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

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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

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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.

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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

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?

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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

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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.

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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.

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