

The IMF's role in low-income countries



The IMF plays a vital role in the international community's efforts to help low-income countries (which constitute 42 percent of its membership) achieve faster economic growth and poverty reduction. The Fund's chief contributions are promoting macroeconomic and financial stability—a precondition for growth and poverty reduction—in these countries by providing policy advice, loans (typically under the Poverty Reduction and Growth Facility), and technical assistance, and promoting a healthy global economy from which these countries can benefit. It also participates in debt relief efforts, mainly through the joint IMF–World Bank Heavily Indebted Poor Countries (HIPC) Initiative; during FY2006, it also participated in the Multilateral Debt Relief Initiative (MDRI; see Box 6.1)—its contribution was approved by the IMF's Board in November 2005.

In FY2006, the IMF introduced two new instruments—the Policy Support Instrument (PSI), for countries that do not need or want Fund financing but that do want its evaluation and endorsement of their policies; and the Exogenous Shocks Facility (ESF), which provides concessional financing to low-income countries faced with external shocks beyond their control.

The Poverty Reduction and Growth Facility (PRGF), which was established in 1999 as a replacement for the Enhanced Structural Adjustment Facility (ESAF), provides concessional financing (loans with below-market interest rates and long-term maturities) to low-income countries experiencing balance of payments problems (see Table 5.1 for a list of the Fund's lending facilities). Members seeking assistance under the PRGF prepare a Poverty Reduction Strategy Paper (PRSP) with input from their external development partners, including the IMF and the World Bank. They must also seek input from domestic stakeholders, such as civil society groups, to ensure “local ownership” of the economic, structural, and social policies outlined in the PRSP. As of April 30, 2006, the IMF had committed SDR 13 billion (nearly \$20 billion) to 55 countries under the PRGF. The Executive Board reviewed both the PRGF and the Poverty Reduction Strategy approach during FY2006.

The Fund has a variety of other instruments for providing financial support to its low-income members, including

Emergency Post-Conflict Assistance, Emergency Natural Disaster Assistance, and the Trade Integration Mechanism, for countries adjusting to trade liberalization.

The preparation of a PRSP is also required for countries seeking debt relief under the HIPC Initiative, which was launched in 1996 as a tool for coordinated action by the international financial community to help reduce poor countries' external debt burdens to sustainable levels. The Initiative was enhanced in 1999 to provide faster, deeper, and broader debt relief aimed at reducing the net present value (NPV) of countries' external public debt to a maximum of 150 percent of exports, or 250 percent of government revenue for small open economies. The MDRI supplements the assistance provided under the HIPC Initiative. Countries are meant to use the resources freed up by debt relief to alleviate poverty and accelerate progress toward achieving the UN Millennium Development Goals (MDGs).

The MDGs include eradicating extreme poverty and hunger; achieving universal primary education; promoting gender equality; reducing child mortality; improving maternal health; combating HIV/AIDS, malaria, and other diseases; and ensuring environmental sustainability—all by the target date of 2015. Although the MDGs have received growing attention, progress toward their achievement has been slow and uneven. At the Conference on Financing for Development, which was sponsored by the United Nations and held in Monterrey, Mexico, in March 2002, the international community adopted the Monterrey Consensus, a two-pillar strategy to improve prospects for achieving the MDGs. The first pillar is the pursuit of sound policies, stronger institutions, and improved governance by low-income countries. The second pillar is greater and more effective international support—including official development assistance (ODA) and trade liberalization to open markets to developing country exports. The Fund and the World Bank monitor and report on progress toward the MDGs, including in the annual *Global Monitoring Report*.

For information on how the IMF's lending activities and debt relief in low-income countries are financed, see Chapter 8.

Box 6.1 Debt relief initiatives

The **Heavily Indebted Poor Countries (HIPC Initiative)**, which was established in 1996, remains the only internationally agreed framework for providing comprehensive debt relief to countries that qualify for HIPC assistance. Participation in the Initiative is voluntary for both creditors and debtors. The initiative was enhanced in 1999 to provide faster, deeper, and broader debt relief and to strengthen the links between debt relief, poverty reduction, and social policies.

To qualify for HIPC assistance, a country must pursue strong economic policies supported by the IMF and the World Bank. There are three phases. In *phase 1, leading up to the decision point*, the country needs to establish a track record of good performance (normally, over a three-year period) and develop a Poverty Reduction Strategy Paper (PRSP) or an interim PRSP. Its efforts are complemented by concessional aid from all relevant donors and institutions and traditional debt relief from bilateral creditors, including the Paris Club. In this phase, the country's external debt situation is analyzed in detail. If its external debt in net present value (NPV) terms, after the full use of traditional debt relief, is above 150 percent of exports (or, for small open economies, above 250 percent of government revenue), the country qualifies for HIPC relief. At the decision point, the IMF and the World

Bank formally decide on the country's eligibility, and the international community commits itself to reducing the country's debt to a sustainable level.

Once it reaches the *decision point (phase 2)*, the country must continue its good track record with the support of the international community, satisfactorily implementing key structural policy reforms, maintaining macroeconomic stability, and adopting and implementing a Poverty Reduction Strategy. Paris Club bilateral creditors reschedule obligations coming due, with a minimum 90 percent reduction in NPV terms, and other bilateral and commercial creditors are expected to do the same. The IMF and the World Bank and some other multilateral creditors may provide interim debt relief between the decision and completion points.

A country reaches its *completion point—the third phase*—once it has met the objectives set at the decision point. It then receives the balance of the debt relief committed. This means that all creditors are expected to reduce their claims on the country, measured in NPV terms, to the agreed sustainable level. A number of bilateral creditors, particularly in the Paris Club, have committed to providing additional debt relief beyond what is required under the HIPC Initiative.

The **Multilateral Debt Relief Initiative (MDRI)** was launched in 2005 as a supplement to the HIPC Initiative, to help accelerate progress toward the Millennium Development Goals. The MDRI allows for 100 percent debt relief by three multilateral institutions—the IMF, the International Development Association (IDA) of the World Bank Group, and the African Development Fund (AfDF)—for countries completing the HIPC process. Unlike the HIPC Initiative, the MDRI does not propose any parallel debt relief on the part of official bilateral or private creditors, or of multilateral institutions other than the IMF, IDA, and the AfDF. Although the MDRI is an initiative common to the three institutions, the decision to grant debt relief is ultimately the separate responsibility of each institution, and the approach to coverage and implementation may vary.

The MDRI became effective at the Fund on January 5, 2006, and 19 countries (17 HIPCs and 2 non-HIPC countries) received MDRI relief the following day. The Fund delivered SDR 2.3 billion in MDRI and remaining HIPC Initiative relief to the qualifying countries, reducing their exposure to the Fund by 94 percent, on average. Cameroon qualified for SDR 0.2 billion in debt relief after reaching its completion point on April 28, 2006, and other HIPCs will qualify for MDRI relief upon reaching their completion points.

Comparing the HIPC Initiative and the MDRI

	HIPC Initiative	MDRI
Country coverage	IDA-only, PRFG-eligible countries with debt indicators above the HIPC Initiative thresholds.	HIPCs that have reached the completion point (and non-HIPCs with per capita income below \$380 in the case of the IMF).
Participating creditors	All creditors, on a voluntary basis.	IMF, IDA, and AfDF.
Debt covered	Debt above the HIPC Initiative thresholds.	All outstanding obligations as of end-2004 (IMF and AfDF) and end-2003 (IDA), and remaining debt outstanding at the time of qualification for the relief.
Modality of delivery	Variable. The IMF provides interim debt relief and delivers the remainder as a stock cancellation at the completion point.	All participating creditors provide debt relief as a stock-of-debt operation at or shortly after the completion point.

Debt relief and sustainability

The IMF, together with the World Bank and other official creditors, made further progress in implementing the HIPC Initiative in FY2006. As of end-April 2006, 29 HIPCs—or nearly three-fourths of the 40 countries that might wish to be considered for debt relief under the Initiative—had reached the decision point and were receiving debt relief, including from the Fund. The debt stocks of these countries

are projected to decline by about two-thirds in NPV terms once they reach their respective completion points, when creditors provide the full amount of debt relief committed at the decision point on an irrevocable basis. To date, 19 HIPCs have reached the completion point, accounting for 64 percent of HIPC Initiative assistance committed by the international community.

The Boards of the IMF and the World Bank decided in 2004 to extend the HIPC Initiative sunset clause to December

31, 2006, for countries that meet the end-2004 income and indebtedness criteria.¹ Subsequently, 11 countries were identified as meeting the criteria, including four countries not previously eligible (Eritrea, Haiti, the Kyrgyz Republic, and Nepal). (Three other countries that met the criteria indicated that they did not wish to avail themselves of the Initiative.)² Grant resources will need to be mobilized to finance HIPC debt relief for those countries that become potentially eligible under the extended sunset clause, including three countries with protracted arrears to the Fund (Liberia, Somalia, and Sudan). Some countries that might be eligible for debt relief under the HIPC Initiative may not be able to adopt a Fund-supported program before the sunset clause expires, however. The Board will consider options by end-July 2006 for dealing with the expiration of the sunset clause.

Status of implementation of the enhanced HIPC

At a Board discussion in September 2005, Directors reiterated their strong support for the Initiative and welcomed the continued progress being made.³ They recognized that progress toward reaching the completion point depended on countries' satisfactory performance under their PRGF arrangements and their Poverty Reduction Strategies. Directors urged staff to continue working with these HIPCs to help them reach their completion points. They emphasized the need to help countries improve their institutional capacity and policy processes—especially management of public expenditure and tracking of poverty outlays.

Directors acknowledged that most of the countries' bilateral creditors had agreed to provide debt relief but stressed that ensuring the full participation of non-Paris Club and commercial creditors remained an important challenge. They reiterated their call to creditors that had not yet joined the international community's efforts to provide comprehensive debt relief to do so and regretted that a number of non-Paris Club creditors had withdrawn from the Initiative. Directors were also concerned about the increase in lawsuits initiated by private creditors against Heavily Indebted Poor Countries. Underscoring the crucial importance of equitable participation and burden sharing in

the HIPC Initiative, they strongly urged Fund staff to help increase creditor participation in the Initiative and facilitate cooperation between creditors and debtor countries. Directors recommended steps to enhance the transparency of creditor participation, give more explicit attention to these issues in Article IV consultations, provide targeted technical assistance to improve debt management systems, intensify moral suasion, and educate creditors on the HIPC methodology.

The Multilateral Debt Relief Initiative

In an effort to step up debt relief, the Fund's Board approved the Multilateral Debt Relief Initiative (MDRI)⁴ in November 2005. This initiative provides debt relief to member countries with annual per capita incomes at or below \$380, as well as to countries above that threshold that reach the completion point under the HIPC Initiative. MDRI relief covers the full stock of eligible debt owed to the IMF at the end of 2004 that remains outstanding at the time of the provision of debt relief.

The MDRI was a response to a proposal advanced by the Group of Eight (G-8: Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States) at the July 2005 Gleneagles Summit for cancellation by the IMF, the World Bank's International Development Association (IDA), and the African Development Fund (AfDF) of debt owed to them by countries eligible for debt relief under the HIPC Initiative.

Directors agreed that debt relief under the MDRI should be part of an effort to strengthen the IMF's role in supporting low-income countries. The IMF must remain fully equipped to advise and assist members in the design of macroeconomic stabilization and structural reforms, in capacity building, and in the provision of financing, whether in response to shocks or to address remaining or protracted balance of payments problems.

On December 21, 2005, the Board approved a list of countries qualifying for debt relief under the MDRI.⁵ To qualify, members must meet three criteria: satisfactory macroeconomic performance, implementation of poverty reduction policies, and progress in public expenditure management. For countries that had already reached the completion point under the HIPC Initiative, the qualification criteria

¹"Enhanced HIPC Initiative: Possible Options Regarding the Sunset Clause," prepared by the staffs of the IMF and the World Bank, July 7, 2004 (www.imf.org/external/np/hipc/2004/070704.htm).

²"IMF Executive Board Discusses the List of Ring-Fenced Countries That Meet the End-2004 Income and Indebtedness Criteria Under the Enhanced HIPC Initiative and the Review of Financing of the Fund's Concessional Assistance and Debt Relief to Low-Income Member Countries," Public Information Notice No. 06/41, April 18, 2006; www.imf.org/external/np/sec/pn/2006/pn0641.htm.

³"IMF Executive Board Discusses the Status of Implementation of the Enhanced HIPC Initiative," Public Information Notice No. 05/129, September 21, 2005, www.imf.org/external/np/sec/pn/2005/pn05129.htm.

⁴"IMF Executive Board Agrees on Implementation Modalities for the Multilateral Debt Relief Initiative," Public Information Notice No. 05/164, December 8, 2005, www.imf.org/external/np/sec/pn/2005/pn05164.htm.

⁵"IMF Executive Board Discusses the First Assessment of Eligible Countries under the Multilateral Debt Relief Initiative," Public Information Notice No. 05/168, December 27, 2005, www.imf.org/external/np/sec/pn/2005/pn05168.htm.

Table 6.1 Countries covered by the MDRI

	Eligible under the “MDRI-I Trust” (per capita income below \$380) ¹	Eligible under the “MDRI-II Trust” (per capita income above \$380) ²
Countries eligible for MDRI relief as of April 30, 2006		
“Completion point” HIPCs: 19 countries that have reached the completion point under the enhanced HIPC Initiative ³	Burkina Faso, Ethiopia, Ghana, Madagascar, Mali, Mozambique, Niger, Rwanda, Tanzania, Uganda	Benin, Bolivia, Cameroon, Guyana, Honduras, Mauritania, Nicaragua, Senegal, Zambia
Non-HIPC countries (2) with per capita income below \$380 and outstanding debt to the IMF	Cambodia, Tajikistan	
Countries that will be eligible once they reach the completion point under the enhanced HIPC Initiative		
“Decision point” HIPCs: 10 countries that have reached the decision point under the enhanced HIPC Initiative	Burundi, Chad, Democratic Republic of the Congo, The Gambia, Guinea-Bissau, Malawi, São Tomé and Príncipe, Sierra Leone	Guinea, Republic of Congo
11 additional countries may wish to be considered for HIPC debt relief. Their eligibility was assessed based on income and indebtedness criteria as of end-2004	Central African Republic, Eritrea, Liberia, Nepal, Togo Somalia is the eleventh country, but data on its per capita income are not available.	Comoros, Côte d’Ivoire, Haiti, Kyrgyz Republic, Sudan

¹The MDRI-I Trust consists of the IMF’s own resources.

²The MDRI-II Trust consists of bilateral contributions administered by the Fund.

³These countries qualified for debt relief under the MDRI before April 30, 2006, with the exception of Mauritania, which qualified in June 2006.

were that they had not experienced any substantial lapses in the three areas.

The list of members eligible for debt relief included 18 that had already reached the completion point under the HIPC Initiative and 2 non-HIPCs (Cambodia and Tajikistan; Table 6.1). Twelve countries, including the two non-HIPCs, were eligible for debt relief under the MDRI-I Trust, for countries with annual per capita incomes at, or below, \$380. The other eight HIPCs, with annual per capita incomes above \$380, were eligible for debt relief under the MDRI-II Trust. (See Chapter 8 for more information about the MDRI Trusts.)

Directors determined that 19 of the 20 countries met the three qualification criteria. Burkina Faso, Cambodia, Ethiopia, Ghana, Madagascar, Mali, Mozambique, Niger, Rwanda, Tajikistan, Tanzania, and Uganda would receive debt relief from the MDRI-I Trust, while Benin, Bolivia, Guyana, Honduras, Nicaragua, Senegal, and Zambia qualified for debt relief from the MDRI-II Trust.⁶ Directors urged all countries qualifying for debt relief to maintain sound macroeconomic policies and progress with structural reforms, and to make productive use of the resources freed by debt relief.

The cost of debt relief to IDA and the AfDF is to be met by bilateral contributions from the G-8 countries and other donors based on agreed burden sharing. The cost to the Fund is to be covered through its own resources, with a call for bilateral contributions to cover additional needs. The G-8 will cover the cost of debt relief for countries that may

become eligible for the HIPC Initiative under the extended sunset clause, while donors will provide the extra resources necessary for full debt relief at the completion point for Liberia, Somalia, and Sudan.

Directors stressed the importance of ensuring that the Fund’s financing capacity was not jeopardized by the MDRI, noting that the cost of MDRI debt relief for Cambodia and Tajikistan was higher than estimated in earlier Board papers and that there was a need to ensure that the PRGF’s financing capacity was not reduced. In this context, they again welcomed the G-8’s commitment to providing an additional subsidy contribution of SDR 100 million and to consider dealing with the potential additional costs of including Cambodia and Tajikistan.

On January 5, 2006, after all contributors to the PRGF Subsidy Account had given their amount for the MDRI to become effective, the Board approved immediate debt relief from the Fund under the MDRI for the 19 countries meeting the qualification criteria and delivered SDR 2.3 billion in debt relief to them (see Table 8.5). This is expected to have a substantial impact on these countries’ external debt service payments. A progress report on the MDRI was produced in late March 2006.⁷

Cameroon, which reached its completion point on April 28, 2006, became the twentieth country to qualify for debt relief under the MDRI, in the amount of SDR 0.2 billion.⁸

⁶Mauritania qualified for debt relief under the MDRI-II Trust early in FY2007 after taking certain remedial actions.

⁷“The Multilateral Debt Relief Initiative: Progress Report on Implementation,” March 20, 2006, www.imf.org/external/np/pp/eng/2006/032006.pdf.

⁸On June 21, 2006, the IMF approved SDR 32.9 million in debt relief for Mauritania.

Debt sustainability framework

In April 2006, Directors reviewed the experience with the joint IMF and World Bank debt sustainability framework (DSF) for low-income countries since it was endorsed by the Boards of the IMF and the World Bank in April 2005 and discussed the implications of the MDRI for the DSF.⁹ Directors noted that the DSF had become an effective tool for assessing and monitoring countries' debt burdens and sustainability in the context of surveillance and IMF-supported arrangements. Directors welcomed the wide use of the DSF by multilateral development banks in their lending decisions. They saw room for making debt sustainability analyses more useful for bilateral creditors, with a view to facilitating donor coordination. Directors also underlined the DSF's role in raising donors' awareness of the need to boost grant financing and deliver on their commitments. While there was scope for improvement to the DSF, the Board saw no need for major changes.

Excessive accumulation of debt, particularly the nonconcessional type, should be avoided in countries benefiting from the MDRI. Directors agreed that, on balance, the indicative DSF debt thresholds should not be lowered because of the MDRI, as this would limit countries' ability to mobilize resources for the MDGs and could run counter to the principle of uniformity of treatment. Directors broadly supported a case-by-case approach to debt accumulation below the debt thresholds.

Strengthening instruments for supporting low-income countries

In FY2006, the IMF continued to reflect on the adequacy of its instruments for engaging its low-income members. Although the PRGF remains the main instrument for assisting these members, the emergence of countries that might not need the Fund's financial assistance on a sustained basis motivated not only a new emphasis on surveillance in these cases but also an examination of other forms of engagement, resulting in the adoption of the Policy Support Instrument and the Exogenous Shocks Facility.

PRGF program design

In September 2005, the IMF's Executive Board discussed the design of policy programs supported with loans under the

⁹The Board's discussion was based on a report prepared jointly by the staffs of the World Bank and the IMF: "Review of Low-Income Country Debt Sustainability Framework and Implications of the Multilateral Debt Relief Initiative," which is available at www.imf.org/external/np/pp/eng/2006/032406.pdf. The summary of the Board's discussion was released in Public Information Notice No. 06/61, which can be found at www.imf.org/external/np/sec/pn/2006/pn0661.htm.



Burkina Faso

The IMF has supported Burkina Faso's economic reform programs almost continuously since 1993 with arrangements under the Enhanced Structural Adjustment Facility (ESAF) and its successor, the Poverty Reduction and Growth Facility (PRGF). During this time, Burkina Faso's performance has generally been good: the annual real GDP growth rate has averaged about 6 percent (among the highest in Africa); social expenditures have increased significantly; and poverty has declined. Nevertheless, Burkina Faso continues to rank among the poorest countries in the world, and reaching the Millennium Development Goals poses major challenges.

Burkina Faso has also benefited from debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative, and, more recently, from debt relief under the Multilateral Debt Relief Initiative (MDRI), including \$82 million in debt owed to the IMF. This debt relief will be used to further raise poverty-reducing spending.

The latest PRGF arrangement, which covers 2003–06, was approved by the IMF's Executive Board in June 2003. Macroeconomic performance under the program has been good, with average real GDP growth increasing to about 7 percent a year in 2003–05, in spite of a number of adverse shocks—oil prices have increased by more than 60 percent since early 2003; in 2004, world cotton prices reached record lows; and drought and locusts have disrupted agricultural production. The overall fiscal deficit during the program period has narrowed slightly relative to the preceding three-year period, while the government has continued to increase spending on health care, education, and infrastructure.

Burkina Faso-IMF activities in FY2006

May 2005	Board considers Joint Staff Advisory Note on Burkina Faso's Poverty Reduction Strategy Paper
September 2005	Conclusion of Article IV consultation and completion of fourth review under Burkina Faso's PRGF arrangement
December 2005	IMF approves assistance under the Multilateral Debt Relief Initiative for Burkina Faso
March 2006	Completion of the fifth review of Burkina Faso's PRGF arrangement



Georgia

Since the mid-1990s, Georgia has engaged in several arrangements with the IMF, including three consecutive programs under the Poverty Reduction and Growth Facility (PRGF) and its predecessor, the Enhanced Structural Adjustment Facility (ESAF). These programs have supported the Georgian authorities in establishing and maintaining macroeconomic stability after a period of civil unrest and hyperinflation in the early 1990s. Since 2001, real economic growth has averaged 7½ percent a year, while inflation has averaged below 6 percent. The programs have promoted structural reforms and financial stability, while bolstering the National Bank of Georgia's reserve position, which has increased fourfold since 2000.

During the most recent PRGF-supported program, which was approved in June 2004, the Georgian authorities have managed an impressive turnaround of the fiscal position. Owing mainly to improvements in tax administration, tax revenues as a share of GDP—a measure of fiscal performance—rose from 14.5 percent in 2003 to almost 20 percent in 2005, enabling higher spending on priority areas, including infrastructure, as well as the clearance of most arrears. This improvement occurred against the backdrop of a significant tax reform in early 2005 aimed at simplifying the tax system. Georgia has also continued to reduce its external debt burden, helped by the marked appreciation of the lari in 2004.

The IMF has provided considerable technical assistance to Georgia, especially in fiscal and monetary policy and financial matters. Using this assistance efficiently, the Georgian authorities continue to implement reforms that should contribute to macroeconomic stability.

Georgia-IMF activities in FY2006

June 2005	Managing Director participates in the annual meeting of the constituency to which Georgia belongs, held for the first time in Tbilisi; the constituency comprises 12 countries represented by the same Executive Director (who is elected by the countries) on the IMF's Executive Board
June 2005	Joint Staff Advisory Note on the authorities' Progress Report on Georgia's Poverty Reduction Strategy Paper, the Economic Development and Poverty Reduction Program
July 2005	Completion of the second review of Georgia's performance under the PRGF-supported program
March 2006	Joint IMF-World Bank mission in Tbilisi to conduct the Financial Sector Assessment Program (FSAP) update
March 2006	Completion of 2006 Article IV consultation and third review of Georgia's performance under the PRGF-supported program

PRGF.¹⁰ Two earlier reviews, one by the staff in 2002 and one by the Independent Evaluation Office in 2004, had confirmed that PRGF-supported programs had become more accommodating to higher public spending, especially to address poverty reduction. However, as an increasing number of low-income countries have reduced macroeconomic imbalances and resumed growth, the policy challenges facing them have evolved. The 2005 review therefore focused on selected policy issues, with particular emphasis on the role of institutions in economic growth, the macroeconomics of managing aid, and the fiscal and monetary policies that encourage growth and poverty reduction.

Directors noted the importance of broad economic institutions for the ability of developing countries to sustain economic growth and avoid crises. They observed that some countries ignited growth without having particularly strong broad institutions initially but were able to improve their institutions during the growth period. Directors concurred that the traditional focus in Fund-supported programs on maintaining broad macroeconomic stability, avoiding overvalued currencies, and pursuing trade openness was vital to helping countries sustain growth and reiterated that Fund conditionality should focus on areas that are critical to the macroeconomy. Fund-supported programs could also make a useful contribution to institutional reform by enhancing fiscal transparency and governance.

Directors saw a need for increased spending in many low-income countries, in particular on public infrastructure investment, health care, and education, for these countries to achieve the Millennium Development Goals. However, there was potential tension between higher government spending and both debt sustainability and private sector activity, which could be crowded out. Directors considered that, while increased aid inflows could relax the constraints relating to taxation, private sector credit, and debt sustainability, real currency appreciation could result in a loss of export competitiveness, dampening growth. However, the countries studied by the staff had avoided real exchange rate appreciation because the authorities had restricted absorption and intensified efforts to raise revenues. The Board emphasized the need for low-income countries to bolster domestic revenues to provide more room for public expenditures, including by expanding

¹⁰The Board's discussion was based on four staff papers: "Review of PRGF Program Design—Overview," www.imf.org/external/np/pp/eng/2005/080805r.htm; "Monetary and Fiscal Policy Design Issues in Low-Income Countries," www.imf.org/external/np/pp/eng/2005/080805m.htm; "The Macroeconomics of Managing Increased Aid Inflows—Experiences of Low-Income Countries and Policy Implications," www.imf.org/external/np/pp/eng/2005/080805a.htm; and "Can PRGF Policy Levers Improve Institutions and Lead to Sustained Growth?" www.imf.org/external/np/pp/eng/2005/080805L.htm. The summary of the Board's discussion can be found at www.imf.org/external/np/sec/pn/2005/pn05127.htm.

the tax base. Directors also noted that a better allocation of existing resources could help increase fiscal space and emphasized the need for strengthening public financial management and improved project selection in this regard. For countries with little debt, external borrowing could be an efficient route to finance development expenditures, but even concessional borrowing could lead to an excessive buildup of debt. Directors reaffirmed that the recently operationalized framework for debt sustainability analysis in low-income countries should be the main vehicle for assessing the appropriate fiscal path.

Directors considered higher aid inflows to be an important complement to domestically generated funds for financing poverty-reducing expenditures. Effective management of these resources is critical for achievement of the MDGs (see Box 6.2). In the event of a large increase in aid inflows, countries with adequate absorption capacity that are able to contain adverse effects on the tradables sector could increase spending, using aid to finance the resulting rise in net imports. However, a more restrained spending policy could be in order if the effectiveness of higher spending is constrained by absorptive capacity, if there is tension between aid volatility and spending rigidities, or if there is an unacceptable erosion of competitiveness. To help limit concerns about aid volatility, Directors urged donors to increase the predictability of aid.

Most Directors supported the case for continuing to target single-digit inflation, as higher inflation levels tend to depress economic growth and hurt the poor disproportionately.

Policy Support Instrument

In October 2005, the IMF established the Policy Support Instrument (PSI), agreeing to monitor and endorse the policies of members that do not need or desire the Fund's financial assistance but still want its policy assessment and

Box 6.2 Workshop and handbook on scaling up aid

On April 19–20, 2006, the IMF and the U.K. Department for International Development (DfID) held a workshop at IMF headquarters to assess the macroeconomic challenges of scaling up aid, an issue that has become potentially critical since the 2005 Gleneagles Summit, at which G-8 countries committed to doubling aid to Africa by 2010. The aim of the workshop was to advance the debate on scaling up aid from theory to the operational issues that confront countries and their development partners. It was attended by African finance ministers and central bank governors, representatives from donors and multilateral development institutions, and academics.

Participants agreed that by responding to increased aid inflows with improved productivity and higher employment, countries could mitigate cases of “Dutch disease”—instances when large revenue or aid inflows significantly reduce the competitiveness of the traded goods sector. They emphasized more balanced aid-financed spending, with investment in productive sectors, and trade liberalization, which could both enhance domestic competition and alleviate exchange rate pressures arising from increased aid. Participants also highlighted the importance of strengthening institutions and governance for effectively managing scaled-up aid. Sound fiscal institutions, especially strong public financial management, could facilitate aid absorption.

Over the next decade, African countries are expected to be the largest beneficiaries of

increased donor aid, which is intended to improve their prospects of achieving the Millennium Development Goals. To that end, the IMF's African Department has published a handbook, *Macroeconomic Challenges of Scaling Up Aid to Africa: A Checklist for Practitioners*,¹ which aims to help African countries assess the macroeconomic implications of increased aid and respond to the associated policy challenges. It is directed at policymakers, practicing economists in Africa, and the staffs of international financial institutions and donor agencies participating in the preparation of medium-term strategies for African countries and lists the five main steps countries will need to take:

- absorb as much aid as possible;
- boost growth in the short to medium term;
- promote good governance and reduce corruption;
- prepare an exit strategy if, or when, the scaled-up aid returns to, or even falls below, normal levels; and
- regularly reassess the policy mix, because scaling-up scenarios are not forecasts.

¹The handbook, by Sanjeev Gupta, Robert Powell, and Yongzheng Yang, is available in full text at www.imf.org/external/pubs/ft/afr/aid/2006/eng/index.htm or can be ordered from IMF Publication Services.

endorsement.¹¹ The PSI is intended to help these countries design effective economic programs and, once approved by the IMF, would signal to donors, multilateral development banks, and markets the Fund's endorsement of a member country's policies. The PSI is a complement to, not a substitute for, the Poverty Reduction and Growth Facility.

The PSI is available to PRGF-eligible countries with a Poverty Reduction Strategy that helps ensure ownership of the policies to be implemented under the PSI and a policy

¹¹“IMF Executive Board Approves the Establishment of Policy Support Instruments for Aiding Low-Income Countries,” Public Information Notice No. 05/145, October 14, 2005, www.imf.org/external/np/sec/pn/2005/pn05145.htm; see also “IMF Executive Board Discusses Policy Support and Signaling in Low-Income Countries,” Public Information Notice No. 05/144, October 14, 2005, www.imf.org/external/np/sec/pn/2005/pn05144.htm.

framework that focuses on consolidating macroeconomic stability and debt sustainability while deepening structural reforms in areas that constrain growth and poverty reduction. The PSI requires that country policies meet the standard of IMF upper credit tranche conditionality,¹² and PSI-endorsed programs will normally be reviewed semi-annually by the Fund. As of April 30, 2006, the Board had approved PSIs for Nigeria and Uganda.

Exogenous Shocks Facility

In November 2005, the IMF's Board approved the establishment of the Exogenous Shocks Facility (ESF) within the PRGF Trust. (The Trust was subsequently renamed the PRGF-ESF Trust.) The ESF provides policy support and financial assistance to low-income countries facing exogenous shocks beyond their control.¹³ Such shocks can have significant negative effects, especially on poor countries that lack economic diversification and have a limited capacity to build up reserves.

The ESF is available to countries eligible for the PRGF that do not have a PRGF-supported program in place. Financing terms are the same as for a PRGF arrangement and more concessional than those under other IMF emergency lending facilities (Emergency Post-Conflict Assistance, Emergency Natural Disaster Assistance, and the Compensatory Financing Facility).

Programs supported by the ESF can be up to two years and should meet upper credit tranche conditionality standards, even though structural reform plans can be less ambitious than under a PRGF arrangement. At a minimum, an interim Poverty Reduction Strategy Paper (PRSP) should be in place at the time an ESF arrangement is approved, or, in exceptional circumstances, at the time of the first review. An on-track PSI could provide the basis for rapid access to ESF financing in the event of a shock, but access would not be automatic.

Board review of the Poverty Reduction Strategy approach

In September 2005, the Board undertook an in-depth review of the Poverty Reduction Strategy (PRS) approach.¹⁴ Under this approach, governments in low-income countries prepare Poverty Reduction Strategy Papers (PRSPs) in

concert with domestic stakeholders and external development partners such as the IMF and the World Bank. PRSPs present countries' macroeconomic, structural, and social policies and programs, over a two- to five-year horizon, aimed at promoting broad-based growth and reducing poverty. PRSPs form the crucial link between national public actions, donor support, and development outcomes. Poverty reduction strategies must be

- country-driven, with broad-based participation by civil society in the adoption and monitoring of the PRS;
- results-oriented and focused on outcomes that benefit the poor;
- comprehensive in recognizing the multidimensional nature of poverty;
- partnership-oriented, aimed at improved coordination of efforts by all development partners; and
- based on a long-term perspective on the challenges of obtaining, and the need for, commitments to reduce poverty.

The joint IMF–World Bank staff papers on which the review was based drew lessons regarding the PRS as a model for more effective development cooperation and suggested actions to strengthen it. Directors agreed that the PRS approach was a useful framework for balancing domestic and external accountabilities for development results and provided a platform for scaling up efforts to achieve the MDGs. They also noted that the use of alternative scenarios could bridge the gap between an operationally realistic PRS framework and more ambitious development plans. Directors suggested that Fund staff help in preparing such scenarios for countries that request them (see Box 6.3). More generally, Directors emphasized that the Fund would play a critical role in helping low-income countries manage higher aid inflows.

Global Monitoring Report

Progress in implementing the policies and actions needed to achieve the UN Millennium Development Goals (MDGs) and related outcomes is assessed annually in the *Global Monitoring Report* (GMR), produced jointly by the IMF and the World Bank in collaboration with other international partners.

The third annual GMR, subtitled *Strengthening Mutual Accountability, Aid, Trade, and Governance*, was published in April 2006.¹⁵ It cites evidence of reduced child deaths in 9 of the 10 developing countries surveyed—Bangladesh, Bolivia, Burkina Faso, Cameroon, Indonesia, Madagascar,

¹²See Table 5.1, footnote 4, for an explanation of credit tranches.

¹³"IMF Establishes an Exogenous Shocks Facility," Public Information Notice No. 05/163, December 8, 2005, www.imf.org/external/np/sec/pn/2005/pn05163.htm. A factsheet on the ESF is available at www.imf.org/external/np/exr/facts/esf.htm.

¹⁴See staff papers at www.imf.org/external/np/pp/eng/2005/091905p.htm and www.imf.org/external/np/pp/eng/2005/091905s.htm. For the Board discussion, see www.imf.org/external/np/sec/pn/2005/pn05128.htm.

¹⁵The *Global Monitoring Report* is available at www.imf.org/external/pubs/ft/gmr/2006/eng/gmr.pdf.

Morocco, Mozambique, and the Philippines. It points to the rapid gains in primary school enrollment, with 50 countries having achieved universal completion of primary school, up from 37 in 2000. And it cites signs of the first decline in HIV/AIDS infection rates in such high-prevalence countries as Haiti, Uganda, and Zimbabwe. But the advances remain uneven. Many countries, especially in Africa and Latin America, are still not making strong inroads into poverty reduction, while progress on human development indicators in South Asia has been insufficient.

The GMR highlights six main points for accelerating progress toward the MDGs and strengthening the mutual accountability of the advanced and the low-income countries:

- Growth has helped reduce poverty, but more even and accelerated progress requires a strengthening of infrastructure and the investment climate.
- Recent progress in human development outcomes points to the need for more flexible aid, better coordination, and improved governance.
- Although major aid and debt relief commitments were made in 2005, better aid and vigilant monitoring are needed to guard against risks to their effective implementation. Trade reform needs new life.
- The focus of the international financial institutions must shift from managing inputs to achieving real results on the ground.
- Governance should be regularly monitored to help track progress, generate greater accountability, and build demand for further progress.
- The international community must support efforts to strengthen governance systems through ratification and support for global checks and balances.

On the theme of good governance, the GMR defines public sector governance as the way a country's government gains and exercises authority over public goods and services. Good governance requires more than technical skills and organizational capacities in the public sector. It also demands clear rules and expectations, transparent information to allow performance to be monitored, and incentives and enforcement mechanisms

Box 6.3 Forum on Poverty Reduction Strategies for the western Balkans

The third Forum on Poverty Reduction Strategies for the western Balkans was held in Thessaloniki, Greece, on May 27–28, 2005. Organized by the IMF and the World Bank, the forum was sponsored by the government of Greece, the U.K. Department for International Development, the United Nations Development Program, and the European Union. Participants included government and civil society representatives from Balkan countries with Poverty Reduction Strategies—Albania, Bosnia and Herzegovina, and Serbia and Montenegro—and representatives from the United Nations Mission in Kosovo (UNMIK) and the former Yugoslav Republic of Macedonia.

The participants recognized that—withstanding recent progress in reducing poverty and moving toward the UN Millennium Development Goals—these countries need to accelerate growth to better address poverty, economic vulnerability, and unemployment. Measures to promote competitiveness are critical to creating jobs and accelerating growth.

Although each country faces specific circumstances in implementing its poverty reduction

strategy, participants identified some common challenges:

- accelerating growth by improving the business environment, reducing barriers to the creation of new firms, curbing corruption, promoting labor market flexibility, improving infrastructure, expanding trade, further integrating and liberalizing product and factor markets, and strengthening regional cooperation;
- enhancing human capabilities by improving the quality of public services and providing well-targeted social protection while maintaining prudent fiscal policies;
- managing the political economy of difficult reforms, such as the privatization and restructuring of state-owned enterprises, and restructuring of public finances; and
- harmonizing foreign aid in the context of a single, country-driven development framework and ensuring that aid reflects the needs, priorities, and absorptive capacity of the recipient countries.

to reward success and address failure. To help achieve this, the report outlines a framework for monitoring “the key actors in a governance system,” namely, political leaders, institutions providing checks and balances, the public bureaucracy, and citizens and firms.

Trade and poverty reduction

Multilateral trade liberalization has been a major contributor to the world economy's unprecedented growth over the past half century. In tackling remaining restrictions on trade, the Doha Development Agenda has the potential to benefit all countries. In 2005, at the urging of the Development Committee and the International Monetary and Financial Committee, the staffs of the IMF and the World Bank prepared a paper, “Doha Development Agenda and Aid for Trade,”¹⁶ following a consultation process with donors and developing countries. The paper emphasized that trade could be an important engine of growth and stressed the importance of achieving an ambitious outcome from the Doha Round. However, some countries might require assistance in alleviating the infrastructural and

¹⁶See www.imf.org/external/np/pp/eng/2005/091905.pdf.

Box 6.4 Helping Africa's cotton producers

Cotton, which accounts for up to 60 percent of the export receipts of many West and Central African states, has been one of the major export success stories in sub-Saharan Africa and is the main source of cash income for millions of smallholders. However, the viability of the sector is under pressure as farmers and ginneries face declining world cotton prices exacerbated by euro-dollar exchange rate movements; distortions in global agricultural trade, including producer subsidies in some major exporting countries; a surge in output from other developing countries; and slow productivity gains. Given the economic and social importance of the cotton sector, these developments threaten the region's macroeconomic stability, economic growth, and poverty reduction programs.

Against this background, the Beninese government and the IMF's African Department organized a high-level conference in Cotonou on May 18, 2005. Senior officials from Benin, Burkina Faso, Chad, and Mali (the "Cotton-4"), cotton producers, and officials from interna-

tional trade and development agencies met to discuss ways to weather the crisis.

Conference participants proposed a multi-pronged approach:

- making cotton production more efficient and boosting farmers' incomes;
- maintaining macroeconomic and fiscal stability in the region by ensuring that changes in world prices are reflected in domestic prices;
- eliminating cotton subsidies and other price-distorting factors within the framework of multilateral trade negotiations; and
- requesting support from development partners, such as the World Bank and the IMF, for reforms that strengthen productivity and institutions and for mechanisms that protect the most vulnerable groups during adjustment.

The text of the Conference Declaration is available on the IMF's Web site at www.imf.org/external/np/sec/pr/2005/pr05121.htm.

At a meeting in November 2005, IMF Executive Directors discussed joint Fund–World Bank proposals on trade-related assistance ("Aid for Trade").¹⁷ They reaffirmed the importance of successfully concluding the Doha Round of multilateral trade negotiations. An ambitious agreement on improved market access in both goods and services, and stronger trading rules in the World Trade Organization, will be key to promoting efficiency, economic growth, and poverty reduction, and hence to achieving the MDGs. Directors pointed to the critical role that developed countries can play in addressing remaining trade impediments by removing market access restrictions, reducing tariff escalation, and cutting agricultural and other subsidies. In the same vein, Directors called on developing countries to commit themselves to further trade liberalization. They stressed that Aid for Trade was not a substitute for an ambitious outcome in the

other supply constraints that prevent them from taking advantage of the opportunities of open international trade and in mitigating and managing adjustment costs (see Box 6.4).

The IMF provides trade-related financial and technical assistance through several different vehicles. In addition to its Trade Integration Mechanism, which allows the Fund to provide loans under its lending facilities to countries facing lower export earnings or higher import prices because of other countries' trade liberalization, the Fund provides technical assistance for data improvements, customs reform, and tax and tariff reform. It also contributes to the Integrated Framework (IF), a multi-agency framework that promotes the reform of trade regimes as part of Poverty Reduction Strategies and coordinates trade-related technical assistance. As part of its surveillance activities, the Fund works with country authorities in identifying areas of opportunity and risk and devising policy responses to the challenges of international integration. The Fund has also strengthened its research capacity in the trade area and is helping to develop methodologies for assessing the impact of trade reforms on member countries. In January 2006, the Trade and Investment Division of the IMF's Research Department sponsored a conference at IMF headquarters at which researchers explored the connections between trade, aid, and growth.

Doha Round but an essential and useful complement aimed at allowing some developing countries to address obstacles to exploiting trade opportunities fully.

Most Directors agreed that an examination by the Fund and Bank staffs of the adequacy of existing mechanisms to address regional or cross-country infrastructural needs would be useful. The Board also supported a firm Fund and Bank commitment to helping countries facing adjustment needs use all available instruments.

Directors agreed that the Fund will continue to have a major role to play in helping members address the potential adjustment costs and any associated financing needs arising from more open international trade. However, they noted that financing needs assessments should take into account countries' implementation capacities. In addition, the Fund should confine its work to its mandate and core areas of competence, be guided by the principles of selectivity and effectiveness, and draw on the expertise of other institutions as much as possible. The Fund will continue to carry this work forward through its regular surveillance function, research, lending, and technical assistance—particularly on

¹⁷IMF Executive Board Discusses Doha Development Agenda and Aid for Trade," Public Information Notice No. 05/169, December 27, 2005, www.imf.org/external/np/sec/pn/2005/pn05169.htm.

tax and customs reforms, and on financial sector regulation and supervision. In this context, Directors noted the establishment of a staff working group to examine the potential revenue impact of Doha tariff reduction scenarios for countries likely to face adjustment shocks.

Directors welcomed the staff's suggestions to enhance the Integrated Framework (IF) within the guidelines for the IMF's work on trade issues generally, and they looked forward to the work of the IF task force in developing

practical ways of implementing the suggestions to improve the IF by increasing engagement by donors, the private sector, and civil society. Directors recognized that members' technical assistance needs could increase as a result of the Aid for Trade initiative. The Fund's response to any such increased requirements will need to be based on carefully exploiting the scope for proper prioritization of projects and redeployment of resources, and may need to be quantified in due course in the context of the Fund's medium-term budget.