8

Future Challenges for the IMF in Low-Income Countries

Jan Derk Brilman, Irene Jansen and Ernst van Koesveld[1]

When the IMF was established in 1945, a role for the Fund in low-income countries was not foreseen. Its founding fathers envisioned an organisation to guard and help preserve the newly created international monetary stability in a world of fixed exchange rates and the gold-exchange standard. With the collapse of the Bretton Woods system in 1971, the oil price shocks in the 1970s and the debt crises in the 1980s, however, the Fund's operations geared increasingly towards emerging economies and low-income countries. Moreover, acknowledging that macroeconomic stability as a prerequisite for sustained economic growth and poverty reduction can only be created over a longer term, the Fund's involvement in low-income countries became much more long-term than the traditional short-term balance of payments support.

In 2003, the IMF started a comprehensive discussion on its role in low-income countries. A first paper was published in July and discussed in the IMF Board in September. A year later, a second paper and discussion followed (IMF, 2004a). Out of these discussions, the consensus emerged that the IMF has an important role to play in low-income countries, and that lending, policy advice and technical assistance should remain the Fund's main instruments to help low-income countries to achieve the Millennium Development Goals (MDGs). More specifically, we believe that the Fund's relationship with low-

[1] Foreign Financial Relations Directorate, Ministry of Finance, the Netherlands. Contact: e.koesveld@minfin.nl. The usual institutional disclaimer applies.

From: Protecting the Poor - Global Financial Institutions and the Vulnerability of Low-Income Countries
Fondad, The Hague, November 2005. www.fondad.org

income countries should be aimed at establishing macroeconomic and financial stability, and supporting that, the microeconomic functioning of public finance and the financial sector. A crucial precondition for the Fund to remain effective in low-income countries is its continuing capacity to tailor the mix of policies and instruments to a country's political and economic realities.

Diverging views emerged however on various more specific issues, including: (i) the Fund's longer-term financial involvement in low-income countries and how to promote a gradual exit to a surveillance-only relationship; (ii) the role of the Fund in cases where financial assistance is not critical to alleviate balance of payments needs, but where involvement for signaling purposes is important; (iii) the Fund's approach to debt relief and how to promote debt sustainability.

These three interlinked issues are the key future challenges for the IMF in low-income countries that we will address in the remainder of this chapter. In Section 1, we discuss the issues of "saying-no" and the design of proper "exit strategies". In Section 2, we argue that when countries have stabilised their economies, the Fund's direct role in providing balance of payments support needs to change into an indirect, signaling role, i.e. to catalyse other sources of financing. Section 3 discusses how the build-up of too high debt levels can be prevented. Section 4 concludes.

1 Exit Strategies from Fund Financing

One of the consequences of the deep-rooted and complex economic problems in many low-income countries is the high level of longer-term financial engagement of the Fund. The IMF has defined a longer-term programme engagement in the case of low-income countries as having at least two ESAF/PRGF arrangements. On this basis, 45 out of the 78 PRGF eligible countries can be classified as such as of December 2004. Of the remaining 33 countries, 24 are recovering from severe economic and/or political instability and are either not yet engaged in a financial relationship with the Fund, implementing a first PRGF or involved in a programme that went off-track. These countries could therefore enter into a longer-term engagement in the future.

It is important to note that following the IEO "Evaluation of Prolonged Use of IMF Resources 2002" and the conclusions of a Task Force, the IMF Board concluded that, "under proper circumstances, long-term

Fund financial engagement can be an appropriate response to help member countries address deep-seated problems that, by their nature, require many years to resolve. These problems have been particularly prevalent in low-income countries and countries in transition." Thus, a longer-term financial relationship with the Fund is not necessarily worrisome. The Board added however that "at times, prolonged use can also be associated with insufficient progress in dealing with key economic problems and can hinder the development of domestic institutions" (IMF, 2003a).

The question then is whether the longer-term Fund engagement in low-income countries has overall been justified. Elements that are of importance in this respect include: (i) whether the economic problems as well as the level of commitment to reform and institutional capacity justify long-term financial involvement; (ii) whether overall and continuous progress has been made through solid implementation and sound programme design; (iii) whether the Fund has acted if this was not the case, for example by adjusting a programme, delaying a review or declaring a programme off-track, (iv) whether successive arrangements show a declining trend in access; and (v) whether explicit attention is given to an exit strategy as part of an *ex post* assessment.

In June 2004, 19 *ex post* assessments on longer-term engagement in PRGF countries were considered by the Board and became publicly available. Before drawing some conclusions on the basis of these assessments, a few caveats are in order. First, it is always easier to draw conclusions with the benefit of hindsight. Thus, a conclusion that the IMF would have better disengaged in a particular country looking back, since ownership and/or commitment were lacking, does not mean that the decision to agree to a new PRGF was not made with due care and consideration at the time. Secondly, since experience with *ex post* assessments is relatively recent, the documents still evolve in their structure and quality. This makes a comparison between the documents somewhat difficult at times. With this in mind, an analysis of the existing *ex post* assessments according to the above mentioned criteria shows that three different categories can be distinguished: (i) countries where the longer-term programme engagement has overall been successful, (ii) countries where the longer-term engagement can be called into question and which currently still have a Fund programme, (iii) countries where the longer-term programme engagement can be called into question and which currently do not have a Fund programme.

Countries With a Successful Longer-Term Programme Engagement

From the 19 countries analysed, seven can be classified as having a successful longer-term engagement with the Fund. In Albania, Armenia, Benin, Ethiopia, Mali, Mozambique and Cambodia the longer-term engagement of the Fund has been justified considering the existing deep economic problems as well as the level of ownership and the institutional capacity. In Mali and Mozambique, ownership and commitment of the authorities have been consistently strong, leading to continuous progress and solid implementation of reforms. In Albania, Armenia, Benin, Ethiopia and Cambodia episodes of political uncertainty or conflict and low commitment have existed, with temporary deteriorations in programme implementation as a consequence. In all five countries however, the Fund responded appropriately and only renewed its programme relationship when ownership and stability were solidly restored and sound progress could again be expected (and indeed materialised). Only in Ethiopia has programme design been clearly unsatisfactory according to the *ex post* assessments, while in most countries some improvements could have been made in this area.

Despite the overall successful engagement of the Fund, none of the seven countries has of yet fully graduated from Fund resources. With the exception of Cambodia, future graduation is however being properly addressed and low access PRGFs are in place or are being recommended by IMF staff for the immediate future. The signaling role of a Fund programme vis-à-vis donors is mentioned regularly as the reason of why a PRGF is preferable to a surveillance-only relationship. In Cambodia, the IMF staff recommends to raise the question of graduation "at the time of approval of each (future) yearly programme."

Countries Where the Longer-Term Programme Engagement Can Be Called Into Question

Unfortunately, in the majority of the low-income countries assessed so far questions can be raised with hindsight about the validity of the long-term presence of the Fund. In Bolivia, Chad, Georgia, Guinea, Guinea-Bissau, Kyrgyz Republic, Lesotho, Macedonia, Malawi, Moldova, Niger and Zambia, economic problems were profound enough to merit a longer-term involvement, but lack of ownership, governance problems or capacity constraints and/or political conflict resulted in a political-institutional climate that was not receptive to reforms. As a result, progress was mixed at best, but more often than not disappointing. The question then emerges why the Fund agreed to continuous new arrangements, knowing that implementation problems would most likely persist. In some of the *ex post* assessments, the Fund explicitly admits that with hindsight more selectivity should have been used in deciding to new programmes, which could have resulted in prolonged *dis*engagement of the Fund. In other cases, the Fund points at pressure from donors to continue the arrangement for signaling purposes or to a change of governments that gave new hope for improved implementation. Often however, new programmes saw similar implementation problems. An interesting case in this respect is Bolivia, where ownership of the national authorities has hardly been an issue, but the high political resistance to reforms from interest groups and the underprivileged majority led to constant implementation failures, irrespective of which government ruled (IMF, 2005). As regards programme design, the *ex post* assessments usually state that more attention should have been given to capacity constraints and the institutional environment, but design flaws have never been a large culprit of the overall disappointing results. Moreover, a few exceptions set aside, the response of the Fund to insufficient progress within arrangements has generally been sound with increases in prior actions, reviews being delayed or not completed and programmes being announced off-track.

Seven out of the 12 countries in this category currently still have a Fund programme. Access has declined in only one of these (Georgia) and *ex post* assessments indicate that a possible exit strategy of Fund resources has not (yet) been properly addressed in four of them. The remaining five countries are no longer involved in a Fund arrangement, even though the Fund foresees a future engagement in most of them, provided that the level of commitment and/or institutional capacity improves. Exit strategies are properly addressed in all of these five countries, while only Guinea has had a declining access of financial engagement of the Fund within this group.

Lessons for Future Fund Engagement and Exit Strategies

The *ex post* assessments give a comprehensive and overall candid overview of past Fund involvement in low-income countries. They are highly useful and should therefore be continued and strengthened further. Several lessons can be drawn on the basis of them.

First and foremost, sufficient levels of ownership, commitment, political stability, good governance and institutional capacity are essential for the success of a Fund programme. Without these, a muddling-through scenario emerges in which limited progress is achieved and the Fund is sooner or later forced to (temporarily) unplug.

Second, it is important that the Fund is able and willing to say "no" at an early stage if warranted. Although it is not and should not become the responsibility of the Fund to improve the overall political and institutional situation in a country, Fund programme design should pay (more) attention to specific capacity constraints. Hence, even if the lack of implementation is beyond the government's control due to e.g. strong resistance from vested interests, the Fund should consider disengaging when constraints are such that the success of a new programme is highly questionable. When improvements in this area have been made – possibly with the assistance of the World Bank, regional development banks and bilateral donors – the Fund should naturally stand ready to re-engage. The important signaling role of IMF programmes however, makes saying no difficult at times.

A third lesson, therefore, is that more nuanced and textured signals – explaining why a programme goes off-track or why a new programme engagement is unwise – are needed. This issue will be raised into more detail in the next section on the signaling role of the Fund. Fourth, the Fund should adhere more closely to the existing principles on declining Fund exposure.[2] Lastly, the Fund should further strengthen its attention to exit strategies, e.g. in *ex post* assessments. An analysis of whether the economic problems in a country merit *financial* involvement of the Fund should be made at the end of each Fund programme and include a view on the (protracted) balance of payments need. Questions concerning ownership and capacity constraints should be properly addressed as well (as is often already the case) and lead to firm suggestions with regard to possible new arrangements (e.g. prior actions). Thought could be given to increasing Board involvement in the case of a longer-term Fund engagement in order to strengthen the focus on exit strategies. Also, precautionary (low access) PRGFs, in which the IMF and a member country agree on a PRGF programme, but the country unilaterally

[2] In this respect, it is a welcome step that the Board decided to reaffirm the essence of declining access and decided to new access norms under PRGF arrangements. The norms are set as follows: 90% of quota for first-time PRGF use, 65% for second-time use, 55% for third-time use etc. Besides these norms, the PRGF also sets a maximum borrowing limit at 140% of quota (185% of quota in exceptional circumstances).

decides not to make use of Fund resources, could serve as a possible exit and are worth considering. The recently approved *Policy Support Instrument* (see next section) forms a valuable addition to this.

2 The Fund's Signaling Role in Low-Income Countries

Although episodic IMF financing is often vital for low-income countries, the Fund's longer-term goal should be to phase out its financial involvement. After countries have sufficiently stabilised their economies, they should rely on, usually more concessional, donor funds to finance their development needs to achieve the MDGs, and ultimately, they should be able to tap international capital markets. In this process, Fund involvement is expected to evolve, with its indirect role, i.e. its role in providing a seal of approval for donors and markets, growing more important. While the Fund's financial involvement may be relatively limited for countries, the financial implications of its signals are sizeable. This section reviews the recent discussion on this so-called signaling role of the Fund, especially from an EU donors' perspective, who together account for over half of global ODA with a further rise expected.

IMF interactions with member countries, notably in the context of surveillance and programmes, have an important signaling function to the international financial community. Although signaling is a kind of by-product of the Fund's core business, it is increasingly considered as one of the main tasks of the Fund in low-income countries. The term "signal" refers to the conveying by the Fund of information that influences the financing decisions of outsiders (such as donors and private market participants). This can be through on/off mechanisms (a typical example of which is a Fund programme, where the signal is given by the approval and continuation of the programme) or through a multi-dimensional picture (a typical example of which can be found in surveillance, where the signal comes from the textured views expressed in the course of surveillance). The Fund also provides assessments of members' macroeconomic conditions and policies in response to various ad hoc requests from multilateral development banks, creditors or donors. The most recent guidelines on these so-called assessment letters (also known as comfort letters) state that the assessments should be both "sufficiently nuanced" and "written clearly" to inform financial decisions of outsiders. They should be circulated to the Board for information, but this does not imply Board endorsement (IMF, 2003b).

From: Protecting the Poor - Global Financial Institutions and the Vulnerability of Low-Income Countries
Fondad, The Hague, November 2005. www.fondad.org

The Risks of an Increased Signaling Role

The Fund's signaling function appears to have become increasingly important, as reflected by the number of IMF Executive Board discussions that touched upon the issue. Recently, the discussion has focused on the signaling role of the Fund in low-income countries, effectively providing a *seal of approval* to donors. An important signaling role for the Fund fits in the view that the Fund's engagement with low-income countries should not be equated with IMF financing being provided over longer periods of time. In particular in the case of so-called mature stabilising countries and pre-emerging market economies, the Fund's signaling may be more important than its (episodic) financing role. The Fund could rely on *catalysing* other funding, especially if the latter are provided on more concessional terms to avoid unsustainable debts.

The signaling role of the Fund has also become more important given donors' gradual shift from project aid to budget support. This shift is based on the belief that national ownership and effective aid allocation are best served by providing direct budget support. Assurances by the IMF that recipient countries' macroeconomic policies and public finance management are of sufficient quality often guide disbursement of budget support. The Fund is uniquely placed to provide such signals, including information on financing gaps, borrowing capacity and absorptive capacity, to inform donor decisions. Especially in the case of countries with Fund-supported programmes, the Fund is considered to play the role of *"gatekeeper"*, providing on/off signals on which much donor financing depends.

The Independent Evaluation Office, among others, has pointed out two possible risks of this development (IEO, 2002; see also DFID/HM Treasury, 2004). The first is that the Fund's actions may result in stop-and-go processes and large swings in official financing, thus further reducing the predictability of aid.[3] The second possible risk is that linking aid to IMF-supported programmes can compromise the quality of these programmes – and hence, the quality of the signal. This is

[3] Bulir and Lane (2002) find that project aid disbursements are more or less independent of the status of an IMF-supported programme. Budget support, being already less predictable than project aid, turned out to be very sensitive to programme interruptions. In fact, the penalty for programme interruptions was 80%: aid disbursements were 80% below the initial commitment level.

because this linkage raises the stakes of programme negotiations to the point of putting strong pressure on both country authorities and the IMF to reach an agreement, even though both parties may have doubts about the programme's feasibility. This, in turn, may contribute to unduly prolonged use of Fund resources and hinder an effective implementation of exit strategies from the side of the Fund. A third risk would be that the Fund's financial involvement will add to the often already high debt levels of countries.

The recent historical review by Fund staff (IMF, 2004b) confirms that there are various difficulties in designing a successful signaling mechanism:

- There is a tension between the intention to influence donors (the Fund's catalysing role) and the intention to leave them to arrive at their own judgement (reducing the negative and unintended consequences of the Fund's perceived gatekeeper role).
- In order for positive signals to be meaningful, negative signals must also have been a possibility. However, the Fund has been reluctant to send negative signals, to protect the frankness of the dialogue with the authorities and to avoid a sharp reduction in foreign financing;
- On-off signals are open to misinterpretation if they set a standard other than upper credit tranche conditionality, which is the normal standard for IMF-supported programmes (so-called Staff-Monitored Programmes, for example, have a lower policy commitment content);
- The credibility of signals is helped when backed by financial resources, although recourse to Fund resources can be a signal of need as well as strength;
- On/off signals tend to crowd out multidimensional ones, and less intrusive signaling instruments are likely to be less effective.

IMF staff therefore concludes that many attempts to develop new signaling instruments have not stood the test of time or have failed to gain Board support.

In Search of a New Signaling Instrument: EU Donors' Perspective

The US has consistently been a strong advocate for a new instrument. In response to the US proposal for a so-called non-borrowing arrangement, IMF staff decided to put on the table a new signaling instrument in September 2004. The new instrument was tentatively named the Policy Monitoring Arrangement (PMA). The Board did not have a final judgement, but encouraged staff to pursue consultations with potential users, private market participants and donors to ascertain the usefulness and potential demand for a signaling mechanism (IMF, 2004c).

To this aim, the Fund circulated a questionnaire to recipient countries, other multilateral agencies and donor governments. The following draws some general conclusions on IMF signaling from the perspective of EU donors. Fourteen EU donors (Austria, Denmark, Finland, France, Germany, Italy, the Netherlands, Poland, Portugal, Spain, Slovenia, Sweden, the United Kingdom and the European Commission) filled in the questionnaire. The Czech Republic, Cyprus, Estonia, Hungary, Latvia, Lithuania and Malta indicated that their aid policies are still under development, while Belgium is currently in the process of revising its policies.

All EU donors use Fund signals to inform their development assistance decisions. In line with the economic literature, donors believe that the Fund signals convey three kinds of information: superior information from the Fund about a country's economy, policies and prospects; assessment of a country's commitment to sound policies; and information on financing needs and available resources. Given its relationship with the national authorities as well as its competence and expertise, the Fund has an information advantage, at least with regard to macroeconomic policies, financial sector issues and public finance management. In effect, the Fund can reduce the information asymmetry of bilateral donors vis-à-vis the recipient countries.

A key issue is whether the approval or presence of an IMF-supported programme is one of the requirements for aid allocation. All EU donors indicate that this is not the case for project aid. The only exception is if the project is in the economic/financial sector and the Fund information brings to light an issue that might affect successful implementation of the project. The picture emerging from the responses of those countries that disburse substantial amounts of budget support varies. Three groups can be distinguished. For the first group of countries, a Fund arrangement being on-track is a *strict* requirement for budget support. If a programme goes off-track, the donors would directly stop providing budget support. For a second group of donors, the Fund arrangement being on-track is *effectively* a policy requirement for budget support. Countries in this group, however, clearly state that there is never an automatic or mechanistic use of this IMF signal; there is always room for own judgement based on a variety of other sources of information. If a Fund-supported programme goes off-track, they will reconsider but not necessarily stop budget support. This decision will also depend on the reasons *why* the Fund cannot but delay programme reviews. A third group of countries focuses completely on the substantive reasons why a programme goes off-track, and attaches no specific value to the on/off signal. None of the EU donors indicate that a Fund arrangement is a legal requirement. Overall, the perception that donor support is directly linked to the status of a Fund arrangement is not confirmed by the EU responses to the questionnaire. In procedural terms, the link is indirect at best.[4]

Nearly all EU donors attach value to a regular, and mostly also frequent, availability of Fund signals, which help donors improve the predictability of aid. This is particularly relevant if a PRGF review is delayed or if there is no IMF arrangement in place; otherwise the normal PRGF review schedule will more or less guarantee regular Fund signals. In the latter case, some donors suggest to issue assessment letters reports on a more frequent basis, for example twice a year, following a pre-announced schedule. They also indicate that assessment letters should contain up-to-date information and be candid on policy strengths and weaknesses with a clear underpinning of the conclusions reached. In this way, assessments letters could effectively combine an on/off signal with a more textured picture.

Various EU donors need an on/off signal, but others do not believe on/off decisions are a necessary feature of a signal or even oppose on/off signals. Most of the donors that need on/off signals consider upper tranche conditionality and Board endorsement as necessary components of a clear signal, for others they are not. Even more importantly, nearly all donors would also highly appreciate more textured and multidimensional signals as they would enhance insight into the development process and foster well-informed decisionmaking. A recurring issue in the responses to the questionnaire is that donors

---

[4] This does not deny the fact that the correlation between IMF arrangements and bilateral budget support is and may remain strong, which suggests that donors do not always use the available room for manoeuvre. Besides, only a few EU donors have responded to the question what they do with the committed resources if they decide to discontinue budget support due to the off-signal by the Fund. Normally, these funds will be allocated for other development purposes or become part of a broader budget prioritisation. One donor applies the interesting rule that for IMF/Bank constituency countries, 50% of the budget reserved for macroeconomic support will be allocated to programmes or projects that are instrumental in getting the Fund programme back on track. This promotes flexibility in decisionmaking and predictability of aid flows.

want the IMF to explain especially *why* PRGF reviews are delayed or *why* a PRGF programme is effectively off-track. At present, there is often a lack of information, which may imply ambiguous and mixed signals. The "noise" around the signal may then dominate the signal itself. Is the delay or off-track situation due to macroeconomic or macro-critical structural policy failures? Is it because of temporary circumstances beyond the control of the authorities and for which the Board for some reason is not expected to grant a waiver? Is it due to typical IMF procedures, for example in terms of its safeguard policies? A better explanation would help donors to assess whether the reasons are relevant or critical for the effectiveness of the aid. Such a process may, in turn, mitigate unnecessarily large swings in aid flows.

The recent experience in Vietnam may serve as a good example in this respect. PRGF reviews were delayed, subsequently the programme was curtailed, because the national authorities were not willing to allow an audit of the central bank management of foreign exchange reserves. In addition to the procedural reason for curbing IMF lending, the Fund – especially the Board – criticised the lack of progress in reforms of the state-owned enterprises and state-owned commercial banks. However, at the same time, the Fund signaled in its documentation and briefings that macroeconomic policies were sound. Based on this set of nuanced information, donors expected that aid effectiveness would not be undermined and continued to disburse funds. Vietnam does not intend to renew the PRGF, but the Fund now informs the donor community better during Consultative Group Meetings and in other documentation and briefings. In the case of Mozambique, financial sector reforms caused a bottleneck in the implementation of a Fund-supported programme, but again donors decided to continue to provide budget support, linking this to annual progress in the PRSP. In both cases, "stop and go" processes were prevented thanks to good communication and a sound mutual understanding.

None of the EU donors believes the *volume* of IMF lending to be an important characteristic of an IMF programme. Rather, the mere presence of an IMF programme is the decisive factor for especially budget support. No donor will – necessarily – stop providing budget support if an average PRGF programme is followed up by a low-access PRGF programme, i.e. around 10 percent of a country's quota. In case a successor programme is not foreseen because the country no longer has a balance of payments need, most donors expect to continue budget support, but effectively need a clear IMF signal to do so. At the same time, some donors believe that if the Fund puts its money on the line, this adds to the credibility of the Fund on/off signal.

In sum, EU donors, including the Netherlands, generally believe that there was a kind of gap in the IMF instruments available to low-income countries, but thought that this gap could largely be addressed by modifying existing instruments and practices rather than to necessarily introduce a new instrument or mechanism. The following suggestions are the most often given:

- provide regular information on the status of a PRGF programme, especially if reviews are delayed or effectively off-track (e.g. according to the review schedule);
- give regular Fund assessments when a PRGF arrangement is not yet or no longer in place, for example by sending assessment letters to donors twice a year;
- provide better explanation, especially of off-signals, to donors to enable them to assess whether there is substantive reason to suspend or even stop financial support;
- give more textured information in addition to on/off signals, which would contribute to a higher quality of decisionmaking on aid commitments and disbursements.

These suggestions are expected to somewhat loosen the linkage between IMF on/off signals and aid decisions. This allows the Fund to continue catalysing other sources of finance, but with a lower risk of compromising the quality of its seal of approval and a lower risk of unjustifiable stop-and-go processes in bilateral aid flows.

Agreement on a New Signaling Instrument

Most EU donor responses were in line with the general outcome of the questionnaire as far as all donors were concerned. The Fund will therefore intensify and improve its policy on the issuance of assessment letters, providing donors with fuller and more textured information. On the issue as to whether the Fund should extend its present tool kit, many non-EU donors responded more positively. Apart from the donors, the low-income countries were also approached to respond to the questionnaire. They turned out to have similar views on the information issues as donors, but were largely in favour of both better using the existing tool kit and introducing a new instrument to fill the perceived gap between a programme relation and a surveillance-only relation. Subsequently, the issue was taken up again by the IMF. Most

G-7 countries favoured the introduction of a new instrument, while others, including the Netherlands, were ready to support the new instrument, but argued that it should meet the following criteria in order to enhance the Fund's effectiveness:

- upper tranche conditionality (tailor-made to country circumstances);
- endorsement by the Fund's Executive Board (adding to the strength of the signal);
- based on a country's poverty reduction strategy (ensuring national ownership);
- provision on a voluntary basis (truly demand-driven);
- clear focus on mature stabilisers (within the group of low-income countries).

The bottom-line of this approach is that a new instrument should not undermine the existing IMF instruments, particularly low-access PRGFs that have proven to be useful to low-income countries that still face a limited balance of payment problem and precautionary arrangements, that are effectively being used by middle-income countries as a way to signal their graduation towards the financial markets. It is therefore important to confine the new instrument to a subgroup of low-income countries that have fully surmounted stabilisation problems, but still need an IMF programme for signaling purposes. To ensure that existing instruments would not be undermined, the design and procedures of the new instrument should be the same. It would also be important that the instrument would not be "put into the market" as a more attractive instrument than existing ones and that countries were more or less pushed to apply for it. Even if countries belonged to the group of mature stabilisers, they should still be free to choose for a (low-access) PRGF-programme.

After consultations with both donors and potential users of the new instrument and collecting views through the questionnaire, the Fund came with a new proposal under the name of Policy Support Instrument (PSI) and targeted towards so-called mature stabilisers. This group currently is limited to a handful of countries in Africa and Asia, but is expected to grow over time. The characteristics of the PSI are consistent with the abovementioned criteria and thus received overall support among the Fund's shareholders. A PSI will also provide the basis for rapid access to concessional Fund resources in case of exogenous shocks, similar to a possible augmentation of a PRGF-arrangements for the existing group of members. With the adoption of the PSI in October 2005, a long discussion on the signaling role of the IMF was brought to a successful end.

We will however have to monitor its usefulness and its implication closely. The introduction of the PSI and the better use of assessment letters do not reduce the Fund's role in low-income countries, but mark a shift in countries that have reached a relatively high degree of stabilisation from direct financing towards indirect support, i.e. advising and catalysing. Together with a more frequent use of low-access PRGF-arrangement for countries that have not fully stabilised yet, this will further help to prevent a build-up of unsustainable debt levels in low-income countries.

3 The IMF and Debt Sustainability

Debt has been a problem for many low-income countries in the past and threatens to be so in the future. There are two sides to the debt problem. First, how to handle unbearably high debt burdens that are already in place, in particular how to decide on debt relief. Second, how to prevent the build-up of unsustainable debt levels. The IMF, together with the World Bank, is playing a leading role in both.

Debt Relief

Twenty-eight countries have already received HIPC assistance and their average debt service has been cut in half. Even though the HIPC process could therefore be called a success, many believe that additional relief is necessary. One of the reasons for this belief is that there are some countries that again reached unsustainable debt positions after receiving HIPC debt relief. An example is Uganda, whose debt-to-export ratio was reduced to less than 150 percent when it reached HIPC completion point in 2000, but had again risen to 288 percent in 2002. There is also discussion on whether a debt of 150 percent of exports is really sustainable, or – if it is deemed so – whether it is bearable in a broader sense since it reduces a country's resources to reach the MDGs. Against this background, the US launched a "Bold proposal" in 2004 to give 100 percent debt stock relief to HIPCs on International Development Association (IDA), African Development Fund (AfDF) and IMF debt. The proposal was quickly followed by counterproposals from the UK, Canada, the Netherlands, France, Japan, Germany and Norway. Discussions focused mainly on three issues.

The first was whether to give debt stock relief or debt service relief (in the latter a country's debt would not be written off, but its scheduled principal and interest payments would be cancelled on a yearly basis). Debt stock relief will provide the most definite assurance for a country of increased fiscal space in the future, thereby increasing predictability, which facilitates financial planning. Debt stock relief can also be preferred since debt stock is (independently of the current debt service) predictive of the risks of a financial crisis and has a negative effect on economic growth through "debt overhang", i.e. the knowledge that a debt stock will have to lead to large debt service payments in the future can reduce incentives to invest, thereby reducing growth. Debt service relief has as its main advantage that it allows for ongoing conditionality, which can help guarantee effective use of the resources that are freed up by the relief. As is made clear by some HIPC countries that have had a drop in their policy performance after receiving HIPC assistance, it is not certain that all HIPCs will maintain the policies that are needed to make effective use of the fiscal space that is created through debt relief. Since providing debt relief on an IDA loan comes down to giving budget support over a period of up to 40 years (the maturity of an IDA loan), proponents of debt service relief are of the opinion that donors should be able to stop this form of "unconditional budget support" if policies deteriorate. An additional advantage of debt service relief, also in enabling ongoing conditionality, is that it can be used to mitigate the moral hazard effects of debt relief. Countries may start borrowing at an unsustainable rate after receiving relief under the assumption that the new debt will also not have to be paid back. By making the debt service relief conditional on prudent debt management, this moral hazard effect can be neutralised. Finally, debt service relief will protect the financial solidity of the participating institutions. If debt stock relief is given and donor compensation does not materialise, the institutions can potentially face a large loss. Debt service relief allows the institutions to stop the relief if not enough donor compensation is available.

The second issue on which views varied was how to determine the level of debt relief. Several countries wanted to simply cancel outstanding debt in full. Other countries believed that 100 percent debt relief would unnecessarily undermine a country's credit culture and that therefore debt relief should only be given in order to reach sustainable debt levels as determined by the new Debt Sustainability Framework (DSF, see below). Basing the amount of debt relief on debt indicators has two drawbacks, however. First, it will result in giving the highest debt relief to those countries that in the past followed imprudent debt policies, thereby rewarding poor performance. Although this will also be the case if the full debt relief option is chosen (since countries with a higher debt will receive more relief in that case as well), this effect becomes more pronounced by only giving relief on debt above a certain threshold. This problem is exacerbated by the fact that the new DSF applies lower debt thresholds to poor performing countries. Countries that are poor performers are thus more likely to have an unsustainable debt and to receive more debt relief. The second drawback is of a more political nature. Although some HIPCs have again built up an unsustainable debt, many low-income countries are below or only slightly above their debt sustainability threshold. Thus, giving debt relief only up to this threshold would greatly lower the overall amount of debt relief.

The third issue of discussion among the different donor countries related to eligibility. In order to qualify as a HIPC, a country needs to have an income below the PRGF-eligibility threshold (885 dollar a year) and at the same time a debt above 150 percent of debt-to-export. Thus, those countries that became eligible for HIPC debt relief were, at the time, among the poorest and most heavily indebted. Various countries believe that the HIPC countries should therefore again be the countries to profit from the new debt relief. Others, including the IMF, find that the HIPC relief has brought the debt burden of many HIPCs under control and that there are non-HIPCs at least as poor as some of the HIPCs. According to them, it would be unjust to let those countries qualify for debt relief which used to have a debt above 150 percent but have since received HIPC debt relief, while at the same time excluding countries that are just as poor but have debt ratios that are (in some cases only just) below 150 percent. For IMF debt relief this is especially problematic since the IMF is expected to finance relief out of its own resources. The use of IMF resources without applying uniformity of treatment is questionable in principle, but is also in conflict with the IMF's legal provisions. Under the Fund's rules, any decision by the Fund to differentiate between members must be based on the application of criteria that are relevant to the objective of the power being exercised. This seems not to be the case for the proposed differentiation between non-HIPCs and post-completion point HIPCs.

In September 2005, a compromise was reached on giving 100 percent debt stock relief, without reference to debt sustainability indicators.

Countries will receive debt stock relief but will at the same time receive a proportional cut in their AfDF and IDA allocations. The net receipts from IDA and AfDF will therefore remain dependent on the quality of a country's policies and institutions (as measured by the Word Bank's and AfDB's Country Policy and Institutional Assessment)[5] reducing the reward for poor performers and upholding the incentives for good performance[6]. It was also decided to give debt relief to HIPCs only, but equal treatment has been guaranteed to a large extent because donor countries will compensate IDA and AfDF for the debt relief given to HIPCs and this additional financing will be distributed among *all* IDA/AfDF-recipients. This procedure cannot be used for the IMF since it is impossible to reduce IMF allocations in proportion to the relief given (since the IMF does not have a fixed allocation per country, but gives its assistance based on balance of payments need). Uniformity of treatment will therefore be achieved by basing eligibility for relief that will be financed by the IMF's own resources on an income criterion. IMF relief for HIPCs whose income is above this threshold will be financed out of the PRGF Trust, which does not belong to the IMF's own resources but which is made up of donor contributions. Although it is not yet possible to say exactly how much debt relief will be given under the initiative, it is clear that it will lead to a comparable amount of debt relief as will be granted under HIPC. The Fund's share amounts to about SDR4 billion, double the amount of debt relief it has committed under HIPC. The initiative will thus provide all low-income countries with a significant boost in resources to support their efforts to attain the MDGs.

How to Prevent the Build-Up of New Unsustainable Debt?

The fact that some HIPCs find themselves in an unsustainable debt situation only a few years after receiving significant debt relief increased the call for prevention measures. In response, the IMF and World Bank

[5] The CPIA consists of a set of criteria representing the different policy and institutional dimensions of an effective poverty reduction and growth strategy.

[6] Relief countries that currently receive loans from IDA will have the advantage that they will effectively trade in these conditional loans for unconditional grants (the relief). This will result in a NPV advantage of about 40% (IDA loans have a grant equivalent of about 60%). On the other hand, if the debt relief lowers a country's debt relief under its debt sustainability threshold (see below) IDA will change its grant financing into loan financing.

Table 1 Debt Thresholds for Public and Publicly Guaranteed External Debt

	Country Policy and Institutional Assessment (CPIA)-category		
	Weak (CPIA<3.25)	Medium (3.25 <CPIA<3.75)	Strong (CPIA>3.75)
NPV/GDP	30%	40%	50%
NPV/Export	100%	150%	200%
Debt service/Export	15%	20%	25%

proposed a new Debt Sustainability Framework (DSF) in February 2004. The DSF determines how much debt a country can have without having the risk of debt becoming too high: its debt threshold. Under the HIPC Initiative, a common threshold of 150 percent of debt-to-exports was used for all countries. This could be defended because of equal treatment considerations (otherwise some countries' debt would be reduced to lower levels than that of others), but it did ignore important country differences in the ability to service debt. The Fund and the Bank therefore tried to develop thresholds that were more country specific. Further research showed that there are two key determinants of debt levels that a county can sustain.

The first is the quality of a country's policies and institutions as measured by the World Bank's Country Policy and Institutional Assessment (CPIA). Thus the IMF and the World Bank set different debt thresholds on the basis of performance. These thresholds can be found in Table 1.

Discussions focused mainly on how high the respective thresholds should be. This choice would have to balance the risk of debt distress with the costs of applying tighter constraints on borrowing. IMF and World Bank eventually chose thresholds that would give a country with a debt ratio at these thresholds an average chance of debt distress (a disruption in debt service payments) in the following three years of about 20 percent. Apart from the wish to be cautious, the concurrent discussions on the IDA grants window also played a role. Since IDA deputies had decided to give IDA grants only to countries with an unsustainable debt, lower debt thresholds would increase the percentage of grants in total IDA allocations, a wish of one important donor, the US. The downside of this relatively low threshold is that the "type I error" is about 60 percent. That is, about 60 percent of the countries that the framework will identify as having an unsustainable debt and therefore in need of reducing its debt burden, will actually not experience any debt servicing trouble if no further actions are taken.

The second key determinant of the debt levels a country can sustain is its susceptibility to shocks such as adverse movements in key macro-economic variables or volatility in export earnings. Therefore, the IMF and World Bank will construct a forward-looking debt sustainability analysis (DSA) under the framework in which they project how a country's debt ratio will evolve given a country's expected economic performance in the medium to long term and given its exposure to other economic factors such as exogenous shocks. If the projections show that a country is likely to break its debt thresholds or that it will not make enough progress in lowering its debt ratios if they are currently too high, the IMF and World Bank will advise on a change in debt policies.

At the time of writing, only a few of such forward-looking DSAs had been constructed. The IMF therefore still has to show that it can cope with a number of challenges that will result out of the application of the DSF. One such challenge is how flexible the IMF will have to be if countries threaten to break their thresholds. Since low-income countries rely heavily on external assistance, their potential to pro-actively manage their maturity structure and currency composition of their debt is limited and the change in policies in order to adapt its debt structure will thus often have to be a reduction in new borrowing. If not enough grant financing is available, this can only be done by reducing government expenditures.

The IMF and World Bank have decided to apply relatively conservative thresholds but if these thresholds really start to bite, countries may prefer to increase their risk of debt distress in order to maintain government expenditure at current levels. Tension in this regard may be increased by the fact that the DSF will likely work pro-cyclical. Since debt ratios will rise if exports or GDP fall, a reduction in borrowing and therefore possibly in government expenditure will be called for exactly when economic times are rough. Note that the IMF is itself also a provider of credit. Would it be tempted to be less strict in order to be able to continue its own lending? The integration of the debt sustainability assessment into the Fund's and Bank's own lending decision is often called the third pillar of the new framework, which will need to be further explored. Another challenge will be how to solve short-term liquidity problems. Since many development assistance loans have a grace period, even shifting from loans to grants will not have much impact on a country's debt service profile in the short to medium term. The IMF can provide extra liquidity support through an augmentation of its PRGF if there is an increased balance of payments need due to a shock, but IMF financing would at the same time add to the debt stock. How should smoothing of short-term liquidity problems be weighted against longer-term solvability issues? We look forward to the coming years, in which increased experience with the framework will provide useful insights on how to deal with these issues.

4 Concluding Remarks

We have discussed some of the main challenges related to the Fund's future role vis-à-vis low-income countries. In many respects, these challenges are closely interlinked. If the Fund is better equipped to design and implement a gradual exit strategy, a country may be better able to shift from IMF financing to other, more concessional funding, which, in turn, reduces the build-up of new, possibly unsustainable debt. This process will be facilitated if the IMF can use the new Policy Support Instrument, providing a strong signal, also on debt sustainability, but without financing.

In general, the recognition of a longer-term relationship between the Fund and low-income countries should not be confused with a need for IMF financing being provided over longer periods. The Fund should phase out its financial involvement when it is no longer effective or no longer needed. The issues of "saying-no" and the design of proper "exit strategies" are among the main future challenges of the IMF. Especially for countries that have stabilised their economies, the Fund's direct role in providing balance of payments support needs to change into an indirect role, i.e. to catalyse other sources of financing for the achievement of the MDGs.

In order to attain the MDGs, low-income countries need significantly more resources and more fiscal space. One of the most pressing issues is the build-up of high debt levels in most poor member states. The new multilateral debt relief initiative and the application of the new debt sustainability framework should prevent the building up of new unsustainable debts.

In sum, we expect the Fund to remain of vital importance in low-income countries in the decade to come, but the nature of its involvement will change, as it has over the last decades. We hope this change will manifest itself in a shift from a direct role in financing balance of payments gaps to a more indirect role in catalysing other sources of funding by providing signals on the macroeconomic and financial developments in countries. This would reflect countries' progress in bettering their predicament.

References

Bulir, Ales and Timothy Lane, (2002), "Aid and Fiscal Management", Working Paper 02/112, IMF, Washington D.C., June.

DFID/HM Treasury (2004), "IMF Signalling in Low-Income Countries", Discussion Paper, HM Treasury and Department for International Development (DFID), London.

IEO (2002), "Evaluation of Prolonged Use of IMF Resources: Evaluation Report 2002", Independent Evaluation Office of the IMF, Washington D.C.

IMF (2003a), "IMF Concludes Discussion on Prolonged Use of Fund Resources", Public Information Notice 03/49, IMF, Washington D.C., April.

IMF (2003b), "Operational Guidance Note for Staff on Letters and Statements Assessing Members' Economic Conditions and Policies", SM/03/216, IMF, Washington D.C., 20 June.

IMF (2004a), "IMF Concludes Discussion on the Fund's Support of Low-Income Member Countries: Considerations on Instruments and Financing", Public information Notice 04/40, IMF, Washington D.C., April.

IMF (2004b), "Signaling by the Fund – A Historical Review", prepared by the Policy Development and Review Department, IMF, Washington D.C., July.

IMF (2004c), "Policy Monitoring Arrangement", prepared by the Policy Development and Review Department, IMF, Washington D.C., September.

IMF (2005), "Bolivia: Ex Post Assessment of Longer-Term Program Engagement – Staff Report and Public Information Notice on the Executive Board Discussion", IMF Country Report No. 05/139, IMF, Washington D.C., April.