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## Reviewing the Role of the IMF in Low-Income Countries

*Caoimhe de Barra*

In an era where “partnership” is the leitmotif of development discourse, the IMF stands apart. In a context of increased multi-donor initiatives to develop joint assistance strategies with partner governments, the IMF largely continues to operate in strict bilateralism, with a limited group of interlocutors in Ministries of Finance and Central Banks.

Tortuous debate on the role of the IMF in low-income countries has taken place at Board and staff level. At its most fundamental, the debate has been about whether the Fund’s role is to have a bilateral relationship with member countries only, focused on macroeconomics, or whether it should position itself as part of a multilateral framework, with a specialisation in macroeconomic stabilisation but a clearer focus on poverty reduction.

This chapter argues that the Fund has a contribution to make to poverty reduction and sustained growth, but that this is only possible if it operates as a partner with other stakeholders at both international and national levels. The Fund should remain focused on its core areas of competence but change the way it operates. To be effective its contribution needs to be coherent with a broader understanding of the nature of development and the political economy of growth and poverty reduction.

This chapter addresses some ongoing areas for debate around the role of the Fund in low-income countries. How should the Fund address poverty? What is the Fund’s role in mobilising finance for development? What are the changes in policy and practice needed to IMF conditionality? What deeper changes are required in the Fund’s signaling role?

## **1 The Role of the Fund in Poverty Reduction**

The primary role of the Fund in low-income countries should be to highlight to governments the implications of alternative macroeconomic policy paths and encourage governments to decide which path to follow, based on that government's consideration of the social, economic and political trade-offs involved, after a process of domestic consultation.

However, a narrow interpretation of this role is not tenable. While growth in many low-income countries has stabilised after a disastrous decline over recent decades, inequality and poverty have increased, even in stable performers with a history of social concern, such as Tanzania. Policies for growth and stability are not enough. Policies, including macroeconomic policies, must be expressly designed to achieve reduction of poverty and vulnerability. They should be subject to rigorous testing for their ability to meet those objectives.

The Fund faces a choice therefore, both in policy development and in application of policy at country level: it can take the option for the poor, or it can try to take a neutral position by adopting a minimalist, technical approach to growth and macroeconomic stability in low-income countries. As decades of experience have illustrated, however, there is no such thing as "neutral policy", economically, socially or politically. Indeed, the political economy of policy change has been a significant blind spot for the Fund.

Taking the "option for the poor" would mean considering vulnerability and inequality as important determinants of potential macroeconomic policy. The operational implications are that the Fund needs to ensure that its macroeconomic analysis is carried out in such a way as to allow multi-disciplinary assessment of the implications of its analysis and recommendations.

The Fund should subject its own work to independent analysis from a poverty-reduction and social vulnerability perspective, in order to ensure that the medium to long-term social and economic implications of its analysis are clear to policymakers and the stakeholders in the Poverty Reduction Strategy (PRS) processes, or its national equivalent. Indeed, the Fund promised no less than this when it included in the key features of the PRGF the promise to subject major reforms to Poverty and Social Impact Analysis (PSIA). To date however, this analysis has proven limited, dealing with a set of discrete structural issues in a small number of programme agreements. Certainly, there is

no sense that PSIA's would routinely be carried out on all major or contentious reforms, in spite of the clear "ownership" imperative of reforms arising from such work, particularly if that is carried out independently of the IMF.

In this chapter, I argue that the Fund should take a partnership approach to its role. This would mean taking a country-by-country approach to policy analysis, stimulating debate among a broad set of stakeholders through increased transparency and being seen to be open to national-level analysis and views. This is further elaborated below.

Institutional resources dedicated to low-income countries should increase, including delegating increased staff and analytical and decision-making capacity to field offices. This is a prerequisite for understanding the country-specific complexities of development in countries for which there are no easy parallels in development history.

## **2 The Fund's Role in Mobilising Finance for Development**

Low-income countries face a deep finance constraint that compromises their ability: to deliver on basic services; to develop sustainable institutions capable of managing scarce resources; to generate growth sufficient to eradicate poverty; and to plan for and withstand foreseeable shocks (see Trócaire, 2004; Oxfam, 2004a). This logic is broadly accepted, and has resulted in pledges of a doubling of aid to Africa by 2010 over 2004 levels, and an overall increase to \$115 billion by 2010, from \$78 billion in 2004. However, even this increase – assuming it is delivered – will be insufficient to meet the Millennium Development Goals, which are themselves a minimalist baseline.

The persistently binding financial constraint faced by low-income countries dramatically narrows their range of options both in relatively good times and when they are faced with a balance of payments problem. Chapter 8 deals with the phenomenon of long-term users of the Fund's resources and argues cogently for a reduction in dependence on Fund resources. These are valid arguments.

However, vulnerability to shocks will invariably lead low-income countries back to the Fund, unless radical solutions can be found, such as those outlined by Martin and Bargawi in this volume. The new IMF shocks instrument will do little to change the fundamental problem of the policy response to shocks, unfortunately. Demand compression tends to be the primary policy response to crises in low-income countries,

given the inadequate levels of finance available and the fact that adjustment based on exchange rate devaluation is frequently economically or politically inadvisable.

Demand compression is a highly questionable tool in such circumstances however, given its negative impact on economic growth. Low-income countries can find themselves locked into low-growth scenarios that could be avoided through adequate, early provision of liquidity. Bird (2005) argues in favour of increased finance rather than reducing aggregate demand therefore. And he is right.

Rather than a new Fund facility for shocks, it would have been preferable to establish a donor financed, grants-based shocks facility to deal with shocks as they arise in a manner that would protect progress made on the MDGs and stimulate a fast recovery.

Unfortunately, there is likely to be little movement on this for some time, therefore it is important to look at the Fund's role in helping to prevent or mitigate shocks and in mobilising the resources promised by donors in recent pledging sessions, including the G-8 meeting in Gleneagles in July 2005.

Aid flows are notoriously fickle; hence, "predictability" has become a central element in the aid effectiveness agenda. The Fund should focus on mobilising higher levels of stable resources through its illustrations of the economic effects of unstable aid flows, and in partnership with other actors, the social effects of chronic resource gaps. In the latest paper reviewing the PRSP approach, the IMF and World Bank (2005) call for alternative scenarios to be included in PRSPs, showing what could be achieved with a different combination of resources, policies and other public actions. There is clearly a mandate for the Fund to use its considerable muscle to advocate for more and better aid.

The Fund has several broad concerns on finance increases however, which may make this difficult. One of the most important is absorption capacity and macroeconomic destabilisation. Recent analysis by the IMF (2005A) highlights the complexity of the absorption issue and in particular shows that aid is not being spent, because countries are fearful of creating exchange rate imbalances and hampering exports. I believe that the answers to this problem are not to be found in limiting aid flows, but in marrying longer-term finance plans with programmes to dramatically develop economic productivity and export capacity.

The implications for the IMF are important. Firstly, it shows that a straightforward cap on the fiscal deficit which limits aid inflows is neither necessary – as countries seem to self-censor for fear of exchange

rate appreciation – nor advisable. It is not advisable as it forgoes opportunities for investment, growth and poverty reduction.

In practical terms, the Fund research suggests that there should be more flexibility in its policy recommendations, including allowing countries to spend unexpected windfalls and to draw down on reserves when aid shortfalls occur. However, the litmus test of this potential change in Fund thinking will be the content of Fund agreements and in particular the targets which are de facto conditions for an ongoing PRGF agreement.

### **3 What Are the Changes in Policy and Practice Needed to IMF Conditionality?**

The legitimacy and effectiveness of conditionality in general are heavily contested but a number of conclusions are by now axiomatic. For example, excessive conditionality is counter-productive and undermines ownership; conditionality should be streamlined across all donors and particularly the IFIs; all conditionality should be based on benchmarks drawn from governments' national development plans; and conditionality should be evidence-based and independent PSIA should be carried out on all major reforms.

Furthermore, it has become widely accepted that policy and process conditionality run counter to normal democratic processes at a domestic level and conditionality should therefore be outcome-based. Conditionality should take the local political economy and potential shocks into account and targets should be stress-tested for realism. Conditionality should be disaggregated so that failure to meet a small number of conditions does not result in aid volatility.

With respect to the Fund's conditionality, there is particular contention around two issues: firstly, as discussed below, the Fund implements conditions independently of other donors, in spite of the move towards harmonised approaches. Secondly, the assumptions used in the design of fiscal and monetary targets and their links to stabilisation, growth and poverty reduction are contentious. The flexibility granted to countries in meeting programme targets is also highly contested. This is particularly true for "poor" performers (Trócaire, 2004).

For example, Martin and Bargawi (2005a) found that the Fund seems to expect countries to reach 3 percent inflation and a 1 percent budget deficit after grants before allowing any room for flexible policies.

They assert that these levels may be too low to be compatible with the growth needed to reach the MDGs. Oxfam (2004, p. 17) found that out of 20 countries with PRGFs, inflation of less than 5 percent was targeted without any discussion of the trade-off between this reduction and poverty-reducing expenditure.

After many years of such critical comment, Fund research (IMF, 2005a) has recently come to the conclusion that an inflation rate of 5-10 percent is appropriate and that countries should be encouraged to aim to remain within this range, rather than to aim for a specific point. This is significant as inflation is one of the “sacred cows” in the Fund. Nonetheless, it is only a small part of a portfolio of analysis that needs to be radically different if countries are to achieve poverty reduction commensurate with the MDGs.

It is widely acknowledged for example, that growth targets for low-income countries should begin with the MDGs. The use of costed MDG outcomes as the basis for determining growth and poverty reduction strategies has finally influenced IFI thinking, it appears. As noted above, the latest IMF and World Bank paper reviewing the PRSP approach calls for alternative scenarios to be included in PRSPs.

This is welcome, but it will nonetheless require a significant shift in culture and practice for the Fund, particularly in relation to the actual development of PRGF programmes at country level. As the IEO (2004) found, average practice in the implementation of good principles under the PRGF, including flexibility, is far removed from best practice. For example, Martin and Bargawi (2005a; p. 106) found virtually no mention of the MDGs in an examination of 72 PRGF-supported programmes.

An approach within the Fund that actively promotes flexibility in PRGFs and alternative scenarios in PRSPs will require changes in the way the Fund does business. Fund staff will have to engage with experts in social and political dimensions of economic growth in order to frame its advice in a context that is squarely focused on poverty reduction and equitable growth. It will require that Fund staff spend more time working in partnership with governments, donors and other stakeholders at a country level, instead of working in isolation, in under-staffed local offices, and interacting almost exclusively with a small cadre of finance officials.

It will need to make its programme advice genuinely transparent and accessible to stakeholders within and beyond government and other donors. It will also need to engage other donors – notably key Board members – to impress upon them the logic of financing development

at adequate levels now in order to reduce poverty, generate growth with equity and build institutions for long-term development.

#### 4 Signaling: Is the Debate Over?

Contrary to the assertion in Chapter 8, I believe the debate on signaling for the IMF is not over. As outlined in that Chapter, the IMF holds a critical, if unsought, role as gatekeeper for budget support, effectively. It is in this position because the broader donor community requires assurance that a country has its macroeconomic situation under control if it is to receive financial assistance. At a general level, this is reasonable. However, there are several problems with the Fund's role as signal-giver.

First, there is a fundamental difference in the purposes of support given by the Fund and other donors. Hence, the information required to make funding decisions differs substantially. The Fund imposes conditionality on countries in order to ensure that its loans, drawn from a relatively small pool, are repaid as quickly as possible and that a country does not fall into arrears. Its conditions are designed to ensure that countries will not fall into future balance of payments difficulties.

Other donors, on the other hand, need to know whether aid is being used for the purposes for which it was intended, e.g. poverty reduction and long-term development. The interruption of a PRGF programme because of failure to meet IMF targets is not a suitable proxy for judging a government's capacity to use aid effectively. Arguably, donors are delegating decisionmaking power to the IMF on development issues that are beyond the Fund's mandate and competence.

Furthermore, while a broad indication of macroeconomic stability is important for donors – particularly in the context of budget support – a PRGF will contain a significant number of conditions that can in theory send a country “off-track” if they remain unmet. These include structural conditions, which continue to proliferate in spite of the streamlining initiative, and micro-conditions.<sup>1</sup> Most budget support donors require an on-track PRGF for disbursement. Countries such as

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<sup>1</sup> Structural conditionality has become tighter in recent years, in the experience of HIPC Finance Ministers, in spite of the streamlining initiative. Martin and Bargawi (2005a, p. 97) also highlight the excessive level of micro-conditions in some programmes and note that there is no conceivable link to macro-stability, for example in the condition to issue ID cards for all teachers in Sierra Leone.

Honduras and Zambia have lost \$400 million and \$50 million respectively in budget support and interim debt relief as a result of going “off-track” in recent years (Oxfam, 2004).

Fund staff sometimes go to significant lengths to keep countries “on-track”, recognising the potential impact of an off-track signal on resource flows. However, such a response is not satisfactory for any of the stakeholders, as highlighted in Chapter 8. Unfortunately, the new Policy Support Instrument (PSI) is probably not the answer either.

The PSI was designed to meet needs of certain mature stabilisers who do not require Fund resources, but for whom the signal of macroeconomic integrity is important. This is effectively an instrument of enhanced surveillance, without a lending programme attached. It remains to be seen how this instrument is used and what its impact is on aid volatility in stabilised countries. It is patently clear however, that this latest instrument retains all the hallmarks of the power imbalances between donors, IFIs and “partner” countries that are theoretically being dismantled under the “aid effectiveness” agenda.

The IMF’s role as gatekeeper has to be radically reformed on a deeper level – one that places the countries’ national policymaking processes at its centre. In the context of reasonably rapid movement towards multi-donor assistance strategies for partner countries, this now looks more possible than ever. Specifically, the PRGF “on/off” signal should be replaced by a country-specific agreement between all donors and government on the triggers that would result in aid reduction or suspension. It should be built into a joint government / donor performance assessment and harmonisation matrix.

While such joint performance assessment frameworks are increasingly common, the IMF – and macroeconomic conditionality – remains resolutely outside these frameworks. In a future scenario, jointly agreed performance targets could be based on the main objectives in the PRSP, or an equivalent national development plan, and would also include all the core macroeconomic targets typically negotiated between the IMF and government.

Donors, including the IMF, would commit not to impose conditionalities unless they appear in the agreed matrix. The PRGF would be based on the targets emerging from such a government-led Poverty Reduction Strategy process – or national equivalent – on a macroeconomic framework, rather than the reverse. Above all, the PRGF should not predetermine the macroeconomic framework for a country, nor should donors link conditionality in budget support matrices to

existing PRGF conditions.

Civil society and parliament should input to and monitor the implementation of such a performance assessment and harmonisation matrix, under a rights and rule-based system. Such an instrument should be an accountability mechanism both for national governments and for donors.

The obstacles to such a partnership-based system are limited and surmountable. The Fund claims that it cannot legally enter multi-donor agreements. This can be changed. It states that it can only negotiate with governments. The above framework does not require it to strike a deal with actors other than national governments. However, it does require the Fund to contribute as one actor amongst many, in offering advice and support to a government that has the freedom to take its own decisions based on national consultation.

## 5 Conclusion

The debate on the Fund's role in low-income countries has been at the heart of policy discussions in the Fund and with external stakeholders for many years. The Fund could try to confine itself to a strictly bilateral relationship with member countries, focused only on macro-economics, but this option has effectively been rendered obsolete by its commitment to the Monterrey Consensus and the MDGs. The Fund has to position itself as part of a multilateral framework, therefore, and it has to leverage its core competence in macroeconomic stabilisation and growth to help deliver the MDGs.

This chapter notes that there is no such thing as "neutral policy" and that therefore the Fund has to take the option for the poor in its programme design. The Fund has to take responsibility for ensuring that its interventions, whether hard (i.e. conditionality) or soft (i.e. technical assistance and capacity building) are consistent with poverty reduction. It has to ensure that its surveillance and analytic work are rooted in protection of expenditure on poverty reduction and are geared towards mobilising higher levels of grant financing, as opposed to having a default option towards deeper demand reduction, structural reform and excessive fiscal and monetary tightness.

Ultimately, the role of the Fund should be to highlight to government and other stakeholders in a Poverty Reduction Strategy-type process the implications of alternative macroeconomic policy paths and

encourage governments to decide in consultation with those stakeholders, which path to follow. This analysis needs to take on board the political economy of change and in particular the implications for poverty reduction, vulnerability and inequality. This will require a greater partnership-based approach to the Fund's work and a change in working culture as well as policy orientation.

Furthermore, the Fund's staff and management need to engage other donors – notably key Board members and Governors – to impress upon them the logic of financing development at adequate levels now in order to reduce poverty, generate growth with equity and build institutions for long-term development.

I would propose a partnership model for the Fund in low-income countries, where the Fund plays an equal role with other donors and supporters of the development efforts of sovereign governments. This is not an outlandish proposition but it might require an extraordinary effort from the Fund and its political principals to relinquish power, adopt a genuinely multilateral attitude and recast itself in the role of partner rather than macroeconomic master.

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