAU issued the Lagos Plan of Action. Among the recommendations of the Berg report (World Bank, 1981) were: a rolling back of the state; the privatisation of parastatals; the imposition of user fees on public services; an export driven trade policy and extensive trade liberalisation; and devaluation of national currencies (Ihonvbere, 1996). The report emphasised an open market, the withdrawal of the state, and the full integration of African economies into a global market where they were powerless and vulnerable. Implementation of these programmes failed to address the structural roots of the African crisis, but concentrated on solving balance of payments problems and generating foreign exchange. African economies could not contest the prescriptions because they were deep in financial crisis and therefore pursued the market programmes to satisfy the donors and other lenders.

After rapidly opening up their economies in the 1980s, African countries laid great emphasis on ensuring the flow of external funds rather than on mobilising domestic resources. The external resources were viewed as an instrument for accelerated growth, and the monetary policies in place were not regarded as hindering domestic resource mobilisation. High interest rates, a stable exchange rate and fiscal restraint were considered sufficient to attract capital inflows. As a result, most countries abandoned their monetary policies, and the exchange rate anchor was used to stabilise the price level through competition from cheap imports. Less government intervention and privatisation were expected to improve the overall efficiency of the market system.

This policy approach led to lower profits and profit expectations of domestic companies, however, and prevented the profit–investment nexus from evolving. The macroeconomic fundamentals did not translate into sound fundamentals capable of producing a conducive environment for investment, technology advancement and expanding exports. The macroeconomic policies in place were successful in controlling hyper-inflation, but failed to consider the fact that world competition lowered domestic prices, which shifted the risks of inflation and excess demand towards deflation and lack of demand.

As a result of criticism from several agencies, among them UNECA and the OAU, the Bank in 1989 published *Sub-Saharan Africa – From Crisis to Sustainable Growth: A Long-Term Perspective Study*, which moved the Bank away from its traditional position towards the realisation that adjustment cannot be carried out at the expense of people. The report considered state participation in the economy and recognised the political dimensions of the crisis, the role of corruption and political competition, the marginalisation of the people from decision making processes, and the need for democratisation in the society. The report emphasised issues of good governance to enable African states to meet their global obligations and to better implement structural adjustment programmes.

The consensus during the 1990s was that there was no alternative to the policies pursued by African economies in the 1980s. It was presumed that interest rates and monetary policy could not be relaxed without a loss of exchange rate stability, price stability and positive capital inflows (UNCTAD, 2004). The combination of low-income growth, overvalued exchange rates and high interest rates inhibited investment incentives and the restructuring of the domestic productive sector, and made it impossible to meet the conditions required to stabilise or reduce the debt burden relative to national income in the medium term. With the great emphasis on fighting inflation, external balance was neglected, being mainly achieved through compressed imports resulting from reduction in overall income growth rather than by raising exports. This is the opposite of the justification for opening the economy to make trade an engine for growth.

In December 1993, the ESAF was enlarged and extended, and in 1996 was made a permanent facility and the centrepiece of the IMF's strategy to help low-income countries. In addition, IMF's participation in the initiative to lower the debt of the highly indebted poor countries (HIPCs) was initially linked to special, more concessional ESAF operations.

Loans under ESAF carried an annual interest rate of 0.5 percent, with repayments made semi-annually, beginning at five and one-half years and ending ten years after the disbursement.

With the realisation that economic recovery in SSA was yet to come, in 1994 the Bank issued the report, *Adjustment in Africa: Reforms, Results, and the Road Ahead*, which was mainly an assessment of the region's progress and prospects. In the report, the Bank abandoned its earlier definition of structural adjustment as supply side reforms in favour of short-run stabilisation. The view that structural adjustment programmes were designed to stimulate growth represented the core justification of the Bank's increasing involvement in policy-based lending during the 1990s.

The stabilisation and adjustment policies advocated by the IMF and the World Bank and widely adopted in Africa have not succeeded in restoring growth in most countries (Stewart *et al.*, 1994). The 1980s and the early 1990s were an exceptionally difficult period for low-income developing countries, particularly in Africa. Many economies were at the point of collapse after years of economic mismanagement and adverse external shocks, culminating in the debt crisis of the 1980s and 1990s. As governments began the task of restructuring and rebuilding their economies, per capita incomes stagnated or declined. Only 7 of the 18 countries with Bank programmes showed improved growth performance, while 14 suffered declines in investment rates and the overall impact of the adjustment operations was rather disappointing. Trade reform has been found to be accompanied by a fall in investment mainly because reform increases the sensitivity of investment to external terms of trade (Fielding, 1997). Although trade reform has been an essential component of government policy mainly as a precondition for aid, there could be a trade-off between the level of aggregate investment and the achievement of trade policy goals.

Africa recorded an average growth rate of about 3.9 percent during 1971-1973 (before the crisis), which peaked at 5.5 percent during 1974-1977. The rate of economic growth continued to decline, however, reaching a minimum of 0.9 percent during 1992-1994. Some regions like Eastern Europe did even worse and recorded an average growth rate of -10.7 percent during that period. The declining trend was reversed during the late 1990s, a development that was mainly attributed to improved macroeconomic stability, increased exports and also restoration of peace in some parts of the African region.

Africa also has a very low per capita income compared with other regions. Per capita income for Africa increased from an average of $339.8 over 1970-1975 to $709 over 2000-2003, compared with an increase from $1,207 to $5,309 for the world during the same period. This marginal increase in per capita income falls short of redressing the substantial income losses and impoverishment of the lost decades. Africa is the only region where the incidence of poverty could worsen by 2015 given that the continent requires a sustained per capita growth rate of at least 4.6 percent per annum to make significant progress towards achieving the Millennium Development Goals (AfDB, 2003). The continent has also continued to receive much lower capital flows than other regions. For example, out of the total of $82.9 billion that went to developing countries in 2003, Africa only managed to get $9.5 billion, while Asia attracted about $84.3 billion (UNCTAD, 2004).

This experience led many observers to question the effectiveness of the remedies embodied in IMF and Bank supported structural adjustment and stabilisation programmes. Debate over the long-term effects of structural adjustment in the Third World in general and Africa in particular is organised along three main lines (Samatar, 1993):

- First, there has been an argument that the economic crisis in the past two decades was caused principally by inappropriate and poorly conceived public policies, which created severe economic imbalances and undermined productive investment.
- Second, UNICEF's critique of Bank policies has been on the negative impact of structural adjustment programmes on the social wage and therefore on vulnerable groups.
- Third, radical critics have been of the opinion that the thrust of structural adjustment strategy is misconceived, inappropriate and detrimental to the long-term development prospects.

A number of policies in the adjustment package have had both positive and negative effects in the medium term – positive because they correct past distortions, but negative because they do not provide essential complementary changes, or because they are too market-oriented and undifferentiated and make it impossible for African economies to build their own capability. The package may have increased short-run efficiency of the resources in use, but it tended to diminish African control and experience, as it reduced the possibility of building up dynamic comparative advantage in non-traditional areas. The problems of structural adjustment programmes of the 1980s in Africa were numerous. They relied too much on reforms in incentive structures while they neglected the provision of crucial public goods. They were naïve about

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the nature of required changes in the financial system, particularly the efficacy of interest rate changes, and about the efficacy of privatisation, especially in agricultural marketing and input distribution. They neglected human capital and poverty even as they were overly optimistic about the prospects for expansion of earnings from traditional exports. Some programmes were under-funded or forms of external assistance were inappropriate. Finally, there was inadequate appreciation of the fiscal implications of reform packages incorporating sharp devaluations and interest rate changes (Stewart *et al.*, 1994).

Adjustment programmes designed to correct domestic imbalances failed to tackle the systemic factors that stifle production and distribution and instead redirected available financial and productive resources towards export production in order to generate foreign exchange (Cheru, 1992). While donor supported adjustment programmes in pricing, interest rates and devaluation policy may be necessary to correct domestic production shortfalls in the short run, these factors alone do not constitute a fundamental constraint to long-term sustainable development in sub-Saharan Africa. Such adjustment measures need to be implemented in tandem with equitable land tenure systems and the provision of credit, inputs and extension services. Shortcomings of the export-oriented strategy adopted in SSA have been evidenced by declining African agricultural output: African agricultural output grew by 2.7 percent in the 1960s, which shrank to about 1.4 percent during 1970-1985 (Cheru, 1992).

Structural adjustment programmes have also been criticised for lacking adequate emphasis on the role of institutions in promoting development (Stein, 1994). Structural adjustment was derived from neoclassical economic theory, which was found to lack institutional considerations and was therefore ill-equipped to promote the development of market institutions in Africa. Priorities for reformers in the 1980s mainly encompassed price reforms in external trade, in product and labour markets, in finance, in taxation and macroeconomic stability, and in privatisation. By the 1990s, however, it was realised that adequate institutions are a prerequisite for successful reform. Three often cited cases of unsuccessful reform as a result of inadequate institutions are: Russia's unsuccessful price and privatisation reform in the absence of a supportive legal, regulatory and political apparatus; dissatisfaction with Latin America's market-oriented reforms that paid little attention to mechanisms of social insurance and safety nets; and the Asian financial crisis whereby financial liberalisation was carried out without financial regulation. Institutional reform affects not only policy parameters but also behavioural relationships (Rodrik, 2000). A well-defined reform that is consistent with the institutional needs of an economy can spur higher levels of entrepreneurial dynamism and economic growth. Moreover, a high-quality institutional environment has greater economic payoffs than a liberal trade regime or adherence to World Trade Organization (WTO) rules. Growth can also be seen as a function of the size of the external shocks faced by an economy (e.g. terms of trade), arbitrated by its ability to deal with them. Appropriate institutions have two roles: to ease the pain of adjustment and to legitimise decisions that certain parts of the society must bear costs, so that unavoidable costs can be borne without leading to social or political collapse (Winters, 2004).

3.4 The Poverty Reduction Growth Facility and the Poverty Reduction Strategy Papers

At the end of 1999, the World Bank and IMF adopted a new framework for their support to low-income countries. The framework comprised two key elements: country-authored Poverty Reduction Strategy Papers (PRSPs), which were expected to draw on broad-based consultation with key stakeholders, and the Poverty Reduction and Growth Facility (PRGF), which replaced the Enhanced Structural Adjustment Facility (ESAF). The replacement of the ESAF by the PRGF raised expectations about the role of the IMF in the struggle against poverty in the world's poorest countries. The programmes supported by the PRGF were to be derived from the PRSPs to ensure country ownership and a clear orientation towards achieving the joint objectives of poverty reduction and growth.

How different are PRSPs from the ESAF? It was clear that PRSPs were intended to mark a significant change in the IMF's and World Bank's roles and ways of doing business in low-income countries. The core aim of the PRGF was to arrive at policies that were more clearly focused on economic growth and poverty and, as a result, enjoyed better national ownership and were more consistently implemented (IMF, 2001a; OED, 2004b). The PRSP process emphasised that there was need to be realistic about what could be achieved in the near term; that the degree of progress would depend on the initial starting conditions and the nature and content of the PRSPs would vary from country to country; and that the process would be a dynamic one. By March 2004, some 37 countries (out of a total of 77 eligible countries) had completed a full PRSP. The main challenges encountered were in the areas of building capacity; opening up the policy dialogue; aligning external assistance behind national strategies; integrating the PRSP into budgetary priorities; and implementing the strategies outlined in the PRSPs.

The introduction of the PRSPs therefore implied the change from: conditionality to ownership; technical assistance to capacity building; negotiation to participation; and "first among equals" to "one among many" (see in this volume, Martin and Bargawi, p. 109). This called for greater government ownership and participation on the side of member countries, and consultative group meetings on the donors' side so that all parties negotiate with governments simultaneously rather than the IMF taking the lead and all other donors' money being pegged on IMF approval. This also called for more open, broader and permanent participation of stakeholders, rather than the two- to three-week closed door donor meetings with respective government technocrats. The previous approach ended up more like public education rather than participation.

The Poverty Reduction Strategy (PRS) approach consisted of a series of programmes designed to encourage broader-based participation in the development of a country-owned, long-term strategy for poverty reduction and growth. The PRS approach drew on key elements in the Comprehensive Development Framework (CDF) and was also meant to address concerns identified by evaluations of ESAF and the related policy framework papers (PFPs). The reviews concluded that PFPs had largely failed to reach their objectives and highlighted a number of problems with ESAF-supported programmes, including lack of national ownership; weaknesses in the analytical and empirical bases of the social policy content of programmes; and insufficient attention to trade-offs involving policy choices that imply significantly different paths for growth and social welfare (IEO, 2004). The new approach was therefore supposed to strengthen country ownership, enhance the poverty focus of country programmes, and provide for stronger collaboration between the Bretton Woods Institutions and more broadly among development partners in supporting country development efforts. Other objectives included greater accountability and an improved setting of priorities and design of public actions.

The underlying principles of the PRSP process were that it would be country-driven and involving broad-based participation; results oriented and focused on outcomes that are pro-poor; comprehensive in recognising the multi-dimensional nature of poverty and the proposed policy response; partnership oriented and involving coordinated participation of development partners; and grounded in a long-term perspective for poverty reduction (IEO, 2004; OED, 2004b). The major purposes of the PRSP are: for the country to lay out realistic but challenging poverty objectives, along with policies needed to achieve them; for the Bretton Woods Institutions to provide a suitable basis for their concessional lending; and for other development partners to offer a key instrument around which to organise their relationship with low-income countries.

To what extent have PRSPs been country-driven? The answer involves looking at how much control national stakeholders have had over the PRSP. Evidence can be found by considering how the process was organised, stakeholders' own perceptions and the extent to which the process became self-sustained beyond the formulation of the initial strategy document. There is substantial evidence that most of the countries drafted their own PRSPs, but stakeholders' perceptions were that the major driving force behind implementation of the PRSP was that it was a condition for getting access to debt relief under the HIPC Initiative and to concessional lending from both the Bank and the IMF. On the sustainability of the PRS process, the PRSP progress reports, which are submitted once every year, show that many countries have not integrated the preparation of the PRSP reports into their budget processes. However, the progress reports show good progress in the implementation of the relevant structural reforms, often in the areas of public expenditure management, decentralisation and privatisation, and in the setting up of working institutional arrangements to monitor PRS implementation. In general, however, the extent to which the PRSPs are country-driven varies from country to country.

Even though the PRS represents a significant step forward, there has been some criticism on the IMF's and World Bank's role in the process (IEO, 2004). There have also been several criticisms of the PRS process itself, including that there was little broadening of the participatory debate on macroeconomic policy, although this varied by country. Moreover, the policy discussions and decision making processes were often not well embedded in existing political structures (e.g. the role of parliament is too limited). Alternative policy options were rarely explored, while impact analyses of macroeconomic policy variables were rarely undertaken and therefore did not represent a significant *ex ante* input into policy formulation. Finally, the linkage to the HIPC Initiative was partly responsible for rushed procedures that reduced the value

Table 2 Population Living on Less than 1 Dollar per Day
(percentages)

	1990	1999	2001
Northern Africa	2.6	2.0	1.9
Sub-Saharan Africa	46.9	42.7	46.4
Latin America and the Caribbean	10.9	10.6	10.0
Eastern Asia	33.0	17.8	16.6
Southern Asia	39.7	30.5	30.4
South-Eastern Asia	18.4	10.8	10.2
Western Asia	1.6	4.2	3.7
Commonwealth of Independent States	0.5	10.3	5.0
Transition countries of South-Eastern Europe	0.4	1.7	2.1

Source: United Nations, *Millennium Development Goals*, 2003.

added of the new approach. In terms of the PRS content and the design of PRGF-supported programmes, one of the main criticisms is that the PRGF still drove the PRSP on the macroeconomic framework, even though related policy issues and programme design was still oriented towards poverty reduction. Programmes are said to be too targeted on reducing fiscal deficits and inflation to below threshold levels, while the IMF was still seeking to impose conditionality that was not derived from the country-driven PRS. Lastly, the IMF has been accused of aid pessimism, whereby projects were designed around projected reductions in aid flows. As well, the macroeconomic framework in the PRGF did not begin from a "needs-based" approach that takes as its starting point the level of external resources needed to help countries progress towards achievement of the Millennium Development Goals.

What emerges from evaluations of the PRS is that the approach has the potential to encourage the development of a country-owned and credible long-term strategy for growth and poverty reduction. Strategies under the PRS generally constitute an improvement over previous development strategies owing to their greater poverty focus, a longer-term perspective and some results orientation. Actual achievements have fallen considerably short of the potential, however. Despite many countries in SSA being able to complete and implement the PRSP process, poverty rates increased from 42.7 percent in 1999 to 46.4 percent in 2001 (Table 2).

It is worrisome to note that SSA is still the region with the highest poverty rates in the world, and could be the only region with worsening poverty incidence by 2015 as opposed to the objective of

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halving poverty by 2015 under the Millennium Development Goals. The inability of the PRSPs to yield the expected results has been partly attributed to shortcomings in the design of the initiative and partly to the lack of clarity of the IMF and World Bank roles in the process. Participation was more broadly based than in previous programmes, but the participatory processes were not designed to strengthen existing domestic institutional processes for policy formulation and accountability (e.g. through parliament). The PRS process has also had limited impact in generating alternative policy options with respect to the macroeconomic framework and macro-relevant structural reforms.

The IMF's and Bank's effectiveness also did not match expectations because their specific role in the process was not clear, and there was insufficient recognition of how the changes the PRS approach would affect their way of doing business. The approach implies a process based on a country-driven strategy that sets priorities within a long-term timeframe; emphasises contributions to informing policy rather than the traditional programme negotiations; and operates within a partnership framework whereby the IMF's and Bank's contributions are only part of a broader picture. The Bretton Woods Institutions have not used the PRS approach sufficiently as a mechanism of identifying priorities on deliverables and for coordinating key inputs from other partners.

What lessons emerge from this process? There are several. First, the structure of incentives generated by the PRS was not well aligned with the intermediate objectives of the approach. A focus on improving fundamental domestic policy processes is likely to yield longer-term gains than a traditional focus on particular policy measures. Actual incentives have not focused sufficiently on improvements in domestic policy processes and institutions, but rather have put too much emphasis on documents and Bretton Woods Institutions procedures. There has been insufficient scope for treating countries differently, with little consideration of initial country conditions (e.g. level of experience in planning). There have been insufficient benchmarks to monitor progress towards the intermediate objectives of improved domestic policy processes, which were meant to be developed at country level but were not. And finally, an asymmetry of commitments existed whereby countries were not aware of the gains to be made by treating the PRSP as an effective strategic road map, rather than as a procedural formality.

The main recommendations arising from the evaluations were to:

- Introduce greater flexibility in the implementation of the PRS approach to fit better the needs of countries at different stages of the process and with different capacities and political and administrative systems. Countries should decide for themselves how to conduct policy formulation, implementation and monitoring processes and what output there should be in terms of documents.

- Shift the emphasis of the initiative from the production of documents to the development of sound domestic policy formulation and implementation processes. This involves building greater results orientation and shifting the emphasis of the incentive structure from procedural aspects and production of documents to achieving substantial changes in domestic processes and policies.
- Clarify what the PRS approach implies for the IMF's and World Bank's own operations and strengthen implementation. Expectations for their role should be tailored to country-specific circumstances.
- Streamline IMF and World Bank documentation and Board scrutiny of PRS documents.
- Strengthen prioritisation and accountability on what the IMF and the Bank are supposed to deliver within the broader partnership framework, which should be built around the priorities emerging from the PRS process, and ensure that resources match commitments.
- For the IMF and the Bank specifically, encourage strengthening of the framework for establishing the external resources envelope as part of the PRS approach. Countries should play a central role in elaborating macroeconomic frameworks and catalysing donor support, while the IMF and the Bank should improve aid predictability.

3.5 Development Policy Lending

Development policy lending refers to "rapidly disbursing policy-based financing, which the Bank provides in the form of loans or grants to help a borrower address its actual or anticipated financing requirements that have domestic or external origins" (World Bank, 2004). The objective of development lending is to help a borrower achieve sustainable reductions in poverty through a programme of policy and institutional actions that promote growth and enhance the well-being and increase the incomes of poor people. These policy operations should be supportive of, and consistent with, a country's economic and sectoral policies aimed at accelerated sustainable growth and efficient resource allocation. Development policy lending replaces all the other instruments such as the sectoral adjustment loans/credit, rehabilitation loans, and programmatic structural adjustment loans and credits, but the Poverty Reduction

Support Credits still remain. The policy incorporates the distinct operational features of special structural adjustment loans, the deferred drawdown options, and debt and debt service reduction operations as options for development policy lending under the unified overall operational policy umbrella.

Appropriately designed policy and institutional development programmes are central to poverty reduction because they bring faster and more equitable growth; reduce an economy's vulnerability to external shocks; help integrate disadvantaged regions or groups; and promote the development of effective anticorruption programmes, adequate systems of social protection, and financial and other mechanisms for managing social risk (World Bank, 2001). Experience suggests that such programmes can be effective only when they are "owned" by the country itself, which underlines the importance of designing policy-based lending to reflect the country's development priorities and its implementation capacity. Institutional capacity and country commitment are also keys to successful conditionality (Dollar and Svensson, 2000).

The shift from adjustment lending to development policy lending in 2004 focuses on the "when" and "how" of policy-based lending support for a country's development policy programme rather than on the nature of the programme itself. Areas that are maintained in the updated policy are requirements that policy programmes still need to be adequately funded and that the country must have an appropriate macroeconomic framework. Changes were made in the treatment of poverty, social, environmental and fiduciary issues, and the share of policy-based lending and the size of loans. New issues that have been added include: analytic underpinnings; disclosure; monitoring and evaluation; risk management; participation; Bank procedures for review; and Board presentation and implementation of operations. The new approach reflects the recognition that there is no single blueprint for policy programmes that will work in all countries, and that any country's policy programme must be designed with country ownership to fit that country's specific circumstances. Feedback from experiences with past Bank adjustment lending has demonstrated that broad participation of stakeholders and adequate analysis of development policies and their impact are important factors in developing effective development strategies.

It is for these reasons that the Bank came up with the change to development policy lending whereby emphasis is on country ownership. The approach focuses on the way the Bank advises countries on their programmes and supports them, but does not include prescriptive guidance on the content and nature of the programmes. The Bank's role is to *advise and support* programmes as countries find different ways to formulate and implement their own policies and institutions for development and poverty reduction, but not to *formulate or prescribe* them. The updated policy sets out key parameters for lending decisions, including the criteria and processes for deciding whether development policy lending is appropriate and how much financing to provide.

Decisions to extend development policy lending will be based on consideration of a country's economic policy and institutional environment and its capacity to carry out the programme. The appropriateness of development policy lending is determined in the context of an evaluation of a country's situation and its track record, which not only includes economic circumstances and policies, but also social and governance aspects. The critical elements of an assessment involve a clear articulation of how the country policy programme supported by the operation is expected to help create the conditions for sustained growth and reduced poverty, and the country's governance and institutional capacity, especially if they affect the country economic performance and the country's ability to carry out the programme. Also important are country ownership, with government and stakeholder commitment to the operation-specific programme of policy actions and objectives, and the implications for the likelihood of sustained implementation, taking into account the country's track record. The adequacy of the macroeconomic framework is a key feature that considers the medium-term structural underpinnings of the macroeconomic policy framework and the country's medium-term development potential, as well as its absorptive capacity. A final important element is debt sustainability, with an aim of supporting policies that enhance a country's capacity to service its debt.

4 National Ownership of Reform Programmes

It can be agreed that the developing role of the IMF and the World Bank has mainly been driven by the quest to increase national ownership of reform programmes, given the argument that national ownership can increase the likelihood of implementation and therefore the success of the reforms. The IMF's re-examination of its policies on conditionality in 2000 had a key objective of promoting national ownership of structural reforms. National ownership has been regarded as the missing link in most of the reform initiatives in low-income countries. Therefore the questions arising are: what is ownership, and how can ownership of reform programmes be enhanced?

There exists a wide range of views on the definition of ownership. Some of these are enumerated below:

- Ownership is a willing assumption of responsibility for an agreed programme of policies, by officials in a borrowing country who have the responsibility to formulate and carry out those policies, based on an understanding that the programme is achievable and is in the country's own interest (IMF, 2001b). Country ownership of reforms refers to the idea that country authorities and other stakeholders are primarily responsible for the design and implementation of reforms. The author views ownership as a prerequisite for effective conditionality rather than as an assessment of the level of implementation of reforms (Mourmouras, 2002).
- Ownership from a typical citizen's perspective is about the right of the country representatives to be heard in the process of diagnosis and programme design and the freedom and ability of the country to choose the programme to be implemented without coercion, rather than about who designs the programme. Country ownership therefore exists when there is a general belief that country representatives freely chose the programme to be implemented and there is also general acceptance of full responsibility for the outcome of the chosen programme (Johnson, 2005).
- What constitutes ownership is seldom clear. The term can be applied in a circularity argument whereby ownership will be present if a programme succeeds, but absent if it fails (Johnson and Wasty, 1993, as quoted by Johnson, 2005).
- There are five dimensions of assessing the levels of national ownership: the locus of programme initiation; the intellectual conviction of key policymakers or key ministries; support of the top political leadership; broad support across and beyond government; and institutionalisation of the measures within the policy system (Killick, 1998, as quoted by Booth, 2003). Morrissey (2001), as quoted by Booth (2003), argued on the other hand that attention should be concentrated on the level of commitment rather than the locus of programme initiation.
- Government ownership is at its strongest when the political leadership and its advisers, with broad support among agencies of the state and civil society, decide that policy changes are desirable, choose what these changes should be and when they should be introduced,

and identify where and how the changes should be built into policy and administration parameters that are generally acceptable (Killick, 1998, as quoted by Johnson, 2005).

- Looking at country experiences, it can be agreed that country ownership in terms of locus of programme initiation is ranked low because all programmes were initiated by the IMF, strong in terms of technocratic commitment, moderate in terms of base support, but critical in terms of institutionalisation. The reports on Kenya, Malawi and Rwanda argue strongly that mainstreaming of poverty reduction, mainly by articulating goals of the strategy within the budget, and then using budgetary incentives to force line ministries and departments to pay attention to them, is the most critical dimension of national ownership (Booth, 2003).

Alongside all these views, however, there is consensus that ownership involves some level of responsibility over not only the initiation of reform programmes but also their implementation. Given the various views on what constitutes ownership, how can ownership be enhanced? There is considerable research evidence suggesting that the most fundamental component in the success of reform programmes has been domestic political economy factors. This implies that the main ways of enhancing ownership are mainly through: genuine participation in designing and implementing macroeconomic and structural reforms; streamlining of structural conditionality; more rigorous programme projections; and encouragement of country-led reform programmes. Improved technical assistance with more of a medium- and longer-term perspective and mainly aimed at capacity building can be an effective tool in promoting ownership since ownership partly depends on implementation capacity. In cases where a country faces long-term structural problems, which implies a longer-term involvement with the IMF, then a country-led process of consensus building is a promising way to strengthen national ownership of effective policies (IMF, 2001b). Identifying outcomes – or "ex post" conditionality – can also be used to embrace ownership, since it sends positive signals to governments that they are in control of policy formulation and implementation, which is an important aspect of national ownership and the success of reforms. The major limitation of outcome conditionality, however, is the basis on which loan tranches should be released. In general, though, ownership is operationally important and should not be undermined by conditionality, implying that consistency between the two aspects should be sought.

5 Conclusion

Development assistance shifted to a large extent in the 1980s from financing investment to promoting policy reform, a reorientation occasioned by the growing awareness that developing countries were held back more by poor policies than by lack of finance for investment (Dollar and Svensson, 2000). Questions have been raised whether the Bretton Woods Institutions' conditionalities undermined country ownership of adjustment programmes. Khan and Sharma (2001) argue that finance considerations alone are justification for conditionality, but country ownership of programmes is fundamental because it aligns the incentives of the borrower and the lender. Policy measures are unlikely to be implemented without firm commitment from the government and other relevant constituencies. The task therefore has been how to reconcile conditionality and country ownership. It has been viewed that donor aid can influence the form of the agreement reached and the agreed timetable for implementation, but whether implementation is carried out depends more on political and economic factors.

Of great importance also is the role of institutions in promoting growth development, since adequate institutions are a prerequisite for successful reform (OED, 2004a). The evolution of the role of the Bank and the IMF in helping countries meet their development strategies clearly indicates that the Bretton Woods Institutions have over time been rethinking the importance of country ownership and the capability of countries to carry out the reform process. There has been a realisation that there is no single blueprint for policy programmes that will work in all countries, and that any country's policy programme must be designed with country ownership to fit that country's specific circumstances.

It can therefore be concluded that government ownership and political will have a greater influence on the timing, extent and sustainability of the reform programme than does the amount of aid flows. The Bank's and the IMF's future role in low-income countries thus involves a great need to adapt their conditionality to the needs of the low-income countries, to improve capacity building through greater empowerment of the borrowing governments and to base lending decisions on longer-term planning. There is also need to move from stabilisation to more pro-poor macroeconomic frameworks.

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9

Stepping Up Ambitions of the Poverty Reduction Strategy

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William Lyakurwa's chapter provides an excellent historical perspective and overview on the performance of Africa, on the evolution of economic thought and approaches and on where we are today.

Why did reform programmes in Africa fail to produce the results that had been foreseen? There are three possible hypotheses, and they are similar to what John Williamson has used in looking at the Washington Consensus. The first hypothesis is that the policy reforms that were part of the programme were not really implemented as had been anticipated. The second hypothesis is that there were important errors in the design of those policies. The third hypothesis is that there were important missing elements.

Without a rigorous analysis, it is difficult to determine how much each explanation attributed to the poor results. There is general agreement that all three were at play. The important thing is to draw the lessons from it. There are both important lessons in *content*, in the form that William Lyakurwa laid out, and important lessons in *process* about political economy and sustainability of reforms. There is now a broad consensus on William's bottom line conclusion, i.e. that the Poverty Reduction Strategy (PRS) approach provides the best possible framework for moving ahead with a country-driven process.

I want to present some nuances on the high growth rates needed to achieve the Millennium Development Goals. I agree that the current

[1] The views expressed are those of the author and do not necessarily represent those of the World Bank.

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growth numbers are absolutely incompatible with the attainment of the Millennium Development Goals and, in particular, with the attainment of the poverty goals. However, I would point out, that since the mid-1990s, there has been both an improvement and a differentiation in performance in sub-Saharan Africa. In the last seven years, some 12 countries recorded growth rates in excess of 5 percent per annum and some 18 countries had sustained growth in excess of 4 percent per annum. There has been a strong improvement compared to the 1980s in the growth performance of African countries. This is most evident from the increase in investments, which is even more encouraging than the improvement in growth.

I want to link that to the forward-looking agenda and the decision on which approaches to choose. In sub-Saharan Africa, there are now a significant number of countries where the conditions are propitious for moving more aggressively on the development agenda, countries that Matthew Martin called the mature post-stabilisers (Chapter 4).

On the other hand, there is still a large number of countries, albeit much smaller than before, that fall into the pre- and early stabilisers group. This landscape of development is important to point out because it shows that there is now a set of countries where the PRS model can provide the basis for stepping up ambitions. But there is another set of countries where we have to think about other approaches, where politics is perhaps the immediate constraint. How are we going to take this kind of model that William put forward and push to get higher results in Africa? If you have to push on the PRS, some issues are worth putting on the table.

Country Ownership

First is this issue of ownership. The IEO review, the Bank's OED review and, indeed, the staff progress reports on PRSPs acknowledge that while we are in the fourth year of the PRSPs, we are really only at the beginning in terms of making these instruments truly country-owned. We have to do a lot better in this regard. There are several elements that need work. The first is to link the PRS much more closely to country decisionmaking processes so that it is not driven by the Fund's PRGF, the World Bank lending, but really by country-driven processes, especially the country budget and planning processes. Second, there is a need within the countries for fuller engagement of line agencies, local authorities, and even of the government, so that this becomes a truly country-owned process. There also needs to be a parliamentary oversight if these PRSPs are to have legitimacy and to have political bite. The PRS process has clearly brought out the value of civil society and we have had mixed progress on the engagement of civil society. And finally, there is a need to align the PRSPs with country decisionmaking processes. If we are going to scale up, the challenge will be how to rely on country decisionmaking processes and align donor support.

Stepping Up Ambitions

The second issue that we have to tackle – which is a little bit at odds with country ownership – is stepping up the results and ambition of PRSPs.

On the one hand, we have a report that will be coming out from the Millennium project that says that we are far behind what needs to be done to achieve the Millennium Development Goals at the country level and that we need to step up efforts in a huge way.

On the other hand, at the country level we are very much tied up with what are the chess pieces that you have to move in order to produce concrete results. So one of the key issues right now is how can you make the PRSPs more ambitious within a country-owned process and how do you translate that into an action plan for both the countries and the donor community? The reality is that we have not done this in even a single country.

This scaling up of ambition, looking at the MDGs, is a big agenda. What does it mean in practical terms?

One clear issue is the issue of growth. If we don't attain a much higher level of growth in Africa, we are not going to be able to achieve any kind of lasting progress on poverty. We do not yet have a very good understanding of the levers that are going to produce that growth. We agree that there is a need to shift from stabilisation to more growth-oriented macro frameworks, and to go from more growth-oriented macro frameworks to more pro-poor macro frameworks. But we have not yet fully laid-out what this means in terms of content. One issue on the growth agenda is the investment climate. Despite all of the reforms in the 1980s and 1990s, the investment climate in Africa still does not compare favourably with that of other developing countries. There is a large, unfinished agenda in strengthening the investment climate in simple things like processes, procedures, but also the rule of law and property rights.

As Louis Kasekende pointed out, infrastructure plays an important role in achieving growth. Relying on the private sector's financing for infrastructure is not going to produce either the scale or the kind of infrastructure that we are looking for.

The second area where ambition needs to be stepped up is the MDG agenda on education, health, water, sanitation and the like. There are three issues on the table.

The first is, what are the conditions under which we can provide sustained budget support for the kind of investment that is needed? This is not the traditional kind of macroeconomic criteria.

The second is the perennial issue of governance. If we are going to be able to provide large sums of money through the budget for education, health, and local service delivery, the issues of governance and fiduciary frameworks on the budget are vital. There has been a lot of good work done under the HIPC Initiative and this is beginning to produce results, but it is not an area where all donors have reached agreement. We are not yet advanced enough in our dialogue with countries to be able to say: "Yes, this is the framework that we will use as a basis to acquire support in terms from our boards in the Fund and in the Bank".

The third is the whole issue of service delivery at the local level. The 2004 World Development Report made a strong case that just putting the money in the budget is not sufficient. There also needs to be effectiveness and implementation at the local level in terms of service delivery.

This takes me to one issue that has not received adequate attention in discussions on PRSPs and donor support, and that is the issue of absorptive capacity. What capacity constraints need to be addressed in order to be able to scale up in the way we are thinking?

In sub-Saharan Africa, the quality of staff and of institutional capabilities of central banks and ministries of finance compares quite favourably with other developing countries and with benchmarks. However, there is much greater need for capacity building at the line agency level. And if you go down to the local level, i.e. education and health, the needs for capacity building are substantial. But when we look at what has been prescribed in the PRSPs, there is a lot of focus on financing and much less attention for the capacity constraints we face when it comes to teachers, health service workers and addressing those kinds of capacity constraints in a sustainable way.

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The Forward-Looking Agenda

Let me close with two other points on the forward-looking agenda. Financing and debt sustainability are clearly key issues. Here the discussion is not just about the adequacy of funding, but also about the predictability of donor funding. Despite all of the hype for the "Education for All" programme, we have not yet managed to acquire even a three-year commitment of donor funding for a programme where you need ten-year commitments going out. The same applies for HIV/AIDS, all of the things where recurrent costs financing in the long term is key.

This issue of recurrent costs brings us to the issue of budget support. There is a movement toward more budget support since its advantages are increasingly recognised. However, the way we are providing donor budget support is still hugely fragmented. This is not just an issue for the Fund and the Bank, but one that we have to resolve through donor harmonisation and alignment efforts.

Finally, I want to mention the issue of shocks. The shortcoming in dealing with shocks is not just a failure of the Fund and the Bank. It really is the architecture of international support right now of how to deal with asymmetric shocks of developing countries which is just not adequate.

The final issue, which does not get enough attention, is the issue of trade and, in particular, agricultural trade. There is nothing that is more powerful for African development than dismantling the trade barriers that currently exist in specific commodities, such as cotton, and more generally for agriculture. This could be the most powerful measure of support to the development agenda.

To conclude, the country-driven PRS provides a good basis, we have agreed on it, but now we need to populate it with content and methods for advancement in order to achieve results.

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New Finance for African Development

Ernest Aryeetey[1]

1 Introduction

The main development challenge facing Africa now is how to reduce significantly the extent and depth of poverty in the region while transforming the structure of its economies. Making poverty reduction the focus of current development initiatives is justified by the extent and depth of poverty in the region and also by the fact that such poverty slows down all manner of social and economic progress. By the early 1990s, as many as 51 percent of the population of Africa lived below a poverty line of $34 per person per month. Throughout Africa, the current average income of each person has been estimated at 83 cents per day. Despite the significant variations among the different parts of the region, it is obvious that Africa will have to devote a significant chunk of its resources to fighting such humiliating poverty in the coming years if its peoples are to survive the growing demands of a rapidly changing world.

In view of the state of poverty, the financing requirements of African nations are now largely determined on the basis of what it will take to achieve the Millennium Development Goals (MDGs) set for 2015. These goals include cutting in half the proportion of people living in extreme poverty, of those who are hungry, and of those who lack access to safe drinking water. They also include the achievement of universal primary education and gender equality in education; to accomplish a three-fourths decline in maternal mortality and a two-thirds decline in

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mortality among children under five. They finally include halting and reversing the spread of HIV/AIDS and providing special assistance to AIDS orphans, while improving the lives of 100 million slum dwellers. Thus, in addition to the financing needs of individual poor nations, there is the need to finance global public goods in achieving those goals.

Since agreeing on the MDGs, there have been a number of attempts to estimate the financing requirements of developing countries as they attempt to achieve faster growth and development. Achieving the MDGs is linked to faster growth and structural transformation in Africa as it implies that the per capita consumption of over half of Africa's population should rise to a minimum of $1 per day. To achieve that level of consumption, it is reckoned that African and other low-income countries must, on the average, grow at 8 percent per annum for the period. This high growth rate requires a much faster rate of investment than countries usually experience. UNCTAD (2000) estimated that the investment-to-GDP ratio would have to rise to a minimum of 25 percent from about 19 percent. But it was unlikely that the poor nations could find the necessary resources to finance such investment growth from the traditional sources, i.e. domestic savings (both private and public) and foreign savings (official development assistance and private capital flows). This made it essential to identify immediately sources of additional financing, while boosting the capacity to generate further resources from the traditional sources.

1.1 Why the Interest in External Finance in Africa?

It is remarkable that a lot of the attention on meeting the financial requirements of poor African nations have focused on external finance. It is important to put in perspective at the onset the significance of external resources and the problem of domestic resources. Indeed, quite a bit of the recent development literature attribute Africa's relatively slow growth in the last three decades to slowness in capital accumulation, leading to increasing attention being paid to the apparently low saving rate in the region (World Bank, 1994). For the entire region, gross domestic savings averaged only 14 percent of GDP in the 1980s, compared to 23 percent for South-East Asia and 35 percent in the Newly Industrialised Economies of Korea, China and Singapore. Aside from being generally low, savings rates have shown consistent decline over the last thirty years in most countries, seldom exceeding 15 percent of GDP. Where rises have been seen, these have been very modest.

Over the years, a number of explanations have been provided for the difficulty in accumulating capital for consistent growth in Africa. These run through the mass of literature on African growth in the 1980s. (See Easterly and Levine, 1997; Sachs and Warner, 1997; Bloom and Sachs, 1998; Collier and Gunning, 1999, etc.). What is common to all the various explanations for slow African growth is the fact that slow capital accumulation is associated with limited participation in world trade. This is in turn explained by many different factors, including those of the prevailing macroeconomic policy framework, inward-looking trade policies, institutional development, poor development of market structures, geography, conflicts, etc.

The issue of trade within the context of recent globalisation has gained considerable significance in explaining Africa's growth and development problems, particularly since it became clear that it has been the main springboard for putting East Asia onto that steady growth path. A growth path has seen East Asia increasingly attracting more external financial resources for its development. Radelet and Sachs (1998) have noted that despite the 1997 crisis in South-East Asian economies, the basic structure for participating in world trade that has evolved in the last three decades remains essentially sound.[2] In Africa, on the other hand, the weak foundation of many economies can be more vividly shown in their modes of international linkages. By the early 1990s, the failure to diversify export structure and attract foreign direct and portfolio investment flows had left the continent virtually ignored by the dynamic forces that swept the international trading and financial systems with the aid of advanced information and telecommunication technology. The absence of active participation in world trade has meant the loss of significant opportunities for many countries to accrue foreign exchange, essential to building up the physical capital required for increased production. There is a genuine fear that Africa will continue to be "marginalised" in the process of global integration and formation of a new international order unless concrete actions are taken to put the region at the centre of world events through trade.

In sum, Africa needs to develop a framework and strategy for closing its resource gap in order to achieve the objective of halving poverty by 2015. While the closure of the resource gap requires effective action to

[2] It was the form and scale of financial integration into international capital markets that triggered the currency and general economic crisis and exposed the vulnerability and fragility of their financial systems.

mobilise domestic resources, there are indications that in the short-medium term considerable attention will have to be paid to mobilising external resources. But the mobilisation of external resources will depend largely on how the region positions itself in the global market.

This chapter is an attempt to summarise all the issues relating to how African countries can best position themselves to close the resource gap. It refers to the more difficult exercise of enhancing domestic resource mobilisation as a "hard option" and the probably less difficult one of attracting external resources as a "soft option".

1.2 Outline of this Chapter

The outline of this chapter is as follows: In Section 2, I look at the estimates of the financing requirements for achieving the Millennium Developments Goals. This is followed with a discussion of the current state of financing for development in the region in Section 3, looking at both domestic resources and external resources. In Section 4, I consider what the financing will be in the medium term in the absence of a radical change in policies and approach to financing development in the world. Section 5 provides a summary of some recent initiatives to introduce innovation into how development may be financed from both domestic and external sources. In Section 6, I turn attention to the hard and soft options that African governments face together with their development partners in financing Africa's future growth and development. This section discusses the structural and policy changes that may be embarked upon in order to free up resources for development in Africa. It is based on several strands of relevant research in this area. Section 7 sums up and concludes the chapter.

2 Financial Requirements for Achieving the MDGs

After making allowance for domestic savings, UNCTAD (2000) estimated that the annual total capital inflows of $9.5 billion to sub-Saharan Africa at the time had to be doubled over the next ten years in order to raise the investment/GDP ratio to 25 percent while the savings/GDP ratio went up to 18 percent to achieve an annual growth of 6 percent. This assumed that the proportion of the capital inflows used for real resource transfers would be around 62 percent with the rest going to finance various financial transactions and reserves.

The UNECA (2000) in turn argued that raising the net capital inflows to $20 billion would raise the investment ratio to 27 percent, which was what Malaysia had used earlier to achieve an average annual growth rate of 8 percent in the 1980s, Africa's desired growth rate. An argument for raising the net capital inflows to $20 billion instead of UNCTAD's $18 billion was justified with the devastating effect that the HIV/AIDS menace was having on the cost of development.

Taking all the above considerations into account, the report of the Zedillo Panel (UN, 2001) estimated conservatively that an additional $50 billion would be required annually to achieve the Millennium Development Goals throughout the developing world. The Panel argued that there was a strong case for international financing of global public goods, and identified the goods that fell in that category as peacekeeping; the prevention of contagious diseases; research into tropical medicines, vaccines, and agricultural crops; the prevention of chlorofluorocarbon emissions; the limitation of carbon emissions; and the preservation of biodiversity. The cost of peacekeeping was estimated at about $1 billion, while the cost of dealing with the HIV/AIDS epidemic was given as $7-10 billion a year. This would include the cost of creating a Global Fund for HIV/AIDS and Health, and another $2 billion a year for the fight against tuberculosis and malaria.

While it has been estimated that the cost of developing vaccines can run into billions of dollars, it is also noteworthy that most developed vaccines are of little relevance in the specific case of developing countries since these countries cannot afford them. The work of the Consultative Group on International Agricultural Research (CGIAR) is still considered important in the delivery of global public goods, spending some $330 million a year on research into crops of relevance to developing countries. It is estimated that the rate of return on its activities is very high, and the primary beneficiaries are poor farmers.

Other areas that are budgeted for in the delivery of global public goods are the control of chlorofluorocarbon emissions. The cross-border cash payments designed to compensate developing countries for joining the global campaign are estimated at $1.2 billion so far. The Zedillo Panel reported that limiting greenhouse gases would be a more costly venture. Since the bulk of those costs are expected to fall on individual countries, it is important that they are allocated fairly among them. In the area of biodiversity, there are no definite estimates of what it would take to counter the continuing loss of plant and animal species. But the Panel members reckoned that it would run into billions of dollars each year. The present expenditure on global public goods of around $5 billion a year is financed from a wide variety of sources, and it is reasonable to assume that the revenue from these will not keep up with the increasing need for such goods.

Other estimates by the World Bank in preparation for Monterrey, also suggested that an additional $30-70 billion was required to finance the process towards achievement of the Millennium Development Goals throughout the developing world.

If the DAC member countries actually delivered ODA equal to 0.7 percent of GNP, as agreed, aid would increase by about $100 billion a year, twice as much as is required to achieve the MDGs. This amount would permit full funding of the Dakar Global Initiative on Education (UN, 2001) and of the programme on Macroeconomics and Health to deal with the health crisis in Africa (WHO, 2001). Such an increase in ODA would also permit the extra expenditure of some $7.5 billion a year on the achievement of universal access to reproductive health facilities, while allowing the CGIAR centres to undertake the research necessary to transform the technological landscape. But that means raising aid from the $57 billion that is currently available globally, and it would appear to be a huge task for the developed nations in view of the expected political fall-out in those countries. It is for the fact that major constraints are expected in the campaign to increase ODA flows that efforts to identify alternative sources of financing are constantly being made. Africa is expected to require about 60 percent of all additional funds raised, an increase from the current 41 percent share of ODA.

3 Current Financing for Development in Africa

The growing reliance by African countries on external resources to finance their investments is a relatively recent phenomenon. By 1980, Gross Domestic Savings (GDS) was 23 percent of GDP, while Gross Domestic Investment (GDI) was 22 percent of GDP leaving hardly any gap to be filled. At the time, foreign direct investment (FDI) formed only 0.7 percent of the region's GDP. Incidentally, the East Asia and Pacific region was investing as much as 32 percent of GDP and saving 30 percent of GDP, creating a somewhat larger gap there for external resources to fill. The gross domestic investment figure for Africa in 1981 has been the highest in the last two decades but it was made up largely of public sector investments. In other words, until the mid-1980s, Africa

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financed most of its investments from domestic public resources, a fact that obviously limited the magnitude of investments that could be made, and the growth of such investments.

The question that is raised by the above observation is whether African countries were unwilling to use external resources to raise the level of investment or such resources were simply not available. Was it a demand problem or a supply problem? The answer would appear to be a combination of both (Aryeetey and Nissanke, 1998). On the demand side, it may be noted that from the latter part of the 1970s through the first half the 1980s, many African countries were struggling with political instability in the wake of oil price shocks that made it difficult for them to develop any coherent macroeconomic management and development programmes. That certainly made it difficult to establish any credible demand for private foreign capital. The evidence on the supply side is provided by the sharp drop in ODA to the region between the 1970s and 1980s. The growth of ODA fell from 25.1 percent in 1974-80 to 13.2 percent in 1981-90. Indeed, very little aid was going to many African countries prior to economic reform programmes.

After the mid-1980s when many countries began to pursue economic reforms, the resource composition changed significantly for the region, as did the structure of demand. By 1990, GDI had fallen to 14.6 percent of GDP, as the average annual growth was -3.8 percent for 1985-90. For the rest of the 1990s, however, investments grew by an average of 3.7 percent annually, reaching 17 percent in 1998. The gradual rise in investments as savings continued the slow growth was largely made possible by external resources in many countries.

3.1 What is the Problem with Domestic Resource Mobilisation?

The issue of domestic resources needs to be put in the right perspective: in too many African economies, there are not enough savings being generated to facilitate the required investment. Africa appears to have low and stagnant savings. Some of the best saving rates in Africa may be found in Angola where the domestic saving rate averaged 28 percent in 1980-96, and Gabon with an average saving rate of 38 percent for the same period. These are by all accounts unusual in a region where a majority have domestic saving rates of less than 15 percent of GDP and sometimes have negative savings. Their high saving rates can be attributed to their being relatively small economies with large oil exports. The public sector dominates saving in these two countries.

Despite the economic reforms that many African countries attempted in the last decade, there is little evidence of these having had a major impact on savings and investments in countries (World Bank, 1994). Over the reform period, only a couple of serious reformers saw some modest improvements in their savings performance. One of the more comprehensive reformers, Ghana, had a very low average domestic saving rate of about 5 percent of GDP throughout the 1980s. Ghana's saving rate only rose from 4 to 7 percent after a decade of reforms. By 1990, only five countries, including Kenya and Zimbabwe, had saving rates above 20 percent. One of the characteristics of all the data on domestic saving rates is that they declined for most countries in the period 1980-96 and has not seen a revival yet (see Elbadawi and Mwega, 1998).

An interesting point about the performance of savings in Africa, in contrast with savings performance in the fast growing Asian economies during the reform period, is that changes in saving rates in Africa have been largely driven by changes in public sector savings (World Bank, 1994). In Asia, they were usually driven by private savings. Srinivasan (1993) observed about largely East Asian savings, "public sector savings, if anything, do not appear to have increased significantly in the last four decades. .... One has to look for an explanation in the behaviour of the private sector for the measured rise in aggregate savings rates". In contrast, private saving in Africa dropped from 11.4 percent of disposable income in the 1970s to 7.5 percent in the 1980s. By the mid-1990s, it was still less than 9 percent. Public savings performed even worse, staying at under 3 percent of disposable income by the mid-1990s after falling from 4.5 percent in the 1980s. In many of the African countries where savings rates declined, they did so because public savings declined faster. Mwega (1997) conducted a comparative analysis of average private saving rates in 15 African countries and found evidence that saving rates were unambiguously lower than in other developing countries. The important issue for Africa is why private savings, dominated by household savings, do not rise fast enough to offset the negative trends in public savings.

A low saving rate among households does not necessarily mean African households do not have assets. A major problem is indeed the non-financialisation of assets reflected in relatively low M2/GDP ratios. From a number of household surveys carried out in several countries, households show assets that are in excess of 30 percent of their incomes (Aryeetey and Udry, 2000). In the analyses of Ghanaian data, Aryeetey and Udry (2000) find that it is only among the wealthiest 10 percent of rural households that financial assets begin to move with income changes. What this reveals is that, there is a certain income threshold level that has to be crossed before households can afford to hold the financial assets required for generating most investments. In other words, the high level of poverty makes relying on households to provide financial resources unrealistic at this stage.

3.2 External Trade Resources: Reducing the Current Account Deficit

For many countries, the largely negative current account balance for most of the last three decades shows relatively little change in the structure and composition of both exports and imports. Most countries are still heavily dependent for export earnings on a very limited number of primary commodities, which fail to provide either a stable or a growing source of revenues.

With an average current account balance of -3.8 percent of GDP for the period 1990-2000 for the whole of Africa, the need for external flows has remained significant. While the export of goods and services grew by only 1.9 percent in 1980-90 and by 4.0 percent in 1990-2000 for the region, this grew by 8.8 percent in the earlier period and by 12.8 percent in the latter period for East Asia and the Pacific. Figures for Africa show a significant drop from the figures for the 1960s when they grew by an average of 6 percent per annum. A number of the East Asian and Pacific economies managed to move from being primary export producers in the 1960s and 1970s to become major exporters of manufactured goods. Indonesia, Malaysia and Thailand raised the share of manufactured exports from less than 6 percent in 1965 to 56 percent, 80 percent and 74 percent respectively in 2001. In contrast, the share of manufactured exports for African countries was only 32 percent, and drops to less than 10 percent if South Africa is excluded.

What is remarkable about the poor external performance of African economies is the fact that aside from being unable to match South-East Asia in the area of manufactured exports, they also lost ground with the export of primary commodities, as Africa's competitiveness in world markets decreased. The export of traditional export commodities such as cocoa, coffee, rubber, spices, tin and tropical vegetable oils declined throughout the 1970s and 1980s. This happened at the same time as Malaysia, Indonesia and Thailand raised their shares in the export markets for the same items. While the export of primary commodities has declined in value for many African countries, they continue to dominate their external trade, accounting for 83 percent of all exports in 1970 and 76 percent in 1992. Africa's overall share in world exports fell from 3.7 percent in 1970 to 2 percent in 1998, and has risen only marginally since then.

Undoubtedly, one of the critical factors responsible for the unchanging structure of Africa's trade patterns has been the lack of openness in economic policies pursued over a much longer time span. Countries did not invest in enhancing export performance in the 1960s and 1970s when many countries followed inward-looking import-substitution policies. By not investing in infrastructure to facilitate exports, and by not developing appropriate export-enhancing policies, the competitiveness of the marginal African exports became completely eroded by the early 1980s when many countries began to undertake economic reform programmes. Unfortunately, the reform programmes of the 1980s did not address all the problems confronting export diversification. These need to be addressed now.

3.3 Capital Flows

African countries have not been able to offset the large negative current account balances with significant growth in capital flows. In the 1980s and the early 1990s, Africa's share of foreign direct investment to developing countries was under one percent of the estimated total of around $200 billion per annum (Collier, 1994). This was despite the fact that private capital flows into the developing world grew remarkably in the 1990s.[3] FDI to low-income countries rose from $5,732 million in 1990 to $53,517 million in 1998, an increase of over 800 percent. For sub-Saharan Africa, however, FDI only rose by $834 million to $4,394 million, i.e. at half the rate of growth to the rest of the low-income world. By 1998, FDI formed only 7 percent of GDI in sub-Saharan Africa and 1.3 percent of GDP, compared to 12.4 percent and 3.9 percent respectively in East Asia. Trends in North Africa (classified together with the Middle East) were better than for sub-Saharan Africa.

[3] There is, however, a growing view that private capital flows to Africa are much larger than data from international financial institutions suggest. Bhinda *et al.* (1999) suggests that FDI flows to Africa more than tripled in the 1990s and that the growth rate was comparable to that in South-East Asia and Latin America. They note that "FDI is diversifying its source and recipient countries and sectors, largely due to innovation by non-OECD investors". The underreporting by countries is attributed to a poor monitoring capacity.

Foreign Direct Investment

A number of studies have shown that FDI usually flows to countries that are experiencing growth (UNCTAD, 2000). It is, however, important to observe that significant and consistent growth does not necessarily lead to equally significant growth in FDI, as the experience of Ghana in the second half of the 1980s and early 1990s quite clearly showed. Despite the fact that Ghana's GDP growth rate was on average 5.5 percent for the period 1984-91, FDI only moved from 0.4 percent of GDP to 0.7 percent.

But there were some new and interesting trends in FDI flows shortly before the Asian crises. The sources of new FDI had begun to vary considerably. Whereas for most countries, the sources have traditionally been the previous colonial powers, these seemed to have changed considerably for a number of countries. Thus, Malaysia became a new source of FDI to a number of African countries, including South Africa. Australian and Canadian firms also become important sources of FDI in the mining sector, just as South African firms began to move into the brewery and service sectors in many African countries. Nigeria nevertheless remains the largest recipient of FDI, but this is not diversified and is mainly restricted to the extractive sector of the economy. One lesson from the new trend is the fact that countries will have to look at many more countries than they have traditionally dealt with. What remains equally important is the need to diversify the countries of origin as well as the economic sectors in which they operate. Using FDI to access technology remains crucial in the search.

The perception that Africa attracts far less private capital than it deserves has been attributed to its not being "structurally able to assimilate these large flows" (Aron, 1996).[4] From the mid-1970s, monetary and fiscal policy continued to be loose, while trade and exchange controls prevented the adjustment of the exchange rate. Unlike the situation in East Asia, the deterioration in the terms of trade coupled with high inflation ensured that the real exchange rates appreciated rapidly, forcing significant macroeconomic instability. With the deterioration in national economic management in most of Africa, aggravated balance of payments problems and fiscal deficits, the continent saw considerable capital flight instead.

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[4] But Bhinda *et al.* (1999) believe that this is due mostly to poor information being sent to investors all the time about Africa.

Other Private Capital Flows

Portfolio investment in sub-Saharan Africa in 1998 amounted to $250 million worth of bonds and $679 million of equity. This had dropped from almost five times the amount in 1995. By 2001, bonds amounted to $1,938 million and equity – $960 million. For North Africa (together with the Middle East), equity holdings were only marginally higher than SSA while far more bonds were available. The East Asia and Pacific region attracted $1,870 million of bonds and $9,007 million of equity holdings in 1998. Equity holdings rose to $19,254 million in 2000 in East Asia and the Pacific. Africa's share of private flows to developing countries has averaged 1.6 percent in the last decade.

While bonds and equity capital are very much missing in African countries, they seemed to diminish further after the East Asian crises. Indeed there are indications that portfolio investments were beginning to rise in Africa up to 1996, with Bhinda *et al.* (1999) suggesting that they were the fastest growing source of private capital. Africa definitely was affected in no small way by the shrinking that has followed in the emerging capital markets.

The serious impediments and challenges facing African financial systems can be summed up as follows: fragmentation, illiquidity, informational inefficiency, limited size and capacity, underdevelopment of human capital, inefficient regulatory schemes, excessive risk factors, dearth of risk-sharing and hedging mechanisms, legal and contract enforceability issues. The irony of the developments in global capital markets is that they are occurring at precisely the time that many African countries are attempting to develop their own capital markets. Reforms of the 1980s yielded a positive outcome in terms of growth of the number of stock markets. There are about sixteen stock markets, and they have become a basis for the commensurate introduction of Africa-based funds trading in New York and Europe. The stock markets have emerged as a real potential for integration of Africa into the global economy. However, the markets remain the smallest of any region in terms of capitalisation, except South Africa and are very illiquid (Senbet, 1997).

3.4 Official Development Assistance: Historical Trends

Having benefited very little from the growth of private capital flows to the developing world in general in the 1990s, Africa has continuously had to use official development assistance to make up for the shortfall in resource flows. This is in spite of the fact that aid was insignificant up to the mid-1980s. In the 1990s, Africa, on a per capita basis of $40, was the largest recipient of ODA. In current prices, net ODA for Africa from all donors more than doubled from $7,395 million in 1980 to $18,155 million in 1994. That was the peak. By 1997, current net ODA flows amounted to $14,212 million. There is every indication of decline as net ODA, which amounted to 10.7 percent of GNP in 1990 fell to 5 percent of GNP in 1997. Incidentally, ODA amounted to less than 1 percent of GNP for East Asia and Pacific, and only 0.8 percent for South Asia in 1997. While aid to most of Africa was increasing in the 1980s, it was understandably shrinking in the high-performing South-East Asian economies.

More than a half of net ODA to Africa came from the DAC donors, while multilateral donors provided a little under a half, with the small remainder coming from non-DAC donors. It is interesting that in the 1990s, Japan emerged as one of the leading bilateral donors to Africa, having taken over that role from the traditional colonial powers in many countries. One of the lessons from the application of Japanese aid in Asian development is that it is possible to use aid as an instrument for jump-starting the growth process, so long as domestic conditions are made conducive to achieving aid effectiveness. In effect, ODA can and should play a useful role in the financing of African development, but there is a need to define the exact role that such assistance will play and a development of the necessary policy and institutional environment.

Recent Trends in ODA and the Millennium Development Goals

Total ODA was $57 billion in 2002, with only about 41 percent going to sub-Saharan Africa. As discussed earlier, it is reckoned that a doubling of it would suffice for annual development needs up to 2015. Currently a half of total ODA comes from the EU and its member states, and a quarter from the United States. The ODA amounts in the last couple of years reflect a marginal increase over the 1990-97 average of $55 billion. As a proportion of the gross national income of donor countries, ODA fell from 0.33 percent in the mid-1980s to 0.23 percent in 2002. Only the Nordic countries, Luxembourg and Netherlands are able to meet the 0.7 percent target.

But there is in general greater enthusiasm to increase ODA allocations currently. Prior to Monterrey, the EU committed itself to raising its ODA to 0.39 percent of Gross National Income, from the then figure of 0.33 percent. Three countries gave firm dates to reach the UN 0.7 percent target, namely Belgium, Ireland and France. Significantly, the US Government announced that it would increase its core development assistance by $5 billion annually, through the establishment of a new Millennium Challenge Account. The new Account is distributed to developing countries showing a strong commitment to "good governance, health and education, and sound economic policies". Observing these changes, the World Bank commented that, "a return by donors to their early-1990s average aid ratio of 0.33 percent of GNP would provide an extra $20 billion" (2001, page 89). It is estimated that if the average ODA from DAC countries could be raised to 0.5 percent of GNP, then the $50 billion additional ODA would be realised. This would then make the search for alternative sources redundant. Atkinson (2004) notes that, "The funding of the MDGs could be achieved solely by increasing ODA. At the same time, it would require a step change from the present, going considerably beyond what has so far been promised. Growth of ODA at 4.9 percent per year will require 14 years before ODA is doubled, and by then the target date of 2015 will have passed. The widening of the circle of aid donors is going to take time. Time is however of the essence. For this reason alone, it is necessary to consider new sources".

3.5 Reversing Capital Flight

Capital flight refers to large private capital outflows from developing countries. It is a problem inasmuch as the outflows present major macroeconomic problems for those countries. Claessens and Naude (1993) carried out estimates of capital flight for various countries that suggested that capital flight in the preceding decade had been more of a problem for some African countries than it had been for South-East Asia. In 1981-91, Nigeria was the seventh largest source of flight capital in the world, with an average annual flow of over $2800 million. The stock of capital flight at the end of 1991 for sub-Saharan Africa represented more than 85 percent of the region's GDP. The situation was worse only in the Middle Eastern and North African region, with the region's capital flight stock equivalent to 118 percent of 1991 GDP. South-East Asia had a capital flight of only 15 percent of 1991 GDP, which was the least in the developing world. More recent figures by Ajayi (1997) placed the stock of flight capital at $22 billion, which is more than has been estimated as required to fill the resource gap. Collier and Gunning (1997)

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reckon that African wealth owners have chosen to locate 37 percent of their portfolio outside Africa. This share is compared to 29 percent for the Middle East, 17 percent for Latin America, 4 percent for South Asia, and 3 percent for East Asia. For individual countries, we note that Gabon, Nigeria and Uganda were included in the top-ten countries for the ratio of capital flight stock to GDP in 1991. Gabon had a stock of capital flight that was almost triple its 1991 GDP. Nigeria and Uganda had the equivalent of about 150 percent and 140 percent respectively of their 1991 GDP staying out. Other major sources of capital flight from Africa in the 1990s have been Zambia and Sudan.

Ajayi (1992) indicated that trade faking was an important vehicle for capital flight in Nigeria. For the period 1970-89, he suggested that "a significant amount of under-invoicing of exports and over-invoicing of imports took place" (p.59). Exports were under-invoiced to the tune of \$8.2 billion while imports were over-invoiced by up to \$5.96 billion. Most of this was related to Nigeria's oil trade. He concluded that domestic macroeconomic policy errors were largely responsible for the capital flight. These included high inflation, exchange rate misalignment, fiscal deficit and the lack of opportunities for profitable investment in the domestic economy. There are indications, however, that criminal transfers arising from political malfeasance and corruption are also a major source capital flight in many countries, and these have to be dealt with differently through the institution of sound governance structures.

Some recent studies have suggested that if there were to be a reversal of capital flight, the private capital stock of most of Africa would go up by as much 64 percent (Collier *et al.*, 1999). The issue that this raises is how best to achieve such reversals. There are, obviously policy as well as institutional issues, to be taken care of.

3.6 Debt Relief

High debt stocks and high interest rates have combined with increasingly adverse terms of trade to make debt service unmanageable for Africa since the 1980s. Despite repeated debt rescheduling facilities, the total external debt of Africa rose by 278 percent from \$60,820 million in 1980 to \$230,132 million in 1998. That of East Asia and the Pacific went up faster by 609 percent from \$94,080 million to \$667,522 million for the same period. While African debt has been smaller in magnitude and grew far slower in the last decade than that of South-East Asia, difficult debt management in Africa was reflected in the higher debt burden. The present value of debt as a proportion of the exports of goods and services exceeded 200 percent for most African countries in the 1990s. For Malaysia, this was only 33.6 percent in 1995 and for Thailand 77.6 percent. Although the debt service ratio (to exports) of 30 percent did not vary much across the developing regions on the whole in the 1990s, the faster growing economies of South-East Asia have been better able to sustain external debt with growing earnings from exports than African economies. Also, while most of African debt (77.5 percent) has been long-term debt and 74 percent of it is public, the problem is made grave by the capitalisation of interest and principal arrears. These make almost 25 percent of the total external debt currently.

The sustainability of most of African debt has for long been one of the critical issues on the international development agenda as most countries have had to continuously deal with several intractable external debt issues. The region's debt is judged to be unsustainable, particularly in relation to the current growth requirements.

Africa has not seen much debt relief over the years despite a lot of rhetoric in this area. The best known of the more recent initiatives is the HIPC initiative launched in 1996.[5] While the original programme was the first comprehensive debt reduction programme from the donor community for highly indebted countries that satisfied a number of policy criteria, it was received with little enthusiasm in the region in view of the perceived difficult conditions for eligibility. In a revised version that has been agreed with African leaders, the enhanced HIPC initiative is generally regarded as more flexible.[6] The interesting thing about the enhanced initiative is its link to the preparation and implementation of Poverty Reduction Strategy Papers in countries. While it is true that African leaders have endorsed this new initiative and the link to poverty reduction, it also remains true that its operationalisation

[5] Phase 1 of HIPC required a 3-year record of compliance with an IMF programme that leads to a decision point. Acceptance at this stage required countries to show they were beyond debt sustainability by having a debt service ratio of 20-25 percent of exports and a present value of debt-to-export ratio of 200-250 percent. This entitled them to a two-thirds reduction of all external debt stock. In Phase 2, another three years of an IMF programme and an acceptance into the category was expected to lead to an 80 percent reduction in debt stock.

[6] The requirement for the present value of debt to export ratio has been reduced to 150 percent, while debt relief commences from decision point and the length of the interim period is based on the achievement of specific development actions.

would be problematic for many countries in view of the uncertainty associated with the road to poverty reduction and the medium-to-long term nature of it. It is certainly not clear what standards will be used to measure poverty reduction that will facilitate unconditional relief.

But beyond the issue of operationalisation, considerable doubt has been expressed about the ability of the enhanced HIPC initiative to provide a lasting exit from debt problems (USGAO, 2000 and UNCTAD, 2004). This is mainly because there has to be strong and consistent growth in the economies but there is no guarantee that debt relief that provides resources for poverty reduction will automatically lead to sustained growth. There are many other investments that African governments need to make in order to ensure that. That also means that many beneficiary countries will still have to borrow extensively in order to meet other obligations, a process that would likely endanger their debt position. Other concerns relate to the resource-intensity of the PRSP preparation process in countries and how the focus on satisfying this requirement could affect the need to develop longer-term growth and development frameworks. In a number of countries there is already tension between country ownership of the PRSP process and donor support for it, as the process seems to have created a new consultancy industry in the donor world. We note here that in the UNCTAD (2004) report on Economic Development in Africa, there are a number of reservations mentioned about the efficacy of the enhanced HIPC initiative. These include (i) inappropriate eligibility and debt sustainability indicators that exclude domestic debt (ii) the use of overly optimistic growth projections (iii) insufficient interim debt relief, (iv) problems in the delivery of HIPC debt relief, (v) the limitations of the burden-sharing concept, and (vi) inappropriate use of discount rates for the calculation of NPV. There is merit in the UNCTAD argumentation, particularly in respect of the issue of domestic debt and the difficulties with the debt sustainability indicators. The main issue remains, however, how to make debt relief growth-enhancing in order to facilitate the achievement of sustained poverty reduction.

4 Development Finance in the Absence of Change

A number of studies suggest that without any dramatic change in current approaches to the financing of investments and other expenditures in Africa, the current volumes and sources will shrink even further (Geda, 2000).

4.1 Domestic Resources

On domestic financial resources, it may be noted that rising rates of poverty would mean that the growth of financial assets among households will be far slower than it is presently and also than is required. The situation is worsened by the fact that structural and institutional factors also play a major role in keeping households from financialising their assets. There is ample evidence that financial sector reforms of the last decade have not resulted in significant resource mobilisation in most countries. While fragmented market structures provide little incentive to financial sector operators to seek marginal savers and borrowers in view of relatively high transaction costs, it is unlikely that those market structures will change independently of the structures of economies. In a sense, there is a vicious circle that makes it excessively difficult to mobilise domestic resources, particularly from households. In the case of public savings, there are indications from the structure of public accounts in most countries that the nature and weight of the expenditure burden on the African state make it extremely difficult for governments to consistently achieve some savings. This is not likely to change in the absence of steady and significant growth.

4.2 Export Revenues

In terms of export revenues, while considerable hope can be held out on account of on going attempts to diversify exports through the development of non-traditional items, the medium-term prospects are quite mixed. While the passage of the Africa Growth and Opportunity Act in the US offers considerable opportunity for strengthening the exports of shoes, textiles and leather products, there is also little understanding of the benefits of the Act among business communities; and indeed, there are few structures in the region for drawing the attention of business people to it.

Other problems with the development of exports remain what may be seen as the protectionist stance of many African economies, despite the considerable liberalisation of trade and exchange rate regimes in the last 10-15 years (O'Brien, 2000). Indeed trade regimes vary extensively across Africa and the degree of openness is lower than in other regions. Thus, "at present, despite considerable reductions in trade barriers over the past decade, most African countries impose fairly high barriers through tariffs and export taxes or through managed exchange rate arrangements" (Oyejide *et al.*, 1997, p.16). Tariff levels in Africa are some of the highest in world trade. Even though there has been significant rationalisation of tariffs and in the number of tariff categories, nominal average tariffs have not declined much in Africa, averaging 40 percent in the 1990s, which is not much different from what they were in the 1980s.

But while African countries may consider the lowering of tariffs in order to fall in line with WTO regulations, it is important to point out that it will not necessarily lead to a rapid expansion in exports. The need to develop suitable production structures for facilitating exports development suggests that financing development from this angle should be seen as a medium-term engagement rather than an immediate one.

4.3 Official Development Assistance

Can Africa expect increased official development assistance in the short term? Despite the very strong case made by UNCTAD (2000) for a doubling of aid to Africa in the short-medium term in order to generate the growth that will attract private capital flows, there is still scepticism about the willingness and capacity of the donor institutions to respond positively to that gesture immediately. On the side of willingness, frequent references to *aid fatigue* and *aid dependency syndrome* in the popular press as well as in academic documents, are used as indicators of a perceived growing unwillingness to raise aid volumes significantly in the short-medium term (Cho, 2000). This is tied to the growing perception among taxpayers in the western world that their governments commit enough already to African countries and the results from these endeavours are not significant (World Bank, 1999). With respect to the capacity to provide additional funds, it may be noted that the US General Accounting Office (USGAO, 2000) raised doubts about the capacity of both bilateral and multilateral agencies to provide debt relief if they were to continue with their already agreed programmes of assistance. They show that three of the four largest multilateral creditors face financing gaps while the bilateral donors face additional budget costs that have to be funded. The suggestion that the USGAO makes is that the capacity of aid institutions to provide additional assistance is limited but requires review. This is not likely to take place immediately without sustained pressure from the entire region and its partners.[7]

[7] This is in spite of the proposed International Finance Facility and the Millennium Challenge Account.

4.4 Private Capital Flows

What are the prospects for FDI and other private capital flows in the short-medium term? The question that needs to be asked alternatively is whether African countries can position themselves to attract private capital. The UNCTAD (2000) argument that private capital will be attracted if there is significant and consistent growth in economies obviously requires careful scrutiny. While growth may attract private capital, there are obviously many other structural and institutional requirements that need to be fulfilled. A number of studies have suggested that "Africa is too risky" (Senbet, 1997). What is the nature of the risk faced by private investors? At a more fundamental level, high macroeconomic instability leads to high volatility in the financial markets. The existing evidence suggests that country risk, by implication, macroeconomic risk, is the predominant source of variation in stock returns across countries (versus industry-specific shocks). However, macroeconomic or fundamental risk is not the only risk faced by African economies. Other categories of risk include political risk as investors are concerned about risk associated with the probability of adverse changes in government policies; foreign exchange risk as local currencies face unhedged currency exchange volatility; and the risk of Afro-pessimism or Afro-contagion arising out of the images of war, famine, massive corruption, failed projects, poor governance, etc. (Aryeetey and Senbet, 1999). Unfortunately, perception becomes reality in an environment characterised by grossly imperfect information. Without an elimination of the high-risk perception it will be difficult to attract private capital.

4.5 Capital Flight

Are there any prospects for reversing capital flight? Incidentally, the conditions that will lead to attracting private foreign capital are the same ones that will lead to a reversal of capital flight. The evidence from other regions, such as Latin America and East Asia, suggests that globalisation of local markets leads to large reversals of flight capital.

Given that Africa stands within the top tier of regions in terms of flight capital stock per GDP, there is a potential for significant reversal of flight capital, if the region becomes sufficiently integrated into the global economy, of course mindful of the broader implications of such globalisation.

4.6 Debt Relief

Discussions of debt relief often present room for optimism. This is largely because debt relief for Africa has managed to find its way onto the agenda of most major international meetings to discuss global development, including those of the G-8 countries. For the UN Millennium General Assembly, the issue of debt relief for impoverished nations has been one of the issues strongest on the minds of leaders. The focus on debt relief in different forms, including debt cancellation, has received considerable attention largely as a result of the pressures from a consortium of NGOs, governments and several humanitarian international agencies. But inasmuch as debt relief manages to get on the agenda of meetings, the resulting initiatives, if any, are often perceived to be inadequate in addressing the problems, in view of the magnitude and scope of the debt problems (USGAO, 2000). Thus, unless debt relief is structured in such a way as to reduce significantly the amount of borrowing that beneficiary countries have to endure and also promote growth, it is unlikely that significant financing of African development can come out of current initiatives.

5 New Initiatives to Enhance Development Finance

In making proposals for tackling the financing gap, the Zedillo Panel (2001) had a very comprehensive "plan" for raising the funds and also managing economies in order to make sustainable the fund-raising efforts. Indeed, they made provision for action in the following key areas:

- Policies in developing countries (including governance, macroeconomic and fiscal policy, social spending and financial system pension reform);
- Private capital flows (including actions by developing countries, actions by industrial countries, actions by international community;
- Trade (including "development round" of negotiations, measures for least-developed countries);
- International development cooperation (including estimates of need, further debt relief for highly indebted poor countries, making aid more effective, and a campaign for the MDGs);
- Systemic issues (including a Global Council and Globalisation Summit, support for multilateralism, faster reform of international financial architecture, reinforcement of the WTO, institutional response to environmental and labour issues, innovative sources of finance, the

role of an international tax organisation, and migration policies).

The Zedillo Panel suggested that, "many of the issues at the heart of development financing have to do with global economic governance. Economic and social policies are subjects not only of national but also of global governance. The dramatic events of the first half of the twentieth century taught nation-states that global interdependence without global rules and institutions is in nobody's long-term interest." They fully endorsed the need for a global rules-based framework, which is noted to have led to the building of the existing multilateral system. They suggested further that, "despite its shortcomings this system has made powerful contributions to the unprecedented progress and stability that much of humankind has enjoyed since the end of the Second World War." In effect, the world should seek solutions to the current financing problems from the same post-war multilateral spirit.

5.1 New Trends in Domestic Resource Mobilisation: The Promise of Microfinance

The biggest revolution in mobilising domestic resources in the last decade has been in the area of microfinance. Microfinance activities are definitely better known in Asia and Latin America than they are in Africa. The Webster and Fidler (1995) study of microfinance institutions in eight West African nations, showed countries with a good number of microfinance programmes, (including Mali, Guinea, Burkina Faso, The Gambia and Guinea Bissau), and others with very few, including Sao Tome, Chad, Mauritania and Sierra Leone. In Kenya, where K-REP, probably the best-known microfinance arrangement in Africa is located, over 300 microfinance institutions (MFIs) have been registered.

A number of evaluations of microfinance projects suggest that their practice has been less successful in Africa than in other developing economies, (Christen, Rhyne and Vogel, 1994). Microfinance programmes, derived from innovative schemes generally, are more likely to be born out of donor projects[8], and are not necessarily community-based. It may be observed that many African microfinance arrangements have benefited from best-practices developed in other developing regions, as they have indeed drawn ideas from more successful projects elsewhere,

[8] Of 62 microenterprise development programmes studied by Webster and Fidler (1995), 82 percent have a micro-credit component. As much as 52 percent offer exclusively micro-finance.

including the following: (i) the issuing of short-term loans; (ii) starting with small initial loans; (iii) concentration on small working capital to firms with proven track record; (iv) specialised services without targeting; (v) simplified services; (vi) localised services; (vii) shortened turn-around time for loan applications; (viii) motivation of repayment through group solidarity or joint liability; (ix) savings mobilisation from the poor; and (x) charging of full-cost interest rates.

But the biggest change outside of Africa, which is yet to gain root in the region, has been the involvement of more formalised financial structures, like banks, in the delivery of microfinance services. Indeed the last decade has seen a relatively rapid expansion in the involvement of formal financial institutions in poor countries in the provision of savings services to marginal customers. Financial systems are being re-organised to make them more efficient as formal institutions pursue marginal clients. A number of them continually search for possibilities to extend services to the poor without affecting costs adversely. Some also reckon that costs will inevitably rise and seek to design structures and organisations that will cover them. This expansion comes from the increasing acceptance of the fact that the aggregate volume of deposits from such customers in many countries is not insignificant (Nissanke and Aryeetey, 1994).

A major approach to mobilising deposits from small depositors by formal financial institutions involves the decentralisation of those services that allows most direct decision making to be done away from the centre of the institution. Such decentralisation may involve the *delegation* of decisionmaking authority to lower levels of the organisation, including greater authority at the branch level, the *deconcentration* of the organisations with the creation of semi-autonomous units within the institution or the *devolution* of authority to organisations that are basically outside of the institution. It would appear that the approaches of delegation and deconcentration are more widespread than the devolution of authority to external agents.

There are obvious advantages and disadvantages in whichever methods that formal financial institutions may choose for the decentralisation of their financial services in the pursuit of the marginal depositor. There are many bank chief executives that would be worried out about the kinds of incentives that branch managers may have to offer in order to attract more deposits from the poor, particularly if these are tied to lending programmes. Associated with the difficult management of incentives is the low calibre of personnel usually found in branches that are closest to poor and marginal customers. Similarly, giving greater authority to a semi-autonomous unit within the institution may introduce a problem of reduced accountability, and the cost of dealing with this may not be insignificant. Obviously if banks in Africa are going to get involved in microfinance, they will have to consider how best costs may be kept down without affecting the expansion of services to marginal clients.

5.2 New Initiatives in Mobilising External Resources

Since the Monterrey Conference, there have been several initiatives to put into action the ideals of that conference. Aside from the actions on debt relief, the most significant have been the several proposals discussed thoroughly in the Atkinson (2004) book. The work, which is a re-visit to several well-known proposals from a number of people and institutions, notes that, while the effectiveness of international organisations has been called into question, and the role and functioning of the United Nations is debated, the same international organisations are generally viewed as the key to the free movement of goods, services and capital. This is what the adoption of ambitious development targets in the form of the Millennium Development Goals is seen to represent. This idea matches with the consensus reached by the Zedillo Panel that multilateral action is required to deal with the financing problem that developing countries face. In this latter project, it is widely recognised that there is need to develop new and innovative sources of funding, both public and private, to be dedicated to social development and global poverty eradication. These ideas are reflected by Atkinson (2004) as follows:

> "The tension between these two forces pervades discussion of resources for world development. On the one hand, there is talk of "donor fatigue". Official Development Assistance (ODA) stagnated for many years until the recent upturn. The amendment to the IMF's Articles approved by the Board of Governors in 1997 allowing a special allocation of Special Drawing Rights (SDRs) remains unratified in 2003. Proposals for any form of global taxation meet immediate opposition from the US Congress. On the other hand, there is widespread appreciation of the need for new flows to allow the Millennium Development Goals to be achieved. There are interesting proposals for new sources of revenue such as a global lottery or the International Finance Facility. Individuals continue to support development charities. US billionaires are personally funding development and world health activities."

The new innovative sources that Atkinson (2004) and his team consider are presented in Table 1.

Table 1 Innovative Sources of Development Funding

Source	Description
Currency Transactions Tax ("Tobin tax")	Tax on short-term capital and currency flows at a uniform rate payable by all banks and foreign exchange dealers, collected on a national or a market basis, covering a range of transactions to be defined (spot, forward, future, swaps and other derivatives) (see Haq, Kaul and Grunberg, 1996; Spahn, 1996; Mendez, 1997; Patomäki and Denys, 2002).
Global environmental taxes	Tax on commercial use of hydrocarbon fuels according to their carbon content; tax on international air passenger mileage and freight transport (see Pearce, 1991; Poterba, 1991; and Cooper, 1998).
Global lottery or Global Premium Bond	Global lottery operated through national state-operated and state-licensed lotteries, with proceeds shared between national participants and an independent foundation established in conjunction with UN (see Ahde, Pentikäinen and Seppänen, 2002). Global premium bond, parallel to national bonds with lottery prises.
Creation of new Special Drawing Rights (SDRs)	New round of creation of SDRs as approved in 1997 but not yet ratified, with donor countries making their share available for development purposes (see Soros, 2002).
Increased private donations for development	Measures to encourage private funding of development through UN agencies. Global funds. Corporate sponsorship. Internet.
International Finance Facility (IFF)	Long-term, but conditional, funding guaranteed to the poorest countries by the donor countries. Long-term pledges of a flow of annual payments to the IFF would leverage additional money from the international capital markets (see HM Treasury and Department for International Development. 2003).
Increased remittances from emigrants	Logistics (reducing cost of remittances), financial institutions (encouraging repatriation) and citizenship rather than residence basis for taxation (see Bhagwati and Hamada, 1982; Mirrlees, 1982; Bhagwati and Wilson, 1989; and Solimano, 2001).

Source: Atkinson (2004)

On the *currency transactions tax or Tobin tax*, it is observed that James Tobin first put the idea forward as a way of curbing financial volatility and not as a means to raise revenue for development. This second potential outcome is generally seen as a by-product (Nissanke, 2003). While some have suggested a tax of 0.25 percent on each currency transaction, it is reckoned in the Atkinson report that a tax of 0.02 percent could easily raise \$28 billion in a year. While this tax is expected to generate a double dividend through a reduction in foreign exchange speculation as well as revenue generation, there is still a lot of debate about it. The debate revolves around the technical feasibility of it, largely in view of the fast development of financial markets. It is not clear how the various financial markets of the world will be affected, particularly if the introduction is not universal.

The main argument for *global environmental taxes* is also the expected "double dividend" as a result of both generating revenue and helping reduce environmental damage. The argument has been made at the national level for corrective taxes on environmental external diseconomies coming from the damage done to the environment. It is estimated that a tax on the consumption of hydrocarbon fuels that harm the environment will have a positive allocational effect as consumers switch spending away from polluting goods towards those causing less or no environmental damage. In view of the desirable nature of such a switch, the world obtains both the revenue and the environmental gain. "A global tax on carbon use at a rate equivalent to 4.8 cents per US gallon (approximately €0.01) levied only on high-income countries could indeed raise \$50 billion a year" (Atkinson, 2004).

On the *global lottery*, (see Addison and Chowdhury, 2003), it is observed that the use of these to raise funds for public sector projects is now commonplace. It is estimated that about \$120 billion is realised yearly from world sales of gaming products. Under the leadership of President Martti Ahtisaari of Finland, a proposal has been made by the Crisis Management Initiative for national lotteries to run national versions of a global lottery game. It is proposed that a part of the net proceeds will be transferred to the United Nations for development projects throughout the world, and this is expected to yield about \$6 billion annually. The main problems expected here are in terms of how low-income persons in developed countries may relate to this compared to the higher income individuals who may not show as much interest. There may also be difficulty arising from the competition with national lotteries.

The campaign for the issue of development-focused *Special Drawing Rights* (SDR) by the International Monetary Fund has been on the development agenda for many years. This was certainly reflected by the Brandt Commission's report (1970). SDRs are international finance instruments created for the purpose of providing an increase in the world stock of monetary reserves from time to time without making countries run surpluses or deficits. Indeed the idea behind the SDR is that large imbalances force countries to incur costs in earning or borrowing reserves, and this should be contained with the IMF allocation of SDR. Recent attention has focused on how SDR might be used for development finance as new allocations of SDR to developed countries may be donated to the funding of global public goods and to poorer nations directly. It is estimated that an amount of $25-30 billion could be raised from a new allocation, and this may be repeated regularly (Aryeetey, 2004).

The UK *International Finance Facility* proposal is intended to be a long-term but conditional funding guaranteed to the poorest countries by the developed countries. The target is to raise the amount of development aid from just over $50 billion a year in 2003 to $100 billion per year in the years up to 2015 so that the Millennium Development Goals can be achieved. In addition to being a significant increase in annual ODA for a limited period, it represents a pre-commitment to provide aid that allows the promises to be securitised. It also allows a substantial immediate increase in development spending. This facility effectively "front-loads" long-term aid flows. It has the advantage of not requiring universal agreement. It is generally seen as a simple and relatively unproblematic way of providing development finance. Most of the concerns expressed about it are to do with the absorptive capacity of recipient countries and what might happen to their macroeconomic conditions as a result (Mavrotas, 2003).

The idea of canvassing for *private donations* for international development has been spurred on recently by such initiatives as the UN Foundation set up by Ted Turner and the Gates Foundation by Bill Gates. While it is acknowledged that donations to charities are a well-established practice in the developed world, the use of such donations for long-term development is not that well established. In the US, more than 1.5 percent of national income is given to charitable causes. In examining the potential for expanded private donations for international development, (see Micklewright and Wright, 2003), the focus is on more generous tax incentives and various measures to encourage payroll giving, and the channelling of these donations into some global funds.

Remittances from migrants rose from $15 billion in 1980 to $80 billion in 2002 worldwide. They are second to only foreign direct investment as a component of external resource flows. Such remittances are used to finance consumption as well as for providing social protection in poor countries. They may also be a source of finance for capital formation helping to provide community infrastructure as well as funds for the finance of new enterprises. It is reckoned that the largest obstacle to further rapid expansion in the flow of remittances is the cost of such transfers. Solimano (2003) has estimated that total charges, including foreign exchange costs, for sending remittances through money transfer operators varies extensively by country of origin and destination and these could go as high as 14 percent for transfers from the US. Bringing such costs down in a more competitive transfer market is expected to yield a lot more remittances.

6 Hard and Soft Options for Financing African Growth and Development

In this discussion of hard and soft options, as indicated earlier, I refer to the mobilisation of domestic resources as the hard options in view of the significant structural and policy changes required for meaningful outcomes to be observed. Soft options refer to the additional resources that may come from re-adjusting developed country interests. Their availability does not in any significant way affect the economic structures of the donor countries. It is important to emphasise the point that Africa's future growth and development has a much larger scope than the MDGs require. That's what makes the hard options imperative.

In the hard option of generating financial resources from domestic assets, there are essentially two things to be considered, as we leave out the trade expansion discussion. The first is the financialisation of the significant household assets in order to enhance the flow of private resources. The second is a re-orientation of formal financial institutions to support the marginal client. Even though generating public savings is important, it is considered here to be inherent in any sound macroeconomic reform programme.

6.1 The Hard Option Financialisation of Household Assets

The composition of household assets reflects the return on different assets, the covariance structure of risks associated with the different assets, liquidity constraints, transaction costs, and production interactions between the different assets. Hence, it is possible to draw conclusions about the financial environment within which households operate by examining the composition of their portfolios. It may be noted that the economic turmoil that has characterised many countries in the last two decades has established the role of macroeconomic phenomena, as well as unstable politics, on household asset choice (Nissanke and Aryeetey, 1998). The choice is also affected by the cultural, demographic and other socio-economic characteristics of their communities. The agricultural production cycle and the risky environment within which they live create an urgent need for liquidity. The need for liquidity puts a premium on relatively liquid assets, often dictated by the seasonality of agricultural activity and the associated rural household income.

Is the predominance of non-financial assets in household portfolios a simple consequence of extremely low expected returns to holding financial assets? This brings into focus the role of interest rates and how they are perceived in small African economies in relation to the return on other assets. Various studies of saving in sub-Saharan Africa have come up with inconclusive evidence of how interest rates influence saving (Mwega et al., 1990 and Oshikoya, 1992). Obviously pervasive market failure in Africa makes the deposit rate an inappropriate tool for gauging the expected direction of people's preferences. Market failure forces the return on other assets to assume a greater role in asset allocation.

As households weigh the decision to put wealth into particular assets, the alternatives that they confront come with costs that are intrinsic to the transaction. One important source of such costs is incomplete information. Here, it may be noted that the nature of information possessed by depositors and deposit-takers as well as contract enforcement possibilities on the financial markets are crucial. If the transaction cost of holding a financial asset is perceived to be too high because there are no credible institutions, other assets would be given a preference.

What the above explanations suggest, in terms of policies and programmes to assist the process of making households assets financial are as follows:

- Reduce the risks associated with rural production (e.g. seasonality of rainfall) possibly through improved irrigation and other infrastructure, and technology application. This will reduce significantly the higher liquidity preference of households, at the same time that incomes go up in the medium term. Credit is often useful for reducing the idiosyncratic risks of poor households.
- Stabilise the macroeconomic environment that ensures that the returns on financial assets are relatively stable and predictable.
- Reduce the transaction costs of holding financial assets. Developing institutions that are not too far away from rural households and yet are cost-effective is the most sensible thing to do. This is what makes appropriate forms of microfinance essential.

In order, however, for any increases in the financial assets of rural households to benefit the overall development of the larger economy, it is important that institutional developments that take place are linked to the rest of the financial system in an integrated manner. The microfinance institutions will need to have a link with both the banking institutions and the informal institutions where they exist in order to be effective (Nissanke and Aryeetey, 1998).

6.2 Enhancing Microfinance through Greater Linkage to Formal Institutions

In the earlier discussion of decentralisation as a way of reaching marginal clients cost-effectively, we placed emphasis on known practices elsewhere that have yielded good outcomes, including the keeping of lean structures, accountability and incentives for increasing operational efficiency, streamlining of operations, and outsourcing and networking (See Wisniwski and Hannig, 1998).

The Use of Lean Structures

Keeping structures lean, particularly in rural areas, has led to substantial reductions in administrative costs in a number of places. But this cannot be pursued at the risk of neglecting essential aspects of the business of providing financial services. For lean structures, it is essential to have bank staff members that have above-average information to be used for making appropriate decisions, regardless of how far away they are from the centre. The experience of Hatton National Bank (HNB) in Sri Lanka illustrates how this may be achieved. HNB made important adjustments in its general rural operations – in the selection and training of staff and adapting deposit products to the programmes' target clientele, in order to build a sustainable microfinance programme.

The functional and operational structure of HNB takes advantage of external economies available from existing infrastructure of established branch offices. HNB senior management has shown continuing commitment to its microfinance programme and established a clear career-development path for the staff selected to carry out the programme. As the general rural credit programme is integrated with regular branch operations and HNB takes advantage of external economies from existing infrastructure in its branch offices, a cross-subsidy from other bank operations may exist.

Expansion depends on availability of knowledgeable mainstream bankers from regular operations and the ability to use the physical facilities and infrastructure of an HNB branch as the anchor for operations of other rural units. The latter is based on exploiting external economies in operations and facilitation in communications, reporting, accounting and internal control systems. Additional coverage of rural areas in a regular branch's market area has been achieved by opening more rural units attached to the branch.

The virtual lack of differentiation in the pricing of regular rural loans and deposits raises the issue of whether transactions costs are being adequately covered. This is not an easy issue to address since the rural loans are not isolated from the rest of regular banking operations. In theory, recovery of transaction costs should be managed with a transaction fee, lower interest rate or adjusting minimum deposit balance to qualify for interest payment. A clear objective and well-defined basis for motivation are core elements of successful microfinance programmes. Institutional commitment, operating autonomy and a management environment conducive to responsive business decision is indispensable.

Accountability and Incentives for Increasing Operational Efficiency:

The idea behind the creation of profit-centres within existing banks is that those centres will not be over-burdened with the "excess baggage" of the main organisation. By having such centres, it is expected that there will be a transparency of costs and that those involved at the centres will have a higher responsibility to perform. There are several examples in the microfinance literature about these attempts to improve upon operational efficiency, and while the best known are found in Asia, it is worth noting that recent innovations in Ghanaian rural banking offer some useful insights into how these are organised.

The biggest lesson to be drawn from the experience of the Atwima-Kwanwoma Rural Bank in the effort to introduce susu operations to its clients is the fact that the institution was willing to learn from the informal sector, adopting from informal savings collectors the practice of making daily collections. The daily contact with clients and potential clients through the susu collector facilitates easy marketing of the bank's products to several thousand people on a regular basis. The personal contact between the collector and the client is known to have influenced significantly deposit flows and sizes (Aryeetey, 1994).

Susu collectors have generally been known to have lower transaction costs per each dollar collected from depositors than regular commercial banks (Aryeetey, 1994), and when banks have adopted the practice their client base has expanded considerably. At the Nsoatreman Rural Bank, which also introduced susu services to clients using contracted independent collectors, each susu collector was able to expand the client base from 150 to 200 in a year. The expansion in total deposits was comparable to what has been achieved at the Atwima-Kwanwoma Rural Bank.

Streamlining of Operations

It has been considerably difficult for many banks to introduce new technology into the delivery of financial services to the poor in many developing countries. Aside from the known hardware problems, the difficulties arise from the dearth of critical information to be used in feeding the new technologies about financial transactions. It is interesting, however, that there are a number of initiatives that appear to have substantially overcome some of these known difficulties. A good example of the use of modern technology to reach small depositors is provided by Standard Bank in South Africa. The development of the facility was facilitated by the fact that the high costs of the ATM infrastructure ensure that the product's fees are prohibitive for the poor. Trying to contain the cost enabled Standard Bank to develop a new electronic product to reach a lower income group than any other banks had previously. Having first set up a "downgraded" service, the bank later brought its E-Bank back into the main organisation. The issue of whether or not to integrate services for the poor into regular operations is probably an important one to consider.

Outsourcing and Networking

There is ample evidence that outsourcing and the development of networks has become one of the commonest ways to decentralise the microfinance functions of banks. It often involves handing over key functions to other agents with greater experience and structures that have access to better information. In many countries, the use of self-help groups is a common way of achieving this arrangement. The experience of NABARD in India is insightful for discussions of the use of decentralised and effective institutions. There are a number of lessons to be drawn from the NABARD experience.

On the issue of why a bank should downgrade, it may be noted that formal financial institutions can be motivated to provide financial services to the poor, if they can achieve a cost-effective volume. The formal banking system has the technical expertise in financial services and management of financial resources, branches in rural and remote areas, regulation and supervision to ensure the safety of deposits, and funds to finance an expanding portfolio. What they lack is an orientation towards working with poor and underserved people. Using a lean structure that generates access to others is sensible and cost-effective.

The NABARD experience shows that advocacy alone may not be sufficient to widen the financial services to the poor. Convincing bankers to serve the poor also required a sustainable financial technology that could generate a large volume of deposits at low cost. In many environments, even a banker committed to serving the rural poor would find it difficult to cost-effectively manage large numbers of small deposits. Suitable product design, streamlined procedures and appropriate delivery technology can drastically reduce transaction costs and default rates.

How important is government support in delivering services with a lean structure? Government support is critical. Raising the programme to the level of a national priority and making it highly visible ensures that organisations that are involved are competent. Another chief task is to build the capacity of formal financial institutions to implement the technology. It is obvious that designing and launching such a programme is not easy; it is best to start small and test out concepts and models. We learn from the NABARD experience that apart from capacity building and advocacy, banks initially need financial incentives such as refinancing and risk funds until they are assured of the soundness of the proposition. The experience also shows that programmes will thrive in a climate of non-interference from the political establishment. Training groups to understand this can help them remain apolitical.

6.3 The Soft Option of Attracting Additional Aid

The literature on aid to Africa suggests that there have been two main constraints to an expansion in aid to the region. These are (a) doubts about the effectiveness of aid to a number of countries, and (b) related to that, "aid fatigue" which is reflected by the perception in donor governments and countries that Africa may have a bottomless pit for drawing aid.[9] But there are studies that show that different types of aid have varying levels of effectiveness, while different donor institutions are able to make varying impacts in different types of environments. What some of these studies and experiences suggest is that greater specialisation can help improve the effectiveness of aid (Carlsson *et al.*, 1998). It certainly stops the current situation of many donors running over one another and makes aid coordination even easier. Greater effectiveness following specialisation can also help place a lid at the bottom of the pit. This in turn can justify the needed expansion in aid flows. So the ultimate question for strategising becomes how to achieve the greater specialisation. The following proposals are put forward:

First, multilateral aid agencies, such as the World Bank, the African Development Bank and the European Union need to begin paying greater attention to aid that seeks to transform the infrastructural base supporting intra-regional flows of goods and services. Currently IBRD loans and IDA grants to sub-Saharan Africa amount to some $37 billion a year; and the amounts have stayed at the same level for close to a decade. These were spread in 16 different sectors, from agriculture to water and sanitation. Some of the largest beneficiary sectors were agriculture and transportation. This is not surprising considering the difficulty that most countries have with financing road construction. If the total IBRD and IDA facilities

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[9] See *Journal of African Economies*, Vol. 8, No. 4, December 1999. This is a special issue based on papers commissioned by the Economic Commission for Africa on aid effectiveness. The papers recognise the fact that the effectiveness of aid is enhanced by the prevailing policy environment as well the appropriateness of the institutional environment in which aid is applied. In an inappropriate environment additional aid is much less useful.

were raised by an additional $5 billion annually this would cover 12.5 percent of the estimated extra financing requirement of the region.

Second, it is proposed that for the purpose of specialisation and in order to boost growth, an increasing proportion of this amount be devoted to regional projects in the sectors of electric power and other energy, oil and gas, telecommunications and transport. This would improve immensely the effectiveness of World Bank lending to Africa as the specialisation leads to greater efficiency while permitting greater cross-border cooperation and trade. The funding going to countries may be devoted to supporting the productive sectors of agriculture and industry, and some social sector activity. It is important to emphasise the fact that it is the transformation of economic structures that will make the most impact in the campaign to reduce poverty. The African Development Bank and the European Union should also devote greater resources to promoting regional projects in the area of industry and environment. There is no doubt that such a re-focus of the institutions will require a re-writing of their articles of agreement but that can be arranged with participation of sub-regional bodies.

Third, bilateral aid agencies may continue to direct a greater share of their country assistance to social sectors. A number of studies (Carlsson *et al.*, 1997) show that bilateral assistance in the social sectors have tended to be more effective than multilateral institution interventions. Currently about 50 percent of DAC support goes into education, health and population, other social infrastructure and economic infrastructure. The rest goes into production, multisector activities, debt relief, programme assistance and emergency aid. Through interaction with various civil society organisations, some bilateral organisations have had a visible impact in social sector interventions. Again, many of them have had greater positive impact in some countries than in others.

Fourth, by common agreement with African countries, it could be organised for various "link arrangements" to be developed between specific countries to go into "partnerships for development" after an increase of 50-100 percent in the total DAC assistance to Africa. A 50 percent increase will provide another $14 billion for the pot, which together with the proposed World Bank support will make about 95 percent of the annual financial requirement. Within the proposed partnerships, focus will be on the social sectors for human capital development mainly and these may draw up to 70 percent of the partnership budget. The rest may be allocated to domestic infrastructure development, particularly roads, railway systems and other internal communications infrastructure.

6.4 The Hard Option of Attracting FDI and Other Private Capital

Long-term growth and development requires long-term private capital. Initially the objective in attracting private capital is to make up for the remaining 5 percent of required external funds. This share should then rise steadily to over 70 percent of net capital inflows as official assistance is reduced in the long term. While quite a lot has been written about how to attract foreign private capital, with emphasis on country risk minimisation, the development of infrastructure, appropriate macroeconomic policies with particular reference to stable exchange rates, etc. there are also opportunities for African states to do a bit more beyond the standard recommendations. Bhinda *et al.* (1999) indicates that improving information flows to investors is the first thing that African countries must do. They provide a list of approaches to removing structural barriers to FDI, measures for stabilising portfolio flows including stable institutions for contract enforcement and the need to improve credit ratings and the macroeconomic situation.

It is worth mentioning a piece of work titled "How Can Sub-Saharan Africa Attract More Private Capital Inflows?" by Bhattacharya *et al.* (1997). They suggest that "sub-Saharan Africa has no recourse but to tap private foreign capital to raise productivity levels necessary for sustained increases in living standards". They expected this to be difficult since many Asian and Latin American countries that were growing rapidly and far ahead of most African countries in terms of financial infrastructure were also targeting the same sources. They suggest that most African countries will have to undertake speedy policy and structural reform to attract private flows. They point out that at the micro level, sub-Saharan countries will need to take concerted action on many fronts: (i) improve infrastructure; (ii) strengthen banking systems; (iii) develop capital markets by accelerating the pace of privatisation and broadening the domestic investor base; (iv) formulate an appropriate regulatory framework and a more liberal investment regime; (v) introduce competitive labour market policies while creating and maintaining institutions for upgrading human capital; and (vi) reform the judiciary system and contain corruption.

In concluding, they stress the point that "a piecemeal approach, even one including tax holidays and other investment incentives, is unlikely to sway investor decisions and attract international resources on a sustainable basis". They also point out that "In sub-Saharan Africa, economic characteristics like output growth, openness, relative stability of real effective exchange rates, low external debt, and high investment rates have encouraged private capital flows. The first three of these have been crucial for drawing in FDI and the last two factors, coupled with output growth, have been particularly important for obtaining foreign private loans".

While it is possible for one to throw one's arms up in the face of the obviously daunting task, there are also clear indications of the things that need to be done at the minimum. There are three things that are non-negotiable in this regard: First, countries must have a strategic framework for industrial development and make clear choices about where and how they want foreign participation; these choices can then be reflected in the various incentive packages that countries may offer. Second, countries must have fairly stable macroeconomic regimes, governed in a transparent manner that keeps exchange rates stable. The approach to exchange rate determination must not be dogmatic but based on country capacity and its position in the world market. Third, the financial systems in African countries must be made more robust and in tune with global developments; thus there is no question about whether capital accounts should be opened, but more a question of the extent and the conditions under which this should take place.

The following suggestions are about some of the conditions that must prevail in both the banking sector and capital markets in order to facilitate the relaxation of capital account regimes, making such relaxation incremental and based on the day-to-day experience of countries, as well as the experiences of others. China's experience in this regard is very important. It is crucial that governments seek to improve the supervision and regulation of their banking sector by considering the appropriateness of such instruments or combinations of them, including:

(i) Asset Regulation: In regulating assets they should be designed not to homogenise all banks to some common pool of risk since banks are characterised by differential investment opportunity sets (e.g. rural banks versus urban banks);

(ii) Capital Regulation: Capital regulation is a useful scheme in terms of reducing risk shifting incentives. When banks' incentives are regulated through capital requirements, this gives them the freedom to pursue the activities that are unique to their investment opportunity set with the attendant risk (unlike the asset regulation discussed above). However, capital regulation has only limited effectiveness in controlling risk incentives; and

(iii) Market-Based and Incentivised Regulation: This may include incentive features of bank management compensation to make up for

the deficiencies in the regulatory schemes involving bank capital and assets. Bank regulation can be more efficient if it takes account the incentive features of compensation in pricing deposit insurance and disciplining bank risk behaviour. Market discipline may also be a way to regulate banking systems. Market-based discipline may come from globalisation. The discipline of the global market forces authorities to be more open and transparent. The policy implication is fairly straightforward. Encourage entry by foreign banks into Africa as a mechanism for pressure and market discipline. This is related to the issues of bank deconcentration and privatisation.

In order to enhance the capacity of the fledgling capital markets to attract private capital from outside, it is important that steps are taken to address the following:

(i) Public Confidence and Informational Efficiency: Public confidence is fostered by an even playing field, with strict enforcement of existing rules. There ought to be an independent judiciary strongly enforcing and protecting rights. The government's role is vital in this regard in ensuring enforceability of private contracts and accounting procedures and legal standards.

(ii) Efficient Capital Market Regulation: At the heart of capital market regulation is investor protection, particularly small participants in the market. Small investors need to be properly protected through strict enforcement of securities laws and regulations. African stock markets can harmonise laws and regulations toward international standards. Government regulation of securities markets should be more of an oversight function over self-regulatory agencies, such as the stock exchanges and brokerage industry.

(iii) Capital Market-Based Privatisation: Capital markets can be an important avenue for privatisation. Such programmes obviously contribute to the depth of the stock markets through increased supply of listed companies. Capital market-based privatisation provides an improved chance of fair pricing of the enterprises, and hence serves as an important means of de-politicising the privatisation process. In addition, privatisation through local capital markets allows for local investor participation and hence enhanced diversity of ownership of the economy's resources.

(iv) Regionalisation of Capital Markets: One way to address the thinness and illiquidity of African capital markets is for the various countries to pool resources for regional cooperation and capital market development. Regionalisation of African stock markets should enhance mobilisation of both domestic and global financial resources to fund

regional companies, while injecting more liquidity into the markets. The francophone example is worth looking at.

(v) Human Capital Development: Global capital markets have become highly sophisticated in recent years with the advancing information technology. They are increasingly characterised by advanced and exotic securities, including a variety of derivative securities, demanding that market participants stay abreast of recent developments in financial theory and practice. Adequately trained financial manpower should be at the centre of capital market development in Africa.

6.5 The Not-So-Hard Option of Making Debt Relief Lead to Increased Resources for Investment

As seen earlier, the main problems with the enhanced HIPC initiative is that countries will continue to borrow even as they receive relief in order to settle other obligations in the pursuit of poverty reduction goals. If payments on these slow down growth, as is expected, making an exit from the debt overhang becomes extremely difficult. The main question is how can debt relief be made growth-enhancing which should then be made to lead to poverty reduction?

First, debt relief must be recognised by creditor countries as additional to new and increased ODA with a focus on enhancing and sustaining both growth and poverty reduction explicitly. It is important that creditor countries do not take out of ODA funds to offset their commitments to the enhanced HIPC initiative.

Second, making debt relief pro-growth requires that relief must come early rather than later. Noting that interim debt relief is possible with interim PRSPs under the enhanced HIPC, the tension between quick debt relief and comprehensive country-owned Poverty Reduction Strategies is still quite real as countries divert their attentions and human resources for long periods to producing PRSPs at the expense of comprehensive medium and long-term development frameworks. The solution to this problem is to make countries focus on their medium and long-term development frameworks, showing the anticipated growth paths and how these provide for poverty reduction. Since many countries have already invested significantly in those medium and long-term development frameworks,[10] speeding up the process of qualifying

[10] This view was expressed by James Wolfensohn, President of the World Bank, launching the *Comprehensive Development Framework*, Washington D.C., 1999.

for enhanced HIPC support will simply be a matter of modifying (where necessary) the existing medium and long-term development frameworks to make the Poverty Reduction Strategy explicit and credible. The Poverty Reduction Strategy must be embedded in a long-term growth and development framework that provides for structural transformation. Indeed that is the only way poverty reduction is going to be sustained.

Third, it is important that a part of the freed-up resources from debt relief are channelled to the private sector for job creation purposes. Governments have to exploit such mechanisms as debt-equity swaps in as far as they promote private investment.

Fourth, improved debt management in African countries is very essential. Governments need to monitor closely future borrowing in order to prevent a re-occurrence of the debt problems. Borrowing must be in response to economic developments and based on ability to foster growth while reducing further poverty.

7 Summary and Conclusions

Despite the need for large multilateral support, it is clear that new actions have to be initiated by both African countries and their development partners to fill the identified financing gap. I have suggested here that while it is essential to mobilise all domestic resources or the task of reducing the resource gap, the structure of African economies would make this feasible only in the long term, hence the urgent need to mobilise external resources in the short to medium term.

In order to first reduce the resource gap and then attract the required external resources, have been called upon to improve the generation of financial resources from domestic assets in the medium to long term by taking steps to reduce the risks associated with rural production and stabilising the macroeconomic environment that ensures that the returns on financial assets are relatively stable and predictable. They are also expected to initiate policies that lead to a reduction in the transaction costs of holding financial assets through the development of appropriate institutions, including microfinance institutions.

The urgent need to attract additional aid is given considerable attention in this chapter. The objective is to make aid provide about 95 percent of the new required external finance after reducing the resource gap through enhanced domestic resource mobilisation and trade, while the remainder is drawn from the private sector. By 2015, most inflows should have private origins and aid would be entirely absent.

Beyond increased aid, however, faster longer-term growth and development require increasing foreign direct investment and other private capital. While this can immediately make up for the remaining 5 percent of required external funds, the objective should be to make private capital provide 70 percent of external finance in the medium term and 100 percent in the long term. Africa has to tap private foreign capital in order to raise the productivity levels necessary for sustained increases in living standards. For this, countries will need to take concerted action on many fronts including improving infrastructure, strengthening banking systems, developing capital markets by accelerating the pace of privatisation and broadening the domestic investor base, developing an appropriate regulatory framework and a more liberal investment regime, introducing competitive labour market policies while creating and maintaining institutions for upgrading human capital, reforming the judiciary system and containing corruption. It is important that these are carried out in a comprehensive framework and not in a piecemeal manner.

Our final point has been that the development partners should let debt relief enhance growth. I have suggested that the current framework for debt relief (i.e. enhanced HIPC Initiative) will have to be improved to enable it respond adequately to various development issues. The main issue is how to make debt relief growth-enhancing in order to facilitate the achievement of sustained poverty reduction. I have suggested that debt relief must be recognised by creditor countries as additional to new and increased ODA with a focus on enhancing and sustaining both growth and poverty reduction explicitly. It is important that a part of the freed-up resources from debt relief is channelled to the private sector for job creation purposes. Having made the above points, it may be observed that the 100 percent debt write-off that UNCTAD and others support is not a bad idea. The principle is hardly contested currently.

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11

Millennium Development Goals: Are They Adequate?

Roy Culpeper

There is much to be welcomed in Ernest's chapter. It provides us with a formidable *tour d'horizon* of the issues that confront financing development in Africa. I would like to underline his emphasis of the need to mobilise both domestic as well as external resources. In my view far too little attention has been put on the mobilisation of domestic resources and I will come back to this point in regard to the way that it is treated in Ernest's chapter. He situates the issues of financing in the context of the policy environment. This is important but it is also controversial as to what that policy environment should be. In short, the chapter offers a lot of food for thought and there are many points with which I agree.

Discussion About the Washington Consensus Is Missing

I would like to make first of all, the following point. The chapter's frame of reference for the policy environment is very much that of the Washington Consensus: the need for internal and external reforms, greater openness and liberalisation to the rest of the world, and so forth. It struck me when reading the chapter that there is little reflection of the debate that Latin Americans have undergone in the last decade on the Washington Consensus. John Williamson's book last year, co-edited with Pedro Pablo Kuczynski was very crucially entitled "After the Washington Consensus" and not "the Post-Washington Consensus". This drew attention to the fact that there is a debate in Latin America as to what the optimum set of reforms in Latin America should be. Ricardo

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Ffrench-Davis at ECLAC puts it very well when he refers in several of his recent papers about the need to "reform the reforms."

That debate has not yet taken root in Africa and it is overdue. Instead, we have seen the launch of the NEPAD initiative on which Ernest is strangely silent. But William Lyakurwa reminded us of the long litany of initiatives that have come out of sub-Saharan Africa, starting with the Lagos Plan of Action and AAF-SAP and so forth, all of which met with stony silence or resistance from the donor community. It is only when NEPAD came along a couple of years ago that the donor community embraced an initiative from African leaders because, unlike its predecessors, NEPAD articulates a policy framework that is much more consistent with the Washington Consensus in spite of the fact that outside sub-Saharan Africa many parts of the developing world have gone beyond that. So it is a bit ironic that finally when there seems to be more convergence between African leaders and Western and Northern donors, it is around a policy framework which itself might be questionable.

The Shortcomings of the Millennium Development Goals

I have some specific comments as to what is said in the chapter, as well as what is not said. I have been quite intrigued by the focus in the chapter on the target of achieving the Millennium Development Goals (MDGs) and I would just like to pose the question whether the MDGs should be the target. The MDGs are in a sense not adequate as a development target. There are broader and deeper goals such as achieving long-term sustainable growth at rates of 6 to 8 percent and related to that, a process of economic and social transformation which adds up to a much more profound agenda of change. I would even go further to say that the MDGs are at once both too ambitious and not ambitious enough. They are too ambitious in that they may not be achieved by many countries in Africa by 2015. The problem is that the costs of not achieving them may come in the form of disillusionment, accusations of failure and the withdrawal of donors from the development struggle.

Furthermore, the problems of development will not go away by the year 2015 and in that sense, the MDGs are not ambitious enough. The MDGs address the symptoms of development failure whereas the real challenge is to tackle the underlying root causes. The real challenge is not only to achieve the MDGs up to 2015, but go beyond them to the issues of transformation in the productive structure. In Africa, the discussion must come around to the centrality of agricultural transformation, because how can one presume any progress on the MDGs, most of all in poverty reduction, without a focus on agriculture? So the question of productive structure deserves a lot more attention than it has received.

A sort of threshold of growth is necessary but not sufficient. There has to be pro-poor growth, there has to be quality of growth, otherwise again we will be falling short of what needs to be done. I should add that the MDGs are actually quite controversial in many developing countries and among civil society organisations in particular. It is with some reluctance or disappointment that many countries or civil society organisations have taken up the challenge of the Millennium Development Goals, because they are competing against something else, and that is the war against terror. The war against terror has intruded into the space of the global development agenda and as a result, there is a compelling need to find a cause to enlist people in the struggle for human development, and the MDGs fit the bill.

Soft and Hard Options

The other point about what is said in the chapter relates to Ernest's "soft options" and "hard options." It strikes me that *all* the options are hard, with some of them harder than the others. However, I was quite surprised by which options are identified as soft and which options are hard.

It seems to me that the option of increasing aid is not "soft." Ernest says in his chapter that some 95 percent of the additional resources requirement should be secured through the aid channel, but this would be supremely difficult to achieve. When one considers innovative ideas such as the Tobin tax, the carbon tax, the arms trade tax, and the International Finance Facility (IFF), reviewed in the recent report that came out of the Lula-Lagos-Chirac initiative at the UN with support of the Secretary General, there are severe constraints, even with the IFF, the most likely of these options. For example, in Canada, it is a non-starter because of the way our accounting system is set up; the commitments to the IFF will have to be booked up-front rather than expended over the course of the disbursements by the IFF. So there is absolutely no advantage to Canada in adopting the IFF. Simply increasing aid is the most practical way to go.

But having raised the option of domestic resource mobilisation, the chapter should have taken the potential of domestic resource mobilisation a lot further than it does, and in a long-term framework. I stress a long-term framework because it is not possible to go from 10 or 15 percent savings and investment rates to a 25 or 30 percent rate in a short time. But it is quite plausible in my view to make such a transition in a 25-year time frame. But those efforts involve institutional transformation, and to some extent behavioural transformation. The East Asian example has been invoked several times in reference to countries many of which were as poor in the 1950s as African countries are today. They have been able to sustain a fairly impressive savings rate over several decades. What can we learn from that specific phase of the East Asian experience and how replicable is it in the African context?

On domestic resource mobilisation, more attention is needed to the taxation and revenue generation capacity of governments. This is very rudimentary in many African countries, leaving them chronically dependent on foreign aid, or worse, foreign borrowing. The tax and revenue generation capacity effort of countries will have to be deepened. But one cannot do that overnight. Why are donors, the Bank, and the Fund not addressing this issue by helping to create the needed tax-generating capacity? Despite all the talk about creating capacity, in this specific area of fiscal capacity building, much more attention is required.

In the chapter there is allusion to the hard option of FDI. In recent work undertaken by Matthew Martin for the North-South Institute, there was an interesting finding. In countries that had liberalised capital markets, capital outflows run at a fairly significant proportion of inflows, around 50 percent. So the net inflows from capital liberalisation are not nearly as impressive as the gross inflows. On top of that, there is also a problem of knowing what the actual numbers are, because of the difficulty of monitoring the level and the destination of capital flows to African countries – again, because of capacity constraints in African bureaucracies. This and other findings are being published in North-South Institute's *Canadian Development Report 2004*, which is on the subject of investing in poor countries.[1]

Missing Points

With regard to what is *not* said in the chapter, there is little about PRSPs. The point I would like to make is that the PRSP and the MDG campaign seem to be on two parallel tracks. One can say that "PRSPs

[1] North-South Institute, *Canadian Development Report 2004: Investing in Poor Countries: Who Benefits?*, North-South Institute, Ottawa, 2004.

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are from Mars and MDGs are from Venus." What we badly need is a much more coherent policy framework to bring them together. There is no reason, especially since the international organisations talk to each other and work with each other on those things all the time, that it should be so. Why are MDGs not much more central in the articulation of PRSPs?

The other point not made in the chapter is the need to address distributional issues more forthrightly. Some other work that the North-South Institute has done lately is on the potential and importance of land reform, particularly in sub-Saharan Africa. Land redistribution is something that the World Bank is now talking about, having eschewed it for the past 50 years because it was much too controversial, so now it is back on the agenda. It is not only important to look at financial fragility, but also important to look at real vulnerability. Hernando de Soto puts a lot of emphasis on the titling of real property so that the poor can use their property as a vehicle for credit mobilisations through the banking system. While I do not subscribe to everything that de Soto says, if one were to link land redistribution to resource mobilisation through the financial sector, the possibility of increasing domestic savings and investment rates certainly becomes much more feasible. Once again, there are lessons that could be learnt from East Asian experience, where land redistribution, growth and poverty reduction went hand in hand.

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Helping the Poor?
The IMF and Low-Income Countries

Edited by Jan Joost Teunissen and Age Akkerman

Development assistance shifted in the 1980s from financing investment to promoting policy reform, since it was believed that low-income countries were held back more by weak policies than by lack of finance for investment. However, the reforms of the 1980s and 1990s advocated by the IMF and World Bank have not brought the expected results. Poverty remained high and the economic reforms lacked sufficient political support.

At the end of 1999, the IMF and World Bank developed a new framework for their support to low-income countries in Africa and elsewhere: the Poverty Reduction Strategy approach. This new approach was meant to focus more clearly on economic growth and poverty reduction.

Helping the Poor? The IMF and Low-Income Countries discusses the successes, failures and shortcomings of IMF and World Bank support to poor countries. Analysing in detail the policies pursued by, especially, the IMF, the book reveals that the assistance has remained insufficient, often mal-directed and still too much inspired by beliefs held in Washington.

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