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The IMF and Poor Countries: Towards a More Fulfilling Relationship

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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 macro-economic 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.

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.

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
<i>Number of Arrangements as of April 30</i>					
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
<i>Amounts Committed Under Arrangements as of April 30</i>					
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

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 to 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

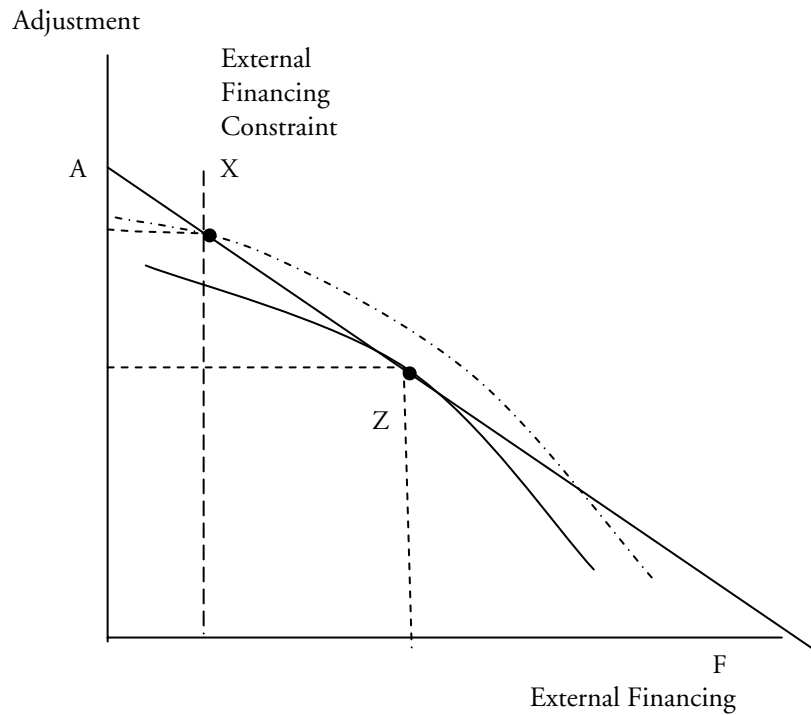
¹¹As noted earlier, studies of the prolonged use of IMF resources have identified these structural characteristics as being significant determinants.

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.

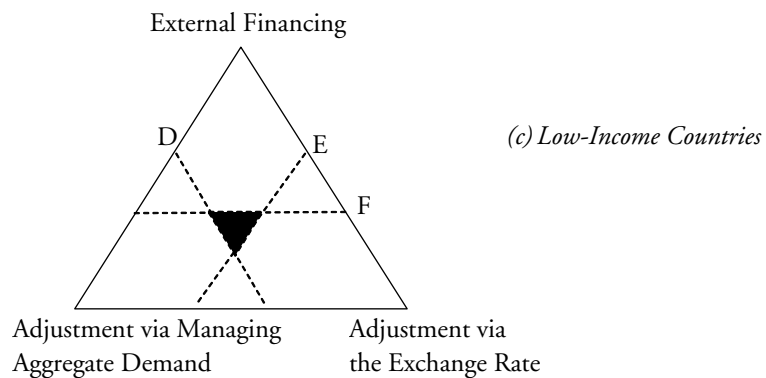
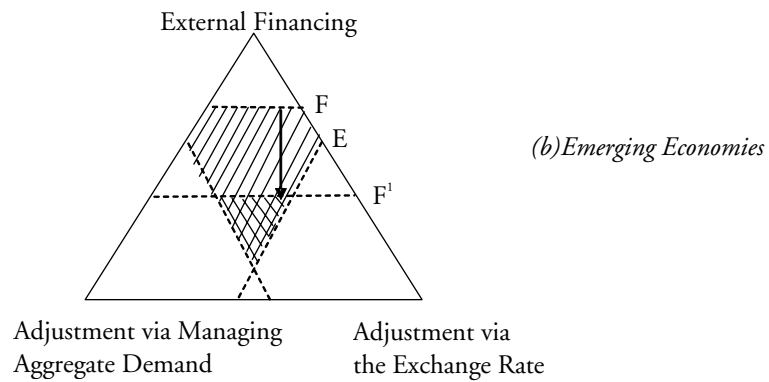
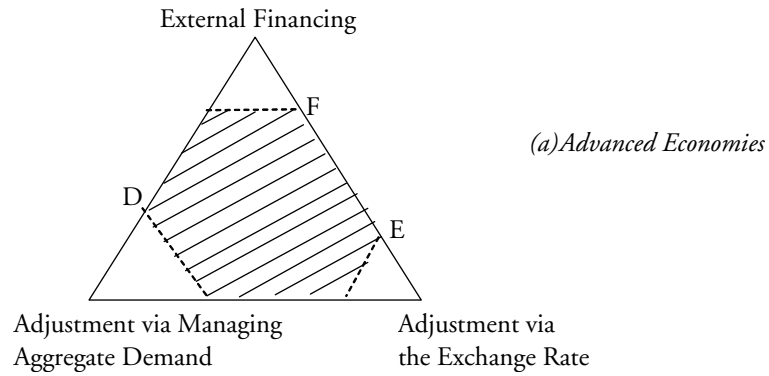
Of course, there are problems in defining an “optimal” balance of payments policy. Can this be done technically on the basis of economic considerations alone, or does it need to incorporate political economy

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, micro-economic 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 facie* 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.

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.

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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