

The IMF's Work on Low-Income Countries

I. Introduction

The IMF remains a committed partner in the international effort to help countries reduce poverty, attain higher growth, and achieve the Millennium Development Goals (MDGs). Notwithstanding many of the significant changes made in IMF operations over recent years, the core work of the IMF remains relatively unchanged, while Fund involvement in low-income countries has gradually evolved to include a specific focus on poverty reduction and on the achievement of the MDGs. The fundamental component of this work is helping members address the macroeconomic challenges inherent in the development process, including those arising from scaling up aid flows. The Fund provides support to low-income countries in different ways: *policy advice, technical assistance and financial support, including debt relief*. The Fund's role in helping countries establish macroeconomic stability and sustainable high growth is central to this support. In its dialogue with countries, the IMF has also given increasing emphasis to improving the quality of fiscal adjustment and governance to achieve growth that will contribute to raising living standards and poverty alleviation. The provision of technical assistance and training to help member countries strengthen the capacity of their institutions and officials to manage economic and financial policies is an important part of the Fund's efforts. In recent years, the Fund has reinforced its efforts in this area by establishing regional technical assistance centers in the Pacific, the Caribbean, East and West Africa, and in the Middle East.

The Fund bases its support for low-income countries on country-owned strategies as described in Poverty Reduction Strategy Papers (PRSPs), which it sees as the main operational framework for implementing the necessary policies and coordinating the efforts of development partners. In this context, Fund staff have been working to align programs under the Poverty Reduction and Growth Facility (PRGF), the Fund's main instrument for providing financial assistance to low-income members, with PRSPs.

As described in more detail below, the IMF has recently refined and strengthened its support of low-income members, including through the introduction of the Exogenous Shock Facility (ESF), the Policy Support Instrument (PSI), the Multilateral Debt Relief Initiative (MDRI), and the Trade Integration Mechanism (TIM). Efforts to improve the IMF's support for low-income countries will continue, as the Fund is currently considering how to strengthen further such support in the context of its evolving medium-term strategy for serving all of its members better.

While it has not been possible to describe every area of work of relevance to the IMF, areas of major importance are discussed below with reference next to section headings of their relationship to commitments under the Brussels Programme of Action for Least-Developed Countries.

II. Support for Country-Owned Poverty Reduction Strategies (Commitment One: Fostering a people-centered policy framework)

As noted above, the IMF bases its support to low-income countries on country-owned poverty reduction strategies. In 1999, the Fund and the World Bank initiated the Poverty Reduction Strategy Paper (PRSP) with the objectives of promoting country ownership of a comprehensive development strategy, making poverty reduction more prominent in policy debates, and fostering outcomes that benefit the poor. This approach is now well established in a substantial number of countries.

The latest joint Bank-Fund review of the Poverty Reduction Strategy (PRS) approach, completed in September 2005, confirmed that this approach is a useful operational framework for implementing and coordinating efforts to foster growth, poverty reduction, and progress towards the MDGs, and to improve the accountability of governments to their citizens and donors. It also provides a platform for scaling up country efforts to achieve the MDGs. Yet, more needs to be done by countries and their development partners to: (i) establish links between the MDGs and the country's policies; (ii) link the PRSP to the medium-term expenditure framework and annual budget; and (iii) strengthen monitoring systems. The review also suggests that broader, institutionalized participation, especially of parliaments, could strengthen domestic accountability.

The Fund has adapted the way it operates to support the PRS process. Because the PRSP serves as a basis for IMF concessional lending under the PRGF, Fund staff aim to enhance the consistency between IMF programs, PRSPs and government budgets. Increasingly, IMF programs incorporate flexibility to accommodate higher pro-poor spending funded through donors or global funds, and program conditions are linked more closely with the objectives of the PRSP. Since 2005, to provide countries greater flexibility to articulate and implement their strategies, endorsement of the PRSP by the Executive Boards of the Fund and the Bank is no longer required for PRGF lending.

The IMF is also cognizant of the fact that economic reforms may often have a temporary adverse impact on the poor. As such, the IMF and the World Bank, together with other organizations, are making increasing use of Poverty and Social Impact Analysis (PSIA) to assess the distributional impacts of major macroeconomic or structural reforms and to formulate countervailing measures. PSIA is a valuable input into policy formulation, promoting a more informed public debate of policy choices and outcomes, and facilitating the adoption of policies that mitigate any adverse effects on the poor and vulnerable groups. In 2004, the IMF set up a PSIA unit with staff dedicated to the specific task of integrating such analysis into the design of IMF-supported programs. This group helps country teams assess the likely effects of key reform measures on different population groups, especially the poor. By drawing on the work of other development partners and augmenting and refining analyses where necessary, the group helps design and integrate into IMF programs compensatory measures to mitigate the negative effects of policy reforms on poor and vulnerable groups.

Looking ahead, to improve further its operations and respond to countries' needs, the Fund has set a number of near-term priorities. These include: (i) helping countries develop alternative scenarios for scaling up aid to reach the MDGs; (ii) assisting countries in managing the macroeconomic implications of higher aid flows; and (iii) continuing to provide technical assistance and capacity-building support in the design of PRSPs in IMF areas of competence. In addition, the PRSP approach needs careful tailoring to the specific challenges faced by fragile or conflict-affected states. The IMF will also continue to work with donors for better-coordinated assistance that will enhance aid effectiveness and rationalize support for PRSP implementation (see section VII).

III. Improving Governance (Commitment Two: Good governance at national and international levels)

The IMF recognizes that good governance is a prerequisite for establishing and maintaining private sector confidence and encouraging sustained growth and poverty reduction. Where necessary, in areas that can have a significant macroeconomic impact, it helps countries adopt broad institutional reforms that promote good governance, and minimize the scope for corrupt practices. It does so through its policy advice, technical assistance and, where relevant, program conditionality, focusing on two main areas:

- **Improving the management of public resources** through reforms covering public sector institutions (e.g., the treasury, customs, the central bank, public enterprises, and offices of statistics) and related administrative procedures. In this context, the IMF provides advice on improving fiscal policy and management (e.g., revenue administration, tax policy, public expenditure management and expenditure control, and tracking of poverty-reducing spending in countries that received debt relief under the HIPC initiative and the MDRI).
- **Supporting the development and maintenance of an appropriate economic and regulatory environment** conducive to efficient private sector activities (e.g., price systems, exchange and trade regimes, and banking system regulations).

In these areas, the IMF seeks to increase transparency as an operational way of improving governance. For example, Fund staff have developed standards and codes for fiscal transparency and for transparency in monetary and financial policies. Countries' observance of standards and codes is assessed, in some cases jointly with the World Bank, through Reports on the Observance of Standards and Codes (ROSCs) and Financial Sector Assessment Programs (FSAPs). Half of the IMF's developing country members have volunteered to participate in such assessments, and received prioritized recommendations for improvement, as well as extensive technical assistance. As another example, under the Fund's General Data Dissemination System, to improve the quality and timeliness of economic and financial data, IMF staff have developed and disseminated data standards that guide countries in the compilation and dissemination of data. The Fund monitors implementation of these standards by the countries that have chosen to participate.

In many natural resource-exporting countries, where corruption and diversion of revenues are of particular concern, IMF staff actively promote transparency in the management of resource revenues. The objective is to achieve a more effective use of natural resources through greater accountability and clearer identification of policy options to address problems related to intergenerational income distribution and income volatility. To support this work, a *Guide on Resource Revenue Transparency* was produced in 2005 that highlights the unique set of issues involved in natural resource revenue transparency and presents good practices for dealing with them. The IMF also supports the Extractive Industries Transparency Initiative (EITI), which promotes the voluntary disclosure by companies and governments of payments and receipts resulting from natural resource exploitation. In addition to promoting transparency in these countries, the Fund's work on financial integrity and in particular anti-money laundering, contributes to the drive against corruption by hindering the diversion of funds through the financial system and assisting prosecutions.

IV. Supporting Pro-Poor Expenditures (Commitment Three: Building human and institutional capacities)

The IMF has encouraged low-income countries to maintain an adequate level of social spending to help foster human development and achieve the MDGs. Some Fund-supported programs in such countries have or have had explicit conditionality to ensure that a minimum level of priority social spending is executed. Accordingly, there has been a shift in the composition of government spending towards the social sectors in countries with IMF-supported programs. Data on education and health care spending in low-income countries with IMF-supported programs over the period 1985–2002 show a significant rise in spending in these two areas. Compared to the year preceding the program, education spending increased on average by about 0.8 percentage point of GDP, and health outlays rose by about 0.5 percentage point in all program countries. Spending in these sectors also increased as a share of total government spending. In low-income countries with IMF-supported programs, the share of education in total spending increased by 2.9 percent and that of health by 1.9 percent. This translated into sizeable increases in real social spending per person, and to improvements in social indicators for education and, to a lesser extent, for health, particularly those associated with the MDGs.

Although the IMF's work on social protection systems is limited, given that other development partners have greater expertise in this area, the Fund has focused on assessing the fiscal costs of these systems and options for implementing fiscally-sustainable pension systems. In this context, IMF-supported programs have paid increasing attention to social protection issues, with a view to ensuring that outlays for social safety nets are incorporated into the budget. This is especially the case for PRGF-supported countries. The IMF also provides technical assistance to member countries for implementing fiscally sustainable pension systems. In addition, advice has been provided on how to adopt social protection instruments into social safety nets during periods of adjustment.

Improved expenditure tracking and management is an important element of reform in the heavily indebted poor countries covered by the HIPC Initiative. Through the HIPC

Assessment and Action Plan, the IMF and World Bank have jointly assessed the quality and capacity of public expenditure systems in these countries and formulated action plans to strengthen those systems. Implementation of these action plans has resulted in substantial progress in a number of HIPCs. Building on this exercise, the Public Expenditure and Financial Accountability program, in which the IMF participates, has extended a public financial management performance measurement framework to a wider group of countries. Efforts are also under way by the Fund to report on MDRI flows and changes in poverty-reducing spending as well as to strengthen public financial management systems in beneficiary countries.

V. Promoting Trade (Commitment Five: Enhancing the role of trade in development)

Trade can be a powerful tool for stimulating development and the Fund has been encouraging member countries to support trade liberalization under the Doha Round. In the context of discussions with industrialized countries, it has consistently advocated better market access for developing countries' exports, and the elimination of agriculture subsidies.

Yet, gains for developing countries will not necessarily be automatic. Some countries might require assistance in overcoming existing supply constraints, and in mitigating and managing adjustment costs. With this in mind, the Bank and the Fund have been active supporters of the "Aid for Trade" agenda, and have proposed a strategy based on the following elements:

- confirmation of the role of the Integrated Framework (IF) as a potentially powerful instrument to help countries identify and embed a trade and competitiveness agenda in their poverty reduction strategies, and to coordinate assistance;
- support for the IF with increased and more predictable financial resources;
- scaled-up trade-related technical assistance, capacity building, as well as investment in high-priority projects; and,
- assistance to developing countries in addressing the potential adjustment costs of more open international trade.

The international community has welcomed these proposals, and is working, in consultation with the World Bank and the Fund, on modalities for implementation. The Fund and the World Bank are also working with countries to encourage the full integration of trade issues into their poverty reduction and growth strategies.

The Fund is committed to assist countries in addressing the transitional costs of trade liberalization. In its analytical work, the IMF has stepped up its focus on the implications of trade liberalization with an emphasis on the specific concerns of developing countries, namely: (i) preference erosion in major export markets; (ii) possible changes in food terms of trade due to the reduction in agriculture subsidies; (iii) the fiscal impact of tariff reductions; and (iv) the implications of financial service trade liberalization for bank regulation and supervision. The results of this analysis will inform Fund surveillance of the sequencing of trade liberalization and domestic tax reform. In its policy advice, the Fund has been helping

members with issues related to tax system reforms in the face of tariff revenue loss, customs reforms, and financial system regulation and supervision. The analytical work will help tailor the Fund technical assistance and enhance its effectiveness.

The Fund is also supporting trade liberalization through its financial assistance. In 2004, it introduced the Trade Integration Mechanism (TIM), which is designed to help members cope with the possible balance of payments impact of liberalization by trading partners including of preference erosion. Bangladesh has already benefited from this facility.

VI. Helping Countries Cope with Shocks (Commitment Six: Reducing vulnerability and protecting environment)

Developing countries are more prone to suffer from serious exogenous shocks than industrial countries, and the incidence of such shocks is particularly high for low-income countries. Although in value terms, the economic damage from natural disasters tends to be largest in developed countries since they have more capital to lose, disasters occur most frequently in low-income countries where damage and the costs of recovery relative to GDP are also the highest. Low-income countries are also the most vulnerable to commodity price shocks.

In its policy advice, IMF staff help countries in the aftermath of a shock to assess the fiscal and balance of payments impacts, so as to develop appropriate fiscal, monetary and exchange rate policies, and determine the additional external financing need. For large shocks with a broad international impact, such as an increase in the world oil price, staff normally analyzes the effects across its whole membership and makes estimates about possible adjustment and financing responses.

The IMF has a number of instruments for providing swift financial assistance in response to exogenous shocks. Of these, augmentation of access under existing PRGF arrangements has been the main vehicle for helping low-income countries. Otherwise, Emergency Assistance for Natural Disasters (ENDA) has been used to provide quick-disbursing assistance to member countries that cannot meet their immediate financing needs arising from a major natural disaster without seriously depleting their foreign reserves. Since early-2005, ENDA has been available to PRGF-eligible countries at a subsidized interest rate.

In January 2006, the IMF established the Exogenous Shocks Facility, a new facility aimed at low-income countries without a PRGF program in place, which cover a wide range of exogenous shocks on more concessional terms than ENDA. Qualifying events include commodity price changes (including oil price changes), natural disasters, and conflicts and crises in neighboring countries that disrupt trade.

Conflict creates a shock with repercussions that can last for many years. The IMF has had extensive experience in providing support to countries emerging from conflict. The Fund typically becomes involved in a country soon after the end of conflict and sometimes even earlier. The Fund's primary role in post-conflict situations is to help countries restore macroeconomic stability and to lay the basis for sustainable, high-quality growth. In this

process, the Fund works closely with other international agencies and bilateral donors. Fund assistance takes three forms: technical assistance focused on rebuilding capacity to formulate and implement economic policies, economic policy advice, and financial assistance. For low-income countries, Emergency Post-Conflict assistance has been provided in recent years at a subsidized interest rate. A key objective of this financial assistance is to provide a bridge until the country has adequate stability and administrative capacity to implement a comprehensive economic program supported by an IMF arrangement.

VII. Mobilizing Domestic Resources (Commitment Seven: Mobilizing financial resources)

The importance of improved public resource mobilization and use is underscored by the need for stronger programs in infrastructure and human development as part of the efforts to achieve the MDGs. While increased external assistance can play a major role, low-income countries also need higher domestic resources to support these priorities—through higher savings, increased government revenues, improved expenditure allocation and oversight, and strengthened domestic debt management.

Regarding the need for higher savings, the IMF plays an important role by helping countries strengthen their financial systems through ROSCs and FSAPs (see section III). An effective financial system promotes economic growth and poverty reduction by mobilizing savings and allocating them to productive uses. It can also reduce poverty directly by protecting savings, allowing migrants to remit funds, and providing small entrepreneurs (including women) with access to credit through microfinance programs.

The IMF also advises its low-income country members on how to raise government revenue, typically through broad-based and simplified tax systems that are easy to administer. While excessive taxation can impede private sector development and reduce growth, and the distributional impact of tax policies need to be carefully considered, in practice, the problem faced by most developing countries is to collect enough revenue to finance essential infrastructure and human development services. In this context, the Fund provides technical assistance to its members in tax policy (including income, consumption and trade taxes), with a view to support the authorities in the design and implementation of their own tax reform plans. Efforts to mobilize tax revenues should also include steps to strengthen the tax administration, which the Fund also supports through technical assistance.

VIII. Facilitating More and Better Aid (Commitment Seven: Mobilizing financial resources)

Higher external aid is needed for low-income countries to accelerate progress towards the MDGs. The Fund has repeatedly called on developed countries to deliver on their ODA commitments under the Monterrey Consensus, and will continue to do so. There are now indications that promises for scaling up aid may actually materialize. In particular, the G-8 leaders committed at the Gleneagles Summit to double aid to Africa by 2010, Development Assistance Committee members from the European Union pledged in May 2005 to achieve a

near-doubling of aid by 2015, and the United States has committed to speed up delivery of aid pledged through its Millennium Challenge Account.

Innovative financing mechanisms, such as the International Finance Facility and global taxes, could augment aid flows and development investment. The IMF has contributed to the analysis of such mechanisms in joint papers with the World Bank for the Annual Meetings and Spring Development Committee meeting in 2004 and with input on air travel taxation for the Annual Meeting in 2005. Several of these mechanisms are now in the early stages of implementation.

But larger aid flows are not enough, and aid effectiveness also needs to improve for aid to achieve the desired results. Better alignment of donor support with national poverty reduction strategies, improved donor coordination, and harmonization of aid modalities and processes across donors could go a long way to reduce transaction costs of development assistance and enhance aid effectiveness. The Fund has been actively supporting international efforts to achieve this goal, in particular through initiatives such as the *Paris Declaration on Aid Effectiveness*, in which donors and developing countries agreed on mutual commitments, as well as on indicators and targets for monitoring progress.

The Fund can help mobilize external aid by sending clear signals to donors about the quality of low-income countries' policies. So far, this has been done mostly in the context of PRGF-supported programs. Yet, as countries' policies improve and aid increases, the relative importance of Fund financing is declining. In this context, the Policy Support Instrument (PSI) was established in October 2005, as a complement to the PRGF, to address the needs of low-income members that may not need or want Fund financial assistance, but seek Fund advice, monitoring, and endorsement of their economic policies. Two PSI programs—for Nigeria and Uganda—have been approved, and discussions with other members on a possible PSI are ongoing.

The Fund is committed to reinforce further its efforts to help low-income countries cope with the intensified challenges associated with a surge in aid. Indeed, while scaling up of aid may facilitate an expansion in vital public services and increased investments, it will also create challenges in terms of macroeconomic management. Increased reliance on aid can expose a country's budget to more volatility and unpredictability, thus complicating budget management, especially if weak domestic revenue collection limits government's capacity to substitute resources in the event of aid shortfalls. Higher aid flows may also exacerbate weaknesses in public financial management systems, and reduce incentives for domestic resource mobilization and fighting corruption. Other issues that aid-recipient governments could face include: (i) the possible impact of large aid inflows on the real exchange rate that may hamper competitiveness and long-term growth ("Dutch disease"); (ii) increased complication in determining the appropriate stance of monetary policy; and (iii) absorptive capacity constraints that limit the country's ability to utilize additional aid inflows effectively and efficiently.

The IMF is already working with aid recipients to help them assess the macroeconomic implications of higher aid inflows, and advise them on policies that facilitate aid absorption, preserve macroeconomic stability, debt and fiscal sustainability, and alleviate structural bottlenecks to unleash growth potential. It will continue to provide technical assistance to strengthen macroeconomic and budgetary policy management. At the same time, it is encouraging donors to support aid recipients by significantly increasing aid predictability and durability of long-term commitments.

IX. Debt Relief and Sustainability (Commitment Seven: Mobilizing financial resources)

In 1996, the World Bank and IMF launched the Heavily Indebted Poor Countries (HIPC) Initiative. The objective of the Initiative was to reduce the external debt of the world's poorest, most heavily indebted countries to sustainable levels. Following a comprehensive review in September 1999, the HIPC Initiative was enhanced in order to provide faster, deeper, and broader debt relief and to strengthen the links between debt relief, poverty reduction, and social policies. The enhanced HIPC Initiative provides substantial debt relief to countries which implement sound economic policies and critical social reforms, as part of an integrated approach to sustainable development. The enhanced Initiative has focused on ensuring that resources released through debt relief are used for productive outlays, in particular, for social sector and poverty alleviation programs. Recently, the HIPC sunset clause was extended to end-2006 with its application ring-fenced to low-income countries with unsustainable external debt based on end-2004 data. This extension provides an opportunity for the remaining countries that could qualify to start to establish a policy track record before this sunset date.

As of February 2006, 28 countries had reached the Decision Point under the Enhanced HIPC Initiative. The total debt relief received by these countries represents a two-thirds reduction in their overall debt stock. Of these 28 countries, 18 have reached the HIPC Completion Point and have received irrevocable debt relief which amounts to US\$22 billion in net present value terms. Yet for debt reduction to have a tangible impact on poverty, these additional resources need to be targeted at the poor. Before the HIPC Initiative, eligible countries were, on average, spending slightly more on debt service than on health and education combined. This is no longer the case for the 28 countries receiving HIPC relief.

While HIPCs are seeing clear gains, difficult problems remain in HIPCs that have not yet been able to reach their decision points. Some of the latter are plagued by uneven policy records or poor governance, and sometimes civil conflict. Some HIPCs also have debts too large to write off given current funding for the Initiative (e.g., Liberia, Somalia, and Sudan), while there is not as yet funding for countries that may enter the Initiative through the sunset clause.

Under the Multilateral Debt Relief Initiative (MDRI), first advanced by the G-8 in June 2005, the objective was for the IMF, the IDA and the AfDF to provide additional debt relief by canceling 100 percent of their claims on countries that have reached the completion point

under the enhanced HIPC Initiative, or may reach it in the future. The MDRI was intended to provide eligible countries with additional balance of payments support from the Fund, thereby freeing up resources to help them reach the MDGs. **In January 2006, the IMF played its part in this Initiative, by delivering MDRI relief to 19 countries, including to 2 non-HIPCs that qualified.** The debt service saved by this relief is estimated to represent, on average, 3 percent of GDP or 15 percent of exports. The impact will differ from country to country, depending on their level of indebtedness. Other countries will qualify for MDRI debt relief from the Fund once they reach the completion point of the HIPC Initiative.

To support low-income countries in their efforts to achieve the MDGs without creating future debt problems and to keep countries that have received debt relief under the HIPC Initiative on a sustainable track, the Fund and the World Bank have introduced an operational framework for debt sustainability assessments (DSAs). If the MDGs are to be financed in a way that does not lead to an unsustainable build-up of debt, it is likely that substantial additional grant financing will be needed.

The consequences of the Multilateral Debt Relief Initiative (MDRI) for the DSA framework are being assessed by Fund and World Bank staff. Many of the countries which will benefit from the MDRI will have debt ratios much below the policy-dependent thresholds that Fund and Bank staffs use to assess the risk of debt distress. Thus, these countries will potentially have additional space to borrow, including at non-concessional terms. They will need to strike the right balance between making faster progress toward the MDGs, avoiding accumulating excessive debt again, and preparing themselves for relying more on market financing in the medium-to-long term.

X. Policy Directions relating to the UN Agenda

The IMF Managing Director's Report on the Fund's Medium-Term Strategy specifies that the Fund should assume a more focused role in its relations with low-income countries with more emphasis on achieving the MDGs. The Report also specifies that, given the challenges related to the MDGs and scaling-up of aid, the Fund should adopt a more flexible approach in its programs with less procedure. While the details of the adjustments to be made in the Fund's engagement with low-income countries have yet to be finalized, the Fund will continue to work with development partners in the context of country-owned poverty reduction strategies.

Under the UN agenda for implementing and following up on the Brussels Program for Action, the PRSP should be the framework for coordinating donor support, setting targets and objectives, and monitoring performance. As noted above, the PRSP is the framework for the Fund's assistance and support to low-income countries, and should cover all the aspects of technical assistance and capacity building, as well as financial assistance that the IMF would provide.

While country review mechanisms such as the World Bank's consultative group and the UNDP roundtable meetings are valuable, the Annual Performance Review of the PRSP provides for a regular assessment of implementation, and this could and should be the principal coordination forum.

As noted in the joint World Bank-IMF Poverty Reduction Strategy Review in 2005, there is a need for appropriate institutional arrangements for in-country dialogue on policy options. In the context of such arrangements, there is a need for meaningful participation to strengthen domestic accountability, by opening space for policy dialogue, including in the macroeconomic area; better information and communication policies; and more effective involvement of parliaments, the private sector and vulnerable groups in the PRS process.

It is important that aid coordination be improved if external support is to become more effective. Progress in achieving better aid coordination and aid effectiveness should be measured along the indicators of the Paris Declaration.