



# IMF POLICY PAPER

## FINANCING FOR DEVELOPMENT: REVISITING THE MONTERREY CONSENSUS

July 2015

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its July 6, 2015 consideration of the staff report.
- The **Staff Report** prepared by IMF staff and completed on June 15, 2015 for the Executive Board's consideration on July 6, 2015.
- A **Staff Supplement**, July 2, 2015.

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### **IMF Executive Board Discusses “Financing for Development”**

The Executive Board of the International Monetary Fund (IMF), on July 6, 2015, discussed the IMF’s role in supporting the post-2015 development agenda, ahead of the upcoming third United Nations (UN) Conference on Financing for Development (FfD) to be held in Addis Ababa from July 13–16, 2015. Having adopted a package of measures to expand developing countries’ access to Fund resources on July 1, the Board supported new initiatives by the IMF to enhance its support for developing country members as they pursue their development goals. The IMF’s policy positions on FfD and the initiatives it proposes to take are discussed in the staff paper “*Financing for Development: Revisiting the Monterrey Consensus.*”

This year is pivotal for global action on development, with the global community set to agree on the objectives and policies for promoting development that is economically, socially, and environmentally sustainable for the next fifteen years. The first stage in completing the debate on these issues will be during the upcoming Third UN Conference on FfD, which will be held in Addis Ababa. The conference aims to reach an international consensus on the actions needed to ensure that sufficient financing is available for developing countries in pursuing sustainable development.

The staff paper discusses the IMF’s policy positions on key topics in the FfD debate that fall within its mandate and it also illustrates the IMF’s role in supporting sustainable development. This role includes: (i) assisting developing countries in designing national policies that support domestic development; and (ii) promoting policies at the global level that are crucial to providing an enabling external environment for developing countries.

The staff paper discusses several initiatives that the IMF could undertake to strengthen its support for developing countries as they pursue their development goals. These include: (i) boosting access to its resources for developing countries to provide them with a wider safety net to manage adverse external shocks; (ii) scaling up support for national capacity building in the key area of domestic revenue mobilization; (iii) expanding assistance for countries seeking to address large infrastructure gaps and boost growth—through use of diagnostic tools and capacity building measures, while maintaining medium-term public debt sustainability; (iv) intensifying engagement on policy issues relating to inclusion, gender, and environmental sustainability, where they are important for growth and economic stability, drawing on the expertise of other institutions as needed; (v) strengthening the effectiveness of the IMF’s work in fragile and

conflict-affected states, both in assisting in policy-making and supporting capacity building; (vi) enhancing IMF technical assistance for domestic financial market development, in collaboration with other international organization; and (vii) strengthening statistical data dissemination through expanded use of new technologies.

#### Executive Board Assessment<sup>1</sup>

Executive Directors agreed that, given the Fund’s mandate and global membership, it should be actively engaged in the global dialogue on mobilizing resources in support of the new Sustainable Development Goals (SDGs), including at the upcoming UN Financing for Development Conference in Addis Ababa.

Directors underscored that success in achieving the SDGs will require a strong partnership between advanced, emerging, and developing countries. They emphasized that sound national policies and ownership will play a critical role in achieving an economically, socially, and environmentally sustainable development process. In this context, Directors concurred that the pace of national economic development will be clearly boosted by an enabling global environment, characterized by: systemic economic and financial stability; strong growth of international trade in goods and services facilitated by broad-based trade liberalization; and steadily growing levels of official development assistance, including targeted technical support, where needed most. Directors noted that delivering this enabling environment will require policy actions by both advanced and large emerging economies. They also agreed that, as part of its core mandate, the Fund should continue to work closely with member countries on the design and calibration of macroeconomic and financial policies to achieve growth, while maintaining stability over time.

Directors agreed that developing countries need a strong domestic revenue base to finance essential public services, including health, education, and infrastructure. They concurred that well-targeted external technical support could boost fiscal revenues significantly over time. Directors agreed that the Fund should continue to support developing countries in strengthening domestic revenue mobilization and management through its extensive technical assistance and training, while stressing the need to further customize policy advice to country circumstances. Directors supported further work by the Fund to help developing countries address international tax issues, such as protecting revenue bases from base erosion and profit-shifting, building on the G20-OECD initiative, and containing inefficient tax competition. Some Directors called for a broader work agenda, covering the various components that collectively constitute “illicit financial flows.”

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<sup>1</sup> At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

Directors noted that efforts to boost domestic revenue mobilization should be accompanied by measures to use these revenues effectively, both through appropriate prioritization of spending needs and through institutional and administrative reforms to improve public service delivery. Social safety nets are necessary to protect the economically vulnerable, but policies need to be effectively targeted to achieve their objectives at an affordable fiscal cost.

Directors noted that domestic financial market deepening is important for economic development, increasing the capacity of both governments and enterprises to finance capital spending. In this context, they saw need for appropriately-focused regulatory frameworks and strong oversight to safeguard financial stability. Directors supported the Fund's efforts, through policy advice and technical assistance, to help developing countries lay the basis for sound and sustainable financial market development. Noting that foreign capital flows are important in generating financing for domestic investment, Directors agreed that the Fund should continue to provide tailored advice on handling capital flows in the context of surveillance and program engagement.

Directors concurred that addressing large infrastructure gaps is critical for boosting growth. In view of the substantial levels of external borrowing needed for infrastructure investment, Directors underscored that the Fund has an important role to play in assisting countries in evaluating the trade-offs between growth and debt sustainability when planning infrastructure scaling up. Using borrowed funds efficiently will be essential, underscoring the importance of building government capacity to manage and implement public investment projects. In this context, Directors stressed the importance of strengthening debt management capacity and called on the Fund to support member countries in this endeavor.

Directors noted the importance of policies to ensure the social and environmental sustainability of economic growth. They called for targeted Fund support for countries seeking to develop policies to promote economic inclusion, including gender inclusion, while underscoring that Fund engagement in these areas should focus on policy issues deemed macro-critical for achieving sustained economic growth and be based on a close collaboration with other institutions such as the World Bank. They also supported the Fund's analytical work and technical assistance on environmental issues, focused as it is on the specific tax and pricing issues in which the Fund has strong expertise.

Directors called on advanced economies to meet their commitments to boost official development assistance, while ensuring that aid flows are better targeted toward the poorest countries. They also called for further policy actions by G20 and other countries to reduce the costs of remitting funds to their home countries by emigrants and migrant workers, recognizing that these remittances are a key source of foreign exchange for many developing countries.

Directors supported the proposed initiatives to enhance Fund support for developing countries as they seek to accelerate economic development on a sustainable basis. Directors welcomed:

- the planned intensification of support for country-owned programs to strengthen domestic revenue mobilization;
- the proposed policy support package for infrastructure provision;
- the plans to strengthen non-financial support for fragile and conflict-affected states, focused on building institutional capacity over the medium term;
- the plans to deepen analytical work on equity and inclusion issues, including gender, and, drawing also on the experience of institutions such as the World Bank, to bring concrete policy lessons to operational work in countries where tackling these issues is important for sustaining growth;
- continuation of analytical and advisory work on energy pricing and environmental tax issues; and
- selected expansion of the Fund's technical assistance for financial market development, and further strengthening its statistical data dissemination and knowledge-sharing, including through greater use of web-based tools and open data platforms.

Directors noted that implementation of the proposed initiatives at significant scale would likely require additional funding. Some Directors took the view that an effectively-targeted scaling up of these activities warranted such support; others called for better prioritization of existing activities and efficiency improvements, noting that any case for additional resources would need to be made as part of the Accountability Framework and the budget process.

Directors called for a productive dialogue at the upcoming UN Financing for Development Conference in Addis Ababa that would lay the basis for strong cooperation between advanced, emerging, and developing economies in support of the post-2015 sustainable development agenda.



June 15, 2015

## FINANCING FOR DEVELOPMENT: REVISITING THE MONTERREY CONSENSUS

### EXECUTIVE SUMMARY

**2015 is set to be a pivotal year for the international development agenda**, with agreements to be reached on the objectives and policies for promoting development that is economically, socially, and environmentally sustainable through 2030. The first stage in completing the debate on these issues is the Third UN Conference on Financing for Development (FfD), to be held in Addis Ababa during July 13–16, 2015, which aims to build an international consensus on the actions needed to ensure that sufficient financing is available for developing countries in pursuing sustainable development.

#### **This paper has three objectives:**

- to bring together in a single paper the IMF’s policy positions on key topics that feature in the FfD debate on how to accelerate resource flows to developing countries and ensure that they are used effectively;
- to describe how the IMF supports its developing country members in addressing *national policy issues* that are central to achieving successful development over the medium-term and engages on *international policy issues* that are key to ensuring an enabling external environment in which developing countries can prosper;
- to outline the new actions that the IMF will take to strengthen its support for developing country members over the medium-term.

Key messages of the paper draw on the Managing Director’s Statement on “Financing Sustainable Development” to the IMFC at its meeting on April 18th, 2015.

#### **New initiatives envisaged include (but are not limited to):**

- enhanced support for developing countries seeking to build domestic capacity in tax policy and administration, coupled with intensified engagement on international tax issues of special relevance for developing countries;
- expanded assistance, through a package of tools, for countries seeking to address large infrastructure gaps without imperiling medium-term public debt

sustainability—augmented by IMF financing, where warranted, to meet balance of payments needs;

- increased access to IMF resources for developing countries, providing them with a wider safety net should they encounter balance of payments pressures;<sup>1</sup>
- intensified engagement on policy issues relating to poverty, equity, and inclusion, where macro-economically relevant, with the aim of bringing such work into the mainstream of IMF operational work;
- strengthening the effectiveness of the IMF's work in fragile and conflict-affected states, both in its operational work and its support for capacity-building over the medium-term.

**The scale at which these initiatives can be undertaken will depend on the extent to which external support can be mobilized.** Efforts to strengthen operational efficiency and re-prioritization of activities will create some internal budgetary space, but a substantial and sustained expansion of Fund capacity-building support will be feasible only with additional support from bilateral donors.

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<sup>1</sup> Details of the changes to Fund facilities will be covered in a supplement to this paper.

Approved By  
**Siddharth Tiwari**

Prepared by SPR with extensive inputs from other functional and area departments.

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## Acronyms and Abbreviations

BEPS	Base Erosion and Profit Shifting
CFM	Capital Flow Management Measures
CIT	Corporate Income Tax
COP-21	United Nations Climate Change Conference, December 2015
CPI	Consumer Price Index
DAC	Development Assistance Committee
DC	Developing Countries
DFI	Development Finance Instance
DIG	Debt-Investment-Growth
DIGNAR	Debt, Investment, Growth, and Natural Resources
DMF II	Debt Management Facility II
DSA	Debt Sustainability Assessment
DSF	Debt Sustainability Framework
eGDDS	Enhanced General Data Dissemination Standards
EI	Extractive Industries
EITI	Extractive Industries Transparency Initiative
EM	Emerging Markets
FARI	Fiscal Analysis of Resource Industries
FCS	Fragile and Conflict Affected States
FDI	Foreign Direct Investment
Ffd	Financing for Development
FSAP	Financial Sector Assessment Program
FSAP	Financial Sector Assessment Programs
G-20	Group of 20
GDP	Gross Domestic Product
GRA	General Resources Account
GSC	Global Supply Chains
GVC	Global Value Chain
HIC	High Income Countries
HIPC	Highly Indebted Poor Countries
HR	Human Resource
IFF	Illicit Financial Flows
IMFC	International Monetary and Financial Committee
LIC	Low Income Countries
LIDC	Lower-Income Developing Countries
LMIC	Lower Middle Income Countries
MAC DSA	Market Access Countries Debt Sustainability Analysis
MDB	Multilateral Debt Banks
MDG	Millennium Development Goals
MDRI	Multilateral Debt Relief Initiative
MOOC	Massive Open Online Courses

MPM	Macroprudential Measures
MTDS	Medium-Term Debt Management Strategy
ODA	Official Development Assistance
OECD	Organization for Economic Co-Operation and Development
P-FRAM	PPP Fiscal Risk Assessment Model
PIM	Public Investment Management
PIMA	Public Investment Management Assessment
PIT	Personal Income Tax
PPP	Public-Private Partnerships
PRGT	Poverty Reduction Growth Trust
RA-FIT	Revenue Administration Fiscal Information Tool
RA-GAP	Revenue Administration Gap Analysis Program
RCF	Rapid Credit Facility
RFI	Rapid Financing Instrument
RTAC	Regional Technical Assistance Center
SDG	Sustainable Development Goals
SSA	Sub-Saharan Africa
TADAT	Tax Administration Diagnostic Assessment Tool
TFA	Trade Facilitation Agreement
TISA	Trade in Services Agreement
TPP	Trans-Pacific Partnership
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
VAT	Value Added Tax
WTO	World Trade Organization

## INTRODUCTION

1. **2000 was a landmark year for international development efforts, with the UN membership agreeing on a global development agenda through 2015, framed around reaching the Millennium Development Goals (MDGs).** Subsequently, a UN high-level conference on “*Financing for Development*”, held in Monterrey in 2002, reached agreement on the key priorities for policy action by advanced and developing economies. The elements of the Monterrey Consensus covering issues within the IMF’s mandate were broadly aligned with IMF policy thinking.
2. **2015 is set to be another pivotal year for the international development agenda, with decisions to be reached on the key objectives and policies for promoting sustainable economic development for the next fifteen years.** A September UN summit in New York is to formally launch new Sustainable Development Goals (SDGs), to be achieved by 2030. The SDGs are broader in scope than the now-expiring 2015 MDGs, reflecting the overarching view that development needs to be economically, socially, and environmentally sustainable, and hence that development policies need to pay due attention to issues of equity and inclusion and to containing the strain of human activity on the environment.<sup>2</sup> A third UN conference on Financing for Development (FfD) is to be held in Addis Ababa in July, with similar objectives to those at Monterrey: reaching agreement on the national and international policy actions needed to generate sufficient financing to support attainment of the new SDGs.
3. **The IMF, with its global membership and mandate to promote economic growth and stability at both national and international levels, is well-positioned to contribute to the global debate on the post-2015 development agenda—and discussions on FfD in particular.** Most of the key issues under discussion in the FfD debate—whether *national policy issues* (such as domestic revenue mobilization, attracting and managing capital flows, prudent expansion of public investment) or *systemic issues* (such as maintaining global financial stability, international tax cooperation)—are at the core of the IMF’s mandate and of its engagement with its membership.
4. **This paper seeks to bring together, in an integrated fashion, the IMF’s policy thinking on the key topics under discussion in the FfD debate that fall within the IMF’s mandate.** It fleshes out the discussion of policy issues highlighted in the Managing Director’s Statements to the International Monetary and Financial Committee in April 2015 (IMF, 2015a). It also identifies new “deliverables”—actions that the IMF will take to better support developing countries as they pursue economic advancement.

<sup>2</sup> Key elements of the debate on environmental issues are being taken forward under the umbrella of the UN Framework Convention on Climate Change. A meeting of the parties to the convention (COP-21) is to take place in Paris in December 2015, where agreement is being sought on a set of national targets for CO<sub>2</sub> emissions.

**5. The international debate on issues surrounding FfD has taken the Monterrey Consensus as its starting point and anchor**, with discussions focused on areas where reforms or new actions are needed. *This paper adopts a similar approach*, organizing the discussion of policy issues to distinguish between issues to be addressed at the national level and issues where collective action and cooperation by the international community is needed (see Box 1). This approach should not be seen as underplaying the importance of actions on one or the other fronts: *success in achieving the new sustainable development goals will require actions at both levels—by developing countries and by the international community—based on a renewed partnership forged during the debates on the post-2015 development agenda*. Reaching agreement on an “Addis Consensus” will be a key step in building that partnership.<sup>3</sup>

### Box 1. Two Key Principles of the Monterrey Consensus

**Monterrey Consensus Principle 4:** *“Achieving the internationally agreed development goals ... demands a new partnership between developed and developing countries. We [the UN member countries who endorsed the document] commit ourselves to sound policies, good governance at all levels, and the rule of law. We also commit ourselves to mobilizing domestic resources, attracting international flows, promoting international trade as an engine for development, increasing international financial and technical cooperation for development, sustainable debt financing and external debt relief, and enhancing the coherence and consistency of the international monetary, financial, and trading systems.”*

**Monterrey Consensus Principle 6:** *“Each country has primary responsibility for its own economic and social development, and the role of national policies cannot be overemphasized. At the same time, domestic economies are now interwoven with the global economic system ... the effective use of trade and investment opportunities can help countries fight poverty. National development efforts need to be supported by an enabling international economic environment.”*

**The organization of this paper is based on the principles cited above:** the need for international partnership, the central role of national policies, and the importance of generating an enabling global economic environment—the last dependent on the actions of the international community and, in particular, of the leading advanced and emerging economies.

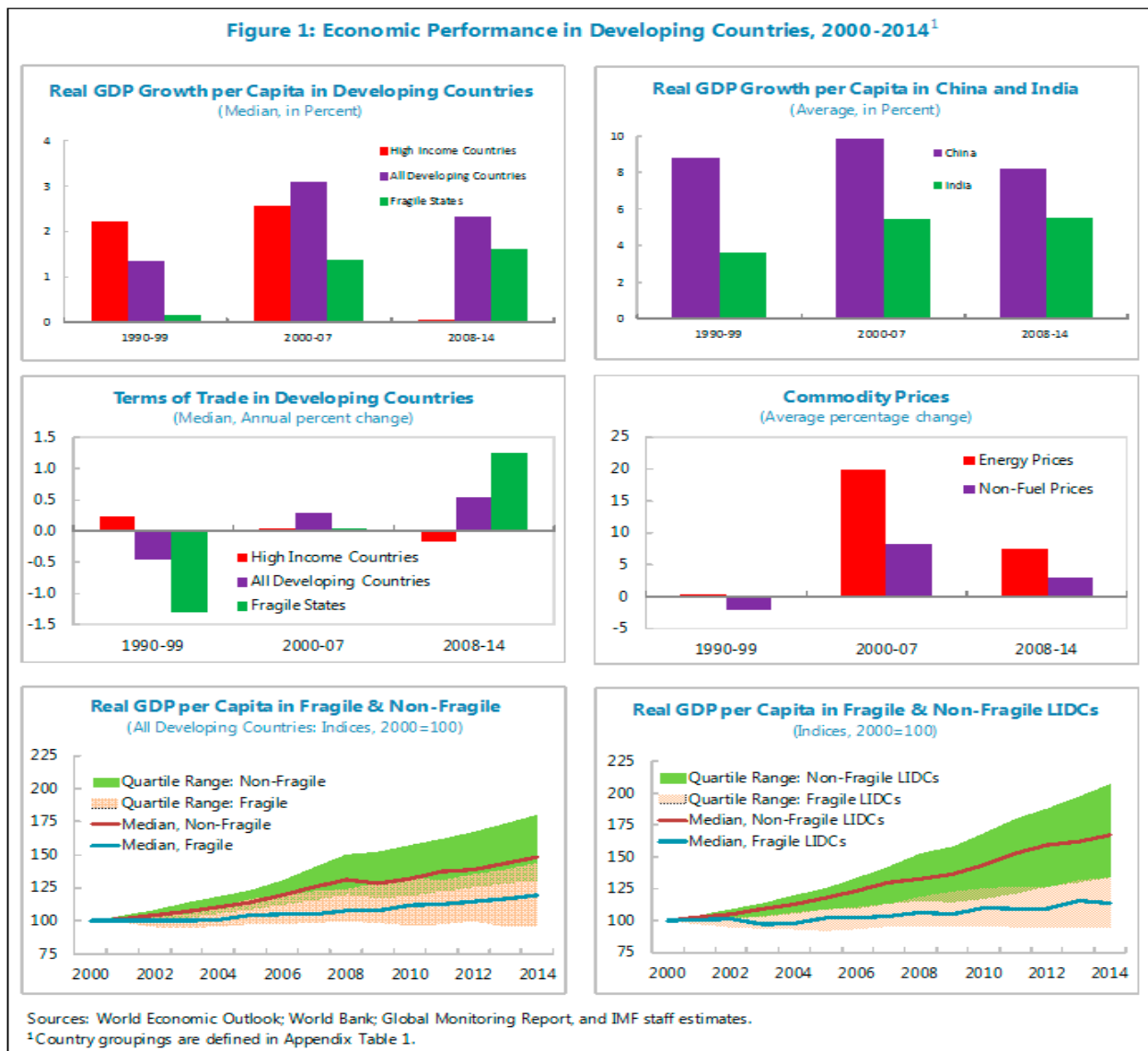
**6. The rest of the paper is structured as follows:** The next section reviews the economic performance of developing countries during 2000–14, highlighting significant changes in the global economic environment that will influence development opportunities in the years ahead. This is followed by a discussion of key national policy actions to attract the resources needed to strengthen prospects for sustainable development; where relevant, the IMF’s own role in supporting policy reforms and capacity-building are noted. Next, the paper examines key areas where action is needed at the international level to provide a supportive global environment for countries pursuing sustainable development. The paper concludes with a discussion of proposed new actions by the

<sup>3</sup> The UN member states are currently negotiating a draft outcome document, the “Addis Ababa Accord,” that aims to build on the Monterrey Consensus while tackling new policy challenges relating to the post-2015 agenda.

IMF in support of the post-2015 global development agenda. An annex discusses issues relating to preventing and resolving public debt crises.

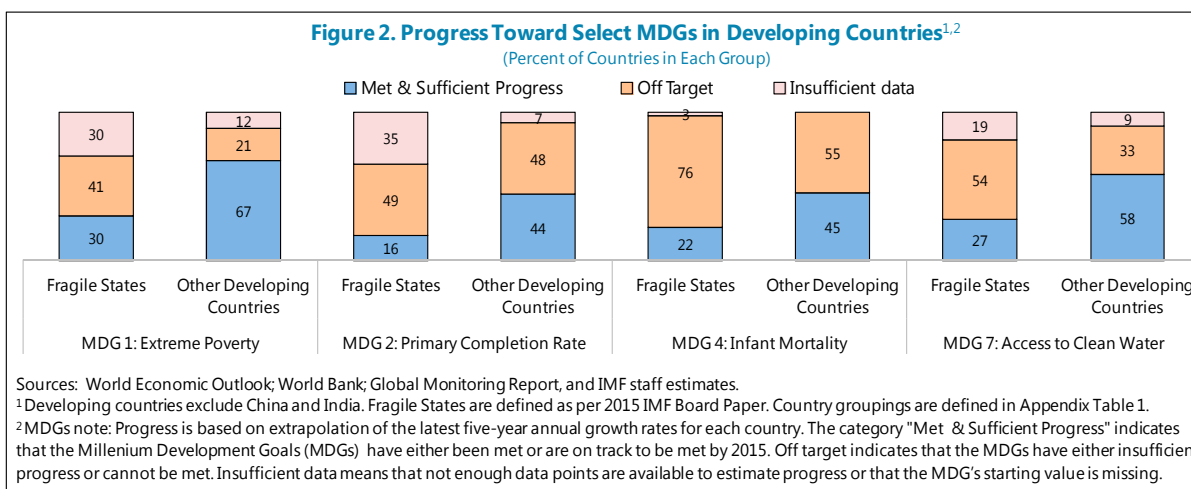
## RECENT PERFORMANCE AND THE CHANGING GLOBAL CONTEXT

7. **Developing countries<sup>4</sup> grew at a strong pace in the 2000s, notwithstanding the global financial crisis in 2008–09.** This was helped in part by conducive external conditions, including robust growth in emerging markets such as China and India, and generally strong commodity prices (Figure 1), but improved domestic policies played a central role.



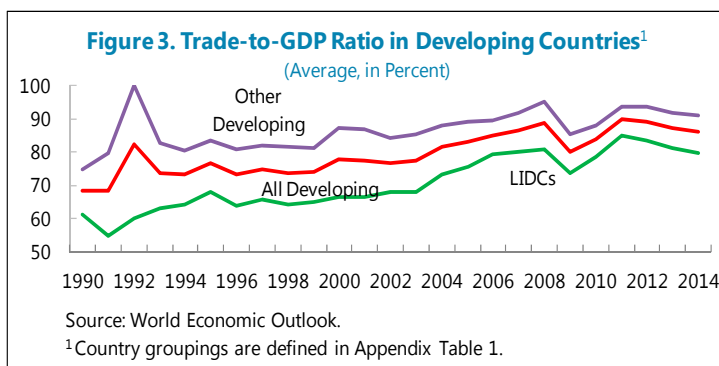
<sup>4</sup> Developing countries here refers to all countries that are not “higher income countries” in the World Bank classification system, a usage adopted here because it is aligned with the meaning of the term in the FFD debate. Given their systemic size, China and India are excluded from the sample of developing countries (see Appendix).

**8. However, economic performance was not uniformly strong, reflecting poor policies in some cases, socio-political fragility, weak governance, and instability in others.** In particular, among lower-income developing countries (LIDCs), whereas per capita real GDP levels in non-fragile LIDCs increased, on average, by almost 70 percent between 2000 and 2014, Fragile and Conflict Affected States (FCS) experienced increases of less than 15 percent in the same period. Moreover, much of the strong growth performance in LIDCs was driven by factor accumulation, with only modest improvements in productivity growth (IMF, 2014a).



**9. The record in achieving the millennium development goals was also mixed.** Some MDG targets—for example with respect to halving the share of persons in poverty—were met ahead of the 2015 deadline by a majority of countries. But progress with respect to education and health goals was unsatisfactory, with less than 30 percent of all developing countries fully meeting the targets relating to infant health and primary education completion rates (Figure 2), key measures of social advancement. Progress vis-à-vis the MDGs was particularly weak in the FCS.

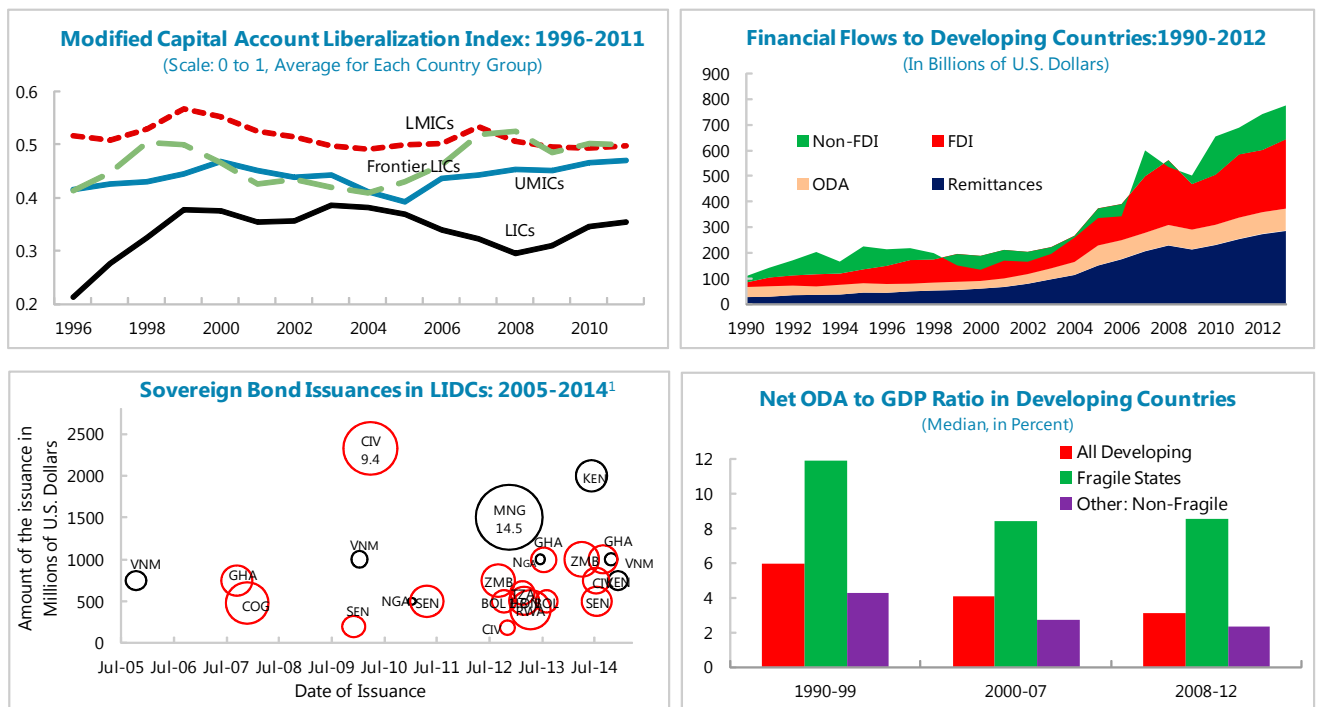
**10. Looking ahead, the post-2015 development goals will be pursued in an economic environment that has changed significantly since the early 2000s.** Key changes in the global environment include the steadily rising systemic importance of dynamic emerging markets, most notably China, which is affecting both the sources of export demand and of capital inflows for developing countries. Key changes within developing countries stem from their greater engagement in international trade and financial flows, implying higher exposure to external shocks, both positive and negative.



**11. Trade openness has steadily risen in all developing countries** over the past two decades, including via the development of global supply chains (GSCs). Since the 1990s, declines in the costs of cross-border movements of goods and services due to trade liberalization, technological progress, better transport logistics and management, and increases in developing countries' industrial capacities have allowed the latter to increase their integration into global production systems and deepen trade links, including with rapidly growing emerging markets. Diversification of trading partners provided a buffer against subdued growth in advanced countries after 2008, but slowing growth in many major emerging markets and rebalancing of demand in China may now hit export growth prospects for some time to come (see IMF 2015b and IMF2015c, Almansour and others, 2015).

**12. The scale and composition of external financing is also changing significantly (Figure 4).** Capital flows to developing countries have expanded more than three-fold since the early 2000s, drawn both by strong growth performance and, in some cases, capital account liberalization measures. While FDI flows and remittances comprise the dominant share of external financing, other private capital flows (e.g., commercial loans and portfolio flows) have also risen sharply in recent years<sup>5</sup>—providing additional financing, but also exposure to a more volatile source of funding with associated risks of sharp reversals of flows (Araujo and others, 2015). Official development assistance (ODA) now accounts for a much smaller share of resource flows to

**Figure 4. Developing Countries' Integration with International Financial Markets<sup>1</sup>**



Sources: World Economic Outlook; World Development Indicators; and World Bank Remittances Database.

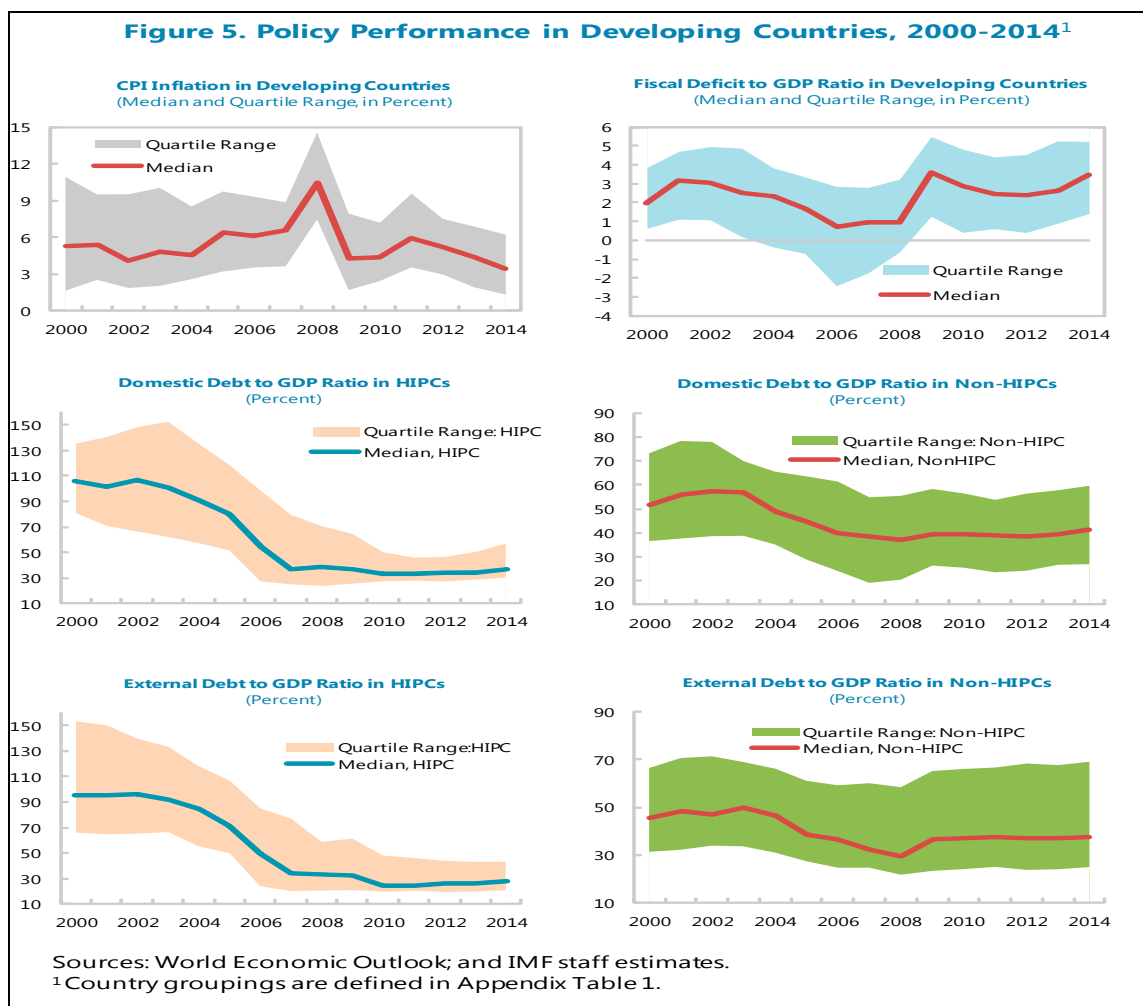
<sup>1</sup>Country groupings are defined in Appendix Table 1.

<sup>5</sup> Many lower income countries can now directly tap external financial markets: in 2014, Côte d'Ivoire, Ghana, Kenya, Senegal, Vietnam and Zambia issued sovereign bonds totaling about US\$7 billion.



developing countries as a group, but continues to play a key role in poorer countries and in FCS.

**13. Developing countries now need to place a high premium on maintaining macroeconomic resilience in a more interconnected global economy.** Most countries experienced a steady improvement in their macroeconomic policy positions in the run up to the 2008–09 crisis, but trends have since reversed for some (Figure 5). Inflation levels have generally remained low—except for the period of the food and fuel price shocks during 2007–08—and have fallen further in recent years. Many developing countries have modernized their monetary policy frameworks, helping to anchor inflation expectations (see IMF 2014b). Fiscal positions also improved markedly in the first half of the 2000s, particularly in many Heavily-Indebted Developing Countries (HIPCs), as revenue mobilization was stepped up and debt service eased as a result of debt relief (see also Annex). Since the crisis, however, fiscal space has narrowed as deficits have widened, and, in a significant number of countries, public debt levels have remained high or increased (IMF 2014c, and IMF 2014d); many small states continue to grapple with severely stressed fiscal positions. Moving ahead with development efforts in the coming years will, in many cases, take place in the context of constrained macroeconomic policy space.



**14. Looking to the longer term, the world is set to experience a major demographic transition**, which will have important implications for the patterns of world trade, savings and capital flows, and labor migration. Global population growth is slowing, while the share of the population that is old is rising steadily. However, the demographic outlook differs significantly across regions, implying significant shifts in the global distribution of the working age population:

- The aging process is well underway in most advanced economies and in some emerging economies, such as China. Rising dependency ratios could strain government finances (e.g., pension funds and health care systems) and lower saving and investment rates, yielding a slowing in growth.
- Many developing countries, particularly in sub-Saharan Africa (SSA), are set to experience a “demographic dividend,” in the sense that the share of the working age cohort in the total population is projected to rise significantly.<sup>6</sup> Per capita income levels could receive a significant boost in these countries, if accompanied by policies supportive of strong employment growth outside the subsistence sector.

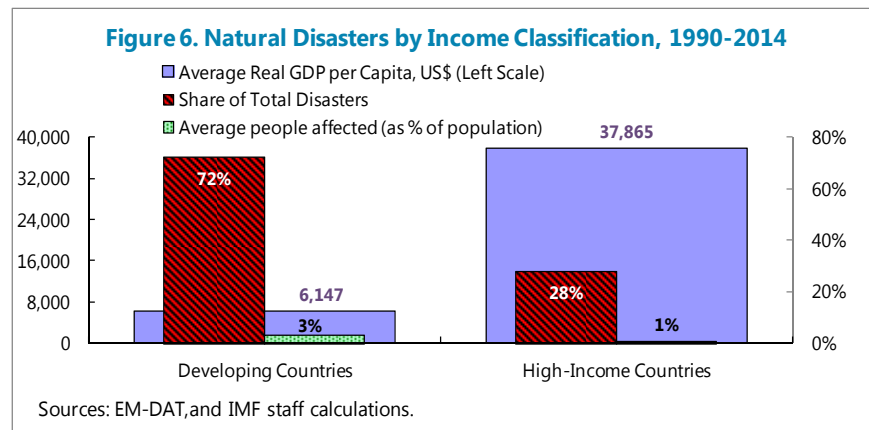
**15. The process of climate change is set to pose increasing problems across the world, with severe adverse implications for many developing countries.** Risks relating to a dramatic change in global climate by the end of the century—with severe economic and social consequences—remain

high (United Nations, 2013, 2014a, and 2014b; World Bank 2014).

Evidence suggests that small states and low-income countries are typically more vulnerable to shocks from climate change (for example, natural disasters), partly owing

to their geographical location, heavier reliance on agriculture, and weaker public management capacity. Increasing water shortages pose threats to agriculture, notably in Sub-Saharan Africa; rising sea levels pose a major threat to island countries, particularly in the Pacific. Global action is needed to contain climate change, with the next key step being to agree on national targets for reducing carbon emissions at the December 2015 climate summit in Paris.

**16. Against this backdrop, the issues at the center of the FfD debate have evolved in important ways since Monterrey.** The core partnership at Monterrey entailed: a) economic reforms in developing countries; and b) the provision of more aid, expanded access to domestic markets,



<sup>6</sup> For further discussion, see IMF (2015c).

and debt relief by advanced economies. Now, while these topics remain a key part of the debate, concerns have expanded to include such issues as ensuring global economic and financial stability, attracting and managing private capital flows, tackling infrastructure gaps without threatening public debt sustainability, and the challenges posed by climate change.

## NATIONAL POLICIES FOR FINANCING DEVELOPMENT

**17. We consider here the role of national economic policies in promoting the financing flows and investment needed to sustain strong growth that is economically, socially, and environmentally sustainable.** The focus is on policies of strategic importance for sustainable development in which the IMF has significant policy expertise.

### A. An Enabling Domestic Economic Environment

**18. A broadly stable macroeconomic environment is a prerequisite for achieving sustained economic growth.**<sup>7</sup> Governments must deliver moderate inflation, contain output volatility, limit boom-bust credit cycles, and ensure that public debt levels can be sustained over time. High and unstable inflation, sharp fluctuations in domestic demand, severe financial sector stresses, and risks of a public debt crisis—all are toxic for longer-term private investment, given the uncertainty and large downside risks that they create.

**19. Ensuring macroeconomic stability over time requires actions to build economic resilience in the face of adverse shocks**—ensuring that shocks are manageable rather than destabilizing. Key actions include: a) *maintaining adequate fiscal policy space*, so that governments can borrow more or draw down accumulated financial assets to finance higher deficits, if needed; b) *maintaining sufficient foreign reserves*, providing central banks with the space to manage balance of payments shocks in an orderly manner (see IMF 2015d); and c) *building adequate regulatory capacity* to ensure that systemically important private institutions—notably domestic banks—are themselves well-positioned to handle potential economic shocks. There are trade-offs to be faced in building resilience—for example, accumulating foreign reserves means foregoing the use of these resources for other purposes—with the appropriate balance to strike depending on country circumstances.

**20. Achieving sustained growth also requires building strong institutions that foster investor confidence in public policy implementation and a business environment supportive of the private sector.** Broad predictability of the policy environment, ease of doing business, protection of property rights, predictable enforcement of sound regulations and laws in a corruption-free manner—each of these factors reduces costs and uncertainty, thereby boosting investment. Measures of the quality of the business environment show improvements over time in

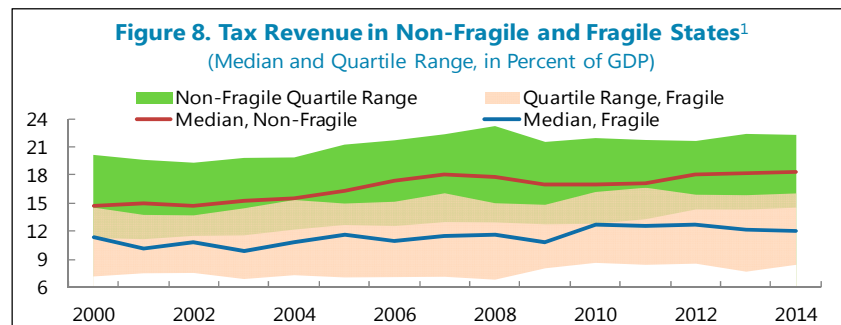
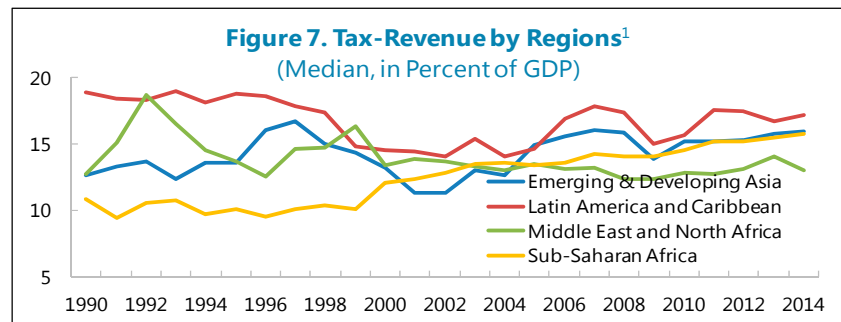
<sup>7</sup> “Broadly stable” does not mean the absence of fluctuations in key macroeconomic variables—impossible in a world where shocks are frequent—but rather a situation in which the baseline macroeconomic trajectory of the economy is resilient to, rather than destabilized by, external and domestic shocks.

most developing countries, although there is wide variation across countries and the gaps vis-à-vis best practice are very large in many cases.

**21. Working with member countries on the design and calibration of national macroeconomic and financial policies and providing financial assistance to help deal with adverse shocks are at the center of the IMF’s mandate.**<sup>8</sup> The IMF’s regular Article IV consultation process provides each member with a customized assessment of macroeconomic and financial conditions, vulnerabilities, and policies, along with concrete advice on policy reforms. Access to IMF financial resources provides important policy space to help countries handle adverse shocks, acting as an available supplement to foreign reserves—support that is especially important to countries with very limited capacity to borrow in domestic or foreign markets.

## B. Domestic Resource Mobilization

**22. A strong domestic revenue base is an imperative if the state is to finance essential public services, including health, education, and infrastructure spending, over the medium term.** Over the past two decades, developing countries have significantly strengthened their revenue collections, with tax ratios gradually increasing over the 1990s and the 2000s across most regions. However, about 50 percent of all developing countries still have tax ratios below 15 percent of GDP, while revenue collection in FCS is often even weaker.



Sources: World Economic Outlook; and IMF staff estimates.

<sup>1</sup> Country groupings are defined in Appendix Table 1.

**23. Experience shows that, with well-targeted external technical support, developing countries’ fiscal revenues can be significantly strengthened,** given strong political will and support. As examples, Peru, over the 1990s, increased its revenue ratio from 6 to 13 percent of GDP, with a further increase to some 17 percent by 2010; Tanzania and Vietnam have achieved sustained increases of 4 to 5 percentage points of GDP over periods of 5 to 6 years; while Mauritania increased the tax revenue ratio (excluding revenues from the mining sector) by 6 percentage points of GDP between 2011 and 2014. Key elements in constructing a balanced domestic revenue base are described in Box 2.

<sup>8</sup> The Fund’s role in contributing to building strong institutions is covered in later sections of the text.

### Box 2. Guiding Principles for Producing a Balanced Domestic Revenue Base

- **Use a broad-based VAT with most items subject to a single rate and a high threshold.** Multiple VAT rates complicate implementation and facilitate evasion; distributive concerns can be addressed by other measures. An appropriately high VAT threshold keeps smaller businesses out of the VAT net, reducing implementation costs for both tax authorities and taxpayers.<sup>9</sup> IMF analysis indicates that broadening the VAT base, with a sensible registration threshold, could raise on the order of 2 percentage points of GDP in developing countries (see IMF, 2011a).
- **Use a corporate income tax levied at a competitive rate on a broad base.** Special tax incentives, in particular, erode tax bases, all too often without offsetting benefits in terms of higher investment. This is one of many areas in which increased transparency—in the form of tax expenditure analyses of the revenue costs of special incentives—can play a powerful role.
- **A progressive personal income tax,** applying to all labor income above a reasonable threshold, and covering capital income.
- **Excise taxes on (only) a few key items**—tobacco, alcohol, fuels—can raise significant revenues while also addressing wider social, health and environmental concerns.
- **Real property taxes,** greatly under-utilized in developing countries, have the potential to increase revenue ratios over time by at least 1 percentage point of GDP in many countries and to immensely benefit local government finances.
- **Move towards taxing carbon at levels designed to compensate for negative externalities,** which would generate significant additional revenues over time. Recent work shows that, depending on the levels chosen, such a move could raise several points of GDP.
- **Analyze and take tailored actions to reduce tax “gaps”**—the divergence between revenue actually collected and the revenue potential with sound administration and well-designed policy. This has been shown to be possible, including on the administrative side. For example, the South African Revenue Service estimated the VAT gap in 2002 to be some 25-30 percent. Following a series of compliance initiatives during 2002-2006, the estimated VAT gap fell steadily, and is now below 10 percent.

**24. Despite progress to date, more effort is needed in improving tax structures and revenue outturns.** Key trends have been: (i) a continued increase in revenue from the value added tax (VAT), which typically accounts for around one-quarter of all tax revenue;<sup>10</sup> (ii) a continued decline of tariff revenues, combined with resilience—to some extent surprising, given the avoidance issues (see below)—of the corporate income tax (CIT); and (iii) persistent weakness in the personal income tax (PIT), with up to 95 percent of the revenue derived from wage withholding on large enterprises and public sector employees. Evasion and avoidance by the very rich—including by concealing assets abroad—is important in undermining overall progressivity of the tax system.

<sup>9</sup> By excluding small traders from the obligation to charge tax, it either confers a competitive advantage on them or benefits their customers, who are likely among the poorer.

<sup>10</sup> There is increasing evidence that countries with a VAT raise more revenue than those without, all else equal (see Keen and Lockwood (2010), Ufier (2014), Adhikari (2014) and Ebeke and others (2015)).

**25. The taxation of the extractive industries (EI: oil, gas, and mining)—now key for many developing countries—poses special challenges.**<sup>11</sup> The EIs often account for over half of government revenue in petroleum-rich countries, and over 20 percent in mining countries. The very large sunk costs and long horizons of EI projects make the credibility and stability of the investment regime especially important to investors; the pervasive uncertainty over resource prices (and input costs) makes the allocation of risk between host government and investor an important and sensitive choice; the dominance of multinationals makes sophisticated tax planning a particular concern; and the exhaustibility of the resource raises issues as to the timing of extraction.

**26. The central fiscal issue on taxing EI is that of ensuring a ‘reasonable’ government share in the rents associated with nonrenewable resources.** While country circumstances require tailored advice, establishing a credible regime built on the combination of a royalty and a tax targeted explicitly on rents (along with the standard CIT) remains a key task for many countries.

**27. The main challenges in strengthening the effectiveness of tax administrations are long-established.** They include: compliance challenges from the hard-to-tax (not only small businesses but also, for instance, professionals); weak revenue administrations, low taxpayer morale, and poor governance; and shallow use of financial institutions, potentially a valuable source of information.

**28. Improving revenue administration is essential for enhanced and fairer revenue mobilization, and for wider governance improvement.**<sup>12</sup> Weak and often corrupt revenue administration remains in many countries a fundamental barrier to effective and fair taxation, and to building trust between government and citizens. Progress with reform has been mixed. On the one hand, the need for focused attention on large taxpayers is now nearly universally accepted (given the highly skewed size distribution of firms, effective oversight of the largest firms can secure 60–80 percent of domestic taxes), while further progress on taxpayer segmentation is also being made. However, the impact of computerization has often disappointed, due in part to inadequate integration within a broader reform strategy; and revenue administrations in many countries continue to be under-resourced in terms of funding and skilled personnel.

**29. Strengthening the legitimacy of the tax system requires dealing better with the “hard-to-tax.”** Coherent strategies are needed, based on understanding the nature of the taxpayer population; identifying key compliance risks, and specifying corrective actions and performance indicators. Shortcuts are tempting but often illusory—e.g., amnesty schemes can undermine compliance by creating expectations of more to come, while discouraging the compliant.<sup>13</sup> Routine interventions, including registration programs, welcoming taxpayer services, and wider intelligence operations, are critical.

<sup>11</sup> The contributions in Daniel and others (2010) elaborate on these issues.

<sup>12</sup> See IMF (2015e) for an overview of the challenges of improving noncompliance, and how they can be addressed.

<sup>13</sup> Baer and Le Borgne (2008).

**30. Progress in addressing corruption requires firm leadership and political will,** and institutional measures, such as strong and proactive internal audit and staff investigation functions, visible implementation of a code of ethics (including prosecutions), and processes that limit rent-seeking opportunities.

**31. Aside from boosting tax collections, it is important to underscore that fiscal space to finance new development outlays can also be created through expenditure reforms.** Most developing countries have significant room to improve both the composition and effectiveness of public spending. Reducing costly energy subsidies can free up significant resources, even with targeted outlays to compensate the poor. Reforms in public service delivery (in sectors such as health and education) can deliver significantly improved outcomes from existing financing, scaling back the need for new resources. Cutting poorly-targeted or wasteful spending and boosting the efficiency of public service delivery can be difficult—requiring strengthening fiscal institutions and pushing through public sector reforms—but will free up fiscal resources and deliver better outcomes from core programs.

**32. The IMF provides extensive technical assistance and training to countries seeking to boost domestic revenue mobilization.** Revenue policy and administration reforms in over 100 countries are supported through a variety of modalities, tailored to national circumstances: missions, short-term expert visits, country/regional resident experts, support from ten regional technical assistance centers, and seminars and workshops. This assistance accounts for about one-fifth of all IMF support for national capacity-building. Technical assistance is also provided in strengthening public financial management and in developing subsidy reform strategies (see also Clements and others, 2013).

## C. Strengthening Domestic Financial Markets

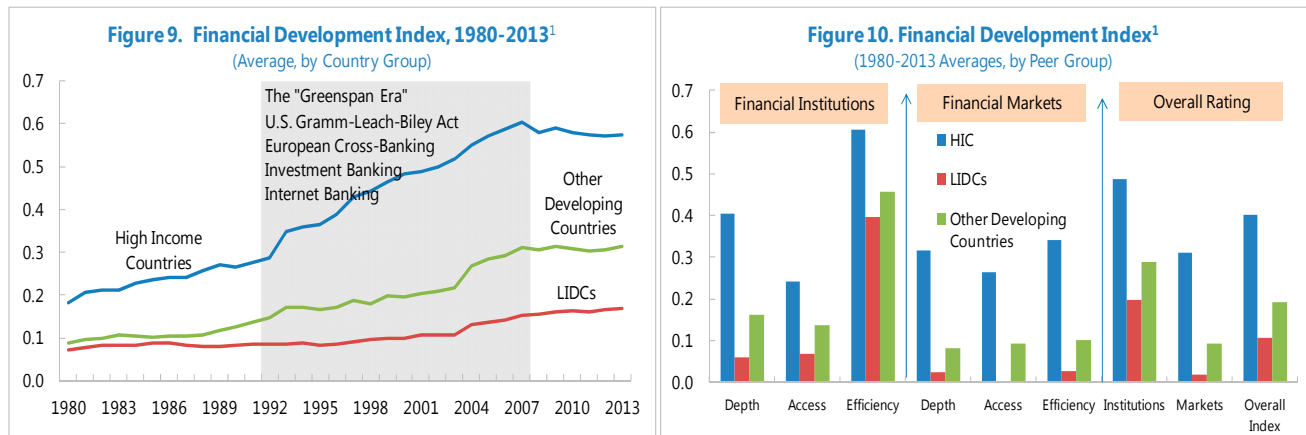
**33. Financial deepening can increase a country's resilience and boost economic growth.** It mobilizes savings, promotes information sharing, improves resource allocation, and facilitates diversification and management of risk. It also supports financial stability to the extent that deep and liquid financial systems with diverse instruments help dampen shocks and mitigate associated risks. Deeper capital markets provide both the public and private sectors with the means to expand operations beyond the constraints imposed by self-generated resources.

**34. The level of financial market development is, unsurprisingly, closely correlated with income levels.** A new, comprehensive index of financial development that encompasses both financial institutions and markets and measures their depth, access, and efficiency,<sup>14</sup> shows that progress in financial development has been made in emerging markets (EMs), and to a lesser extent in LIDCs, but there is still a considerable gap vis-à-vis advanced economies, particularly with respect

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<sup>14</sup> See Sahay and others (2015).

to the depth of financial markets. IMF analytical work concludes that most developing countries would reap growth and stability benefits from further financial sector development.



Source: IMF staff estimates.

<sup>1</sup>Country groupings are defined in Appendix Table 1.

**35. Government policies can help promote financial depth, especially in the early stages of development.** The state has a very important role to play in providing supervision, ensuring healthy competition, protecting creditor and depositor rights, and strengthening financial infrastructure. Experience points to useful roles for the state in promoting transparency of information and reducing counterparty risk, for example, by facilitating the inclusion of a broader set of lenders in credit reporting systems and promoting the provision of high quality credit information, particularly when there are significant monopoly rents that discourage information sharing.

**36. The pace of financial deepening matters.** The global financial crisis highlighted the dangers of financial systems that grow too big too fast. When financial sector development outpaces the strength of the supervisory framework, there is likely to be excessive risk taking and ensuing instability. This puts a premium on developing good institutional and regulatory frameworks as financial development proceeds.

**37. Better—not necessarily more—regulation promotes financial stability and development.** A commonly held view is that tighter regulation to help safeguard financial stability can frequently act to hamper financial development. But lessons from the IMF's engagement with member countries, through its support for capacity-building and the Financial Sector Assessment Programs (FSAP), suggests that, among the large number of recognized regulatory principles, there is a small subset of principles that are critical both for financial development and financial stability.<sup>15</sup>

<sup>15</sup> These key principles capture: (i) the ability of regulators to set and demand adjustments to capital, loan loss provisioning, and employee compensation; (ii) regulatory definitions, such as definitions of capital, nonperforming loans, and loan losses; and (iii) financial reporting and disclosures.



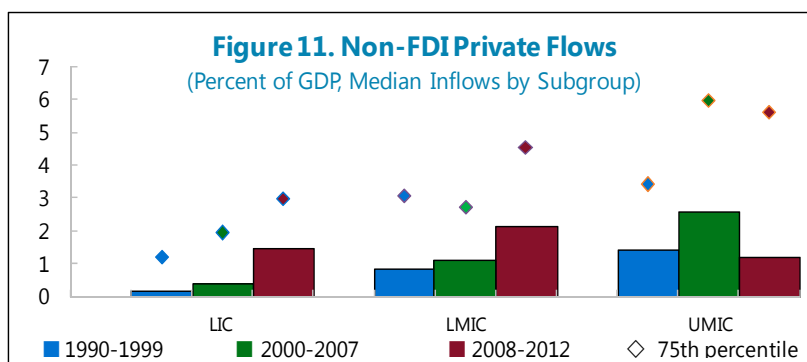
Observation of these key regulatory principles is beneficial for both financial stability and financial development.

**38. There is no “one-size-fits-all” in sequencing the development of institutions and markets, but as economies evolve, the relative benefits from institutional development decline and those from market development increase.** Closer financial linkages with the outside world are neither a panacea for further development nor an inevitable source of instability. Policies to enable greater financial deepening need to be accompanied by measures to promote financial inclusion (broader access to financial services for households and small firms), both to strengthen growth prospects and expand financial choices for the poor.

**39. The IMF contributes to financial market development through its policy advice and technical assistance to create an enabling environment for market functioning, address market failures, and strengthen financial market regulatory oversight.** The focus of technical assistance is on (i) establishing and strengthening the functioning of foreign exchange, derivatives, domestic debt securities, and money markets and instruments; (ii) strengthening the market infrastructure (payments/settlement systems); and (iii) ensuring that financial development initiatives are appropriately balanced against the need to maintain financial stability through effective supervisory and regulatory frameworks. The joint IMF-World Bank *Financial Sector Assessment Program (FSAP)* provides developing countries with a comprehensive analysis of the financial sector.

## D. Attracting Foreign Private Finance

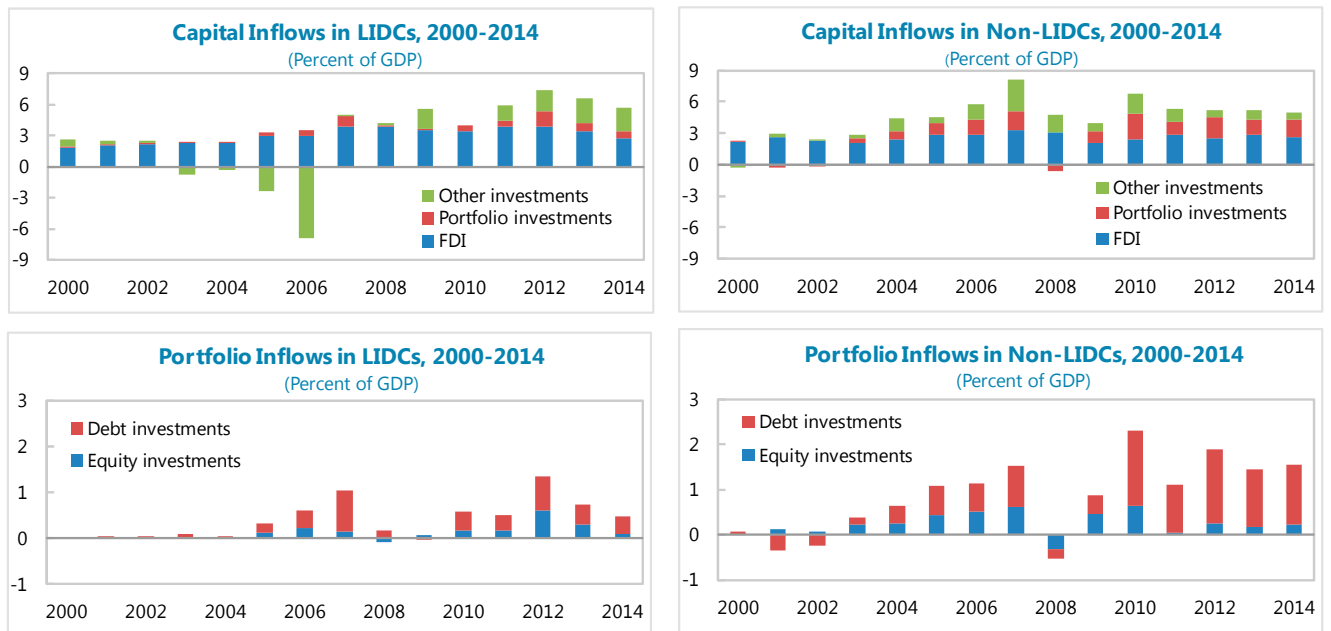
**40. Capital flows to developing countries have risen substantially over time.** The increase, along with a rising share of non-foreign direct investment flows and debt-creating inflows (such as bank loans and portfolio inflows) is particularly noteworthy in low and lower middle income countries (Figures 11-12).



**41. Foreign private capital flows can play an important role in providing financing for domestic investment as countries develop.** The benefits of capital flows for financial and economic development are well recognized and include: consumption smoothing, greater efficiency of resource allocation for productive investment, increase in the competitiveness of the domestic financial sector, and the transfer of technology and management practices, particularly through foreign direct investment. Overall, the positive empirical relationship between capital flows and growth is well-documented for non-debt creating flows, albeit less so for debt-creating flows.

**42. Foreign direct investment, in particular, when supported by an appropriate policy regime, can be a very important contributor to growth.** Key structural factors that help attract and sustain FDI flows include an enabling economic environment with transparent and predictable business sector regulations (with regard to entry, operations and treatment of foreign firms), competitive and smooth functioning of markets, and coherence of trade and tax policies (see UNCTAD, World Investment Report, various issues). FDI flows are not unaffected by changing cyclical factors and “push” conditions in host countries (Dabla-Norris and others, 2010), but are much less volatile than other forms of capital inflow.

**Figure 12. Gross Capital Inflows in Developing Countries, 2000-2014<sup>1</sup>**



Sources: World Economic Outlook; and IMF staff estimates.

<sup>1</sup> Country groupings are defined in Appendix Table 1.

**43. But significant non-FDI capital inflows can carry risks, further exacerbated in countries with insufficient levels of financial and institutional development, and inadequate regulation.** Debt-creating flows are generally associated with risks of heightened macroeconomic volatility (see IMF, 2011b) and vulnerability to crises. In the absence of adequate financial regulation and supervision, financial openness can create incentives for financial institutions to take on excessive risks and leverage, leaving themselves vulnerable to sudden reversals in flows. Direct external borrowing by corporates can also pose stability risks.

**44. Capital account liberalization should be carefully paced and sequenced to maximize the benefits of access to foreign private financing.** A country’s readiness to opening the capital account will depend on its specific circumstances, in particular the soundness of macroeconomic, legal and accounting frameworks, as well as financial system development and financial regulatory capacity. Country experiences suggest that exchange rate flexibility can also help cushion the real

economy against the effects of capital flow volatility. Improvements in data collection sufficient to allow effective monitoring of cross-border financial flows that are not intermediated through the banking system are also required.

**45. Developing countries that already have an open capital account need to factor in the risks associated with capital flows in framing macroeconomic and financial policies.** Sound macroeconomic policies, including monetary, fiscal, and exchange rate policies, should be complemented with effective financial supervision and regulation. The policy toolkit could include macroprudential measures (MPMs) to limit systemic financial risks, including risks associated with capital flows. Capital flow management measures (CFMs) can also be appropriate in certain circumstances—such as when underlying macroeconomic conditions are highly uncertain, the room for adjusting macroeconomic policies is limited, or the needed policy measures require time to be effective—but they should not substitute for warranted macroeconomic adjustment.

**46. As part of its regular Article IV consultation, the IMF provides tailored advice to member countries on handling capital flows.** The IMF's institutional view on the liberalization and management of capital flows (IMF, 2012) provides a consistent approach to assessing capital flow policies across member countries, where relevant for surveillance and policy advice, while taking into account their specific circumstances. IMF policy advice is supplemented with technical assistance on capital account liberalization, where warranted.

## E. Meeting Infrastructure Gaps: Scaling up Investment and its Financing

**47. Deficient physical infrastructure is widely viewed as a major constraint on growth in developing countries, especially poorer countries** (IMF 2014g).<sup>16</sup> Addressing large infrastructure gaps is essential to support economic growth,<sup>17</sup> but doing so will require high levels of investment, much of it necessitating external financing. With the state typically accounting for the bulk of infrastructure provision in developing countries (telecommunications being a notable exception), public policies in relation to infrastructure provision play a key role in driving economic growth but also in influencing public debt sustainability over the medium-term.

**48. Policy choices on infrastructure provision entail a number of distinct decisions.** There are macro-level decisions on the mix of projects to undertake and on the pace at which public investment is increased, taking account of absorption capacity, the strategic importance of specific projects, and the implications for public debt sustainability over time. There are micro-level decisions on whether a project is justified, on how the project should be implemented (e.g., by the public sector or with private participation) and financed, and on how the output of the project should be priced to end-users, which will determine any longer-term financing burden on the

<sup>16</sup> A key distinguishing factor between developing countries that have grown at a sustained pace and developing countries that have not is the quality and level of infrastructure (see IMF, 2013a).

<sup>17</sup> See Araya, Schwartz, and Andres (2013) for analysis of the factors explaining why private investment in infrastructure has been modest in most developing countries.

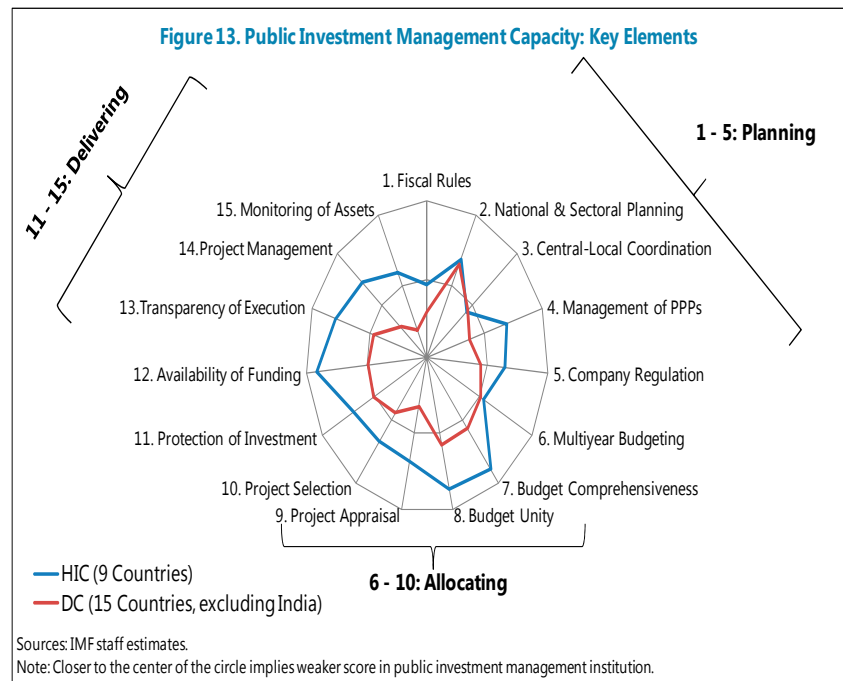
budget. The capacity of the public sector to execute investment projects efficiently plays a key role in these decisions: for many developing countries, regulatory and implementation capacity constraints in project development and execution are a more binding constraint than the availability of funding (IMF 2015f, OECD and African Development Bank, 2014).

**49. IMF policy advice and engagement on infrastructure policy has focused on a) the macroeconomic aspects of scaling up investment in infrastructure, and b) the tasks involved in strengthening public investment institutional capacity.** The micro-level decisions are no less important, but lie within the purview of the multilateral development banks and the government's investment advisors.

**50. The key challenge in macro-level assessment of public investment plans is to assess the impact of a proposed investment plan and accompanying financing strategy on growth, the near-to-medium-term macroeconomic outlook, and the projected evolution of, and sustainability of, public debt levels.** In working with policy-makers, staff have used various techniques to estimate the growth impact of investment plans: the *Debt-Investment-Growth (DIG) framework* provides a formal modeling technique to explore in detail the full macroeconomic impact of alternative investment and financing strategies over the medium-term (Buffie and others, 2012).<sup>18</sup> A *Debt Sustainability Assessment (DSA)* is used to examine the implications of alternative proposals for public debt levels and the risks posed to debt sustainability. Iterative analysis of public investment plans (as part of a wider fiscal policy) is a core element of the policy dialogue with member countries during the regular consultations and program discussions.

**51. In the context of scaling up infrastructure investment, two areas where institutional capacity typically needs to be strengthened are a) public investment management (PIM) and b) public debt management.**

- **Public investment management:** The key elements in determining PIM capacity are shown in the Figure 13. Priorities for reform in developing countries include adopting more rigorous and transparent arrangements for



<sup>18</sup> A specialized version of the framework ("DIGNAR") is also available for the particular macroeconomic issues of public investment scaling up in natural resource exporters (Melina and others, 2014).

appraisal, selection, and approval of investment projects and strengthening institutions related to the funding, management, and monitoring of project implementation. A new tool for evaluating PIM capacity and identifying areas where remedial actions are needed is being developed by IMF staff (see concluding section);

- **Public debt management:** Plans to boost public borrowing levels call for paying special attention to strengthening debt management capacity. The joint World Bank-IMF medium-term debt management strategy (MTDS) tool provides a framework for developing debt management strategy; it is backed with support for capacity-building in the analytical, operational, and institutional aspects of debt management, and on debt market development.

**52. Over the past two decades, private participation in infrastructure via public-private partnerships (PPPs) has been on the rise.** While PPPs can ease short-term borrowing constraints, there is an increasing awareness of the long-term contingent liabilities that the state may be incurring in entering into such arrangements. IMF staff has developed a new tool, the *PPP Fiscal Risk Assessment Model* (P-FRAM), to allow a full exploration of the macroeconomic and fiscal risks stemming from a PPP project (see concluding section).

## F. Social and Environmental Sustainability

**53. Sustainable development requires not merely economic growth, but also policies to promote economic inclusion and environmental sustainability.** While this paper focuses on policies to generate financing for sustained growth, it is important to also underscore the central role of policy measures to achieve the social and environmental objectives of the SDGs.

**54. Key areas requiring policy attention in developing countries will typically include:**

- a) improved delivery of public services, including health, education, and water and sanitation;
- b) promoting women's economic inclusion, including through reform of labor markets and removal of legal restrictions;
- c) actions to boost productivity in the rural economy, where the bulk of the poor reside;
- d) better access to financial services; and
- e) targeted social protection schemes.

Separately, interventions, calibrated to country circumstances, will be needed to protect the physical environment from degradation, while accommodating economic growth.

**55. IMF engagement on these policy issues has been selective, reflecting the mandate of the organization.** The IMF has expanded its analytical work on macro-relevant elements of inclusion, including on jobs and growth, inequality, access to finance, and the economic impact of gender inequities. Some of this work, notably on jobs and labor market policies, has long been an important element of IMF operational work: other elements (such as the drivers of female labor force participation) have also featured in operational work when the issue is deemed to be of macroeconomic significance. IMF analytical work on environmental issues has focused on tax and pricing issues, again reflecting institutional expertise: a substantial body of work has been produced on carbon pricing, energy subsidies and pricing, and environmental taxes (see, for example, Parry and others, 2014; Gupta and Keen, 2015).

## TOWARDS AN ENABLING GLOBAL ENVIRONMENT FOR SUSTAINABLE DEVELOPMENT

**56. Developing countries require an accommodating global environment to attract adequate private investment flows and generate rapid export growth.** This section examines key policy areas where actions are needed at the international level to ensure that developing countries can prosper in their pursuit of growth and sustainable development.

### A. An Enabling Global Economic and Financial Environment

**57. Providing a resilient global economic and financial environment is an overarching priority.** The global financial crisis and ensuing macroeconomic turmoil served as a stark reminder that global macroeconomic and financial instability is a risk to all. With greater interconnectedness, financial events in systemically important countries can quickly spill over to other countries, with large knock-on effects on global economic activity.

**58. To safeguard systemic stability, it is important that:**

- *Policymakers in the major economies maintain an ongoing dialogue to ensure that national actions are informed by an understanding of spillovers and that the mix of national policies is supportive of global economic stability.* Explicit coordination of policies is likely only under exceptional circumstances, but regular dialogue acts to limit policy surprises and promote cooperative solutions where mutual gains can be realized.
- *Financial regulations across the major financial centers are appropriately configured, mutually consistent, and rigorously implemented.* Much progress has been made in strengthening and coordinating financial sector regulations after the financial crisis had revealed many regulatory weaknesses, but some key reform measures remain to be implemented, including addressing too-big-to-fail issues, reform of derivatives markets, and better assessing the emergence of new risks outside the scope of the current regulatory perimeters.
- *A global financial safety net provides countries, and investors, with confidence that unexpected liquidity needs triggered by shocks can be met.* The multi-layered safety net forged during the 2008–09 crisis—expanded IMF resources, regional financing arrangements, and bilateral swap lines—contributed importantly to stability, but provides uneven levels of protection to many emerging market economies and has since been underutilized during periods of turbulence.

**59. Policy actions are currently needed to boost sluggish global growth over the medium-term, thereby providing a strong foundation for financing flows.** Reform priorities vary across countries, given different cyclical positions, the varying importance of crisis legacy issues across the advanced economies, and the need for rebalancing of demand in China. Supporting domestic demand remains a priority in the Euro Area, less so in other major advanced economies; actions to promote fiscal consolidation over the medium-term are important in many advanced economies,

where debt levels rose significantly over the course of the economic crisis. Structural reforms are needed to improve the medium term economic outlook in many countries, both advanced and emerging. The priority list again varies across countries, with product and labor market reforms featuring in many advanced economies, infrastructure provision, education reform, and improving the investment climate needed in many emerging markets economies (IMF, 2015g).

**60. Working to supporting global economic and financial stability is core business for the IMF,** which was founded, inter alia, to “provide the machinery for consultation and collaboration on international monetary problems” (IMF Articles of Agreement, Article I).

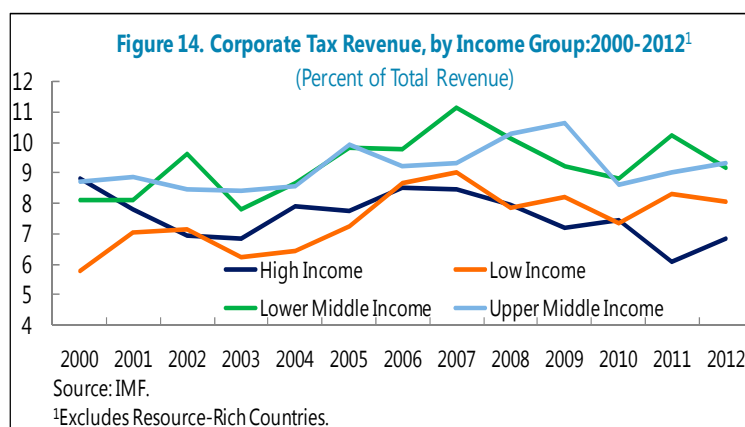
- One key function of the IMF—multilateral surveillance—is to generate the diagnostic and analytical work that underpins the ongoing policy dialogue between national policy-makers. Drawing on the lessons from the crisis, this work now includes an intensified focus on cross-border policy spillovers and risk transmission mechanisms, alongside more established work streams such as exchange rate and external sector assessments.
- As part of this function, the IMF is also an active contributor to the work on strengthening the international financial regulatory framework and assessing financial vulnerabilities that may call for individual or collective action.
- The IMF stands at the center of the set of arrangements that collectively constitute the global financial safety net. Actions to sharply increase the IMF’s lending capacity were an important component of the response of the international community to the economic crisis: work is being undertaken to strengthen the safety net and its coverage, including through closer cooperation between the IMF and regional financial arrangements.

## B. International Tax Cooperation

**61. The current international tax agenda is focused on two initiatives:** a) the G20-OECD

project on “*Base Erosion and Profit Shifting*” (BEPS), targeting profit shifting by multinational firms; and b) making *Automatic Exchange of Information* the global standard, to tackle tax evasion through sharing of tax information across countries. There are no reliable estimates of the aggregate amount of revenue at stake, but strong signs that these issues are at least as important for developing countries as for high

income countries. Developing countries are especially vulnerable to BEPS because they are typically more reliant on CIT revenue than advanced countries and have fewer alternative revenue sources (Figure 14); the evidence is that they are especially strongly affected by spillovers from taxation



policies in other countries.<sup>19</sup> It is critical that the reshaping of the international tax system over the coming years be sensitive to their particular circumstances and capacities.

**62. Building on these initiatives will require bringing developing countries more fully into the debate and ensuring that new tax rules address their concerns**—an area where the IMF is well-positioned to assist, given its extensive experience on the full range of tax issues in developing countries. With other institutions, the IMF is working on toolkits to help implement outcomes of the BEPS process that are appropriate for developing countries, and is deepening its long-standing work on tax incentives to develop a suite of tools to help countries avoid wasteful tax incentives.<sup>20</sup> The IMF will also continue to support full engagement of developing countries in international tax discussions, and—as with the issue of offshore asset sales, now the subject of joint IMF-OECD work—to draw attention to issues of special importance to them.

**63. The challenges posed for developing countries by international tax competition go beyond the current BEPS agenda and may require a multilateral approach.** Developing countries are differently situated from advanced countries, not only in terms of administrative capacity, but because they (especially LICs) are typically “sources” of corporate income rather than places in which multinationals are tax-resident. And close regional and wider cooperation in tax-setting is needed to avoid mutually damaging competition for mobile investment. International cooperation is also needed to address illicit financial flows not related to tax evasion—such as money laundering and the shifting abroad of monies acquired corruptly (see Box 3).

**64. Developing countries will need tailored technical and analytical support to strengthen the international aspects of their tax systems.** That said, it will be important that work in this area—now attracting much attention—be integrated into a wider tax reform strategy, and not divert staff resources away from long-standing, but fundamental tasks, such as improving VAT refund systems, developing property taxation, and strengthening administration, that will yield high returns in revenue.

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<sup>19</sup> IMF (2014e).

<sup>20</sup> The Fund has been tasked by the G20 to take the lead in reporting on options for the efficient and effective use of tax incentives in low income countries.



### Box 3. Illicit Financial Flows

**The recent report of a high-level panel on illicit financial flows (IFFs) from Africa (the “Mbeki Report”) has focused attention on the scale of the funds exiting the continent and on policy reforms to stem these outflows.**<sup>1/</sup> The report suggests that the magnitude of these outflows could be as much as US\$ 50 billion per year.

**The high-level panel utilized a broad definition of IFFs—“money illegally earned, transferred or used”—and made use of the term “illicit” (rather than illegal) to include activities that, while not illegal “go against established rules and norms”.** This approach was very valuable in drawing attention to a wide range of questionable activities, but it joins together a diverse set of activities (some legal, some illegal) that cannot be easily measured or analyzed as an aggregate.

**This paper has paid significant attention to one key form of “illicit flow”—the evading (illegal) or avoiding (legal) of national tax laws in developing countries.** The policy prescriptions focused on strengthening tax administration; international exchange of tax information; modifying tax laws and regulations to close loopholes and simplify collection efforts; limiting, and carefully monitoring, the awarding of tax incentives; and strengthening international tax rules.

**There are many other types of flows that fall within the definition of IFF employed by the high-level panel—the movement of funds derived from criminal activity or from the abuse of authority for personal gain (corruption and embezzlement), the movement of legally acquired funds abroad to circumvent capital controls (whether it be to diversify portfolios, seek safe havens for savings threatened by inflation or expropriation, or evade taxes).**

**Policy actions are warranted to limit these various kinds of flows,** but the appropriate measures (such as anti-money laundering regimes, strengthening anti-corruption enforcement, anti-bribery laws, international exchange of tax information, addressing disincentives to invest locally) vary with the activity being targeted.

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1/ African Union and United Nations Economic Commission for Africa, 2015, [\*Illicit Financial Flows: Report of the High Level Panel on Illicit Financial Flows from Africa\*](#).

## C. International Trade as an Engine for Development

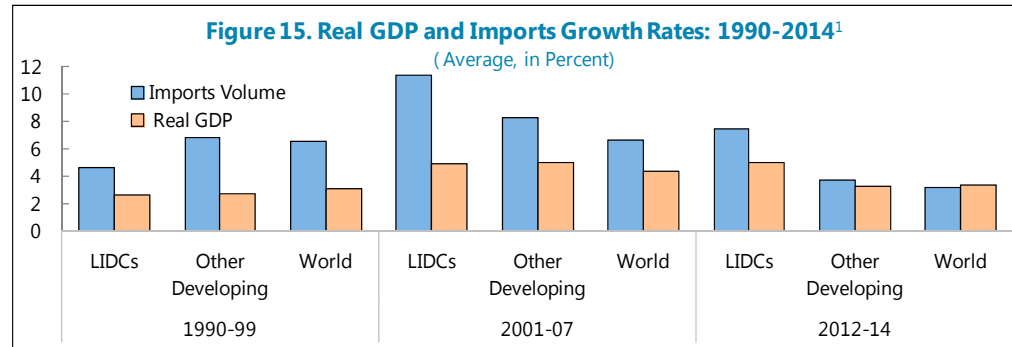
**65. Trade has increased dramatically during the last three decades, particularly for developing countries.** The value of world goods exports increased from US\$2 trillion in 1980 to over US\$18 trillion in 2013, growing at near 7 percent per year. The share of developing countries in global goods exports rose from 27 percent in 1980 to 43 percent in 2013, while the share accounted for by trade among developing countries has risen steadily reaching 17 percent in 2013. The development of global value chains (GVCs), involving the geographic dispersion of various stages in

the process of producing final goods, has been an important contributor to this growth, but these GVCs remain highly concentrated in specific regions—North America, Europe and Southeast Asia.

**66. The pace of expansion of international trade has slowed significantly in recent years—** from 7 percent in 2011 to 3¼ percent in 2014, alongside a much smaller decline in global growth

(from 4.2 percent to 3.3 percent over the same period). The slowdown likely has a significant structural component: econometric

estimates suggest that the long-run world elasticity of trade to GDP fell from 2.2 in 1986–2000 to 1.3 in 2001–2013.



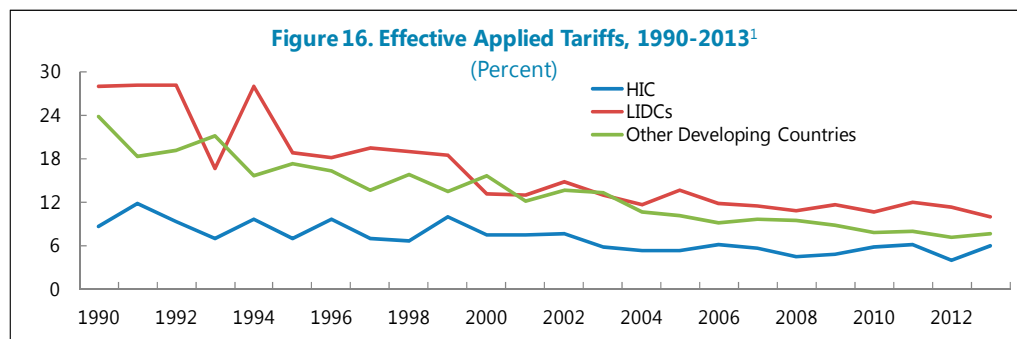
Sources: World Economic Outlook; and IMF staff estimates.

<sup>1</sup>Country groupings are defined in Appendix Table 1.

**67. An important factor underpinning the slowdown in trade is that the benefits of past reforms have matured and new liberalization proposals have languished.** In the 1990s and early 2000s, reforms in anticipation of and resulting from WTO membership allowed many countries to

rapidly integrate into the global trading system. Applied tariffs fell from averages of nearly 30 percent to less than 15 percent in developing countries and from 10 percent

to less than 5 percent in advanced countries. More recently, the process of unilateral liberalization has slowed and multilateral negotiations have stalled.



Source: UNCTAD TRAINS. \*Simple averages of MFN Applied and Preferential tariffs.

<sup>1</sup>The data for tariffs does not pertain to a consistent sample of countries over time.

**68. There are still significant gains to be made by developing countries from further integration into the international trading system.** Some policy reforms need to be home-grown—such as calibrated import liberalization measures and efforts to improve trade infrastructure, including regional trade links—but development partners can provide important support through “Aid for Trade,” trade-related capacity-building efforts, project preparation assistance and other backing for bankable regional transportation projects.

**69. Reforms are also needed at the international level.** Swift implementation of the Bali Trade Facilitation Agreement (TFA) could generate substantial benefits, particularly for the least developed

countries.<sup>21</sup> High barriers to imports and domestic subsidies on agricultural products in advanced economies remain a significant obstacle to export expansion for many developing countries—a key issue in the Doha dialogue. Preferential access to developed country markets remains important for poorer countries and should ideally be maintained and expanded.

**70. The recent increase in “small group” and regional trade arrangements needs to avoid fragmenting global trade.** Recent trade liberalization efforts are taking the form of preferential (e.g., Trans-Pacific Partnership (TPP)) and plurilateral negotiations (e.g., Trade in Services Agreement (TISA)). While these efforts may help advance liberalization in new trade areas, they also run the risk of fragmenting the global trade system and increasing costs from trade diversion. Thus, these efforts need to be pursued openly and transparently, adopt liberal rules of origin, and be aligned with eventual multilateralization. Ideally, membership of these agreements would be open to all countries that are prepared to implement comparable liberalization. Over time, arrangements based on these principles can maximize the benefits of agreements and ignite reciprocal opening efforts from non-members.

**71. The IMF provides support to developing countries in trade policy through policy advice and support for capacity-building in related areas, particularly customs administration.** Technical assistance has also been provided as part of a broader effort to facilitate trade reforms in countries joining the WTO or intensifying their engagement in regional trading arrangements.

## D. Official Development Assistance

**72. Official Development Assistance (ODA) accounts for a modest and declining share of the resource flows to developing countries, but remains an important source of finance for lower income countries and FCS.**<sup>22</sup> That said, ODA, and other forms of official assistance, continue to play a significant role in bolstering domestic development efforts in many countries. ODA levels have grown in real terms over time, but remain well below the long-established UN target for advanced countries of providing 0.7 percent of gross national income in ODA—averaging about 0.3 percent in 2013. To date, only six advanced countries (Denmark, Luxembourg, The Netherlands, Norway, Sweden, and the United Kingdom) have met the 0.7 percent target.<sup>23</sup> Sub-targets for providing ODA to the least developed countries are also being missed by large margins.

**73. Raising aid levels, including for climate finance purposes, should be a priority in the advanced economies and other higher income economies, notwithstanding significant**

<sup>21</sup> According to WTO estimates, the TFA could reduce trade costs by between 10 and 15 percent, resulting in global welfare gains of between US\$0.4 and US\$1 trillion through increased trade flows and revenue collection, enhanced business environment, and stronger foreign investment.

<sup>22</sup> See Figure 4 on page 11.

<sup>23</sup> These numbers are drawn from OECD-DAC statistics, and cover only those countries that report to the DAC; other high income countries that are not OECD member also deliver significant amounts of aid: the Netherlands fell below the 0.7 percent target for the first time in 2013.

**domestic budgetary challenges.** Used well, aid can deliver very large payoffs in terms of reducing poverty, meeting basic needs, and helping build national capacity. But there are cases where, given poor donor coordination and weak alignment with national government priorities, aid delivers little in terms of lasting results. Sustaining support for higher aid levels among donor taxpayers will be feasible only if aid effectiveness is assured.

**74. Aid effectiveness has become a center piece of the FfD debate in recent years.**<sup>24</sup> The starting point for achieving good results is effective coordination between the recipient government and its multiple development partners (both official and philanthropic), which requires both a) shared goals, aligned with national priorities, and b) transparency and mutual accountability between the government and its partners.<sup>25</sup> Donors are now seeking to better integrate their aid efforts into the national development agenda, to assist in strengthening national procurement and financial management systems, and to tackle aid fragmentation and predictability. Further efforts are needed: “the call continues to go out for transparent and harmonized financing conditions, procedures, and methodologies across donor countries.”<sup>26</sup>

**75. One area where the role of aid and development agencies is expected to expand significantly is in leveraging extra external private financial investment in developing countries.** There are significant market failures (or missing markets) that impede a link-up between the large pools of savings in developed countries—particularly those held by long-term institutional investors such as pension funds—and the opportunities for high-return investments in developing countries.<sup>27</sup> Obstacles cited include the absence of bankable projects, the lack of capacity among institutional investors to conduct due diligence of projects themselves, and the difficulties that developing countries face in “pre-committing” to leaving policies affecting project profitability unchanged. Public entities—including the multilateral development banks (MDBs) and national development finance institutions (DFIs)—can address these market failures through targeted financial interventions (including credit enhancement, support for project preparation, providing mezzanine financing, promoting passive participation of private investors alongside MDBs), thereby leveraging substantially larger amounts of private financing participation. The merits of such “blended financing” will depend very much on the specific transactions and projects being developed.<sup>28</sup>

**76. It will be important that donors ensure that aid allocations for low income countries and FCS increase as a share of total aid,** in the interest of better targeting of scarce resources.

<sup>24</sup> See the Fourth High-Level Forum on Aid Effectiveness in Busan, Korea in 2011.

<sup>25</sup> See OECD-UNDP (2014).

<sup>26</sup> United Nations (2014b), p.30.

<sup>27</sup> Some of the key obstacles are not “market failures”, but rather concerns about the stability and integrity of national policy and regulatory regimes—underscoring the importance for attracting investment of an enabling domestic economic environment, as discussed in Subsection A of the previous section.

<sup>28</sup> See “*From Billions to Trillions: Transforming Development Finance*” (2015) and United Nations (2014b).

Middle income countries typically have stronger tax bases, better developed domestic financial markets, and more access to external capital markets than LICs and FCS. That said, many of the world's poorest continue to live in some of the larger, more financially developed economies, such as India (33 percent) and Nigeria (7 percent); cutting back on pro-poor aid projects in these countries would not be appropriate.

## E. Remittances

**77. Global remittance flows now far exceed ODA flows, playing a key role in supporting income levels in many recipient countries:** they represent the national payback from labor resources that have permanently or temporarily left the country. Given the global demographic transition discussed in the second section, cross-border labor movements can be expected to increase over the longer term, with positive implications for remittances as a source of national income for many developing countries.

**78. The costs associated with executing remittance payments are typically high relative to the size of the amounts being remitted.** With transactions costs as a share of the amount transferred typically falling with the size of the transfer, these costs impose a particularly heavy tax on poorer workers and their dependents. In this context, the G8 Heads of States, in 2009, pledged to reduce the global average costs of transferring remittances from 10 percent to 5 percent over five years—a commitment adopted by the G20 countries in 2011.<sup>29</sup> With about 80 percent of the global remittance flows (about US\$ 436 billion) sent from or to G20 countries, this commitment was expected to provide a strong push to reduce transfer costs. The average cost has reportedly declined to 8 percent, although some countries still face significantly higher remittances costs.

**79. The increasing large numbers of migrants from developing countries to higher income countries can provide source countries with the opportunity to raise funds from a niche market more willing to take the country risk: national diasporas.** Some countries, such as India and Israel, have been highly successful in raising funds through special bond issues or by having domestic banks offer accounts for non-resident nationals. A challenge in tapping this market is to contain the transactions costs of raising these funds.

**80. Further policy action is needed to reduce the cost of remittance transfers.** Measures needed include: reducing barriers to entry in the remittances market, while ensuring the financial integrity of intermediaries, and the development of a better payment-system infrastructure. In this context, the G20 Leaders reiterated their commitment to reduce transfer costs in November 2014 and individual G20 countries submitted specific action plans. These action plans are welcome and should be pursued vigorously and assessed for effectiveness.

<sup>29</sup> Recent estimates indicate that a 5 percent reduction of transfer costs would translate into more than US\$ 15 billion per year for the recipient population (see World Bank, 2010, and <https://remittanceprices.worldbank.org/en/about-remittance-prices-worldwide>).

## NEXT STEPS: IMF INITIATIVES IN SUPPORT OF SUSTAINABLE DEVELOPMENT

**81. The IMF is already heavily engaged across many of the key policy areas discussed in the preceding sections.** We focus here on initiatives the IMF will undertake to further strengthen its support for its developing country members in their pursuit of sustainable development, reflecting priorities that have figured in the FfD debate where the IMF has the capacity to contribute.

- *Supporting developing countries in strengthening their capacity to collect domestic revenues, both through domestic capacity-building and international tax cooperation;*
- *Helping countries address large infrastructure gaps in an efficient manner that does not imperil public debt sustainability;*
- *Building economic resilience/policy space;*
- *Developing policies that adequately address issues of equity/inclusion and of environmental sustainability;*
- *Providing effective support to meet the special needs of Fragile and Conflict-Affected States (FCS), many of whom are falling behind relative to the rest of the developing world;*
- *Promoting the development of domestic financial markets;*
- *Improving macroeconomic data collection and dissemination to enhance the information base for decision-making.*

### ***Strengthening domestic revenue mobilization and management***

**82. Developing countries have called for enhanced support from international institutions and bilateral partners in generating domestic budgetary revenues,** through support for national capacity-building in tax policy and administration and enhanced international tax cooperation to contain the shifting of potential revenues aboard.

**83. The IMF already allocates one-fifth of its support for national capacity-building efforts to providing assistance in the areas of tax policy and administration.** Further resources will be allocated to this end when well-targeted country-owned requests for assistance materialize; the room to provide enhanced support would be further increased if additional bilateral donor support is forthcoming, including for the IMF's regional technical assistance centers (RTACs). Assistance in designing appropriate and transparent tax arrangements for extractive industries is an area where further engagement could yield particularly high returns.

**84. The IMF will support nationally-owned strategies for revenue reform, and continue to widen the application of a range of revenue tools it has recently developed to support**

**countries.** Prominent among these is ‘**TADAT**’ (Tax Administration Diagnostic Assessment Tool), a tool to provide a standardized assessment of performance of the revenue agency. Other tools include **RA-FIT** (Revenue Administration Fiscal Information Tool), which provides a web-based platform for compiling comparative data, thereby allowing benchmarking of the operational performance of the revenue agency relative to other countries; **RA-GAP** (Revenue Administration Gap Analysis Program), which helps revenue collection agencies estimate the shortfall of actual from potential collections, identify the underlying causes, and design corrective actions; and **FARI** (Fiscal Analysis of Resource Industries), a modeling framework used to evaluate, compare and help design fiscal regimes for extractive industries, which is being prepared for public release in late 2015.<sup>30</sup>

**85. Shifts among the different modalities for supporting revenue agencies and finance ministries may be warranted to maximize the effectiveness of IMF support.** Many officials in developing countries have underscored the value of hands-on assistance in implementing reforms, suggesting that greater use will need to be made of resident advisors, regular visits by experts, and the resources of the RTACs. But, with no “one size fits all,” these are issues that will need to be resolved in collaboration with national authorities.

**86. Measures to enhance international tax cooperation, including—but not limited to—BEPS and enhanced information exchange, have the potential to enhance the effectiveness of domestic efforts to collect tax,** although it is important that efforts to exploit the potential of new initiatives do not direct resources away from the longer-term challenges of gradually building a fully effective tax administration.

**87. The IMF will deepen its work on international tax issues of relevance for developing countries,** while working to support the establishment of appropriate fora for discussions of tax issues of common interest, including enhanced regional cooperation. One issue where regional collaboration is needed is to limit the frequency of “zero-sum” tax competition among countries for a near-fixed pool of potential external investment.

**88. The IMF will continue its support for developing countries in their efforts to increase the efficiency of public spending.** This will help to contain the spending pressures faced by many countries, and create fiscal space for increased spending on social sectors and infrastructure (IMF, 2014g). Specifically, the IMF will support capacity building on efficient design of redistributive spending programs (see IMF, 2014h and IMF, 2014i), reducing energy subsidies, and public investment efficiency and management (see further below).

**89. The IMF will continue to expand its technical assistance to developing countries on designing easy-to-administer carbon pricing schemes and wider energy price reforms.** Such

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<sup>30</sup> The Fund has also recently launched, in collaboration with the Extractive Industries Transparency Initiative (EITI), a natural resource revenue template to improve the collection, transparency, and consistency of government revenue from natural resources.

measures would enable countries both to “internalize adverse externalities” in terms of environmental damage in the pricing of carbon and to generate additional revenues.

### ***Infrastructure Policy Support***

**90. Many developing countries are, or will be, scaling up investment spending to address severe growth-constraining infrastructure gaps.** Where requested, the IMF will expand its work to assist policy-makers in a) evaluating the macroeconomic and financial implications of alternative approaches and b) assessing/improving institutional capacity in managing public investment. The measures, taken together, constitute an infrastructure policy support package that countries can choose to access in whole or in part.

**91. This policy support package for infrastructure provision would include some or all of:**

- *A Public Investment Management Assessment (PIMA)*, using a new tool being developed that assesses capacities in three stages of public investment—planning, allocation, and implementation. Reform priorities would be identified and capacity building strategies developed in collaboration with other institutions—particularly the World Bank.
- *A Debt-Investment-Growth (DIG) modeling framework*. The DIG model enables policy-makers to assess the growth, debt, and fiscal implications of alternative investment programs and financing for strategies.
- *Debt Sustainability Assessments (DSA)*. Already the workhorse tool for assessing the medium-term implications of specific budgetary policies, the assessments would seek to better allow for the contingent liabilities incurred under Private-Public Partnerships (PPPs).
- *The PPP Fiscal Risk Assessment Model (P-FRAM)* is a new tool designed to quantify the macro-fiscal implications of PPP projects and associated fiscal risks.
- *Technical assistance in developing a Medium-term Debt Management Strategy (MTDS)* and in debt portfolio risk management. An established tool, implemented jointly with the World Bank, this work would be expanded to cover assessment of contingent liability risks associated with guarantees or new investment financing instruments.

**92. Use of these tools, and the resulting assessments and capacity building plans, would be summarized in the ensuing Article IV reports,** underpinning an integrated discussion on strengthening the infrastructure investment policy environment. An external website would be developed on which country assessments and reform strategies would be presented (with the authorities’ consent), as a mechanism for facilitating knowledge-sharing across countries, and with the investor community.



***Enhancing policy space and resilience***

**93. Access to IMF financial resources provides a financial safety net to help countries manage adverse shocks, acting as a potential supplement to foreign reserves when there is a significant balance of payments need.** This support is especially important to countries with limited capacity to borrow in domestic or foreign markets. The case for expanding the access of developing countries to Fund resources is discussed in a separate Board paper, “*Financing for Development: Enhancing the Financial Safety Net for Developing Countries* (IMF 2015h).” Staff will issue a supplement to the present document following Board discussion of IMF (2015h), describing any changes in access levels and terms approved by the Board.

***Increased Engagement on Equity/Inclusion and Environmental Issues***

**94. As noted previously, the IMF has expanded its analytic work on macro-relevant elements of inclusion, including on jobs and growth, inequality, access to finance, and the economic impact of gender inequities.** Some of this work, notably on job creation, is already being drawn upon in the IMF’s operational work. A program is underway to establish how best to bring policy insights from the ongoing work on inequality, gender, and energy/environment issues into Article IV consultations, using a diverse group of 25 countries as pilot cases.

**95. Looking ahead, the IMF intends to:**

- **Intensify efforts to bring concrete policy messages on equity/inclusion issues to operational work**, drawing on the lessons from the current pilot project and on the experience of other institutions (such as the World Bank).
- **Expand the analytical work underway** on a) inequality (on the role of global drivers, the influence of fiscal policy and of structural reforms), b) gender (the impact of gender inequities on growth, inequality and financial inclusion, gender budgeting, and the drivers of labor force participation), c) jobs (informality, reform of labor market institutions), and d) financial inclusion (assessing the growth and distributional consequences of potential reforms, and tradeoffs with financial stability), again with a view to drawing clear policy messages of relevance for IMF operational work.<sup>31</sup>

**96. Looking to the medium-term, it is expected that equity/inclusion issues, where viewed as being macro-relevant, will be a regular component of IMF operational work.**

**97. The IMF will continue with its work on energy pricing and environmental tax issues, drawing on this body of analysis in its operational work in countries.** As noted earlier, the IMF

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<sup>31</sup> The IMF’s recently launched Financial Access Survey now provides data on financial inclusion encompassing internationally-comparable basic indicators of financial access and usage (<http://fas.imf.org>).

will seek to provide technical assistance to help developing countries design easy-to-administer carbon pricing schemes.

### ***Strengthening Support for Fragile/Conflict-Affected States (FCS)***

**98. FCS face exceptional development challenges that typically result, for extended periods, in sluggish growth and poor performance in improving key social indicators.**<sup>32</sup> These usually involve some combination of a) weak state institutions; b) a difficult security situation; c) an impaired capital stock, including physical infrastructure; d) an enhanced scarcity of human skills, due both to emigration and disruption of the education system; e) deep social cleavages; and f) a highly uncertain outlook, reflecting both political uncertainty and vulnerability to shocks.

**99. Producing sustained economic and social advancement in such situations is inevitably a lengthy process, even if some “quick wins”, such as job creation through public works programs or military demobilization, can be obtained.** The IMF’s engagement strategy with the member needs to be framed within a relatively long time horizon, recognizing the high risk of reversals; the strategy needs to be grounded in a strong understanding of the socio-economic situation;<sup>33</sup> and, given the scale of the needs and the relative weakness of state institutions, engagement needs to proceed in close coordination with other major development partners, including the World Bank.<sup>34</sup>

**100. The IMF is committed to strengthening the effectiveness of its work with FCS.** This will affect both operational work, focused on short-term economic management and associated lending, and capacity-building, focused on strengthening key state institutions (such as the central bank and tax collection agency) over the medium-term. Capacity-building efforts need to be embedded in an agreed medium-term strategy that is closely coordinated with lead development partners, realistically aligned with local absorption capacity, and endorsed and owned the government. And the delivery of support needs to be tailored to country needs, which will often entail the use of resident advisors or regular repeat visits by experts.

**101. Full implementation of this approach will require adjustments within the IMF,** including in such areas as HR policies, the level of engagement with key development partners, and the closer integration of area departments into capacity-building support.<sup>35</sup>

<sup>32</sup> For further discussion, see IMF (2011c) and World Bank (2011).

<sup>33</sup> All Fund engagement with member countries needs to be informed by a good understanding of the socio-economic situation, including the views of key actors and interest groups: in an FCS context, this understanding needs to be substantially deeper if Fund engagement is to be fully effective.

<sup>34</sup> The need for close coordination with the country’s main development partners should not be seen as undermining the core relationship for Fund staff—that between the Fund and the national authorities.

<sup>35</sup> See IMF (2015i).

**102. The preponderance of FCS member countries are PRGT-eligible, and hence will benefit from the proposed changes in access to IMF resources discussed above.** That said, access to IMF resources should not be seen as the optimal form of external support, given that these are concessional loans that will need to be repaid over time. Grants are a more appropriate form of financial assistance to countries that typically face a long road to exiting fragility and achieving sustained strong growth.

### ***Strengthening Domestic Financial Markets***

**103. The IMF will enhance its support for financial market development in developing countries** by a significant increase in targeted TA on financial market deepening, along with support for building effective regulatory, supervisory, risk and crisis management frameworks and enhancing sound public debt management that increases financial sector resilience. It will also operationalize current analytical and policy work (see Sahay and others, 2015) on how best to promote financial market deepening without weakening financial stability.

**104. The IMF will explore the scope for developing, in collaboration with the World Bank, a diagnostic product that would help to guide targeted capacity building in financial market development in LICs.** Development of such a tool would require external financial support.

### ***Other Initiatives***

**105. The IMF will strengthen its statistical data dissemination and knowledge sharing by better leveraging its technology.** Dissemination of data and technical assistance can be improved by greater use of web-based tools and Open Data Platforms (for example, the enhanced general data dissemination standards (eGDDS)), Massive Open Online Courses (MOOCs), and promotion of peer-to-peer learning in cooperation with training partners in the regions as well as the IMF Institute training curriculum.

**106. Small developing states are recognized to have specific development challenges and vulnerability to external shocks, including natural disasters.**<sup>36</sup> The IMF, in collaboration with other international institutions, will work with small states as a group, or with regional sub-groups, on developing medium-term policies to achieve sustained growth; the challenges, including those of managing elevated debt levels and weak fiscal situations, are often cross-cutting in nature. IMF teams' country analysis will be modified to incorporate the recurring costs of natural disasters, with policy emphasis being placed on developing economic resilience.

### ***Resource Issues***

**107. Implementation of these initiatives as a full package will likely require additional financial resources.** Internal budgetary space is being generated through efficiency improvements,

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<sup>36</sup> See IMF (2013b).

exploiting new technologies and using more cost-effective mechanisms to support capacity-building (such as via the RTACs), and through re-prioritization of current activities. But a substantial and sustained expansion of Fund capacity-building support in areas such as domestic revenue mobilization or financial market development will be feasible only with additional support from bilateral donors.

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## Annex. Tackling High Levels of Public Indebtedness

**1. Tackling the burden of high levels of public external debt on developing countries was an important theme at the Monterrey Conference in 2002**, in good part reflecting the difficult situation of highly indebted poor countries (HIPC) at a point in the time when the HIPC Debt Relief Initiative was only beginning to yield results. The Monterrey Consensus on FfD noted that: “Speedy, effective, and full implementation of the enhanced Initiative, which should be fully financed through additional resources, is critical” (para 49).

**2. The HIPC Initiative is now close to completion, the debt relief provided having been substantially augmented via the Multilateral Debt Relief Initiative (MDRI) in 2005.** 36 of the 39 countries eligible for HIPC have completed the process and received comprehensive external debt relief and public debt levels in low income countries have fallen sharply over the past decade (see Annex Figure 1). But there continues to be a significant number of developing countries where the public debt burden remains substantial—middle income countries (often small states) with long-standing debt problems that did not benefit from HIPC/MDRI, countries that have accumulated significant amounts of debt in recent years or suffered severe output shocks.

**3. The challenges faced in undertaking a debt restructuring have evolved significantly:** the holders of debt are now typically a diverse group of official creditors, private lenders, holders of sovereign bond issues, with domestic financial institutions also playing a significant role in many cases.

**4. This annex looks at how public debt crises can be prevented and, when they occur, at the principles that should guide timely resolution.** Recent trends in public debt levels in developing countries are summarized in Annex Box 1.

### Prevention

**5. Sustained sound fiscal management, paying due attention to ensuring medium-term debt sustainability, is the first line of defense in preventing a sovereign debt crisis.** This avoids accumulating dangerous levels of debt in the first place. Diagnostic tools for analyzing the links between fiscal policy and debt sustainability have been strengthened substantially over the past decade, and provide a core input into the regular dialogue on macroeconomic policies (the “Article IV Consultation”) between the IMF and member countries and into the design of IMF-supported programs.

**6. The IMF has developed a debt sustainability analysis framework for countries with significant access to international capital markets (market access countries, hence MAC DSA).** The MAC DSA was substantially revamped in 2013, drawing on lessons learned from countries’ experiences during the global financial crisis.<sup>1</sup> The new framework provides for a risk-based

<sup>1</sup> See [Staff Guidance Note for Public Debt Sustainability Analysis in Market Access Countries \(IMF 2013c\)](#).

approach to DSAs (more in-depth analysis where a priori risks to debt sustainability appear greater), a systematic approach to assessing the realism of baseline assumptions, high risk benchmarks for the level of debt burden indicators, and a heat map to summarize and communicate the key risks to debt sustainability in an objective manner. It also focuses on assessing risks to the banking sector, a potentially important contingent liability for the sovereign.

**7. The IMF and World Bank have jointly developed a DSA framework for use in low income countries (the LIC DSF), which typically rely on official external concessional financing rather than external private sector funding.** This framework was upgraded following a 2012 review that concluded that the approach had worked well in identifying vulnerabilities facing LICs, but needed to increase the attention paid to total public debt, rather than focusing narrowly on external public debt,<sup>2</sup> given the risks associated with rising domestic debt levels in some countries.

**8. The use of DSAs as a “reality check” in setting fiscal policy and public sector borrowing plans provides clear signals when fiscal policies pose a threat to medium-term debt sustainability.** Part of this reality check requires paying appropriate attention to the adverse shock scenarios embedded in the DSAs, which identify how the debt situation would evolve if the baseline scenario turns out to be overly optimistic. Policy-makers may decide that the medium-term pay-off to their fiscal plans warrants taking some additional risk on the public debt side: DSAs ensure that such decisions are taken with an understanding of the risks to debt sustainability—and, hopefully, encourage policy makers to implement risk mitigation measures (such as managing the maturity profile of debt).

**9. The IMF and World Bank have jointly ramped up technical assistance to better support low income countries to manage debt.** A joint donor-funded trust fund—the Debt Management Facility (DMF II)—was established in 2014 to finance support for capacity-building with respect to medium term debt management strategies, identifying debt vulnerabilities in a timely manner, and accessing international capital markets in due course.

### Crisis Resolution

**10. Notwithstanding recent progress in prevention, debt crises still occur and need to be resolved in an efficient manner.** Resolving debt crises efficiently requires timely and appropriate resolution that balances the interests of debtors and creditors:

- Delays in resolving a debt crisis are costly to both the debtor and its creditors. For a country cut off from other sources of financing, a drawn-out resolution process creates prolonged hardship for its citizens, with governments forced to ration scarce funds between core public spending and meeting credit obligations. For creditors, delays weaken the national economy, further eroding the recovery they can expect on their claims.

<sup>2</sup> The design and performance of the LIC DSF will be reviewed again in 2016.

- A resolution that places too much of the burden on the debtor (not providing sufficient debt relief) maintains a debt overhang and a drag on growth. Conversely, a framework that places too much of the burden of resolution on the creditors (very large haircuts on their claims) would discourage lending and push up borrowing costs.

**11. Efficient resolution of debt crises is a shared responsibility of the international community, with a key role for the IMF, other official creditors, and the private sector:**

- First, as a lender of last resort, the IMF has a critical role to play in the crisis resolution process. The IMF's lending policies on whether and how much to lend to a crisis country are a key consideration in a country's decision on whether to seek a restructuring of its debt. If the debt situation is such that viability cannot be restored without a debt restructuring, the IMF's DSA helps identify the amount of debt reduction/financing needed from official and private creditors to restore debt sustainability. In designing its lending policies, the IMF is well positioned to balance the interests of debtor and creditor governments—as both groups are represented on the IMF's Executive Board—and pay due regard to the stability of the international financial system.
- Second, bilateral official creditors have to coordinate on the terms of a debt restructuring to reach agreement in a timely manner. Historically, such coordination was provided in the context of the Paris Club, whose members accounted for most of the official bilateral lending to developing countries. With the emergence of important new official creditors, the share of Paris Club creditors in official bilateral flows has fallen considerably; achieving effective coordination among official creditors could be more challenging in future restructurings.
- Finally, private sector creditors also have an important role to play in resolving debt crises. When a debtor can no longer fully service its debt and a restructuring is required, private creditors need to find mechanisms to reach a common agreement, even though individually they have an incentive to hold out. The introduction of collective action clauses in international sovereign bond contracts since 2003 has constituted an important step to facilitate cooperative outcomes in sovereign debt crises. However, there is scope to further strengthen these clauses.

**12. Within its mandate to pursue market-based and contractual approaches to resolving sovereign debt crises, the IMF is promoting reforms in a number of areas.** In May 2013, the Executive Board endorsed a work program on sovereign debt that encompassed three areas:<sup>3</sup>

- *Reform of the IMF's lending policies.* The IMF is currently considering how best to calibrate its framework for large-scale lending operations to limit the costs of crisis resolution, while reducing moral hazard and excessive debt accumulation.

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<sup>3</sup> See [Sovereign Debt Restructurings—Recent Developments and Implications for the Fund's Legal and Policy Framework](#), IMF 2013d).

- *Framework for engaging with official and private creditors.* IMF staff will shortly commence work aimed at articulating a clearer framework for engaging with the official sector on debt restructuring, especially with regard to non-Paris Club creditors. This work will also review the IMF's lending-into-arrears policy, which was designed to avoid situations in which private creditors can have a de facto veto over IMF lending decisions.
- *New clauses in sovereign bond contracts.* In October 2014, the Executive Board endorsed key features of enhanced collective action and pari passu clauses for international sovereign bond contracts that would limit the influence of holdout creditors in circumstances where a debt restructuring is needed. Several countries have now included clauses consistent with these recommendations in new debt issuances.

### Annex Box 1. Trends in Public Debt Levels in Developing Countries

**Public debt burdens have eased across developing countries over the past decade, although the experience has differed significantly across income group** (Annex Figure 1):<sup>1</sup>

- Among 119 developing countries, 98 recorded improved or broadly stable debt-to-GDP ratios between 2004 and 2014; 21 countries recorded an increase (panel B).
- Among middle income countries, debt-to-GDP ratios typically declined in the run up to the global economic crisis, but increased somewhat in the wake of the crisis, as countries provided fiscal stimulus to support domestic demand.
- For low income countries, debt ratios dropped significantly over the period, with the large declines typically due to provision of external debt relief under HIPC/MDRI.

**Looking more closely at the experience of lower income (PRGT-eligible) countries:**<sup>2</sup>

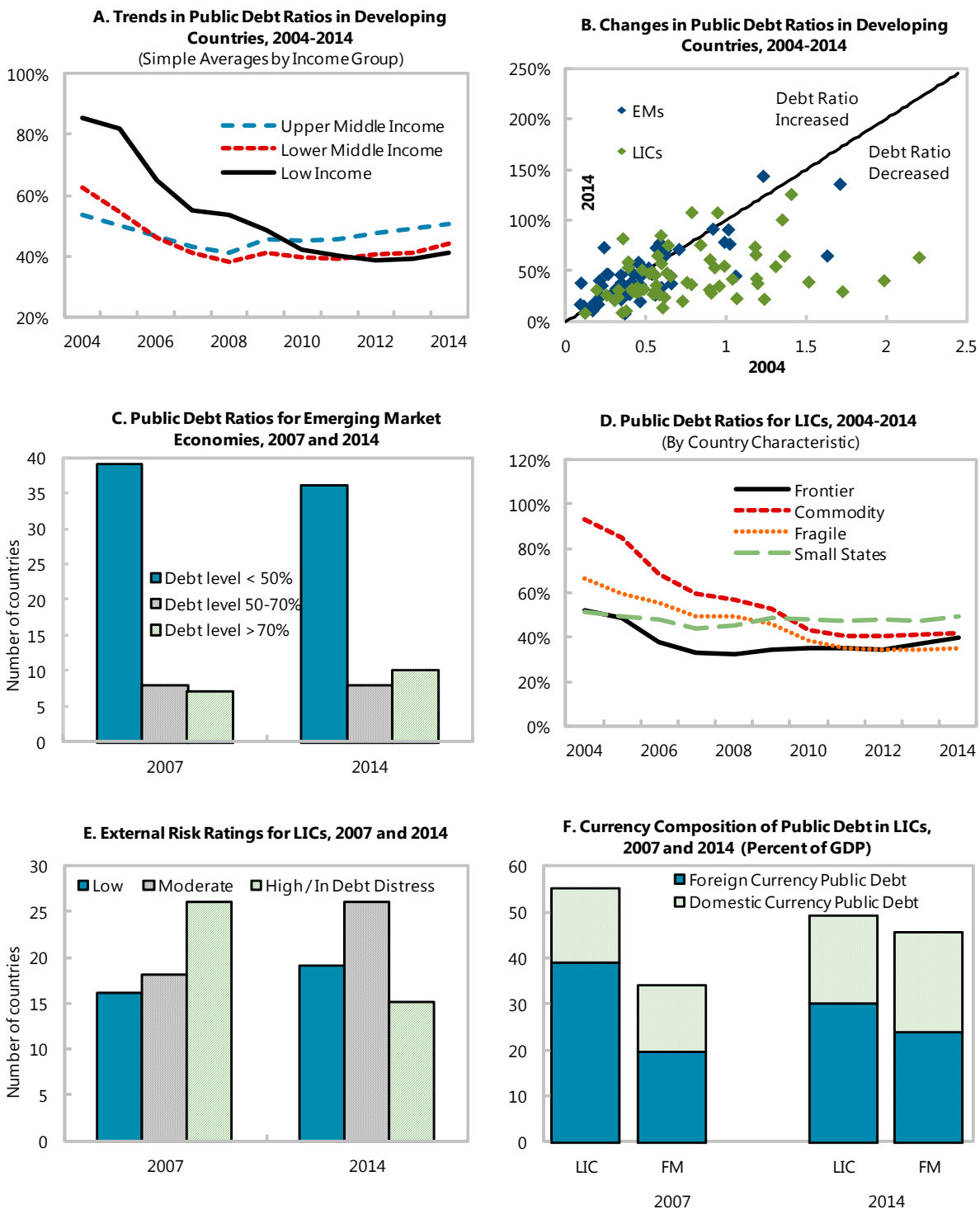
- While debt levels have typically fallen markedly over the past decade (panel D), the effects are less-marked for frontier economies, which have been building up debt in recent years. Small states have seen no clear trend in debt burdens over the period, in part reflecting the fact that relatively few were eligible for debt relief under HIPC/MDRI.
- The number of countries classified as being at high risk of/in debt distress has halved over the past seven years, but still account for one-fifth of the total (panel E).<sup>3</sup> The majority of the high risk cases are either small or fragile/conflict-affected states. Debt denominated in domestic currency debt now accounts for close to half of public debt in low income countries, a share that has increased significantly in recent years (panel F). In several frontier market economies, financial deepening has proceeded to the point where non-resident investors are becoming a significant presence in the market for domestic-currency public debt.

1/ Public debt burdens are measured by the size of the debt of the general government as a share of GDP, based on data from the IMF's World Economic Outlook database.

2/We use the term "lower income countries" to refer to the 74 countries eligible for concessional financial support from the IMF's Poverty Reduction and Growth Trust (PRGT). The country sub-groupings are taken from IMF, [Macroeconomic Developments in Low-Income Developing Countries](#), 2014: see appendices I and II.

3/ The risk ratings are based on the joint World Bank/IMF Low-Income Countries' Debt Sustainability Framework.

**Annex Figure 1. Public Debt Ratios and Risk Ratings in Developing Countries, 2004-2014<sup>1</sup>**



Sources: World Economic Outlook; International Finance Statistics; and IMF staff estimates.

<sup>1</sup>Public debt ratios refer to Public Debt-to-GDP ratios in all figures.

## Appendix. Developing Countries and Country Groups<sup>1,2,3,4</sup>

<b>Emerging and Developing Europe (10 countries)</b>		<b>Sub-Sahara Africa (44 countries)</b>	
Albania	FYR Macedonia	Angola*	<b>Liberia*,**</b>
Bosnia and Herzegovina*	Montenegro	<b>Benin**</b>	<b>Madagascar*,**</b>
Bulgaria	Romania	Botswana	<b>Malawi*,**</b>
Hungary	Serbia	<b>Burkina Faso**</b>	<b>Mali*,**</b>
Kosovo*	Turkey	<b>Burundi*,**</b>	Mauritius
		<b>Cameroon**</b>	<b>Mozambique**</b>
		Cabo Verde	Namibia
		<b>Central African Republic*,**</b>	<b>Niger**</b>
		<b>Chad*,**</b>	<b>Nigeria</b>
		<b>Comoros*,**</b>	<b>Rwanda**</b>
		<b>Congo, Democratic Rep. *,**</b>	<b>São Tomé and Príncipe*,**</b>
		<b>Congo, Republic *,**</b>	<b>Senegal**</b>
		<b>Côte d'Ivoire*,**</b>	Seychelles
		<b>Eritrea*,**</b>	<b>Sierra Leone*,**</b>
		<b>Ethiopia**</b>	South Africa
		Gabon	<b>South Sudan*</b>
		<b>Gambia**</b>	Swaziland
		<b>Ghana**</b>	<b>Tanzania**</b>
		<b>Guinea*,**</b>	<b>Togo*,**</b>
		<b>Guinea-Bissau*,**</b>	<b>Uganda**</b>
		<b>Kenya</b>	<b>Zambia**</b>
		<b>Lesotho</b>	<b>Zimbabwe*</b>
<b>Emerging and Developing Asia (26 countries)</b>		<b>Latin America and the Caribbean (25 countries)</b>	
<b>Bangladesh</b>	<b>Nepal</b>	Argentina	Mexico
<b>Bhutan</b>	Palau	Belize	Nicaragua**
<b>Cambodia</b>	<b>Papua New Guinea</b>	<b>Bolivia**</b>	Panama
Fiji	Philippines	Brazil	Paraguay
Indonesia	Samoa	Colombia	Peru
<b>Kiribati*</b>	<b>Solomon Islands*</b>	Costa Rica	St. Lucia
<b>Lao People's Democratic Republic</b>	Sri Lanka	Dominica	St. Vincent and the Grenadines
Malaysia	Thailand	Dominican Republic	Suriname
Maldives	Timor-Leste*	Ecuador	Venezuela
Marshall Islands*	Tonga	El Salvador	
Micronesia*	Tuvalu*	Grenada	
<b>Mongolia</b>	Vanuatu	Guatemala	
<b>Myanmar*</b>	<b>Vietnam</b>	Guyana**	
		<b>Haiti*,**</b>	
		<b>Honduras**</b>	
		Jamaica	
<b>Middle East (16 Countries)</b>			
	<b>Commonwealth of Independent States (11 countries)</b>		
<b>Afghanistan*,**</b>	Armenia		
Algeria	Azerbaijan		
<b>Djibouti*</b>	Belarus		
Egypt	Georgia <sup>4</sup>		
Iran	Kazakhstan		
Iraq*	<b>Kyrgyz Republic</b>		
Jordan	<b>Moldova</b>		
Lebanon	<b>Tajikistan</b>		
Libya*	Turkmenistan		
<b>Mauritania**</b>	Ukraine		
Morocco	<b>Uzbekistan</b>		
Pakistan			
<b>Sudan*,**</b>			
Syrian Arab Republic*			
Tunisia			
<b>Yemen*</b>			

<sup>1</sup>Developing countries here refers to all countries that are not "higher income countries" in the World Bank classification system, a usage adopted here because it is aligned with the meaning of the term in the external debate. Given their systemic size, China and India are excluded from the sample of developing countries.

<sup>2</sup>59 countries in bold typeface are low-income developing countries (LIDC) and 73 countries in regular typeface are other developing countries (Other). The LIDC are countries eligible for IMF's concessional financial assistance with a per capita Gross National Income (measured according to the World Bank's *Atlas* method) in 2011 of below twice the IDA's effective operational cut-off level, and Zimbabwe. 'Other Developing' are the non-LIDC emerging market and developing countries. 37 countries, with an asterisk,\*, included in the list of countries in a post-conflict and fragile situation, are referred to as 'Fragile States', as of May 2015 (IMF Board Paper). Somalia (LIDC & fragile state) is excluded due to insufficient macro data.

<sup>3</sup>38 countries, with two asterisk,\*\*, signs are in the list of countries that have qualified for, are eligible or potentially eligible and may wish to receive HIPC Initiative Assistance (as of April 2015).

<sup>4</sup>Georgia, which is not a member of the Commonwealth of Independent States, is included in this group for reasons of geography and similarities in economic structure.



July 2, 2015

## FINANCING FOR DEVELOPMENT: REVISITING THE MONTERREY CONSENSUS—ENHANCING THE FINANCIAL SAFETY NET FOR DEVELOPING COUNTRIES— SUPPLEMENTARY INFORMATION

**This supplement provides information on the decisions that were adopted by the Executive Board on July 1, 2015 to enhance access to Fund resources for developing countries.** The information contained in this supplement provides an update to the brief discussion on “enhancing policy space and resilience” in paragraph 93 of the main paper.

**The IMF legal framework permits members that meet certain income thresholds to be eligible to receive financial assistance on concessional terms from the PRGT (PRGT-eligible countries).**<sup>1</sup> Members who do not meet these income thresholds can only be financed on non-concessional terms through the Fund’s General Resource Account (GRA).<sup>2</sup>

**Among PRGT-eligible countries, there are: a) those that are eligible to receive all financial support from the IMF in the form of loans from the PRGT and b) those that are presumed to receive support in the form of a blend of PRGT and GRA resources (“blenders”).** Countries in the first group are either relatively poor or are at high risk of debt distress, and thus particularly vulnerable to shocks.<sup>3</sup>

**The decisions taken on July 1 include:**<sup>4</sup>

a) *Raise access norms and annual and cumulative normal access limits by 50 percent across the concessional facilities for all PRGT-eligible countries.*<sup>5</sup>

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<sup>1</sup> There are currently 73 IMF member countries that are PRGT-eligible.

<sup>2</sup> For those countries that receive financial support on non-concessional terms, the interest rates levied on borrowings from the GRA are typically much lower than the interest rates paid by developing countries on commercial borrowings: the current rate of charge on borrowings from the GRA at normal levels of access is 1.05 percent.

<sup>3</sup> For detail on the rules determining those PRGT-eligible countries that received blended support, see *Review of Facilities for Low-Income Countries—Proposals for Implementation and Proposed Decisions*.

<sup>4</sup> For a full elaboration of the decisions adopted on July 1 see *Financing for Development: Enhancing the Financial Safety Net for Developing Countries and Proposed Decisions*.

<sup>5</sup> Except for the cumulative access limit for the exogenous shocks window of the Rapid Credit Facility which is raised by less than 50 percent.

- b) For PRGT-eligible countries that are “blenders”, changing the blending proportions from 1:1 (PRGT/GRA) to 1:2 (PRGT/GRA).

**These measures increase access to Fund resources for all PRGT-eligible countries by 50 percent.** This includes an increase in the maximum level of PRGT credit outstanding from 300 percent of quota to 450 percent of quota.

**For PRGT-eligible countries that are presumed “blenders”, the expanded access for new programs takes the form of additional financing from the GRA:** the 50 percent increase in access levels in the PRGT is combined with a shift from one-half to two-thirds in the share of resources provided from the GRA. A Fund-supported program that provides access at the norm would now involve an unchanged amount of resources provided from the PRGT plus a doubling of the amount provided from the GRA. That said, access to PRGT funding over time is expanded because the expansion of the cumulative limit on PRGT access affects both blenders and non-blenders alike.

**The reform has the overall effect of shifting the use of (scarce) PRGT resources from the better off/less vulnerable countries to the poorer/more vulnerable countries within the group of PRGT-eligible countries,** ensuring better targeting of these resources to most needy.

**Decisions taken on July 1, 2015, also:** a) increase access to fast-disbursing support, thus benefitting all countries in fragile situations or hit by conflict or natural disasters; and b) increase the concessionality of such support provided to PRGT-eligible countries. Specifically, the decisions are to:

- a) Increase access to fast-disbursing support by 50 percent under the RFI (to all member countries) allowing enhanced assistance for countries in fragile situations, hit by conflict, or natural disasters as is done for the RCF (to PRGT-eligible countries);
- b) Increase the level of concessionality of such support to PRGT-eligible countries by setting the interest rate on RCF loans at zero percent on a permanent basis.