INTERNATIONAL MONETARY FUND

October 26, 2018

2018 REVIEW OF THE FUND'S CAPACITY DEVELOPMENT STRATEGY—REPORT OF THE EXTERNAL ADVISORY GROUP

Prepared By

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[1] The views expressed in this report are those of the External Advisory Group and do not necessarily reflect the views of IMF staff, management, nor its Executive Board.

[2] The External Advisory Group serves as an independent check on staff's analysis and proposed recommendations, which were set out in the 2018 Review of the Fund's Capacity Development Strategy—Overview Paper. In this capacity, the group met three times: May 30, 2017, May 3, 2018, and July 26, 2018.

INTRODUCTION

1. **Overall, the External Advisory Group (EAG) considers the 2018 Capacity Development (CD) Strategy Review to be an excellent report.** Critically reviewing progress since the 2013 CD Strategy, the review emphasizes both continuity and change, using internal and external stakeholder assessments to identify the weaknesses in the existing strategy and its implementation. CD is a difficult task both to carry out and to evaluate progress. The report has done an excellent job in integrating various sources of input and evidence to base its recommendations. In particular, the EAG appreciates the early and ongoing consultation that allowed us to play a productive role and that many of our suggestions are reflected in the final report (including quotes from EAG members throughout the report). We also appreciate discussions and feedback received from staff, which helped us clarify some points.

2. **The EAG broadly endorses the findings and the proposed recommendations of the report.** The report highlights that CD has become a larger part of the Fund's activities and that this reflects that achieving the Fund's core mission and objectives in an increasingly complex and integrated world, in an increasingly diverse set of country conditions will require more, better—and different—approaches to CD. The five specific areas of recommendations on (i) clearer roles and responsibilities, (ii) strengthening of both prioritization and monitoring, (iii) more integration of CD with surveillance recommendations, (iv) greater internal consultation and sharing of CD information, and (v) greater external coordination and cooperation are roughly right (and, as one EAG member, Gus O'Donnell, is quoted in the report (p. 27), "it is more important to measure the right thing roughly than the wrong thing precisely").

3. **The EAG would like to highlight six issues, three specifically about the Fund's implementation of the recommendations and three concerning broader issues around CD strategy.**

The three large issues specifically around the Fund's internal management and implementation:

(a) Integration of CD issues into bilateral surveillance, particularly Article IV consultations;
(b) How to move towards learning from technical assistance (TA), specifically through more disclosure of TA reports;
(c) How to use emerging behavioral insights into changing the social norms within the Fund to make integration of the Fund's three activities work effectively in a country context.

There are also three more generic issues about how CD in the domains in which the Fund works are to be effective moving forward:

(d) Tactically how to bring the "organization" (and sub-units) directly into the current training and TA products in a country-specific strategic approach to CD;
(e) A clear distinction between the analytical types of organizational capability needed and how to tailor the CD approach to those distinct types;

(f) Behavioral insights into how to make CD work to create capable organizations (outside the Fund).

INTERNAL ISSUES AFFECTING THE IMPLEMENTATION OF THE REVIEW RECOMMENDATIONS

A. Integrating CD into Surveillance

4. One question discussed by the EAG at each meeting was how the diagnosis of country capacity would affect the extent to which CD issues were integrated into the IMF's surveillance reports, specifically Article IV consultations. There are two clear considerations:

(a) One is that there are topics and countries for which surveillance without consideration of capacity is inadequate. There are a number of issues in the Fund's mandate for surveillance for which capacity for implementation, not just the quality of the policy adopted, is central and hence some mix of organizational capability and individual technical capacity must be regarded as integral to the surveillance exercise. Two examples illustrate this point. First, it is clear that tax mobilization is central to adequate fiscal performance. Yet in many countries there have been extended attempts at improving the capability and capacity of tax administrations (by the Fund and other partners) and yet little improvement in overall tax effort or buoyancy. Discussing tax mobilization solely as a "policy" or "analytic" issue in surveillance reports and ignoring capacity and capability issues cannot be regarded as adequate. Second, the experience of the global crisis revealed that even countries with what would have been regarded as very high capability for regulating the financial and banking sectors could not stay abreast of the pace of change in the sector and seriously underestimated the systemic risks facing the financial sector, in a variety of ways. Article IV surveillance of the risks or performance of the banking sector without an assessment of the capability of the central bank and relevant government partner agencies to themselves properly assess (and regulate) the banking sector cannot be adequate. The integration of Financial Sector Assessment Programs (FSAP) formally into surveillance (not TA) was a recognition that capacity issues are core to surveillance (though FSAPs are not done everywhere).

And, beyond specific topics that require attention to capacity, it is also the case that, by its very nature as a global institution, the Fund operates in countries with a wide array of governmental capabilities. The Fund carries out Article IV consultations with both the world's richest and most capable states, but it also has a clear mandate to work with fragile states, which, for obvious reasons, are an increasing part of the Fund's overall work. So perhaps a mandate for capability issues to be discussed in all Article IV consultations is overly broad, but to do surveillance in fragile and low capability countries without an explicit consideration of capability issues seems fraught with risks of missing key issues—and not integrating the

Fund's activities in a maximally effective way. But a mandate to integrate capability into surveillance *only* into fragile states is too narrow.

(b) The other clear consideration is that a top-down directive to include capacity issues into surveillance reports runs the risk of "ticking boxes" and reluctant compliance of those responsible with what line managers and front-line staff may perceive as just (another) central, single-issue, unfunded mandate. There is a very real risk that simply adding "capacity" to an increasing list of issues surveillance reports should mention/discuss will actually backfire, generating lip service to CD and its integration while creating resentment and resistance to actual integration.

The Fund ought to be capable of devising a "Goldilocks" policy that balances the "too hot" of a top-down mandate for CD issues to be integrated into all Article IV consultations and a "too cold" approach of leaving it entirely to the discretion of the regional or country teams. Such an approach could balance the risks of "too blanket a mandate for integrating capacity and surveillance" against the risks of "too little integration of surveillance and capacity assessment."

B. Transparency and TA Reports

5. Another issue discussed at each EAG meeting was the transparency of the TA reports. Currently less than 5 percent of the TA reports are published, which the Review points out, is in spite of a long-standing Fund policy encouraging publication. Again, there are clearly two important, off-setting, considerations:

(a) On the one hand, 5 percent is unacceptably low. As one background study pointed out, the lessons to be drawn from Fund-supported TA are potential "global public goods." While this does feed into some products, not having sufficient information, experience, or lessons drawn from these engagements in the public domain precludes a potentially rich and important source of information from playing a role in improving capacity building, not just of the Fund but in development practice more generally. Greater dissemination of TA reports can potentially also generate valuable inputs from nongovernmental stakeholders into the design of more effective CD, as the Fund has experienced from broad disclosure of program documents over the years.

(b) On the other hand, in order for TA to be effective, the person providing the TA must be trusted by the authorities and must have access to information, at least some of which has legitimate reasons for being confidential and not generally available. The Fund cannot have a policy on TA reports that puts the providers of TA in the position of disclosing confidential information acquired in the course of their responsibilities in making reports. Similarly, those who provide TA are often in the position of participating in discussions and considerations of policy actions in which they have a fiduciary responsibility to act as an agent for the government or authority they are working with. And, given the nature of politics, all countries make at least some decisions that go against the advice of experts (rich countries being no exception—or perhaps even lead in this category). Again, compelled disclosure of the internal deliberations cannot be part of a long-term fruitful relationship of providing or engaging in TA. These considerations are behind the policy of needing country clearance to make TA reports public.

6. **Again, between these two hands there must be some "Goldilocks" approach that balances the costs and benefits of confidentiality and client trust with those of transparency, learning, and feedback.** For instance (when a country chooses not to disclose), it might not consume too many additional resources to produce (in addition to the TA report whose disclosure is subject to country clearance) a short two-to-three page precis of "lessons learned from the engagement" that is completely anonymized with respect to country. The processes for clearance of the precis could be weighted more in favor of Fund control of the process and give the client less veto power (say, only on grounds that anonymity was violated). This could give much higher rates of publication of material that contributes to the feedback and learning on the effectiveness of CD while maintaining adequate confidentiality and client trust. While this is not a recommendation of this particular approach, a continuation of the existing set of policies and practices will almost certainly lead to a continuation of existing outcomes. Some new approach is therefore needed if one is to expect more transparency—without compromising on key commitments to confidentiality needed to sustain effective TA engagement. We do not mean to be strong advocates of any given approach, but remain optimistic that, if feedback and learning from TA engagements is acknowledged as a challenge, the Fund can find a "just right" path that improves on the existing outcomes, building on existing efforts.

C. Behavioral Insights: CD and Change Management Inside the Fund

7. **The EAG appreciates the inclusion in the Overview Paper of Box 3 (authored by EAG member Elizabeth Hardy) on "Behavioral Insights and Organizational Change," as the insights from behavioral economics, psychology, neuro-science, and other social sciences into processes of organizational change have been important.** We emphasize that the insights of the Box apply both to the IMF itself in attempting to become more effective in capacity building and to the IMF's thinking about improving organizational capability in its partner countries through its own work.

8. **One of the key insights of Box 3 is that changing organizational practices, even when all parties agree that change would, in principle, be a good thing, is difficult.** Paradoxically perhaps, internally strong and broadly effective organizations, like the Fund, can suffer from status quo bias and inertia. Many of the recommendations require that people in the Fund do things differently than in the past and it would be good to have a more concrete plan for how the recommendations of the Review will help staff and management overcome the powerful inertia of "business as usual."

9. A second key insight of Box 3 is the importance of "social norms"—above and beyond an organization's formal policies—in determining behavior. Even though the "E" of EAG stands for "External," many of the EAG have worked in and around the Fund (e.g., Lord O'Donnell as a member of the Board, Antoinette Sayeh as Director of the African Department), others in partner organizations (e.g., Lant Pritchett at the World Bank) or partner governments (e.g., Mari Pangestu in the Cabinet in Indonesia). Therefore, we appreciate that part of the Fund's success has been that it is a strongly normed organization, with many staff deeply committed to the mission and mandate of the Fund, to professional and disciplinary norms, and to the often implicit culture and norms of the organization.

10. A concern is that part of the Fund's culture and social norms, and a part that is integral to the Fund's success and hence not to be depreciated or devalued, is a high valuation put on highly skilled and global quality technical *analysis* and on policy *formulation*. A similarly high appreciation and valuation of the (often very different) skill sets needed to create the capacity and capability to help organizations in Fund partner countries turn that policy analysis and formulation into changed country organizational practices is needed. This valuation needs to be created in the Fund's culture if the recommendations of the Review are to be accomplished. There is no question this will be difficult as the pride of place that high quality macroeconomic analysis and policy formulation receive in the Fund is deeply, and rightly, entrenched. While it does not need to be replaced, this skill set needs to be complemented with the vision of working together in an integrated fashion with other skill sets to be fully successful. Box 3 gives excellent guidance on the ways in which the Fund can act to inspire the organizational change to make the Review's recommendations for greater transparency become reality.

BROADER ISSUES WITH CREATING EFFECTIVE STRATEGIES FOR CD

11. There are also three issues concerning the effectiveness of strategies for CD that need to be raised moving forward.

A. Bringing the Organization and its Capability Directly into CD Strategy

12. In thinking through strategies for CD, it is helpful to distinguish between the capacity of an organization and the capacity of the individuals in an organization. To make this clear, one can call one concept organizational capability and the other individual capacity (although the terms could as easily be reversed). In some circumstances, organizational capability may be determined and limited by the capacities of individuals. In this instance, an individual focused "training" strategy that augments the capacities of individuals is likely correct. However, in other instances the organizational capability may be limited not by the available capacities of the individuals in the organization, but by organizational features—the ability of the processes of the organization to coordinate action and motivate individuals for instance. As an example, the *capability* of a hospital to produce good health outcomes might be limited by the surgical skills of its doctors, in which case an *individual capacity*-based approach to training would improve capability by improving capacity. But (as has been demonstrated in India) the *capability* of a hospital might be limited by the motivation of its health professionals to actually use the *capacity* they already have. In this case, an individual capacity-driven training approach would likely fail.

13. This distinction is important as the Fund is engaged with country organizations in which both are likely to be true. For instance, monetary policy formulation is an activity that is extraordinarily demanding in individual capacity. The fact that the world's most highly renowned economists and analysts disagree at times is an indication of just how hard it is to synthesize the available information, process it through an appropriate model/conceptual frame, and decide on the appropriate action. This suggests that the individual capacity of individuals to do economic and policy analysis is often a key constraint on central bank capability and an individual training approach is the key to CD. There are also technical tasks, like the construction of national accounting, that require specialized training to create the individual capacity to create reliable statistics. Again, individual training is the right strategy.

14. When individual capacity inside the organization is the key constraint on organizational capability, a certain kind of TA that places someone with those individual capacities into the organization actually helps raise capability immediately. This still means the TA has to be integrated with CD, but the dovetailing of creating the skills to replace the TA is straightforward.

15. However, on other issues affecting the Fund's mandates, like tax collections or financial supervision, it is less obvious that individual capacity is the key binding constraint—versus the possibility that the organization has not created the right processes and motivations for its employees/agents and/or the organization has difficulty in creating political authorization for it to act in fulfillment of its (nominal) mission and mandate. If, in fact, the key binding constraint is not individual capacity but organization capability, then a CD strategy cannot be built around individualized training in the capacity for specific skills—the individual training has to be built around an organizational strategy to build capability. When organizational capability (which can be the lack of a sufficient political mandate) is misdiagnosed as a lack of individual capacity, then training and TA can both be carried out effectively when measured as people finishing the requisite training courses, or TA assignments placed—but with little or no long-term impact on the capability of the organization in practice. Typically, individual capacity and organizational capability both influence outcomes and interact, but clarity on how the causal pathways of the adopted CD strategy will affect organization performance is helpful.

16. In countries with organizations that have received training and TA for decades but where those organizations are still very weak, it is worth creating an ability of the Fund (within its prioritization and evaluation of CD) to use a diagnostic tool to assess whether individual capacity is actually the "binding constraint" to organizational capability or not. If it is not, this would suggest an organization capability-oriented strategy to CD, that uses training and TA in support of that strategy. The risk is that there are many features of the individual-centered training strategy that will lead there to be "demand" for IMF CD (especially at zero price to the organization or person), even where all parties are clear that CD won't really help. Clarity by the country organization as to how the training and TA it receives is integral to a viable strategy for organizational capability might be a key part of prioritization for choosing local partners. We recognize that "political will" may impede progress in ways that make either an individual or organization focused approach difficult. However, this is precisely the kind of realism that an organizational capability rather than strictly individual capacity approach can bring into the formulation of a country-tailored CD strategy.

B. Clear Distinctions of the Types of Capability Needed by Organizations to Tailor Capability-Building Strategy

17. One of the challenges for the Fund is its success. The Fund, as a global institution embedded in an organization, has been remarkably successful at promoting its broad mission and mandate of creating a global financial system that enables broad-based prosperity (this statement is debatable, but defensible). Part of that success has been increasing both the individual capacity and the organizational capability of central banks and other key ministries, such as finance and statistical agencies, through its decades-long, ongoing commitment to CD. While it is of course impossible to run the historical counter-factual, it is hard to overstate the long-run impact the existence of the Fund has had on central banks and their capability and effective operation around the world.

18. Why is success a challenge? Because if one has had success with framing a house using a hammer to drive nails, it is a challenge to recognize that not all future challenges can be solved by continuing to hammer away at them. The success of the Fund in its core mission has created a natural tendency to work on a broader variety of challenges: if one has been successful at encouraging the *formulation* of fiscally responsible budgets one might want to extend into the mechanics of budget *implementation,* if one has been successful at constraining excess growth of credit one might want to encourage the more effective allocation of credit, if one has been successful at formulating tax policy, one might want to extend to the effective collection of those taxes. The challenge is whether the set of individual capacities and organizational capabilities needed for success are the same and hence whether one can deploy identical strategies for CD.

19. The capacity and capability for *policy formulation* are often those of relatively few individuals who require very high and sophisticated levels of technical analysis. Some policies are, more or less, self-enforcing and need little additional organizational capability. However, policy implementation of some policies requires the ongoing, day-to-day action of many agents that are consistent with the policy as formulated to be successful. In these tasks, it may not be the lack of high levels of individual capacity but rather organizational capability to induce agents to carry out their role that is lacking. The main point is that a Fund-wide strategy for CD needs an analytical frame of the types of actions the Fund can support and how these causally impact the *capability* of organizations that recognizes the very different types of organizations (and activities within organizations) the Fund is now working with. The same CD strategy is unlikely to both create capacity for formulating macro-economically sound budgets (policy formulation) and for translating those budgets into effective expenditures (policy implementation). The Fund currently works on both aspects (in for instance its tax work) but greater diagnostic clarity on the type of capability that is the constraint can lead to more tailored and hence effective CD strategies.

20. This distinction permeates the CD strategy. What kinds and types of individual training experiences, the integration of TA with training, the prioritization of CD activities: none of these decisions can rely on a single vision of how to build capability.

C. Behavioral Insights: CD and Change Management in Partner Country Organizations

21. The Review rightly emphasizes the need for "country engagement" and "country ownership" in defining a strategy for capacity building. But the insights of Box 3 of the Overview Paper (and the above points) also suggest that "organizations" are a key intermediary between "country" and "individual" and that this is important. There is no doubt that the Fund has been successful in building individual capacities worldwide on key macroeconomic, fiscal, and financial skill sets. However, the elements of Box 3 suggest that organizational change is more than just increased individual capacities, there have to be organizational approaches to inducing individual behavior change. For instance, social norms often enable persistent low-level equilibrium traps with corruption (a symptom of low organization capability for purpose). That is, if people believe that others in the organization are acting corruptly and believe the "norm" is corruption then it will be hard to induce a single individual to change their behavior—irrespective of what they might know about its effects as they may perceive their action would be norm-deviating (and hence individually risky) and ineffective at changing outcomes (as they are just one individual). Therefore, an organizational capability strategy needs to be articulated that utilizes training that is sensitive to the needs to shift social norms. Similar observations apply to the other behavioral insights like "status quo and inertia" and "commitment"—these can be explicitly acknowledged as common inhibitors of translating knowledge into action and hence built explicitly into CD (e.g., using commitment devices and follow up on those as part of the CD). Regardless of where a behavioral intervention is used, an experimental approach is recommended to determine what is most effective in generating the desired outcome.