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The Role of the IMF in Well-Performing Low-Income Countries

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Abstract

The IMF began to play a prominent role in low-income countries in the late 1970s and 1980s when many countries faced overvalued exchange rates, growing budget deficits, high inflation, and low reserves. But times have changed, and many low-income countries no longer face these problems and do not need classic IMF programs. This paper explores options for the role of the IMF in well-performing low-income countries that no longer require IMF financing. It argues that in these countries the IMF should use more non-funded programs, and it should play a much less dominant role in overall conditionality. These countries should be able to focus more on achieving high-priority development goals that are outside the expertise of the IMF, such as in health, water, education, private sector development, and agriculture. While playing a less prominent role, the Fund should continue to be engaged in helping countries to maintain an appropriate macroeconomic framework. For some countries, a non-funded program like the new Policy Support Instrument (PSI) would be appropriate, while others could shift further to a program of surveillance and monitoring. In well-performing countries the Fund should provide public ratings on macroeconomic policy, ideally fully incorporated into the World Bank's CPIA rating system.

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The Role of the IMF in Well-Performing Low-Income Countries

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By Steven Radelet[1]
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I. Introduction

The IMF began to play a significant role low-income countries in the late 1970s and 1980s when many of these countries were facing large macroeconomic imbalances, overvalued exchange rates, growing budget deficits, high inflation, and low reserves. At the time, a central role for the IMF was appropriate, since the nature of the problems matched the IMF's areas of expertise and its core purposes. When it became clear that the imbalances in many low-income countries were more than short-term liquidity problems, the Fund introduced longer-term, more concessional programs with a greater emphasis on structural reforms (in particular, the Fund introduced the Structural Adjustment Facility in March 1986 and the Extended Structural Adjustment Facility the following year in December 1987).

There were many implications of the growing role of the Fund in low-income countries during the 1970s and 1980s, but two are worth highlighting here: the changing substance of the programs, and the changing relationship with donors. First, the Fund became much more deeply involved in a range of structural issues, including privatization, banking, health and education policies, and legal reforms. A long-standing debate ensued (which continues today) about which issues are most relevant for Fund programs, which are most relevant for World Bank programs, and which should be left out of both. Whereas there was reasonably wide agreement on a central guiding principle – the Fund should get involved in issues that have a direct bearing on macroeconomic balances – there was much less agreement on precisely what that meant in practice and where to draw the lines. This debate was made more difficult by the fact that the key macroeconomic issues differed across countries, and changed over time within individual countries.

Second, the Fund took on a key signaling role for the major donors, providing the "seal of approval" of a country's policies upon which other donor flows often were contingent. In effect the Fund became the gatekeeper for nearly all flows of foreign aid to many low-income countries. Some financing was explicitly tied to Fund programs, such as Paris Club (and later HIPC) debt restructurings and certain World Bank loans, while other donors implicitly tied their financing to Fund programs. In the context of large macroeconomic imbalances, the rationale for the Fund's lead role was that donors should

[1] Thanks to Bilal Siddiq for research assistance in preparing this paper, and to Ted Truman for comments on an earlier draft.

have a coordinated approach, and they should not be providing significant finance in the face of unsustainable imbalances and in the absence of an agreed and implemented macro program. Given the clear importance of macro problems at the time, the lead role was defensible.

But times have changed. To a large extent, the period of protracted macroeconomic imbalances that affected many low-income countries has slowly drawn to a close over the last 10 years. There are still many low-income countries that face significant macroeconomic imbalances, but these problems are not nearly as widespread or as severe as they were two decades ago, and for many low-income countries they have all but disappeared. From a broad historical perspective, we are now at the tail end of the widespread macroeconomic-cum-debt crises that began in the 1970s and early 1980s.

In many of the low-income countries, inflation rates have dropped substantially. Out of 31 PRGF countries with available data, inflation has averaged less than 5% in 16 countries, and less than 10% in 25 countries (Table 1). The once ubiquitous black market premiums on exchange rates have all but disappeared (Table 2), rates of money creation have slowed, and budget and balance of payments deficits (net of concessional aid flows) have narrowed. Foreign exchange reserves (measured in months of imports) have doubled, on average, for PRGF countries since the mid-1980s (Table 3). In 12 of 28 countries, reserves now exceed 4 months of imports, and in several countries they are much larger. The debt burdens that first accumulated during that time period are being written down or written off. Whereas the median per capita growth rate was –0.2 percent in the early 1980s, it was 2.0 percent during the five years from 2000-04.

Just as the Fund originally evolved to respond to these macroeconomic imbalances, the challenge today how it should evolve in response to the changing priorities in many low-income countries. There is a wide array of important issues pertaining to the changing role of the Fund in the low-income countries – far too many to be covered in this paper. The primary focus is on the design of facilities for low-income countries that have achieved and maintained macroeconomic stability for several years and no longer require IMF financing (section II). The paper only touches on program design of the current PRGF facility (section III), arguing for greater flexibility in examining a wider range of macroeconomic frameworks and greater exploration of the tradeoffs inherent in different policy choices. It concludes with a brief discussion of grants (Section III), arguing that the IMF should not provide grants to low-income countries.

The major conclusion is that in countries that have achieved sustained macroeconomic stability, the Fund should move towards greater use of non-funded programs and should play a less dominant role in overall conditionality, while continuing to work with countries to ensure an appropriate macroeconomic framework. The Fund has introduced a new program instrument – the Policy Support Instrument (PSI) – which is a good first step in this direction, but only a first step. The Fund needs to ensure that its stronger-performing low-income countries have the space to focus on achieving other high-priority development goals that are not traditionally the focus of IMF programs. In the best performing low-income countries, the most appropriate arrangement would be a

program of surveillance and monitoring in which the Fund would continue to provide useful and advice and provide signals to the government, the private sector, and the international community. In these countries, the Fund should provide ratings on macroeconomic policy, ideally fully incorporated into the World Bank's CPIA rating system.

All Low Income Countries are Not Alike

The critical starting point is to recognize at the outset that low-income countries are not a homogeneous group. Some have achieved and sustained stability for several years, others are just beginning to stabilize, and a few continue to face significant imbalances. Recent discussions within the Fund have distinguished between three sub-groups of low-income countries:

- pre-stabilization countries, where macroeconomic imbalances are large and the government has not yet or is just beginning to take relevant actions, and where traditional IMF financing is appropriate;
- early stabilization countries, where the macroeconomic situation has stabilized but not yet been fully consolidated, and governments continue to implement significant macroeconomic and structural reforms, and where continued PRGF funding is appropriate; and
- mature post-stabilization countries, where macroeconomic stability has been established for some time, governments have developed some capacity for continued macroeconomic management, and IMF financing is not required to redress macroeconomic imbalances.[2]

The recognition by the Fund of this spectrum of countries within the low-income countries is, by itself, an important step forward. It reflects a broader trend among many donors to develop a wider array of approaches for working in different types of low-income countries. Many European donors have begun to move to budget support for countries that are perceived as better performing, while retaining project financing in others. The World Bank now provides direct budget support to help finance broad-based poverty reduction strategies in some countries, but not all, through a new instrument called Poverty Reduction Support Credits. The United States has introduced the Millennium Challenge Account to provide financing to a relatively small number of low-income countries that meet certain criteria. Differences are emerging in the extent of "country ownership" and the "participatory approach" in setting priorities and designing programs, the length of donor commitment, financing modalities (budget support versus project financing), and evaluation mechanisms, as well as in the scale of funding. In effect, country "selectivity" has evolved from the original concept of simply providing more money to countries with stronger policies and institutions, to engaging with different kinds of countries through a variety of different programs, instruments, and processes (Radelet, 2004).

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[2] The exact terminology and definitions differ across papers. Gupta (2002) and Adam and Bevan (2004) use the term "mature post-stabilization" countries, while a more recent Fund document refers to them as "mature stabilization" countries (IMF, 2005). The precise definitions of the group differ slightly, but all include low inflation and relatively small budget deficits (or at least small domestic financing of budget deficits).

II. IMF Facilities in Mature Post-Stabilization Countries

The Fund has begun to diversify the approaches it takes in low-income countries to better match the changing circumstances in different countries. In response to the changing circumstances in some countries, in 2004 the IMF Board considered but rejected the idea of introducing an Enhanced Monitoring Policy for low-income countries. Instead, in October 2005 (as this paper was being produced) the Fund Board approved the Policy Support Instrument (PSI), a non-funded program with upper-tranche conditionality aimed at mature post-stabilizers. But before examining the specifics of the new instrument, it is useful to step back and explore some of the basic rationale for taking a new approach in these countries. What is it that the mature post-stabilizers need, and don't need, from the Fund? And what are the drawbacks of continuing with the current PRGF arrangements?

Key functions for the IMF in Mature Post-Stabilizers

It is easiest to start with what the mature post-stabilizers do *not* need from the IMF: money for traditional balance of payments support. While many of these countries have substantial financing needs for *development* purposes, they do not need IMF balance of payments support, and IMF financing does not and should not finance development projects. The lack of financing need is recognized by staff and the Board (IMF, 2004a). Since in most of these countries reserves are at healthy levels and exchange rates are relatively stable, IMF financing provides little marginal benefit. Indeed, net IMF financing for many of these countries is small (or negative), and an increasing number of PRGFs for these countries are designed to provide only small amounts of financing. It is possible that some countries may need IMF financing at some point in the future to respond to terms of trade shocks or other difficulties, but a possible need sometime in the future is not a strong rationale for an ongoing funded program. One argument often made is that while these countries do not actually need the money, Fund programs should include money in order to provide leverage for important policy changes. We examine that argument later in the paper.

Nevertheless, while IMF financing generally is not needed, there are several important roles that the IMF can play. First, many countries continue to seek technical advice and assistance from the Fund on a variety of issues, including the macroeconomic framework, exchange rate policy, and sterilization of large foreign exchange inflows. In particular, if aid inflows increase along the lines recently promised by the G-8, some countries will be dealing with complex issues involving aid absorption and the impact on the exchange rate, export competitiveness, and interest rates, among other issues. Fund staff can provide valuable assistance to countries wrestling with these issues.

Second, the Fund can continue to provide a useful signaling role on the macroeconomic framework to government officials, donors, the private sector, and other interested parties. The macro framework remains important, and it makes little sense for each individual donor to undertake its own independent analysis. The key issue going forward is one of balance, and whether or not the Fund's signaling role should be given the

absolute prominence that it has been given in the past, especially since macroeconomic issues are no longer the most pressing concerns in this group of countries. We return to this issue below.

Third, and more controversially, some countries assert that they need the IMF for domestic political cover when presidents or members of parliament advocate for looser monetary and fiscal policy, or in some cases more direct management of the exchange rate. In this view, sensible economic and financial policies supported by policymakers in the Ministry of Finance or Central Bank may not carry the day without the implied threat of the termination of an IMF program. In effect, the IMF helps play the role of an independent central bank that cannot be manipulated by political pressures in countries where such independence has not yet been fully established. The extent to which this is the case, or more importantly whether this is healthy in the long run are open questions, but we note it here as a possible benefit of continued Fund involvement.

Why not continue with the PRGF?

So given these possible rationales for Fund engagement, why not continue with the PRGF? There are four key concerns, three affecting the borrowing countries, and one more broadly about the Fund itself.

First, the continued pre-eminence of Fund conditions relating to the macroeconomic framework may send the wrong signal to government policymakers and donors about a country's highest priorities. Because of the Fund's strong influence, policymakers (and donors) spend significant time worrying about the details of macroeconomic management. But in the mature post-stabilizers, macroeconomic management is *not* the most pressing concern. With the broad achievement of macro stability, the most important problems are deeper development issues that are outside of the Fund's core areas of expertise, such as education, health, agriculture, roads, and institutional reforms.

In most of the low-income countries, the time and attention of senior skilled policymakers is a very scare resource that must be allocated judiciously. While these countries should not lose sight of an appropriate macro framework, on the margin they should be focusing greater attention on longer-term development issues. The balance has begun to swing in recent years with the introduction of the Policy Reduction Strategy papers (PRSPs), but Fund conditions still detract attention from more pressing issues in many cases. The continued prominence of Fund conditions constrains that shift in government priorities, and in effect forces governments to put too much emphasis on stabilization policies and too little on growth and development.

Macroeconomic stability clearly is necessary for sustained growth, but it is far from sufficient. Too often the Fund's seal of approval, intended to provide signals on the macro framework, is interpreted by some policymakers and donors as a seal of approval of a country's much broader *development* framework. This problem was deepened by the introduction of the Poverty Reduction and Growth Facility in 1999. While the content was not so different from the previous ESAF, the title and shift in accompanying

language implied that the programs contained the core elements necessary for reducing poverty and establishing sustained growth. The signal this sends is straightforward: if the IMF is happy, the country must be on track for poverty reduction, growth and development. But this is not necessarily the case. In many countries the key constraints to poverty reduction are outside the purview of the PRGF and the Fund's expertise: disease, weak education systems, poor governance, weak institutions, weak agricultural systems, and the like. The pre-eminence of the PRGF may push policymakers to spend too much of their time on the details of macroeconomic policies and not enough on these other key issues, to the detriment of long-term growth and development.

Second, and much less noticed but of possibly greater importance, continued strong involvement by the Fund actually may undermine the process of building strong independent monetary and financial institutions and policy-making capacity in the recipient countries. Development specialists now (belatedly) agree on the importance of strong institutions. The issue of how to best help build and strengthen institutions is not well understood, and is certain to rise in prominence on the development agenda during the next decade. It seems reasonable to assert that a country's long-run macroeconomic stability is dependent to a large extent on the strength and capabilities of its monetary and fiscal institutions, especially the central bank and the ministry of finance. So a key question is: How do different types of Fund involvement affect institution building over time in the recipient country?

The role of the Fund in strengthening institutions is in many ways like a pair of crutches, which can be either helpful or harmful, depending on the context. Crutches can provide critical support and stability when an ankle is badly sprained or broken, but prolonged reliance on the crutches can undermine the process of strengthening the ankle and slow the pace of full recovery. At some point a patient with an injured ankle moves from two crutches to one, then to no crutches but with the occasional use of a handrail, to eventually needing no support at all. Importantly, when the crutches are discarded, the patient may occasionally experience some pain, or even stumble and fall once in a while, but putting some stress on the ankle is necessary to gain full strength and mobility.

When key financial institutions are extremely weak or broken, the Fund can help provide important support through both its advice and its conditionality. Generally speaking, central banks in the mature stabilizers have become much stronger and more capable than they were twenty years ago, and the IMF deserves some credit (which it often does not get) for helping in this process. Central banks today have greater understanding of the importance of a macro framework and much greater capacity to design and implement macro policies, and many have gained greater credibility and some measure of increased (if not full) independence.

However, when the IMF continues to play an intense supporting role over too long a period of time, it can lead to over-dependence on the Fund and impede the long-term strength of government institutions. In many countries the IMF acts as a substitute for a quasi-independent central bank. With a Fund program in place, monetary and fiscal policy cannot be significantly changed or modified through domestic political debate,

much as is the case with an independent central bank. But this is not healthy in the long run. Central banks need to gain credibility and independence on their own, and non-financial policymakers must begin to understand and appreciate the importance of a strong independent central bank. While an argument can be made for the Fund to help smooth this process, the occasional stumble or setback may be necessary for citizens and policymakers to fully appreciate the importance of sound monetary and fiscal policies. This process did not happen overnight (or without bumps along the way) in industrialized countries, and is unlikely to do so in the low-income countries. The Fund has been deeply involved in many of the PRGF countries for many years. Of the 20 countries with PRGF programs in 2002-03, 12 were on their third, fourth, or fifth successive programs (IMF, 2004a), meaning they had had continued strong involvement with the Fund for at least nine and upwards of 15 straight years – close to a full generation of policymakers in some countries. In many of these countries, it is time for the Fund to gradually play a smaller role – not an abrupt departure, but a diminishing role -- that allows domestic policymakers to play more of a lead role and institutions to develop more on their own.

Third, a continuation of an IMF program supported by borrowing from the Fund raises debt levels higher than they need to be in many countries. While current IMF net flows to many of the mature stabilizers are now quite small (or negative), given the debt problems of the last two decades, it is only sensible for countries to avoid unnecessary borrowing where possible. A non-funded IMF instrument would help reduce debt burdens in many countries.

Fourth, continued long-term IMF involvement in the mature post-stabilizers via funded, high conditionality programs may not be in the best interest of the IMF itself as an institution. Most obviously, PRGF programs in countries that do not need funding unnecessarily tie up financial resources that could be better used elsewhere. In addition, extended involvement through an ongoing PRGF brings the Fund inexorably into a wider range of issues that are beyond its core capabilities and creates pressure for the Fund to be more of a development institution rather than a balance of payments financing institution. As a result, the Fund has continued to expand the set of issues on which it works, and its activities overlap to a greater degree with other development agencies, most obviously the World Bank. Although coordination between the two agencies clearly is useful, extensive overlap in their functions is not. The expansion of activities also puts large strains on staff to provide ever more assessments and background documents as part of the PRSP process.

The more the IMF moves in the direction of becoming a development agency (or a quasi-substitute for an independent central bank), the further it strays from its core responsibilities articulated in the Articles of Agreement. Its strategy over the past several years in the mature post-stabilizers raises issues about the fundamental direction and scope of the institution. The Fund faces a fundamental choice: should it continue to be deeply involved in the most critical issues facing these countries, leading it to become more of a development agency? Or should it step back and re-focus on its core capabilities? To be effective in helping these countries achieve long-term development would require hiring a greater number of staff with development backgrounds and a

continued expansion of content in programs, and it would lead to greater overlap with the purposes of other existing organizations. Stepping back would allow the Fund to be more focused and to concentrate on its core areas of expertise, and allow other agencies with stronger development expertise to take a more prominent role, while the Fund would play more of a supporting role. This change would be healthier for the organization, for the mature stabilizers, and for the broader architecture of international approaches to development issues.

Options for the Fund in Mature Post-Stabilizers

There are several broad options for the Fund in moving towards a non-funded (or lower funded), less prominent relationship with the mature stabilizers, while still maintaining engagement in which it could provide inputs to government discussions and signals to government officials, donors, the private sector, and others (IMF, 2004a):

- *Low access PRGFs*. The Fund has shifted to low access PRGFs with small amounts of funding in some cases. This step frees up some PRGF resources, but otherwise changes very little in the relationship, and therefore does not solve most of the issues raised earlier. A low access PRGF could be a useful first step in a transition to a non-funded program, but not a final step.
- *Precautionary PRGFs*. Precautionary PRGFs have been considered by the Board at least twice since 1998. Like the low access PRGF, this arrangement would help free resources, although the PRGF Trust would still have to set aside some resources for a precautionary arrangement. It could also send a stronger signal about a country's changing relationship with the Fund, while allowing the country to access financing if the need suddenly arises. However, there are certain legal and administrative difficulties with the PRGF that make this option less attractive (IMF 2004a, page 26). Moreover, it does not go far enough in altering the relationship to address the concerns raised above.
- *Non-funded formal programs with upper credit tranche conditionality*. The new Policy Support Instrument (PSI) is in this category. Country programs would contain both macroeconomic and structural conditions and would have regular reviews and assessments, much like the PRGF, but without financing (precautionary or otherwise). An instrument along these lines seems a reasonable next step, as discussed below, especially if it is seen as a transition step to a surveillance relationship.
- *Surveillance and Monitoring*. A form of "intensified" surveillance, augmented by assessment letters and other tools, would provide a means through which Fund assessments could be part of the PRSP process without giving undue prominence or influence to the Fund. This kind of relationship would allow for greater government ownership and control for countries with an established record of good performance.

A sensible way forward for the mature stabilizers is a two-step process through which they would first move to a PSI-like program, then to intensive surveillance.

The introduction of the PSI is a good first step in this direction. It would support non-funded programs in PRGF-eligible countries lasting up to three years, presumably with

the possibility of renewal. Macroeconomic and structural policies would have to meet the standards of upper credit tranche conditionality, with regular review and other features similar to the PRGF. The act of a country moving from a PRGF to a PSI would send a strong signal of endorsement of the country's recent record and its macro policies. Importantly, it would help to signal a shift in key priorities from macro to other development and growth issues. It could also be implemented in a way that gives the member country much more say in designing the macro program and relevant structural conditions that is consistent with its PRSP and broader development goals.

A PSI also would help in the event of a major macroeconomic shock, as having an upper tranche conditionality program in place would smooth the way for rapid access to a financed program should conditions warrant it. However, a balance needs to be struck on the details of conditionality. Although upper tranche conditionality makes sense as an interim step, the PSI naturally should include less detailed conditionality than the PRGF, providing sufficient assurances of a strong macroeconomic framework while allowing recipients greater flexibility on a wider range of issues.

While a PSI is an important intermediate step, it should be seen as a transition program for more successful countries to a less formal program of surveillance and monitoring, rather than as an instrument for prolonged engagement by the Fund. The goal for all countries should be to eventually graduate from formal IMF programs. The Fund's role in low-income countries with a surveillance arrangement would be two-fold: (1) to provide input and advice on a range of issues, including fiscal policy, a sensible envelope for total social spending, aid absorption, financial sector development, and minimizing risks of shocks; and (2) to provide useful signals to government officials, donors, and the private sector.

By the time of a shift to a surveillance program, most countries that currently have a PRGF will have had at least twelve years under formal upper credit tranche programs (e.g., at least three PRGFs and one PSI) so will have a long record of reasonable macroeconomic stability and strong policy management. Progress has not always been smooth, of course, and not all countries will be ready to move to surveillance, but as tables 1-4 attest, there are many countries where performance clearly has been strong enough to move in this direction. For these countries, at this stage the Fund should be assessing the government's program, rather than convincing the government to adopt a program designed by the Fund. Upper tranche conditionality would not be necessary for a country without a balance of payments problem and with many years of reasonably strong macroeconomic management. With an intensive surveillance program, Fund staff can remain engaged, and can provide useful input and advice to government authorities, and well as critical information and assessments for donors, the private sector, and others.

Signaling and Rating

There is a long history of debate about the signaling function of IMF programs, recently summarized in a paper prepared by the Policy Development and Review Department (IMF, 2004b, also see Lombardi, 2005)). Most of the recent experience has been around

signaling to private creditor markets about the policies, finances, and debt sustainability of emerging markets facing capital account crises, and in this context the signaling role has raised some valid concerns around the role of the Fund vis-à-vis private credit markets. There has been less discussion and experience around signaling in low-income countries where international private credit markets play a much smaller role.

The clearest signal the Fund sends is the bi-modal "on-off" switch of having a program in place. If a country requests a program and is deemed to meet the required policy standards, a program goes forward; if policies are insufficient the program does not start or goes off-track. The Fund also sends more nuanced signals through staff reports and other assessments, including in non-funded programs. But to be most helpful in the context of non-funded surveillance activities in terms of a low-income country's poverty and growth strategy, the Fund should move to more graduated signals: a rating system for macroeconomic frameworks, limited to low-income countries in the context of their PRSPs.

The concept of the Fund as a rating agency has come up before in the context of emerging market debt crises, and there has been a strong view that "the Fund should not become a ratings agency." But of course, in many ways the Fund already *is* a ratings institution, and has been for most of its existence. The Executive Board (and management and staff) are quite comfortable with the traditional bi-modal form of rating of the "on-off" switch; at the other extreme they are increasingly comfortable with more nuanced and textured assessments outside of a funded program – not an on-off switch but plenty of information and judgments (some objective, some subjective) with implied ratings upon which outsiders can base their own conclusions.

While these two extremes have been accepted, there is resistance to an intermediate – and arguably more informative – graduated ranking scale in which the Fund would rate a country's macro framework or structural policies on a scale of, say, 1 through 10. There is an obvious close parallel with the World Bank's Country Policy and Institutional Assessment (CPIA) system, which rates countries on a scale of 1-6 on assessments of 16 areas of policies and institutional strength. The Bank has used the CPIA internally for many years, chiefly as an input to funding allocation decisions, and plans to make it public next year (quintile ranks are already publicly available). The major regional development banks have adopted similar systems.

Ideally, for countries that have achieved many years of macroeconomic stability, the IMF's assessment of the macro framework should be seen as one component of broader assessments of a country's growth and poverty reduction strategies, but it would no longer be the dominant component as it is now. Indeed, the World Bank's CPIA preferably would become the more important signal of a country's development strategy to donors and other interested parties, with the Fund playing a supporting role.

One option would be for the Fund to provide an independent, periodic rating of the country's macroeconomic framework, at least once and perhaps twice a year. The Fund could rate countries on a scale of 1-10, giving ratings of, say, 8 through 10 for very good

or excellent performance, 6 or 7 for acceptable but weaker performance, 5 for questionable, and 1-4 for poor programs. The process would be similar to intensive surveillance, augmented by in-depth analysis and rating of several keys aspects of macroeconomic policy: fiscal, monetary, exchange rate, reserve management, and other germane issues.

A second, and probably preferable option would be for IMF assessments to formally become part of the CPIA ratings. In this way the relevant CPIA categories would be rated jointly by the Bank and Fund. The most relevant of the 16 CPIA categories for a joint assessment would be (1) macroeconomic management, (2) fiscal policy, (3) debt policy, and (4) financial sector policies, with possibly some input on (5) trade. This system would have the advantage of the two organizations providing a unified rating, which would force some coordination and would be easier for outsiders to interpret. A joint effort would also minimize risks to the Fund.

Some Concerns

Several concerns have been raised about the idea of the Fund playing a less prominent role in the mature stabilizers, either through a non-funded program or through surveillance.

- *Countries will fall back, and macroeconomic performance will weaken without a strong IMF role*. Undoubtedly this will happen in some countries, but not in others. But the fact that some countries may need a structured, funded program at some point in the future does not seem a strong reason to maintain funded programs for many years in all countries. The IMF should not be in the business of maintaining programs in countries so that these countries won't need programs in the future. If the need arises, new programs can be designed and implemented where necessary. Moreover, some moderate slippage in some countries may be necessary in the long run to build a durable domestic constituency for strong macro management and an independent central bank. It is more than just slightly paternalistic to take the view that all low-income countries require a strong IMF presence in order to design and maintain reasonable macroeconomic policies.
- *The IMF will have no policy leverage in the absence of funded programs*. This point is debatable both in terms of the extent to which the IMF *should* have strong policy leverage in well-performing countries that have no balance of payments needs, and the extent to which money is necessary for adequate leverage. On the first point, as argued earlier, in many countries the governments should be focusing more of their attention on other pressing development problems and not quite as much on traditional IMF issues. That is, it is appropriate for the Fund to lose some influence in these countries. Maintaining strong leverage so a country expends great effort to reduce its inflation rate from 7% to 5% may not serve the country well if as a result the finance minister pays much less attention to other pressing issues, such as establishing a system for generating sustainable revenues to finance the public health system. On the second point, money may not be necessary for adequate leverage (Bevan, 2005). Ratings by Moody's and Standard & Poor are influential even though

neither provides money, statements by auditors are powerful even though they do not provide money, and commercial banks rely on credit rating agencies that do not provide money. Indeed, many would see it as a conflict of interest if they did! In the mature stabilizers, the Fund's influence should come through the quality of is advice and input to the government, and the quality of the information it provides to outside observers. If its advice and assessments are of high quality, it will maintain adequate leverage and influence.

- *If the Fund steps back from playing the prominent role as gatekeeper for the donors, no one else will step up.* For this shift to work effectively, the World Bank must take on a more prominent signaling role. A larger World Bank role would be wholly appropriate since the most pressing issues pertain to long-term growth, development, and poverty reduction. It makes much more sense for the Bank to be the institution providing the prominent signals to other donors about the quality of the member countries development and poverty reduction strategies. The question is whether the Bank will be able to play this role effectively. The CPIA could be at the core of such an assessment, but other changes would be necessary within the Bank. Without going into a longer discussion of the merits and demerits of a more prominent role, the key point here is this: any discussions of a significant change in the role of the IMF in low-income countries should take place alongside corresponding discussions of the appropriate role of the World Bank. The two institutions must evolve together in this regard.

  Over the years many people have argued that the PRGF more appropriately belongs in the World Bank, given its focus on poverty reduction, growth, and long-term development (Birdsall and Williamson, 2002). The combination of the Fund moving to a PSI/intense surveillance relationship and the World Bank taking a more prominent lead role in helping countries design and implement their development strategies would have many of the benefits of formally moving the PRGF, as it would allow each agency to play the more prominent role in their respective areas of core competence.

III. Increasing Flexibility in PRGF and PSI programs

Shifting attention from the PSI back to the PRGF, there has been extensive debate and controversy in recent years about whether or not IMF programs in low-income countries are too restrictive, thus inhibiting growth, poverty reduction, and the achievement of the Millennium Development Goals (Radelet, 2004; Lombardi, 2005). Some have accused the Fund of capping social spending or requiring countries to reduce the size of the civil service in order to achieve program goals. Others believe that Fund conditions require unnecessarily tight fiscal and monetary policies, going beyond what is necessary to maintain macroeconomic stability. Without getting into the detail and specifics of these debates, at their core is a process question: how can the Fund best help countries explore a *wider range* of different policy options within the limits of prudent macroeconomic frameworks?

PRGF programs typically examine alternative scenarios for external shocks or foreign financing. For example, in many cases they lay out contingency plans in the event that foreign financing is less than expected or if a country is hit by adverse terms of trade shocks. However, this flexibility and examination of alternative scenarios is not normally extended to policy choices (Bevan, 2005). There is never just one set of monetary and fiscal policies that are consistent with broad economic goals; moreover, there often are tradeoffs inherent between two or more goals. PRGFs (and eventually PSIs) could be strengthened by the Fund working with member countries to consider a wider range of policy options, and more deeply exploring the key tradeoffs that governments face in setting macro policy.

For example, what are the tradeoffs for a country in aiming for 7% inflation rather than 5%? How should a country think about devoting scarce fiscal resources, on the margin, to retiring domestic debt or spending on critical social programs (Bevan, 2005)? If a country wants to expand domestic spending on health to ramp up a critical immunization program, what are the pros and cons of various financing options? How much additional foreign financing might be needed to achieve particular goals, given domestic financing constraints? What are the trade-offs and options in differing approaches to sterilizing large aid inflows? These issues require both short-term and long-term analysis.

This kind of flexibility in analysis in examining a range of options should be a core part of both the PRGF and PSI, with even greater flexibility and a wider range of options within the PSI. Laying out an array of policy options will help government think more clearly about the tradeoffs and help non-financial policymakers within government understand the rationale for various options, thus helping instill stronger "ownership." It will help donors and policymakers recognize that macroeconomic goals are just one priority, and achieving those goals must be balanced with achieving other pressing goals. It would also make the Fund less vulnerable to charges of simply imposing policies on countries regardless of the consequences. And it may help Fund staff to explore and accept options that they may not have fully considered that may be better for the member country while still maintaining macroeconomic discipline.

IV. Should the IMF provide grants?

I strongly favor both bilateral and multilateral development banks providing their development financing as grants for low-income countries. In the World Bank, these grants should be allocated based on income levels, not debt sustainability or by sector. In particular, the Bank should provide all of its financing as grants to countries with per capita incomes below $500 (Radelet, 2005). It should provide IDA loans to countries with income above $500 to the IDA cutoff, currently $965 per capita, and could provide some blended financing for some countries around the $500 threshold level. Moreover, as argued above, I believe the Fund should provide less money or even no money in many countries.

But the IMF should not provide grants. Its purpose should remain to provide temporary financing at a penalty rate (in the poorest countries, a penalty rate relative to grants). It

should not be a source of long-term development finance. To do so would be at odds with the basic purposes of the Fund, and would draw it in to become even more of a development institution, rather than less of one. It would also encourage protracted use of IMF programs. The PRGF's subsidized terms are appropriate, and if all other financing comes in the form of grants, members will find these terms relatively unattractive, and they will prefer to obtain their financing from sources other than the Fund. Maintaining this distinction will preserve the incentives for members to revert to IMF financing only when necessary and to keep IMF programs relatively small. Since IMF financing is relatively small in most countries, if all other donor financing is provided as grants, IMF programs generally will not create debt servicing difficulties.

V. Conclusions

The era of widespread macroeconomic imbalances across many low-income countries has drawn to a close in recent years. Many low-income countries that have had IMF programs in place for many years have now achieved sustained macroeconomic stability and several years of nascent growth. While some individual countries undoubtedly will face significant macroeconomic challenges in the future, the IMF's role in countries that have achieved stability should evolve in tandem. In particular, the Fund should move towards greater use of non-funded programs and play a less dominant role in overall conditionality, while continuing to work with countries to ensure an appropriate macroeconomic framework.

The new PSI is a good first step in this direction, but it is only a first step. The Fund needs to ensure that its stronger-performing low-income countries have the space to focus on achieving other high-priority development goals that are not traditionally the focus of IMF programs. In this context, IMF targets and conditionalities should play a less prominent role in these countries relative to targets related to health, water, education, private sector development, agriculture, and other critical development issues. The Fund should provide more flexibility in its programs so that policymakers can explore the tradeoffs of different approaches and different specific goals, while maintaining a broadly appropriate macroeconomic framework.

For some low-income countries, it may be appropriate to move beyond a PSI to a program of surveillance and monitoring in which the Fund would continue to provide useful and advice and provide signals to the government, the private sector, and the international community. In these countries, the Fund should provide ratings on macroeconomic policy, ideally fully incorporated into the World Bank's CPIA rating system.

These changes would allow low-income countries with strong macroeconomic policies to devote greater attention other pressing development needs. Greater independence from the Fund would also help countries build stronger monetary and financial institutions that can stand on their own. It would also ensure that the Fund maintains its focus on its core areas of proficiency and allow other agencies with stronger development expertise to play a more prominent role in low-income countries that have achieved stabilization.

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Table 1. Annual Inflation (CPI, %)

	1984-88	2000-04
Cape Verde	7.09	0.41
Congo, Rep.	1.88	1.07
Dominica	3.14	1.23
Senegal	5.00	1.30
Niger	-0.77	1.64
Burkina Faso	2.10	1.70
Cameroon	8.49	1.75
Cote d'Ivoire	5.94	2.93
Ethiopia	4.47	2.97
Tanzania	32.60	3.12
Uganda	151.50	3.13
Bangladesh	8.64	3.27
Nepal	9.93	3.34
Sierra Leone	87.40	3.95
Pakistan	5.75	4.23
Chad	4.37	4.89
Mauritania	5.64	5.48
Rwanda	2.62	5.72
Nicaragua	2410.65	7.30
Kenya	9.35	7.82
Sri Lanka	9.56	8.76
Honduras	3.88	8.84
Gambia, The	26.44	8.89
Lesotho	13.10	9.25
Madagascar	15.35	9.50
Burundi	6.28	10.40
Mozambique	77.41	12.62
Malawi	20.73	17.57
Zambia	51.29	21.81
Ghana	29.14	22.44
Congo, Dem. Rep.	54.04	183.75
Average	99.13	12.29
Median	8.64	4.89

Source: IMF, International Financial Statistics

Table 2. Black market premium on exchange rate

	1984-88	1994-98
Sri Lanka	17.7	0.9
Honduras	52.1	1.0
Ghana	89.5	1.2
Nicaragua	12525.1	1.5
Lesotho	11.1	2.7
Lao PDR	106.9	3.5
Guinea	523.1	3.5
Burkina Faso	1.1	3.6
Cameroon	1.1	3.6
Chad	1.1	3.6
Congo, Rep.	-1.1	3.6
Cote d'Ivoire	1.1	3.6
Mali	1.1	3.6
Niger	1.1	3.6
Senegal	1.1	3.6
Pakistan	7.8	5.3
Tanzania	210.8	5.4
Gambia, The	13.8	5.5
Guyana	586.7	5.6
Mauritania	143.9	6.2
Mozambique	2462.8	7.4
Madagascar	18.9	8.1
Kenya	12.7	8.9
Sierra Leone	335.9	9.7
Uganda	267.3	12.0
Zambia	239.8	13.8
Congo, Dem. Rep.	6.2	15.6
Nepal	27.3	19.6
Bangladesh	175.3	23.7
Malawi	32.6	27.7
Rwanda	42.2	33.3
Burundi	26.2	35.2
Ethiopia	153.4	53.1
Average	548.4	10.3
Median	27.3	5.4

Source: World Bank, World Development Indicators, 2005.
Note: More recent data is not available for most countries

Table 3. Total reserves in months of imports

	1984-88	2000-04
Tanzania	0.4	7.3
Nepal	3.4	7.3
Uganda	1.0	6.6
Rwanda	4.0	5.7
Lesotho	1.4	5.6
Mali	0.6	5.3
Mozambique	1.3	5.2
Pakistan	2.1	5.1
Burkina Faso	4.4	4.8
Honduras	1.0	4.6
Ethiopia	2.0	4.1
Guyana	0.2	4.1
Lao PDR	0.0	3.7
Cote d'Ivoire	0.1	3.6
Kenya	2.1	3.3
Burundi	2.6	3.0
Malawi	1.8	3.0
Madagascar	2.1	3.0
Senegal	0.2	3.0
Sierra Leone	2.2	2.5
Ghana	5.2	2.5
Sri Lanka	1.9	2.5
Dominica	1.5	2.5
Nicaragua	0.6	2.4
Bangladesh	2.4	2.3
Zambia	1.1	2.0
Cape Verde	6.8	1.8
Congo, Rep.	0.1	0.6
Average	1.9	3.8
Median	1.6	3.5

Source: World Bank, World Development Indicators, 2005

Table 4. Growth in GNI per capita (%)

	1984-88	2000-04
Albania	-1.2	5.8
Mozambique	1.7	5.2
Kyrgyz Republic	5.9	4.0
Bangladesh	1.1	3.5
Lao PDR	-1.2	3.3
Mongolia	3.5	3.3
Mali	-2.1	3.3
Ethiopia	-1.0	3.0
Rwanda	-1.1	2.9
Uganda	-1.2	2.9
Ghana	2.3	2.7
Sri Lanka	2.7	2.7
Mauritania	-0.5	2.7
Zambia	-0.8	2.5
Senegal	-0.2	2.5
Cameroon	-0.4	2.5
Cape Verde	4.0	2.4
Burkina Faso	1.6	2.0
Lesotho	3.9	1.9
Gambia, The	-1.1	1.9
Pakistan	3.7	1.7
Congo, Rep.	-3.0	1.4
Nepal	3.6	1.3
Honduras	0.8	1.2
Guinea	1.8	0.6
Burundi	2.2	0.3
Nicaragua	-6.4	0.3
Guyana	-0.7	0.1
Niger	-2.3	-0.1
Madagascar	-0.9	-0.2
Malawi	-0.4	-0.6
Kenya	1.6	-0.8
Dominica	6.4	-1.2
Congo, Dem. Rep.	-0.2	-1.3
Cote d'Ivoire	-2.4	-3.6
Mean	0.6	1.7
Median	-0.2	2.0

Source: World Bank, World Development Indicators, 2005