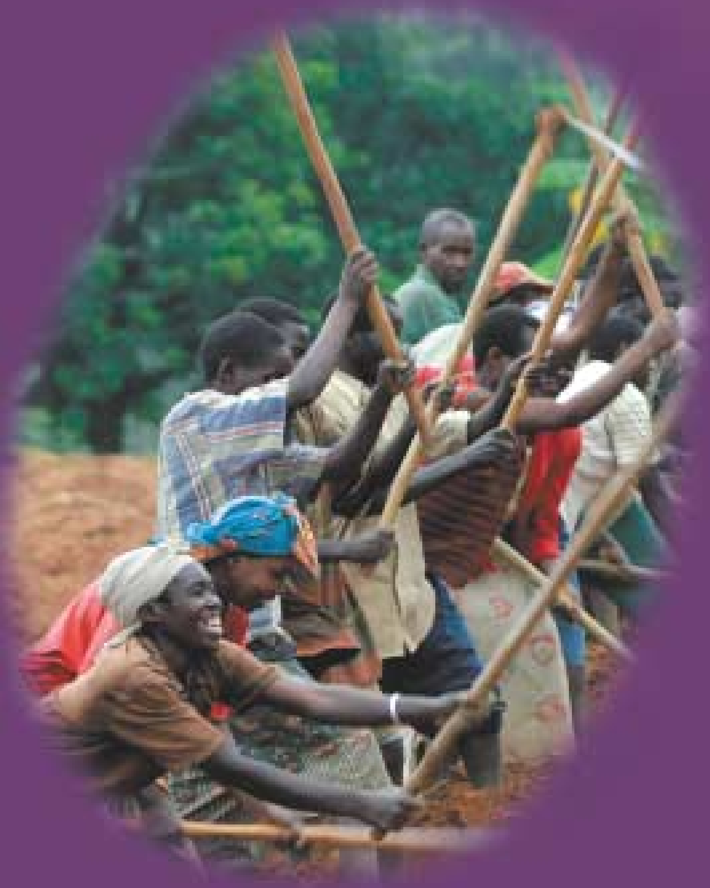

The Other Side of the Coin...

An alternative perspective on the role of the International Monetary Fund in low-income countries

Trócaire Policy Briefing - September 2004

TRÓCAIRE

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COVER PHOTO: *Batwa farmers from Rwanda. Photo: Noel Gavin / Allpix.*

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Acronyms

AFRODAD	African Network on Debt and Development
APR	Annual Progress Report
BWI	Bretton Woods Institutions
CCJDP	Catholic Commission for Justice, Development and Peace
CIDSE	International Cooperation for Development and Solidarity
CSO	Civil Society Organisation
CSPR	Civil Society for Poverty Reduction
DFID	Department for International Development
DRC	Democratic Republic of Congo
EC	European Commission
ESAF	Enhanced Structural Adjustment Facility
EURODAD	European Network on Debt and Development
FOSDEH	Foro Social de la Deuda Externa y Desarrollo de Honduras
GAO	General Accounting Office
GDP	Gross Domestic Product
GoH	Government of Honduras
GoR	Government of Rwanda
GoZ	Government of Zambia
HIPC	Heavily Indebted Poor Country
IEO	Independent Evaluation Office
IFI	International Financial Institution
IMF	International Monetary Fund
I-PRSP	Interim PRSP
ISS	Institute of Social Studies
JCTR	Jesuit Centre for Theological Reflection
JSA	Joint Staff Assessments
JSAN	Joint Staff Advisory Notes
LIC	Low-income countries
LoI	Letter of Intent
MC	Mission Chief
MDG	Millennium Development Goals
MTEF	Medium-Term Economic Framework
NGO	Non-Governmental Organisation
OED	Operations Evaluation Department
PDR	Policy Development and Review Department
PEM	Public Expenditure Management
PRGF	Poverty Reduction and Growth Facility
PRS(P)	Poverty Reduction Strategy (Paper)
PSIA	Poverty and Social Impact Assessment
SMP	Staff Monitored Programme
SPA	Strategic Partnership with Africa
TASOET	Tanzanian Social and Economic Trust
TNDP	Transitional National Development Plan
UNDP	United Nations Development Programme
ZCCM	Zambia Consolidated Copper Mines

Executive Summary

The International Monetary Fund (IMF) is currently carrying out a review of its role in low-income countries (LICs). The aim of this paper is to contribute to that review by providing an alternative analysis of its implementation of the lending instrument which supports the Poverty Reduction Strategy Paper (PRSP) process, i.e. the Poverty Reduction and Growth Facility (PRGF).

It also addresses the broader framework for the International Monetary Fund's (IMF) operations in low-income countries and makes recommendations for changes in policy and institutional arrangements. The paper is based on primary research in three countries (Honduras, Zambia and Rwanda) and secondary research in other LICs.

In July 2004 the IMF's Independent Evaluation Office (IEO) finalised a review of the IMF's role in implementing the PRSP and PRGF initiative. The overall finding on the implementation of the PRSP was that *'actual achievements thus far fall considerably short of the potential'* (IEO 2004, p.9). This is found to be due to shortcomings in the design of the PRSP initiative and the failure of the IMF to recognise the changes the PRSP approach implies for the IMF's 'way of doing business'.

PRGF-supported programmes were to be characterised by a group of innovative key features. These include: embedding the PRGF in an overall strategy for poverty reduction and growth (e.g. alignment with the PRSP); ensuring broad participation and greater country ownership of PRGF-supported programmes; ensuring appropriate flexibility in fiscal targets; and supporting government budgets that are more pro-poor and pro-growth.

This paper finds that progress in implementing the key features of the PRGF has been slow and uneven across countries. In countries facing unstable economic and political situations, such as Honduras and Zambia, the IMF has not changed its way of operating and has not been willing to explore alternatives to its standard neo-liberal policies.

The framework around the PRSP needs to be radically reformed on the basis of partnership and ownership. This paper outlines a long-term 'alternative architecture' for the PRSP approach, in which the IMF would play an equal role with other donors and focus on providing policy advice only, except in the case of shocks.

As a short-term measure, the paper proposes that the principles underpinning the PRSP approach be applied to the development of any new PRGF. That is, the IMF should release draft PRGF documents to all stakeholders to allow informed debate on the government's options; IMF staff should outline the rationale and assumptions behind their policy proposals for PRGF programmes; independent Poverty and Social Impact Assessments (PSIA) should be carried out on any contested policy proposals; and no PRGF should be finalised until it has gone through this process. This would address the problem of aligning the PRGF to a weak PRSP, by applying the PRSP process to developing a macroeconomic framework for the PRGF.

The paper proposes to replace the IMF's signalling role with country-based agreements on the conditions under which aid would be suspended or reduced. These agreements would be made under joint donor / government 'performance assessment and harmonisation frameworks'. Conditionality, including macroeconomic and structural reforms, would be based on government-specified targets drawn from the PRSP and agreed by all donors under this framework. It is imperative that the Highly Indebted Poor Countries (HIPC) initiative be delinked from the PRGF.

This paper further proposes institutional reforms to facilitate a partnership-based role for the IMF, including relocation of staff to country offices and reversing the relative decline in staff time devoted to low-income countries.

The IMF is entering the final phase of an internal review of its role in LICs and is preparing to carry out a joint review of the PRSP initiative with the Bank. These reviews need to examine the need for immediate changes to policy and practice around: inflexibility in macroeconomic policy models; adjustment lending to LICs; participation; transparency; conditionality; fiscal flexibility; and poverty and social impact analysis. Unless it does so, the PRSP approach will lose political traction and public support and the IMF's stated aim of working for poverty reduction will finally lose every shred of credibility.

1. Introduction

In recent years there has been an intensified discussion on the role of the International Monetary Fund (IMF) in poor countries. This discussion has been spearheaded by two offices at the IMF, namely the Independent Evaluation Office (IEO) and the Policy Development and Review Department (PDR).

In late 2003 the IEO embarked on an evaluation of the IMF's role in implementing the Poverty Reduction Strategy Paper (PRSP) and Poverty Reduction and Growth Facility (PRGF) approach.[1] The final PRSP / PRGF evaluation was presented to the Board of the IMF on the 21st of July 2004.

The PDR, as the IMF's policy making body, has been the key architect behind the attempts to modify the role of the IMF to fit the new aid paradigm. Most prominently this led to the transformation of the Enhanced Structural Adjustment Facility (ESAF) into the Poverty Reduction and Growth Facility (PRGF) in 1999. In 2003 PDR began a major review of the role of the IMF in low-income countries (LICs). This review has yet to reach a conclusion (see Chapter 2).

1.1 Aim, scope and methodology

The aim of this paper is to provide an alternative viewpoint on the role of the IMF in low-income countries in the context of the PDR's ongoing review and to make recommendations for changes to the IMF's way of operating if it is to make a positive contribution to poverty reduction.

There are always two sides to a story. Given the fact the review of the IMF's role in LICs is being led by the institution itself, it is necessary to ensure the other side of the coin is brought to the fore.

There is a fundamental question around whether the IMF is capable of playing a positive role in eradicating poverty in the developing world. For over twenty years the IMF has been accused of promoting policies that hurt the poor rather than alleviate poverty. The IMF faces an enormous challenge in overcoming the internal institutional obstacles to ensuring poverty reduction is the prime objective and outcome of its work in LICs. Significant problems concerning its reputation also have to be overcome.

In this paper, we acknowledge that steps have been taken in the right direction but emphasise the magnitude of the tasks facing the IMF.

The paper focuses on the role the IMF has played in low-income countries after the introduction of the PRGF. It draws on primary research in Honduras, Rwanda and Zambia carried out in 2004 and desk-based research on other LICs.

This paper also draws on broader analysis of the IMF's role in shaping macroeconomic and structural adjustment policies in poor countries. In addition, a discussion of the findings and recommendations of the IEO's recently published evaluation of the IMF's role in the implementation of the PRSP and PRGF initiatives is presented.

1.2 Structure

Chapter 2 presents a brief literature review. It aims to capture the key elements in the debate on role of the IMF in LICs to date drawing on both official and independent sources.

Chapter 3 and Chapter 4 outline the main findings from the country case studies with respect to selected key features for the PRGF approach. Chapter 3 addresses the key features of embedding the PRGF in an overall strategy for poverty reduction and growth (e.g. alignment with the PRSP) and ensuring broad participation and greater country ownership of PRGF programmes.

Chapter 4 asks whether the IMF fulfilled its commitment to ensuring appropriate flexibility in fiscal targets and supporting government budgets that are more pro-poor and pro-growth.

Chapter 5 briefly examines country experiences under the remaining key features: more selective structural conditionality; emphasis on measures to improve public resource management/accountability; and the commitment to carry out poverty and social

1 The IEO was established in July 2001 to provide an 'objective and independent evaluation on issues related the IMF' (www.imf.org/ieo). It is independent from IMF management in that it reports directly to the Board of Directors of the IMF.

impact assessments on major macroeconomic and structural reforms.

Chapter 6 looks into some of the crosscutting issues emerging in relation to the role of the IMF in low-income countries. Findings from the country-specific research are used to outline an alternative architecture for the IMF in low-income countries over the medium term and to address how the IMF should align its policies to the PRSP in the immediate term.

Chapter 7 draws conclusions and presents a list of recommendations to the Board of Directors and the PDR. Some of these are actions which can be undertaken immediately while others are to be viewed within a longer-term perspective on the role of the IMF in LICs.

BOX 1

Summary of the Key Features of the PRGF:

1) Broad participation and greater country ownership;
2) Embedding the PRGF-supported programme in a broader set of measures set out in an overall strategy for growth and poverty reduction;
3) Government budgets that are more pro-poor and pro-growth;
4) Ensuring appropriate flexibility in fiscal targets;
5) More selective structural conditionality;
6) Emphasis on measures to improve public resource management / accountability;
7) Social impact analysis of major macroeconomic adjustment and structural reforms.

2. The PRGF: review of analysis to date

This section provides a brief review of commentary on and analysis of the PRGF instrument to date, drawing on sources from the International Financial Institutions (IFIs), official donors, Non Governmental Organisations (NGOs) and academics. It highlights the key issues which frame the ongoing policy debate surrounding the PRGF and the role of the IMF in low-income countries. It therefore provides a context for Sections 3, 4 and 5 of this paper.

2.1 International NGOs

European Network on Debt and Development's (EURODAD) PRGF review

In 2003 the European Network on Debt and Development (EURODAD) undertook a systematic desk-based analysis of 18 PRGF-supported programmes and presented findings from this research in a matrix and a 'users guide' to the extensive findings (EURODAD 2003). Three additional papers addressed some of the key features of the PRGF. The main findings of the desk review are presented here.

Quantitative targets and fiscal flexibility

The study finds that the IMF still promotes fiscal austerity in general, although there are country variations to the macroeconomic projections. This is most significant in countries that have not achieved macroeconomic stability. It was found that fiscal targets have often been excessively optimistic and that the IMF continues to use rigid economic models for its analysis. In addition, the relatively tight margins for the fiscal balance reduce governments' ability to use fiscal policy as a tool of economic policy, thereby reducing 'policy space'.

Inflation targets were very low on average (below 5 percent). Targets for international reserves were found to be high, at an average of about 4.5 months of imports. Alternative fiscal or monetary policy scenarios or tradeoffs were not outlined in any of the 18 PRGF programmes.

Structural conditionality

Despite the introduction of the streamlining initiative, in general PRGF programmes were found to contain a strong tendency to favour traditional reforms such as privatisation, liberalisation and the introduction of value added tax. There was only a superficial discussion of the macroeconomic relevance of the structural conditionality in the majority of the programmes.

In general, 'good performers' faced fewer conditions than countries with a poor track record with the IMF. Aggregate conditionality does not seem to have diminished as the Bank has adopted structural conditionality abandoned by the IMF. There was a marked continued reliance on policy-based conditionality, which severely undermines ownership.

Growth and social expenditures

Growth projections were found to be relatively realistic. However, only 4 out of 18 programmes provided more than one growth target and the absence of alternative (contingency) growth strategies in most programmes was identified as a major shortcoming. The research found that it was difficult to assess social expenditure targets as data applied in PRGF programmes used varying criteria to define 'social expenditures'.

PSIA

The majority of programmes did not refer to PSIAs at all. Encouragingly, however, EURODAD's research suggests that the more recent programmes tend to discuss PSIAs more frequently.

Financing

There was virtually no discussion of how to close the financing gap in the countries examined or, more broadly, how to finance the achievement of the Millennium Develpoment Goals (MDGs). It was concluded that the PRGF's low concessionality makes it an expensive instrument but one which low-income countries continue to use because of its 'gatekeeper' function.

Other International NGOs

Trócaire, Oxfam and World Vision carried out multi-country analyses of the role of the IMF and the implementation of the PRGF in 2003 / 2004.

Trócaire's research for a 2004 CIDSE (International Co-operation for Solidarity and Development) / Caritas Internationalis paper (*'PRSP: Are the World Bank and IMF delivering* *on Promises?*) found that the IMF needed to reshape some of its core processes, policies and structures if it was to deliver on the potential of the Poverty Reduction Strategy (PRS) and PRGF approach (CIDSE/Caritas Internationalis 2004). It found that the principle of ownership required the IMF to engage in a genuine partnership approach with other agents, including government, donors and civil society. It proposed that a development forum with broad stakeholder participation be adopted as a structure within which to take key decisions on the PRS and macroeconomic framework.

An Oxfam paper,*'From Donorship to Ownership – Moving Towards PRSP Round Two'* (2004) found that donors, notably the IMF, retained too much control over PRSP policy content, employing conditionality and backstage negotiation to the detriment of participation. Oxfam highlighted how IMF economic frameworks and conditions were undermining progress towards the MDGs all over the world. There was no attempt by the IMF to depart from its traditional economic model or to build evidence-based pro-poor economic policies. Progress on PSIA is fundamental to the development of pro-poor policies, according to Oxfam. The IMF however, had made no progress in this area.

World Vision's '*Promoting Growth for Poverty Reduction: The Role of IMF Lending Advice'* (2003) addresses the deficiency of IMF lending advice in terms of promoting pro-poor growth. World Vision suggests that the IMF should revise its policy advice to make its lending more oriented towards poverty reduction within the following seven critically important areas: the creation of momentum for growth, income distribution, environmental sustainability, flexibility in lending advice, the political-economy of development, human development and human capital formation, and HIV/AIDS.

2.2 Southern NGOs

An AFRODAD paper from August 2004 pointed to the failure of the IMF to grasp the implications of ownership, stating that there was an urgent need to build participatory approaches to the PRGF. Growth strategies promoted by the IMF focused on areas which would have little impact on the poor, the vast majority of whom are engaged in smallholder agriculture. Hence, the paper recommends more tailored and inclusive growth strategies.

AFRODAD also highlight the need to ensure that financial sector reforms promoted by the IMF are pro-poor. Pointing to the private sector-oriented analysis behind the inflation target, AFRODAD find that access for the poor to credit is unduly constrained. Overall, AFRODAD argue that the PRGF should be redrawn and draconian conditionality done away with.

2.3 Academics

In 2001 Adam and Bevan carried out a study on the PRGF on behalf of the UK Department for International Development (DFID). It examined each of the seven key features and provided a brief analysis of 10 different country cases. The paper broadly concluded that the IMF had made *"substantial progress in terms of implementing both the letter and the spirit of the PRGF"* (Adam and Bevan, 2001, p.27).

With respect to fiscal flexibility the paper concluded, however, that the IMF could take a more proactive stance. The paper also addressed the question of whether the PRGF was appropriate as the IMF's arrangement for low-income countries in the longer term. The authors were particularly concerned about whether this instrument was suitable in countries that have achieved macroeconomic stability and have access to more concessional financing.

2.4 Official contributions to the debate

The Meltzer commission

The 'International Financial Institution Advisory Commission', now known by the name of its chairman Allen H. Meltzer, is widely viewed as having sparked off the extensive discussions about the role of the IMF in LICs. The US Senate established the Commission in 1998 in the aftermath of the financial crisis in Asia and a number of other emerging economies.

Amongst other controversial proposals (e.g. 100% cancellation of repayments of Bretton Woods Institution (BWI) loans), the commission recommended the IMF should stop providing long-term loans for poverty reduction in LICs and restrict its lending to the provision of short-term liquidity.

US General Accounting Office (GAO)

In 2001 the US General Accounting Office (GAO) was asked to evaluate: a) how PRGF design differed from previous lending programmes, b) what had actually changed in recipient countries' programmes, and c) whether these changes increased the LIC's chances of graduating from concessional borrowing.

Based on desk research and three country case studies[2] GAO concluded that the design of IMF programmes had changed little. This was partly attributed to the fact that some of the elements in the PRGF had already been pursued in the past although not concretely articulated as objectives. Ownership was hampered by limited government and civil society capacity.

The report did not rule out the possibility that the PRGF approach could lead to earlier graduation from concessional borrowing but found that the impact of the PRGF on growth was unknown.

Nordic Governments

A review carried out by the Nordic governments (2003) of the implementation of the PRSP in seven countries highlighted critical issues with respect to the role of the IMF. While it identified some small steps towards alignment of the PRGF with PRSPs, overall it found that the PRGF '*still has the characteristics of traditional IMF instruments, where the focus is on macroeconomic stability and the linkage to poverty reduction instruments seems weak*' (Nordic Governments 2003, p.5). According to this review the outlook for social impact assessment of the macroeconomic policies and structural measures under the IMF's control was bleak.

2.5 The IMF's own reviews

A prolonged internal discussion in the IMF preceded the transformation in 1999 of the Enhanced Structural Adjustment Facility (ESAF) into the PRGF. The ESAF was subject to an internal evaluation in 1997 and an external evaluation in 1998. Thereafter, the Board requested staff to elaborate a new and improved programme design for lending to low-income countries, taking into consideration the findings of the reviews (IMF 1998a, IMF 1998b).

Many of the current key features in the PRGF (see Box 1) emerged from the two evaluations (in particular the external evaluation). It was noted that programmes with extensive conditionality generally had low success rates and that important measures had to be taken both at country level and by the IMF to support country ownership.

At the national level, governments needed to make better use of technical assistance and to build national consensus behind programmes through broad dialogue. The IMF was advised to revise its negotiation process and conditionality regime so as to make them more supportive of national ownership. This would involve deeper and broader discussions and analysis of the macroeconomic framework and IMF policies

Other issues the evaluations emphasised were: systematic incorporation of social impact analysis into programme design; sequencing structural reforms so as not to hurt the poor; improved collaboration with the World Bank; humanisation and demystification of the IMF's image; and strengthening resident missions.

First PRGF review – 2002

In 2002 the IMF concluded its first internal review of the progress in implementing the new PRGF approach. This review indicated good progress had been made in incorporating key features of the PRGF into programme design but that there was also scope for improvement. The macroeconomic frameworks of PRGFs were assessed to be generally consistent with those of the PRSPs. However it was noted that due to the broad nature of many PRSPs, the PRGF could be 'aligned' albeit only at a very general level. It was envisaged that tighter links would emerge as countries gained experience with the PRSP approach.

The review was very positive in its assessment of streamlining structural conditionality based on the IMF's core areas of competence. It voiced a concern that this process might in fact have gone too far. That is, in some cases there was insufficient coverage of structural reforms by conditionality. With regard to pro-poor and pro-growth budgets the review concluded that countries had been able to increase poverty-reducing expenditures relative to the levels under ESAF-supported programmes. On a number of issues, primarily related to fiscal policies, the review assessed progress to have been 'uneven'.

IMF in Low-Income Countries - internal review 2003 - 2004

From 2003 onwards two parallel processes were initiated with the objective of strengthening the implementation of the PRGF's key features. The first is an ongoing work programme on the role

[2] Albania, Benin and Honduras

of the IMF in low-Income Countries led by the PDR. The second was an evaluation by the IEO of the IMF's role in implementing the PRSP and PRGF approaches (see below).

The PDR-led review of the IMF's role in LICs is extremely comprehensive, as illustrated by the papers listed in Box 2. This paper, however, concentrates on the three staff papers most relevant to the scope of this analysis.

Alignment

In April 2003 the IMF released a paper on one of the key areas of controversy in the IMF's approach to the PRSP process: improving the alignment of PRGFs with PRSPs. The key questions are when and how the IMF should let PRGF content be determined by a country-driven strategy. In the paper it is asserted that alignment will only become *'truly effective when the PRSP itself is closely aligned with the budget process in each country'* (IMF, 2003d, p.1).

This paper established the distinction between temporal and policy alignment. Temporal alignment means that a PRGF is drawn up after a full PRSP has been formulated. It was proposed that where PRGFs preceded full PRSPs the IMF should let the existing PRGF-supported programme expire and start a new three-year programme. Policy alignment refers to the content of PRGFs being derived from national PRSPs. The paper notes that when a PRSP lacks specificity, PRGF-related documents should flesh out specific and dated measures to support the achievement of the broader objectives set out in the PRSP. In these cases, PDR suggests that staff reports should outline more explicitly how specific elements of the PRGF-supported programme relate to the PRSP.

In essence, the message from the alignment paper is that PRSP countries need to improve their internal processes in order to meet IMF and World Bank standards for processes and policies. Only then can the IMF align its PRGF programme content with the national strategies.

Role of the IMF in Low-Income Countries

A paper with a much broader scope entitled '*Role of the Fund in Low-Income Member Countries over the Medium Term*' was published in September 2003 (IMF 2003b). This paper states that the IMF has a role to play in LICs over the long term, an issue that had first been contested by the Meltzer commission in 1998 (see above). This role would extend beyond

BOX 2

List of main papers on the role of the IMF in LICs and links

April 25, 2003: Aligning the Poverty Reduction and Growth Facility (PRGF) and the Poverty Reduction Strategy Paper (PRSP) Approach
http://www.imf.org/external/np/prsp/2003/eng/042503.pdf

May 23, 2003: Debt Sustainability in Low-Income Countries—Towards a Forward Looking Strategy
http://www.imf.org/external/np/pdr/sustain/2003/052303.htm

August 8, 2003: IMF Assistance for Countries Facing Exogenous Shocks
http://www.imf.org/external/np/pdr/sustain/2003/080803.htm

September 4, 2003: Role of the Fund in Low-Income Member Countries over the Medium Term—Issues Paper for Discussion
http://www.imf.org/external/np/pdr/sustain/2003/072103.htm

February 3, 2004: Debt Sustainability in Low-Income Countries—Proposal for an Operational Framework and Policy Implications (Joint paper with the World Bank)
http://www.imf.org/external/np/pdr/sustain/2004/020304.pdf

February 24, 2004: The IMF's Support of Low-Income Member Countries: Considerations on Instruments and Financing
http://www.imf.org/external/np/pdr/lic/2004/eng/022404.htm

February 24, 2004: Strengthening IMF-World Bank Collaboration on Country Programs and Conditionality—Progress Report (Joint paper with the World Bank)
http://www.imf.org/external/np/pdr/cond/2004/eng/022404.pdf

countries that have attained macroeconomic stability. It states that the overall objective of the IMF's financial and technical assistance as well as policy advice is to: '*…help low-income members move to a point where they can rely predominantly on private sources of financing.'* (IMF 2003b: 9).

The paper establishes four country typologies; post-conflict countries, early stabilisers, mature stabilisers, and pre-emerging market economies. It asks whether existing instruments are adequate to support these different types of low-income countries. It concludes that the PRGF-supported programmes are 'a good fit' for early and mature stabilisers.

Instruments and Financing

The instruments and financing paper elaborates on some ideas sketched out in the '*Role of the Fund in Low-Income Member Countries over the Medium Term*' paper (IMF 2004g). It set out a number of proposals to address prolonged use of IMF resources, i.e. by establishing norms for access, introducing low access PRGF arrangements and carrying out enhanced monitoring to assist countries with limited balance of payments needs. Proposals include longer timeframes for access to emergency assistance in post-conflict countries and mechanisms to improve the response to shocks. Moreover, the paper outlined figures on financing requirements and options. The paper did not deal with the PRGF and the finding that this instrument is a 'good fit' for 'early and mature stabilisers'.[3]

2.6 IEO evaluation of the PRSP and the PRGF

The IEO's evaluation of the IMF's role in implementing the PRSP and PRGF initiative is by far the most extensive evaluation undertaken of these instruments to date. The evaluation was initiated in January 2003 and concluded with a discussion by the Board of Executive Directors on July 21, 2004.

The overall finding of the evaluation is that *'actual achievements thus far fall considerably short of the potential'* (IEO 2004a, p.9). This is mainly due to shortcomings in the design of the PRSP initiative and the failure of the IMF to recognise the changes the PRS approach implies for the IMF's 'way of doing business'.

Participation and ownership

The evaluation finds that '*the PRS process has had limited impact in generating meaningful discussions, outside the narrow official circle, of alternative policy options with respect to the macroeconomic framework and macro-relevant structural reforms'* (ibid. p.9). Results in terms of ownership are found to be mixed but generally limited to a narrow circle within government.

Roadmap for poverty reduction and pro-poor growth

The PRS approach is found to have contributed significantly to stakeholders' understanding of the multi-dimensional nature of poverty but less to the identification of constraints to accelerating growth and making it pro-poor. The evaluation also finds that PRSPs, in many cases, fall short of providing a strategic roadmap for policy making. Again, this is most pronounced within the area of macroeconomics and related structural reforms.

Capacity constraints

Capacity constraints are highlighted as having caused a *'severe impediment to progress'* (ibid. p.10). An important observation is that capacity building efforts have often been driven by a need to satisfy the demands of IMF-supported programmes rather than the countries' long-term development needs.

Joint Staff Assessments

One of the most significant criticisms is that Joint Staff Assessments (JSAs) have not lived up to their intended purpose. JSAs have played a limited role in informing lending decisions and *'many key issues are left to be resolved in the context of PRGF-related negotiations.'* (ibid. p.69).

PRGF-specific findings

The evaluation finds that there has been limited progress in aligning PRGFs with PRSs, which is primarily ascribed to the poor quality of the strategies. Its findings show that PRGFs provide greater fiscal flexibility than ESAFs and that there is not a systematic disinflation bias.

The IMF's way of doing business

The evaluation finds that the IMF's overall contribution has fallen well short of the goals outlined in the original policy papers. Key findings include the lack of IMF involvement in the participatory processes and failure to contribute to the understanding of micro-macro linkages.

[3] Concerted NGO advocacy at the Spring Meetings in 2004 centred on the need for the IMF to address this issue. IMF staff repeatedly assured NGOs that this concern would be taken into account in a programme design paper to be published later in 2004. At the time of going to press, such a paper had not been published.

Policy space and flexibility

The paper finds that the IMF has been more flexible in its policy prescriptions in countries where macroeconomic stability has been achieved but not in countries facing more difficult economic and political environments.

Incentives

Focusing on the structure of incentives, the report outlines that the processes are still too driven by Washington-defined procedures and that there is too little scope for country-specific variations. Benchmarks to monitor progress towards immediate objectives are insufficient which results in a lack of clarity for assessments and lending decisions. Finally, the IEO finds that the approach commits countries to deliver more than the IMF and the World Bank are obliged to deliver, resulting in an imbalance of responsibility and accountability.

IEO Recommendations

Crucially, the report finds that *'it is not clear in practice how much countries have to gain by treating the PRSP as an effective strategic road map, rather than as a procedural formality'* (ibid. p.12).

The IEO proposes that this fundamental flaw be addressed through shifting the emphasis from procedures around producing a PRS paper to improving domestic policies and processes.

Countries would set their own results-based objectives and identify benchmarks for monitoring. The role of the IMF would be to: assist in the establishment of those benchmarks; help resolve internal and external obstacles to achieving the country's goals through technical assistance and advocacy towards rich country members (especially on trade and donor resources); provide candid assessments of the country's performance in meeting both country-specific and universal benchmarks in a revised JSA or through another instrument.

It proposes the IMF place more emphasis on activities to better inform broad-based policy discussions in its areas of competence, that the rationale for the IMF's policy prescriptions be open to scrutiny & debate and that the IMF be open and transparent about its policy views.

In countries where the PRSP still does not constitute an 'operational roadmap' the IEO proposes that the IMF maintain a focus on opening up policy space and that it includes macro-micro analysis (PSIA) in programme design.

IMF responses

The IMF staff state they share the IEO objective of *'better alignment of the PRGF with the PRSP, and more clarity on what happens if the PRSP is too weak or unrealistically ambitious to serve as a framework for a PRGF'* (IMF 2004e, p.4).

The IMF staff found however, that the IEO recommendations imply excessive IMF involvement in assessing the country's decision-making processes. The staff suggest they maintain a focus on providing advice and support for the development of sound frameworks.

The IMF staff and management recognise:

- that the PRSP principles should still be applied to the IMF's role even in countries where the PRSP is not operationally viable (ibid. p.9);
- that countries themselves should decide how policies will be developed, implemented and documented (IEO Recommendation 1);
- the need to give more emphasis to IMF staff involvement in the domestic policy debate over macroeconomic policy (IEO Recommendation 4);
- the need to open the rationale for IMF policy recommendations to broader scrutiny (IEO Recommendation 4);
- the need for more candid and graduated assessments, which would better inform stakeholders about IFI expectations and assessment criteria, while avoiding 'undue on-off signals from the IMF for donor financing' (IEO Recommendations 5 & 6).

The Board added the following observations following their discussion of the IEO evaluation (IMF 2004g):

- More should be done to integrate the results of PSIAs into IMF-supported programmes;
- Further staff analysis will be required to gear the PRGF towards addressing the macroeconomic challenges of meeting the MDGs;
- The link between the JSA and lending decisions by the IMF should be dropped and the JSA should aim to provide candid feedback to countries and help the IMF coordinate with the Bank;
- The resource implications for changing the IMF's way of doing business need careful scrutiny.

2.7 PRSP / PRGF alignment: the critical question

In their response to the IEO report, the IMF staff propose that the PRGF and programme mission cycles should be aligned to the PRSP where it provides a 'good operational roadmap' (IMF 2004e).

Where the PRSP does not provide a 'good operational roadmap' the staff propose that a flexible approach is adopted, under which the PRGF is not expected to align to the PRSP. The IMF would negotiate its programme with traditional interlocutors and there would be no participatory dimension to this process for fear of *'…derailing the incipient participatory processes…'* (ibid. p.9). The IMF staff propose that programmes would be negotiated with government and that they would 'explain' why it may differ from the PRSP. In this scenario there would be no role for domestic stakeholders, beyond government, in the determination of the national macroeconomic framework (see Section 3.4 also).

This deeply unsettling proposal runs counter to the stated recognition by staff that PRSP principles should apply even where the policy-making environment is weak. It constitutes a rowing back on the commitments made by the IMF as part of the PRS approach. Staff, while accepting many of the IEO's conclusions in principle, anticipate an essentially unchanged operational approach in most countries.

This potentially sends a strong signal that the 'best practice' highlighted by the IEO need not apply in instances where they are dealing with 'poor performers'. It also illustrates a difference of views among some members of the Board of Directors.

The Board is somewhat more circumspect about alignment, noting that further reflection is needed where the IMF believes LICs could 'aim higher' in their PRSPs and that 'flexibility' in aligning the PRGF to PRSPs should not imply delinking the PRGF from the PRSP process, but that the IMF should work to strengthen this process (IMF 2004g).

The outcome of discussions between staff and the Board on PRSP / PRGF alignment is clearly critical. It is equally critical that the internal review of the role of the IMF in LICs, which includes a review of PRGF programme design, addresses the issues highlighted by the IEO and other external commentators.

This paper therefore addresses and provides proposals on the most contentious issues in: (a) PRGF design and implementation; and (b) the broader role of the IMF in LICs. It does this primarily through the lens of experience of countries with a problematic relationship with the IMF.

It begins with the issue of alignment of the PRGF to the PRSP and then addresses the IMF's approach to participation in Chapter 3. In Chapter 4, the principles of flexibility on fiscal targets and support for pro-poor and pro-growth budgets are examined. Chapter 5 analyses and makes recommendations on streamlining structural conditionality, IMF support for public expenditure management (PEM), and its commitment to PSIAs. Chapter 6 addresses broader issues around the role of the IMF in LICs and proposes an 'alternative architecture' for alignment of IMF activities under the PRSP.

BOX 3

Staff vision of IMF role in the PRSP process

The IMF staff sees itself as:

- Making more substantive contributions in the form of policy advice on formulation of macroeconomic strategies and their budget implications;
- Providing frank opinions on these strategies and making convincing arguments in favour of its own views and proposals;
- Reformulating the JSA and calibrating the responses so as to avoid on / off signaling and to give a more useful assessment of PRSPs (staff are looking at the questions of what purpose the JSA is intended to serve, for which audience, in what format and what is to be assessed);
- Participating ('where appropriate') in public debates on macroeconomic options and structural reforms;
- Helping the government make its case for its macroeconomic choices;
- Bringing the results of any PSIAs into these discussions;
- Providing Technical Assistance to strengthen budget policies and processes promoting sustainable growth and poverty reduction.

IMF 2004e

3. Alignment and participation – evidence from country case studies

'The approach implies a very different way of organising IMF inputs based on: a country-driven strategy that sets priorities within a long-term timeframe; emphasising contributions to informing a broader public debate rather than traditional program negotiations; and operating within a 'partnership framework' that recognises explicitly that IMF contributions are only one part of the broader picture."

Independent Evaluation Office (2004a, p.13)

As the quote above illustrates there is no doubt that the introduction of the PRSP/PRGF approach in 1999 demanded significant change in the IMF's way of doing business in low-income countries. The following chapter is based on primary research in Honduras, Rwanda, and Zambia on the role of the IMF and the development of PRGF-supported programmes in these countries.

These three countries were not part of the most recent IEO / OED evaluations and the sample has a slight bias towards countries that have a problematic relationship with the IMF. This is a deliberate choice in order to emphasise the

BOX 4

Status of case study countries in PRSP / HIPC II process

Honduras

ESAF/PRGF:	March 1999
I-PRSP:	April 2000
PRSP:	August 2001
PRSP progress report:	January 2004
1st post-PRSP PRGF:	February 2004
HIPC decision point:	June 2000
HIPC completion point:	Not yet reached (expected January 2005)

Zambia

ESAF/PRGF:	March 1999
I-PRSP:	July 2000
PRSP:	May 2002
PRSP progress report:	March 2004
1st post-PRSP PRGF:	June 2004
HIPC decision point:	November 2000
HIPC completion point:	Not yet reached (expected June 2005)

Rwanda

ESAF/PRGF:	June 1998
I-PRSP:	November 2000
PRSP:	June 2002
PRSP progress report:	August 2004
1st post-PRSP PRGF:	August 2003
HIPC decision point:	December 2000
HIPC completion point:	Not yet reached (expected December 2004)

particular problems characterising the relationship between 'poor performers' and the IMF. The findings are structured around the key features of PRGF and a few other key issues with regard to the role of the IMF in LICs.

3.1 Embedding PRGF in overall strategies for growth and poverty reduction

'Alignment' of the PRGF and PRSP is perhaps the most significant area where the IMF has yet to deliver on its promises. As illustrated in Chapter 2, it is an area that the Policy Development and Review department has been struggling with and has devoted considerable time to, with the objective of improving the integration of PRGFs into PRS frameworks. It is also an area that has sparked considerable internal and external debate.

This chapter analyses the case study countries' experiences with PRGF / PRSP alignment and presents recommendations for reform. This section also provides some background information on the countries examined. Firstly, we focus on the perception that the lack of alignment is a transitional problem.

The IEO evaluation concludes that *"success in embedding the PRGF in the overall strategy for growth and poverty reduction has been limited in most cases – partly reflecting shortcomings in the strategies themselves"* (IEO 2004a, p.9). The problem is to *"a considerable extent a transitional issue"* (ibid. p.72).

The reasoning behind this statement is that many existing ESAFs were turned into PRGFs in 1999, predating the formulation of PRSs. The IEO then assumes that when a full PRSP has been negotiated the PRGF which follows will in most cases be aligned with the PRS.

In theory, this may be the case but within our sample of countries there is evidence that such progress has not been smooth. In Honduras and Zambia new PRGFs were negotiated after a full PRSP had been formulated. These PRGFs were not aligned with the overall strategy because the IMF appears to have deemed the PRSP to be of poor quality. This happens even in cases where the PRSP has been commended by donors and in Joint Staff Assessments, as was the case in both Honduras and Zambia. In Rwanda, where donors likewise agreed that the PRSP was of a relatively high standard, the IMF's programme, while accommodating some changes to the economic framework, has nonetheless restricted poverty reducing expenditure.

Honduras

Alignment

Honduras provides an example of a situation where the macroeconomic framework in the PRSP was adopted directly from the existing PRGF.

Honduras' PRSP was preceded by an ESAF that was negotiated in early 1999. This ESAF was renamed a PRGF later that year. In 2000, the government began preparing a PRSP. A study commissioned by the Swedish International Development Cooperation Agency found that IMF influence in Honduras contributed to the PRGF programme being adopted as macroeconomic policy in the PRSP (Institute of Social Studies 2004b).

The growth targets in the 2001 PRSP were adopted from the 1999 PRGF and these underpinned unrealistic fiscal targets (FOSDEH & Oxfam International 2003, p.14). The 1999 PRGF envisaged growth rates of 5 to 6 percent of GDP. This growth target was later reduced to 4 percent of GDP but remained far beyond the actual growth rate of 2 percent recorded in 2003 (ISS 2003a; p.82).

In turn, the PRSP included an unrealistic target of reducing the fiscal deficit from 4.5 percent of GDP in 2001 to 2.6 percent of GDP in 2002. These targets were largely based on IMF analysis and recommendations.

It seems that important internal and external factors were not taken into account in calculating the fiscal targets under the 1999 PRGF. Detailed analysis should have been carried out to assess the impact of the electoral cycle, the global recession, falling coffee prices and rising oil prices on the Honduran economy and the poor. If such an analysis had been done, more modest and realistic growth projections may have emerged in the 1999 PRGF.

On the 2nd of February 2004, after a two year hiatus, the Government of Honduras presented a Letter of Intent to the IMF seeking approval of a new PRGF agreement. Two days later the PRSP progress report was published, and on the 18th of February the Board of the IMF approved the new PRGF.

The February 2004 PRSP Progress Report includes a revised macroeconomic framework, described as the outcome of the consultative process involved in drawing up the Report. According to the 2004 Progress Report, civil society organisations expressed concerns about the macroeconomic framework negotiated with the IMF noting that this *"contradicts the rest of the PRSP policies, since it includes measures that, according to their thinking, will negatively affect the poor"* (Government of Honduras 2003, p. 9).

The revised macroeconomic framework in the 2004 PRSP Progress Report seems to be derived directly from the new PRGF policies, as outlined in the press release summarising the PRGF-supported programme. For example, the fiscal projections remain unchanged and growth targets strongly resemble those set out in the PRGF - rising from 3 percent in 2003 to 4.5 percent in 2006 (IMF 2004c).

Important information which should be publicised is not contained in the press release. For example, there is no outline of inflation targets or structural reforms. In the first half of 2004, the IMF concentrated on the need for the Government to reform public wage agreements, yet this is not mentioned in the press release either. Given that the PRGF-supported programme is supposed to be public, it is unacceptable that the IMF has not published its staff report analysis of the Honduran Government's request for a PRGF.[4]

In summary, the macroeconomic framework in the Honduran PRSP is drawn from the PRGF, therefore alignment is the reverse of what was intended. This was the case for the first PRSP and continues to be the case for the revised macroeconomic framework, which is presented in the February 2004 PRSP progress report.

PRGF suspension and its impact on PRSP implementation

The 1999 PRGF went off-track in 2002. In February 2004 a new PRGF was approved after two years of negotiation, during which the Government of Honduras went to considerable lengths to reach a solution. During this period, significant structural reform was implemented with no assessment of impact on the poor. In the meantime very little happened in terms of PRS implementation. Official donors withheld their budget support and some interim HIPC debt relief was suspended as a result of the interruption of the PRGF-supported programme.

Because the PRGF-supported programme went off-track in 2002 the Government did not have access to donor resources to continue PRS implementation during 2002 and 2003. A new PRGF was then negotiated and signed in February 2004. Given that the existing PRS was neither implemented nor updated, by February 2004 it was out of date. Therefore it would not have been a relevant basis for alignment, assuming the IMF had intended this. The outcome is a vicious circle where the macroeconomic framework is consistently determined by the PRGF-supported programme.

This disruption to the PRS cycle and its implementation is largely, though not entirely, the result of IMF insistence on conditions which were politically near-impossible to implement. The Government of Honduras must also take a share of the blame for inefficient PRS implementation, having devoted considerable resources to non-poverty reducing expenditure such as a bail-out of large agricultural banks.

Alignment with national political cycle

The PRGF and PRS processes were not well aligned with the national political cycle in Honduras, with negative implications for their implementation. The third review of the first PRGF was completed in October 2001, at the same time as the country's full PRSP was approved. At this point the elections for a new President were imminent and in January 2002 a new Government took over.[5]

The new Government thus inherited both a PRSP and an austere economic reform package from the former Government. In addition, the new Government inherited a weak fiscal situation due to the traditional practice around Honduran elections, whereby outgoing governments often overspend.

The IMF had an opportunity at this point to recognise the changes in the national context. It could have begun negotiating a new PRGF based on the full PRSP, which had been agreed six months previously. In this manner, the electoral process could have been used to strengthen the public debate about economic policies. However, the IMF continued with the existing PRGF-supported programme, which quickly went off-track.

[4] The IMF's staff report outlines the IMF's analysis of the economic challenges the country faces and what it believes has to be done to address this issue. Hence, it spells out the IMF's stance in negotiations with a government and subsequently the Letter of Intent (a government's official request for assistance) is closely related to the content of this document. In order to understand the 'mechanics' behind a country's PRGF supported programme the staff report is key.

[5] The Honduran Constitution stipulates that a president can only rule for one four-year term. Therefore it was certain that a new administration would take over by the end of 2001.

BOX 5

The Honduran PRSP / PRGF context

In June 2000 Honduras reached decision point under the HIPC II initiative after completing an interim PRSP document. During the remainder of 2000 and the first half of 2001, the Government of Honduras, under the Flores administration (1998 – 2002), formulated a full PRSP, which was approved by the Boards of the IMF and World Bank in October 2001. In the same month the IMF completed the third review of the existing three-year PRGF agreement.

This meant that the conditions for the country to proceed towards HIPC II Completion Point and qualify for full debt relief were in place a few months before the new Government, under President Maduro, took office in January 2002. However the PRGF went 'off-track' in late 2001 because of overspending.

Negotiations under President Maduro towards bringing the first PRGF back on track were unsuccessful. In February 2004 a new three-year PRGF agreement was signed. During 2002 and 2003 Honduras did not receive budget support and the country did not progress towards HIPC II Completion Point. The cost of this setback is estimated to be around US $400 million (Honduran newspaper el Heraldo, Wednesday 26 November 2003).

By mid July 2004, an IMF mission that had spent two weeks in the country concluded that after three months, the new PRGF remained 'largely on-track' (IMF 2004f). It remains to be seen whether this new PRGF will remain on-track long enough for the country to achieve Completion Point under the HIPC II initiative, or if it will follow the pattern of earlier programmes and go off-track due to domestic political pressure. The contentious issues in the PRGF relate to fiscal targets, public sector wages, and legislative reform governing the Civil Service and the Financial Sector. Currently, HIPC II Completion Point for Honduras is scheduled for early to mid-2005.

Ultimately the new PRGF, signed in early 2004, deals with a different context than that embodied in the PRSP document approved in 2001. The macroeconomic framework has been revised outside of the regular PRSP cycle and in all likelihood will determine the macroeconomic framework of the second round PRSP. In conclusion, the misalignment of the PRSP with the PRGF and of both documents with the electoral cycle is an ongoing issue in Honduras.

Zambia

The Government of Zambia enjoyed a stable relationship with the IMF throughout the PRSP formulation process, which ended in May 2002. An ESAF had been agreed in March 1999 and was renamed a PRGF later that year.

The first PRGF review was completed in July 2000 at the same time as the country presented its Interim PRSP (I-PRSP) to the World Bank and IMF. The third and fourth PRGF reviews took place in 2001. The framework for macroeconomic and structural policies was never open to serious consideration in the process of PRSP formulation because the Government of Zambia was already implementing the ESAF/PRGF programme.

The ESAF/PRGF programme was replaced by a staff monitored programme (SMP) in July 2003. The SMP's main aim was to control an increasing fiscal deficit that was emerging as a result of a salary increase for public employees. Essentially, the IMF insisted on a ceiling on the central government wage bill of 8.7 percent of GDP in 2003 and 8.1 percent of GDP in 2004. It also dictated a number of changes to the wage negotiation process with the unions (IMF 2003c).

This happened outside the PRSP framework. The IMF's policy agenda in the SMP programme was not linked to the PRSP framework. At the process level the main objective underlying the SMP was to get Zambia back on a PRGF-supported programme. This was imperative so that the country could resume its progress towards HIPC II Completion Point, which was suspended when the PRGF went off-track.

BOX 6

The Zambian PRSP / PRGF context

Zambia reached HIPC II Decision Point in November 2000. The ESAF/PRGF was approved in March 1999 but the first review was delayed until July 2000 due to lack of progress in privatising the copper parastatal ZCCM. The I-PRSP had been approved in early July 2000 and Zambia formulated its full PRSP between July 2000 and May 2002.

In January 2002 a new administration led by President Mwanawasa took over. This did not lead to any disruption of the PRSP process and the IMF and the World Bank approved Zambia's full PRSP in May 2002. Initially the PRSP formed an integral part of the new government's attempt to reintroduce development planning in the Transitional National Development Plan (TNDP).[6] Subsequently however, the new administration downgraded the importance of the PRSP as a national strategy and it was reduced to a budget line in the national budget.

By March 2003 the PRGF had gone off-track due to lack of progress on the structural reform agenda. Subsequently, the fiscal stance became an issue as the government approved a salary increase for public employees. This issue prevented the existing Zambian PRGF from being resumed and in July 2003 it was replaced by a Staff Monitored Programme (SMP). This was supposed to be in place until December 2003 but was extended to June 2004.

Zambia is estimated to have lost approximately US $50 million in budget support in the period that the country did not have a PRGF-supported programme. The government and the IMF agreed a new PRGF-supported programme in May 2004, which was endorsed by the Executive Board on June 14th. The first review is expected to take place in December 2004 and Completion Point to be reached in mid-2005.

In 2004, negotiations for a new PRGF were initiated. As was the case in Honduras, the Zambian PRSP had now been without funding for so long that it had become largely irrelevant as an operational strategy. Therefore no attempt was made to link the PRGF to the existing PRSP. Instead the IMF Resident Representative argued that the PRGF was linked to the country's budget. The problem is, however, that the Government budget in Zambia has little focus on poverty reduction, which should be the primary objective of the PRGF-supported programme.

The Government of Zambia was supposed to initiate formulation of a second-generation PRSP in 2004.[7] Given that there is a new PRGF in place since June 2004 it is highly unlikely that the Government of Zambia will be able to break the cycle where the PRSP adopts the macroeconomic framework directly from the PRGF. Hence this is not simply a transitional problem but is much more deeply rooted in the IMF's focus on getting a PRGF-supported programme in place, with little regard for the PRSP's nationally-driven policy objectives and processes.

Rwanda

In 2002, shortly after the negotiation of the PRGF, the Government of Rwanda argued that its policy intentions in the PRSP were not taken into account fully in negotiating the PRGF. This is closely related to the clash between the Government and the IMF on the relationship between fiscal deficits, poverty reduction and macro-stabilisation (see section 5.3).

A Strategic Partnership with Africa (SPA)[8] mission report in October 2002 revealed an acute lack of alignment between the PRGF and the PRSP which had both been recently finalised. In particular it was found that the number of conditionalities imposed was onerous and usurped ownership. Monitoring arrangements

6 The former government under President Chiluba (who favoured a 'market oriented' approach to development) had done away with development planning.

7 Recent observations by Zambian Civil Society Organisations (CSOs) indicate that this is not going to happen. The government has apparently requested to postpone this to end 2005. This would appear to illustrate that PRGF implementation is given higher priority than PRSP implementation by the government and the creditor/donor community.

8 Quoted in Booth (2003). The Strategic Partnership with Africa (SPA) is an informal association of bilateral and multilateral donors and includes the World Bank, African Development Bank, the IMF, UNDP, OECD/DCA and the EU. Its primary purpose is to support and monitor the implementation of poverty reduction programmes financed by the World Bank, IMF, EU and bilateral donors.

BOX 7

The Rwandan PRSP / PRGF context

The Government of Rwanda completed its PRSP in late 2001 which went to the IMF Board for approval in June 2002. The process for drawing up the PRSP was marked by a strong government effort, backed by DFID and the United Nations Development Programme (UNDP), and participatory poverty assessments were carried out nationwide. This fed into a process of validation, which while somewhat flawed nonetheless involved all stakeholders in discussions on the final document.

In March 2002, there were allegations of undue interference by the World Bank in the editing process, with the World Bank insisting that the PRSP be revised to include a greater governance focus before it could be submitted for endorsement (Booth et al, 2003, p.257).

The PRGF was agreed in August 2002 in an IMF board meeting at which there was reportedly a lack of consensus on Rwanda's performance, given political issues and the Government of Rwanda's involvement in neighbouring Democratic Republic of Congo (DRC). In the period leading to the approval of the PRGF, the IMF and the Government had serious policy differences over the level of fiscal deficit which Rwanda could sustain (see Section 5.3).

The first review of the PRGF went to the IMF Board in June 2003, based on targets to the end of December 2002. The IMF found that most quantitative and structural performance criteria were observed with a few important exceptions: the performance criterion on the domestic fiscal deficit was not met and arrears to external creditors were accumulated. At this meeting the IMF Board took the view that they would pass this review but would not tolerate any more waivers / slippages. The US apparently held a particularly tough stance (interviews, Kigali, May 2004).

By the time the second PRGF review fell due (c. October 2003) it was clear that the Government had gone seriously off target. Negotiations continued until May 2004, when the Government and IMF reached agreement on a revised programme. In June 2004, the Board signed off on a joint second and third review of the PRGF. Rwanda is due to reach HIPC II Completion Point in December 2004.

The most salient feature of the process was the Government's insistence that Budget Support donors (DFID, the European Community, Sweden, the World Bank and the African Development Bank) should be allowed to attend all meetings with the IMF as observers.

However, there are limitations to the degree to which this will challenge the IMF's hegemonic role, as budget support donors must *'ensure that all macroeconomic conditionalities and indicators in bilateral agreements with Government are drawn from the macroeconomic framework, as outlined in the PRGF arrangement…'*[9] Therefore, all stakeholders – government and donor – must align in practice to the PRGF, while alignment to the PRSP is somewhat theoretical.

relied solely on inputs and outputs, ignoring outcomes; there was an excessive number of reviews and reporting requirements; there was no explicit link between the PRGF and PRSP matrices; and the PRGF included policy requirements which are not part of the PRSP. The lack of transparency and openness with which substantial programmes of assistance are negotiated raised doubts about the ownership of the proposed reforms by Government and national stakeholders.

As both the PRSP and the PRGF were approved in mid-2002 respectively, there has been a seeming temporal alignment between them. However, this has masked considerable policy friction, as was highlighted in the debate on the fiscal stance sparked by the PSIA. This policy

9 Partnership Framework for Harmonisation and Alignment of Budget Support between the Government of Rwanda and its Development Partners, 2003, para. 29.

friction arose once again in the negotiations to put the PRGF back on track after its slippage in August / September 2003.

Macroeconomic stability in Rwanda has been relatively strong in the last number of years, with the exception of 2003, when three major events led to a rapid increase in the fiscal deficit, greatly increased inflation and stored up budgetary problems for 2004: an election overspend, late disbursal by donors of budget support and a government-guaranteed loan to a state company to fund hotel building. Domestic spending exceeded the target by 1.2% of GDP and external budgetary support fell short of the anticipated level by $73 million (i.e. 4.4 % of GDP). The domestic fiscal deficit for 2003 amounted to 5.5 percent of GDP and the overall government deficit after external grants amounted to 2.5% of GDP. [10]

A core stipulation of the PRGF programme since its inception has been to impose a strict cap on external borrowing. Given the added budgetary pressure in 2004 the IMF proposed that the government revise its budget expenditure estimates, scaling back on a number of programmes (equivalent to 1.4% of GDP), unless external grant financing could be found to cover the cost of these programmes. While this is intuitively reasonable, the IMF further argued that the contingency expenditure should only be made if 'appropriate monetary control' had been achieved, thus effectively limiting the government's space in using grants, should they become available.

The IMF argued that a criterion for choosing which programmes to scale back on was the level of priority accorded to them in the PRSP.[11] However, officials noted that some of the most impactful poverty-reduction programmes were affected (see Section 4.2).

While a genuine financing problem existed with respect to the 2004 budget, the key question rests in where the decisions on such policy are made and what the external pressures on government to adopt them are. The IMF ensured that the government reduced its expenditure plans and that Parliament ratified this agreement, rather than the government agreeing a programme of budget reductions in a transparent manner through parliamentary procedures.

[10] Government of Rwanda Letter of Intent, May 2004, p. 3 -4.

[11] Interview, Kigali, May 2004.

3.2 PRSP / PRGF Alignment: a practical proposal

In this section it has been shown that the IMF has not made any effort to align the PRGF with domestically-produced PRSPs and that this is not merely a transitional issue. PRGF-supported programmes have been introduced in Honduras, Zambia and Rwanda in the first half of 2004. For all three countries, a new PRSP should in principle be in place by end-2005.

Based on past experience and on the indications in IMF staff responses to the IEO review (see Section 2.7), these newly agreed PRGFs will determine the macroeconomic framework in the second generation PRSPs. This pattern must be broken if the IMF is to fulfil the PRGF principles and indeed, if the PRSP approach is to regain any credibility as a genuinely country-driven process.

Long-term: a partnership-based 'alternative architecture'

As outlined in Section 2.7, there are strong divergences in opinion about whether and how the PRGF should align to the PRSP. This paper proposes that the architecture around the PRSP needs to be radically reformed on the basis of partnership and ownership. Section 6.5 outlines a long-term vision of how an 'alternative architecture' could bring about a situation where all donors operate within a government-led structure, ensuring alignment and harmonisation.

Under this architecture, the IMF's role would be to provide policy advice, rather than to act as a gatekeeper for development finance. The IMF should cease to engage in adjustment lending to low-income countries and concentrate primarily on providing policy advice uncompromised by conditionality attached to loans. Its lending role should be limited to short-term mitigation of the impact of shocks (see Box 8 and Section 6.2).

Conditionality, including macroeconomic (quantitative) and structural conditionality, should be determined under a donor / government partnership agreement. All conditionality should be clearly outlined in a joint conditionality matrix that is derived from the PRSP. The conditions under which donors would reduce or suspend aid should be agreed between all donors and the Government, replacing the IMF's signalling role. Civil society and parliamentarians should contribute to and monitor this conditionality / performance assessment framework.

Short-term: aligning the PRGF with weak PRSPs

Recognising that moving towards such an approach would take time, some minimum interim steps around the negotiation of PRGF-supported programmes must be taken. In order to address the issue of PRGF alignment with weak PRSPs, the *principles* underpinning the PRSP process must be applied when developing a macroeconomic framework for the PRGF.

Aligning new PRGFs to existing PRSPs:
The IMF should open up PRGF processes on the basis of PRSP principles. That is:

- draft PRGF documents should be released to all stakeholders in a timely fashion to allow informed debate on the government's options;
- IMF staff should outline the rationale and assumptions behind their policy proposals and illustrate how they are derived from the PRSP;
- independent PSIAs should be carried out on any contested areas;
- the HIPC initiative should be delinked from the PRGF to allow debt relief and donor resources to be disbursed.

No new PRGF should be finalised until it has gone through this process.

Aligning existing PRGFs to new PRSPs:
In situations where a PRGF is in place before a second generation PRSP is developed, the existing PRGF should be subject to a fundamental review. In most countries, the PRSP was drawn up through different sectoral working groups. The following steps should be followed in a macroeconomic working group led by Government which includes donors, civil society, the private sector and other stakeholders.

This group would:

- analyse the implications of the PRSP objectives for macroeconomic policy;
- assess the need for and implications of PSIA-type analysis in different areas;
- debate intermediate objectives;
- outline key institutional processes for achieving those objectives;
- identify capacity and / or resource gaps for achieving the objectives;
- identify how to fill those gaps in a coordinated manner, including domestic and external resource mobilisation;
- revise the PRGF to fit within the parameters and targets agreed by the forum.

BOX 8

Replace PRGF lending with long-term development assistance

Recent research in 29 mostly low-income countries found an alarmingly high incidence of long-run non-sustainability in fiscal deficits (Jha, 2004, p.3). This indicates that LICs are facing structural problems with their fiscal deficits, rather than short-term balance of payments problems. These deficits can only be dealt with through increases in external grant financing over the medium term and investment in pro-poor growth. The PRGF is not an appropriate instrument for financial support in these circumstances, given its high cost and short-term focus (Eurodad 2003a).

Donors need to be encouraged to help close the financing gap with a stable flow of long-term development assistance. Public Expenditure Management systems have to be supported to meet the country's needs, rather than the reporting objectives of external donors. Donors also have a role to play in supporting parliamentary and public oversight of the use of public resources (see Section 5.2).

The IMF does have a role to play in preventing and responding to shocks. However, it should ensure that it has a clear graduation strategy and that it focuses on mobilising other donor resources for medium-term recovery.

Key Recommendation 1:
Over the medium-term, the IMF should cease to engage in adjustment lending to low-income countries and concentrate primarily on providing policy advice uncompromised by conditionality attached to loans. Its lending role should be limited to short-term mitigation of the impact of shocks.

Key Recommendation 2:
The IMF should align new PRGFs to existing PRSPs by opening up the PRGF negotiations to a multistakeholder process, in accordance with PRSP principles. This includes release of draft PRGF documentation by the IMF; outlining the rationale and assumptions behind IMF policy proposals and illustrating how they are derived from the PRSP; and accepting the findings of independent PSIAs. No new PRGF should be finalised until it has gone through this process

Key Recommmendation 3:
Where new PRSPs are in preparation, the existing PRGF should be subject to a fundamental review in the multistakeholder working group which is responsible for the macroeconomic chapter of the new PRSP. The IMF should play a full and open role in such a group, contributing its analysis without directing policy choices.

Key Recommendation 4:
The signalling role of the IMF should be revised by all donors under country-specific partnership framework agreements which include the conditions under which donors would reduce or suspend aid, thus replacing the IMF's signalling role (see Sections 6.1 & 6.4).

3.3 Participation in formulating macroeconomic and structural policies

Under the PRS and PRGF approaches staff are expected to engage more actively with interlocutors outside government. The 2003 'PRSP Progress in Implementation' report notes that the IMF mandate requires that its *'principal line of communications remains with the member government, but that as the participatory process matures, discussions about macroeconomic policy choices and trade-offs can be expected to include all parties in the context of the broader PRSP dialogue'* (World Bank and IMF 2003, para.127).

Furthermore, the IMF 'Guide for Staff Relations' (2003a), states clearly that IMF staff should meet with Civil Society Organisations (CSOs) early enough in the process so that the consultation is meaningful, to ensure ample opportunity for questions and comments and to debate options. Despite this clear initial commitment to participation and subsequent clarifications on the role of IMF staff, the IMF has in practice done far too little to open up the discussion on macroeconomic and structural reform policies.

In the following sections a number of failures to apply these guidelines on participation are documented. These incidents should be seen not only as failures to meet demands from local CSOs but also as missed opportunities to strengthen national ownership. These situations have emerged especially in cases where important macroeconomic and structural adjustment trajectories have been determined under PRGF negotiations rather than under PRS processes.

This paper argues that in cases where the macroeconomic framework is not yet firmly established in the PRSP the IMF has a particular responsibility to involve the broader public and representatives of civil society in a discussion of policy choices and trade-offs.

Honduras

In Honduras the renegotiation of a PRGF-supported programme was stretched out over a two-year period from early 2002 to early 2004. This lengthy process should have offered many possibilities for consultation with civil society. While the fault around lack of participation in

BOX 9

The Government of Honduras and the 'Fiscal Pact'

In July 2003 the Ministry of Finance published the document 'Honduras – The Need for a Pact of Fiscal Responsibility for Development' (Government of Honduras, Secretaria de Finanzas 2003). Following its publication the Government held discussions with civil society organisations and private sector actors as a response to the IMF recommendation to the Government of Honduras to negotiate a fiscal pact.

The main objective of this process was to reach a consensus among the most representative sectors in the country on fiscal policies. However, uneven power relations between large business interests and the other civil society actors frustrated progress. Business interests, in particular the large factory owners and the owners of international fast-food franchising chains, opposed tax reforms that would alter the generous tax policies in their favour agreed with previous governments. The result is the burden of fiscal adjustment falls once again on the middle and low-income strata in Honduras.

FOSDEH, the civil society network, withdrew from the discussions after recognising that there was no room for amendment to the agenda adopted by the government and that it was being dominated by large business interests. Civil society continued to monitor the negotiations.

drawing up the macroeconomic framework does not lie entirely with the IMF (see Box 9), it should have nonetheless more rigorously applied the above-mentioned staff guidelines in meeting directly with civil society in a meaningful manner. Civil society actors were only granted two brief and poorly structured meetings with the IMF before the finalisation of the PRGF. The lack of adequate IMF presence at the country level explains the paucity of engagement with civil society in Honduras, as in other countries.

By end-November 2003 a preliminary agreement between the IMF and the Government of Honduras had been reached. In January 2004, FOSDEH, the leading civil society network working on debt and social and economic development, published a commentary on this agreement. FOSDEH drew no distinction between the 13 years of structural adjustment policies the country had already endured and the draft PRGF-supported programme. It is alleged that the draft PRGF-supported programme was known to only five persons in the Government of Honduras and selected individuals from the IMF and the donor community. Given the secrecy surrounding the agreement between the IMF and the Government of Honduras, the promises about openness were seen by civil society as empty rhetoric. To date, August 2004, the IMF staff report on the Honduran PRGF request remains unpublished which is highly unsatisfactory.

Honduras has been compared to Bolivia because, like Bolivia, tensions in 2003 around some elements of the PRGF negotiations led to major social discontent and civil unrest. The IMF could have helped avoid this scenario by promoting a more open and informed discussion.

Zambia

Zambia has a number of very active civil society organisations working on economic issues such as debt relief, structural adjustment and budget polices. To the widest extent possible they seek to influence initiatives such as the PRSP, PRGF and HIPC. These organisations cooperate in the network Civil Society for Poverty Reduction (CSPR).

In early 2004 it became clear that the government had initiated negotiations on a new PRGF with the IMF. CSPR therefore wrote a letter addressed to the to the Minister of Finance and National Planning[12] calling upon the government to ensure *'participation through wider consultation on all policy related issues, targets, indicators and benchmarks to be incorporated in the new PRGF'.*[13] In the letter the government is encouraged to engage: *'…civil society, Members of Parliament, and other key stakeholders in a consultative process to disclose the proposed contents of the new PRGF and seek concerns, recommendations and*

[12] Cc'ed to the IMF's resident representative, World Bank resident representative, the Cabinet, Members of Parliament, and all Heads of Missions.

[13] All quotes in this paragraph are from CSPR (2004)

feedback from non-state actors before it is finalised in June 2004.' Finally the CSPR network underlined the importance of the Government extending its willingness to consult stakeholders as demonstrated in the PRSP process *to '…key international agreements'* such as the PRGF that *'…touch upon the livelihoods of the Zambian people.'* CSPR never received a reply to this request.

The IMF resident representative later invited Zambian CSO's to discuss 'Zambia's social-economic situation' with a visiting mission team of the IMF. The invitation was addressed to the Jesuit Centre for Theological Reflection (JCTR) who after having consulted with other organisations requested *'…that the visiting team share with us the ongoing discussions on the contents of the next Poverty Reduction and Growth Facility (PRGF) and what consequences this will have on the socio-economic situation of our country'* (JCTR 2004).

The letter also expressed growing discontent with the IMF's approach to consultation*: 'To be honest, such a topic would make the meeting much more relevant to our immediate concerns about the future of Zambia's socio-economic situation.'* (ibid.) This illustrates how certain CSOs are not satisfied with meetings whose main purpose is to enable an IMF mission to 'tick' the participation box on its consultation forms. Organisations that are genuinely concerned about the development of their country want, at a very minimum, to be appraised of the issues on the agenda in order to be able to take an informed stance.

Instead of ignoring the repeated calls for inclusion the IMF should have encouraged the government to open up the discussion of the policies embedded in the new PRGF. An easy way to do this would have been through assembling the dormant macroeconomic working group. This group had been 'deactivated' after the finalisation of the PRS but the negotiation of the PRGF ought to have been used as an opportunity to bring this group back to life.

Rwanda

Civil society in Rwanda is in a weak state both as a result of the genocide and the fractured society which it engendered and because of a longstanding culture of unquestioning compliance with the authorities.

In this sense the case of Rwanda differs from Honduras and Zambia where very strong and vocal NGOs operate. However, a number of initiatives have seen increased activity and engagement between government and civil society. The ministry responsible for the PRSP (MINECOFIN) has recently made some efforts to bring civil society organizations into these processes. This is partly in response to concerns from stakeholders regarding the need to open up the PRSP planning and decision-making processes.

These efforts have included attempts to create mechanisms for dialogue with civil society and invitations to civil society to participate in government-planned PRSP activities. The effort in early 2004 to draw civil society organizations into the process of drafting the second Rwanda PRSP progress report is especially notable. This exercise was carried out as a joint effort, bringing together government, donors and civil society organizations working through sector working groups/clusters.

The Resident Representative has engaged in a number of meetings with NGOs. For example, as part of a mission in November 2003, the IMF organised a meeting with CSO representatives (e.g. farmers association, unions, local and international NGOs based in Rwanda). At this meeting issues such as the delay in reaching Completion Point and other pertinent issues were discussed. There were also, however, serious limitations to this discussion. For example, the IMF Mission Chief was very reluctant to discuss the IMF's response to a Poverty and Social Impact Assessment (PSIA) on the optimal size of the fiscal deficit (see Section 5.3). The Mission Chief claimed that NGOs should not have access to this study as it was seen as confidential. In addition, the notice to attend the meeting was too short and the lack of a specific agenda made it difficult for CSO to prepare and to engage in a meaningful discussion.

3.4 IEO and IMF responses to the participation issue

Our research concurs with the IEO's finding about the *'limited impact in generating meaningful discussions, outside the narrow official circle, of alternative policy options with respect to the macroeconomic framework and macro-relevant structural reforms'* (IEO 2004a, p. 7).

Staff of the IMF also agree with this finding and the necessity to do something about it: *'staff recognizes the need to give more emphasis to IMF staff involvement in the domestic policy debate over macroeconomic policy and to open the rationale for IMF policy recommendations to broader scrutiny'* (IMF 2004e, p.5).

However, it is deeply disappointing to find that, operationally, the IMF proposes there should be no participatory process attached to the PRGF discussions. Indeed, it employs a rather deprecatory means of doing so: *'rather than derailing the incipient participatory processes by integrating them into PRGF-supported programme discussions….the IMF proposes to negotiate a programme with government and 'explain' why it may differ from the PRSP'* (ibid., p.9).

Concern about staff's operational intentions is further compounded by the fact that some members of the IMF Board of Directors seem to be stuck in the 'stone age' of development thinking:

> *'…other Directors were of the view that a more proactive public role could be seen as influencing the political decision-making process, which is not part of the IMF's mandate. Some of these Directors also commented on the limitations of the participatory approach, including a tendency to produce broad and unfocused documents' (IMF 2004g, p.4).*

The IMF staff and management responses on participation throw up several salient points. Firstly, in spite of the views of some directors, participation can strengthen the national ownership of macroeconomic and structural reform policies and increase transparency at the national level.

Secondly, as also emphasised by the IEO, taking a more proactive role should not be interpreted as *dictating* the public debate, rather as aiming to broaden the debate and open up IMF positions to scrutiny (staff have to be commended for emphasising the latter also).

Finally, it is true that CSO involvement often increases the *comprehensiveness* of strategies. Unfortunately the IMF, the World Bank and many donors choose to see comprehensiveness as 'broad and unfocused' because many PRSPs do not simply outline a 'home-grown' structural adjustment programme but have strong social and human resource development approaches built-in. It is regrettable that some members of the Board of the IMF perceive comprehensiveness as a limitation of participation rather than a strength. This illustrates the magnitude of the cultural shift which must take place within the IMF if it is to make a positive contribution to poverty reduction.

PRGF design is obstructing open and transparent macroeconomic policymaking

This paper finds that the IMF must be more proactive and open in promoting, or indeed allowing, participation in debates on the macroeconomic policy choices under consideration for the PRGF-supported programme.

The macroeconomic framework in the country case studies has been uniformly drawn from a pre-existing PRGF. Therefore CSOs have tried to influence the process where macroeconomic decisions are actually being made (i.e. PRGF negotiations). Their efforts have been largely in vain however. The IMF's failure to meet one of the PRGF key features - broad participation and greater ownership - is of great concern.

The essential problem is that the key trigger to reach completion point under the HIPC initiative is to keep a PRGF 'on-track' for at least a year. This has resulted in the PRSP process being of less relevance to governments than the PRGF. It makes sense for governments to prioritise firstly, negotiating a new PRGF-supported programme, and secondly, implementing it, regardless of whether there is a fit with the PRSP.

In this way the PRGF has undermined the PRS process and been counterproductive to any efforts to establish open and participatory forums for macroeconomic policymaking.

It is important to state that *PRGF negotiations are not the right forum for participatory* *processes to unfold*. Participatory formulation of macroeconomic and structural reform policies should be nationally driven, conducted as part of the PRS processes, and aligned with budgetary and Medium-Term Economic Framework (MTEF) cycles. Unfortunately the sequence of events in the case study countries has revealed that, for governments, having an on-track PRGF has become more important than strengthening the PRS process. And as long as this situation prevails key discussions of macroeconomic policies will not be transferred to the PRSP framework.

It is therefore crucial that the PRGF is delinked from the HIPC initiative and that donors drop this signal for budget support in order to lessen the importance currently given to the PRGF.

Until these changes are implemented however, the IMF and governments must open the policy debates under the PRGF to broader scrutiny as outlined in Section 3.2 ('PRSP / PRGF Alignment: a practical proposal').

In summary, draft PRGF documents should be circulated in a timely manner and roundtable discussions held with all stakeholders in order to establish: (a) whether the macroeconomic direction proposed under the PRGF accords with the PRSP; (b) what additional independent analysis (i.e. PSIA) is needed to ensure pro-poor outcomes of policy reforms; (c) what indicators and targets will form a joint donor conditionality / performance assessment framework; (d) what are the capacity and resource gaps and how these will be filled.

Key Recommendation 5:
The PRGF should be delinked from the HIPC initiative in order to ensure resource flows for poverty reduction are not disrupted.

4. Fiscal flexibility and pro-poor budgets - evidence from country case studies

'In recent years, African countries have been told to 'live within their means', however meagre those means might be. The IMF and World Bank have had to deliver this painful donor message. 'Belt tightening' for people who cannot afford belts became the order of the day.'

Jeffrey Sachs in The Economist, 20 May 2004

'…now is the right time to tighten the belt'

World Bank representative in Lusaka*

'Directors… welcomed the finding that the design of these programs have improved in a number of ways. For example, fiscal targets have become more flexible to accommodate increased expenditures on pro-poor programs…'

IMF Executive Board of Directors, 21 July 2004

4.1 Ensuring appropriate flexibility in fiscal targets

Throughout the 1990s, largely due to extensive advocacy by NGOs, the IMF became increasingly aware of the social costs of its recommended structural adjustment programmes in general, and fiscal austerity in particular. As a result, the concept of fiscal flexibility for low-income countries was introduced under the PRGF. A key element in this revised approach to fiscal flexibility was that IMF staff should include more normative fiscal targets in PRGF programmes and use these to signal financing needs to donors. The application of this key feature is analysed in this section, which also examines the outcome of the IEO's research into fiscal flexibility in the PRGF (IEO 2004a).

Zambia

Under the 1999 ESAF/PRGF programme fiscal projections were initially very restrictive. The overall deficit target was around 1.5 percent of GDP. The IMF notes that the *'central government fiscal deficit was broadly in line with the program until 1998'* (IMF 2004i, p.6). After this date, the IMF blamed the deteriorating fiscal stance on losses associated with financing the state owned mining company, ZCCM. However, after ZCCM had been privatised in 2000 the country still experienced problems meeting the fiscal targets. IMF analysis found that the soaring deficit figures were related to *'weaknesses in expenditure policies and management'* (ibid., p.8).

As can be seen from Table 1 the targets introduced in the 2004 PRGF do not indicate increased flexibility. Unlike the 1999 programme, where lack of progress on structural reforms was normally the main point of contention with the IMF, the fiscal deficit is now highlighted as Zambia's main macroeconomic problem.

As noted in Section 3.1, the 1999 PRGF went off-track and was replaced by a Staff Monitored Programme (SMP) in May 2003. This occurred because the government's increase in public salaries exceeded the level of fiscal deficit deemed sustainable by the IMF.

The IMF's response to the Government of Zambia's increase in public salaries initially showed a certain element of flexibility. It is unclear what fiscal target the IMF held in 2003 but the Government of Zambia itself had outlined the ambitious target of a deficit of 1.55 percent of GDP in 2003 (Kasonde, 2003).[14] When the SMP was negotiated the IMF outlined a macroeconomic framework that would partly accommodate the increased spending by the

* Referring to the need for Zambia to address its fiscal deficit to get IMF and Bank supported programmes back on track, May 2004.

[14] Given that fiscal targets in Zambia are normally negotiated with the IMF, and that this target overall was in line with the 1999 – 2002 targets, the IMF is almost certain to have supported this target.

Table 1: Fiscal balance and projections in Zambia
(percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Overall fiscal balance	-6.6	-4.0	-7.0	-8.1	-6.4	-6.6 (prel)				
Projections						-1.55[i]	-3.4[ii]	-3.2[ii]	-2.4[ii]	-2.4[ii]

Source: IMF (2003c), Kasonde (2003)

i Figure from the Minister of Finance's budget speech. Later revised and expanded to -5.2 percent of GDP in the Staff Monitored Programme.

ii 2004 PRGF arrangement (IMF 2004j)

government. The fiscal target was set at 5.2 percent of GDP.

Thus the IMF was flexible in accommodating a fiscal deficit that was larger than originally projected to give the SMP a chance to stay on track. However, it should be noted this was in the context of a SMP, where the IMF did not have any resources at stake. Furthermore, it was clear from the SMP that the government had to bring the wage bill under control if it was to entertain any hopes of getting a new PRGF.

The government was unable to meet the fiscal deficit target of 5.2 percent of GDP in the SMP however. The final deficit for 2003 is estimated to have been about 1.5 percent higher than the target. By the end of 2003 Zambia was off-track on the SMP and budget support had been suspended by most donors. This led to the widespread view in early 2004 that Zambia needed to agree to a new PRGF-supported programme, regardless of the consequences.

The new PRGF-supported programme is a return to business as usual. The cornerstone in the new programme is *'strong front-loaded fiscal adjustment'* (IMF, 2004a). In 2004, the government must reduce the fiscal deficit by more than 3 percent of GDP, from 6.6% in 2003 to 3.4%. By 2006 the deficit should be reduced to 2.4 percent of GDP to keep the programme on track.

Thus, the brief signal of fiscal flexibility demonstrated in the 2003 SMP seems to have been a one-off occurrence. Most stakeholders would agree with the IMF that the Zambian Government's fiscal management 2003 was unsustainable. However, it is alarming that the IMF has now returned to a strict fiscal austerity line, which has yielded little results in the past, has not been consulted upon with a broader group of stakeholders and remains largely unrealistic.

Honduras

Honduras has experienced even less flexibility with regard to its fiscal targets than Zambia. This has contributed to delayed support to the Honduran government from other donors for implementation of the PRSP. As mentioned in Chapter 3, Honduras' 1999 PRGF went off-track in late 2001 when the outgoing government failed to meet the fiscal targets. Civil society organisations believe that the targets envisaged were highly unrealistic given the international economic context at the time. In addition, the elections in 2001 made fiscal discipline less likely, since historically, governments in Honduras have been prone to increasing spending at the end of their term.

The IMF describes Honduras as suffering from a 'credibility problem'. Essentially, the efforts of the government to implement reforms and exert discipline over finances do not meet the expectations of the IMF. When the first PRGF in Honduras went off track on fiscal grounds, the IMF persistently sought strong political commitment from the government to address this issue. Evidence of political commitment is generally sought through adherence to strict conditions.

There is no doubt that the IMF should be exerting pressure on the government to combat corruption and reinforce the public expenditure management system (PEM). These are factors that have a considerable bearing on fiscal discipline in Honduras. However, the overall targets in the PRGF-programme appear unrealistic, which undermines the IMF's attempts to ensure improved PEM systems.

The new PRGF requires the combined public sector deficit in 2004 to be reduced to 3 percent of GDP. This represents a reduction in the deficit of 1.6 percent of GDP from an estimated deficit of 4.6 percent of GDP in 2003. In 2005, an

Table 2: Fiscal balance and projections in Honduras
(percentage of GDP)

	1998	1999	2000	2001	2002	2003	2004	2005	2006
Overall fiscal balance	-1.3	-3.6	-5.0	-6.0	-5.3				
Projections							-3.0	-2.5	-1.75

Sources: Institute of Social Studies (2004a), IMF (2004b)

election year, this has to be further reduced to 2.5 percent of GDP and in 2006 it is envisaged that the new Government taking office in January will finish its first year in office with a deficit of only 1.75 percent of GDP. Reaching such ambitious targets by 2006 would represent an impressive change in fiscal management in Honduras, when compared with the fiscal deficit that stood at 5.3 percent of GDP in 2002. Unfortunately, it is not clear that spending practices in election years will change, and if growth targets are also not met then these deficit targets may remain out of reach (IMF 2004b).

The incentives for complying with such tight fiscal discipline are extremely high since compliance will give access to much-needed HIPC II debt relief and budget support. In turn, the opportunity cost of not reaching the PRGF targets is great, but the trade-offs required to achieve them may prove extremely costly to society in the interim, as a result of spending and public wage cuts. The measures required by the PRGF may therefore directly affect the possibility of reaching the poverty reduction targets embodied in the PRSP.

It is clear that a fiscal deficit equivalent to approximately 5 percent of GDP is not sustainable in the long run and most actors in Honduras agree that it has to be dealt with. However, this deficit has to be put in the context of the external shocks that have hit the Honduran economy over the last five years. In 1998 the country experienced the worst natural disaster in its history. The damage caused by Hurricane Mitch is estimated at around US$3,800 million, an amount equivalent to approximately 70 percent of Honduran GDP in 1998 (Government of Honduras 1998).

In addition, the recession that affected the United States' economy in late 2001 has had a negative impact on the Honduran economy in terms of exports and foreign investment. Finally, the worsening terms of trade caused by declining coffee prices and increasing oil prices on the world market have adversely impacted on the development of the economy and have particularly affected the poor (FOSDEH and Oxfam International 2003).

Even under these conditions, the IMF have prescribed a strict fiscal policy. Little attention is paid to issues around increased flows from other donors, as promised under the key features of the PRGF. The IMF has not highlighted to donors the negative impact of a shortage of resources on Honduras' ability to meet the Millennium Development Goals (MDGs).

If the Government finds that it is unable to: reach the ambitious fiscal targets embodied in the PRGF; renegotiate salaries with significant public sector groups; and effect the legislative reform governing the Civil Service and the Financial Sector, HIPC II Completion Point will be further postponed and resources for the implementation of the PRSP will remain insufficient. This is not an unlikely scenario. The incentives for reaching HIPC Completion Point may be strong, but achieving them may be politically difficult and the trade-offs costly in terms of social impact, especially for the poor. Public wage contracts have proved notoriously difficult to renegotiate, and legislative reforms to laws governing the Financial Sector and the Civil Service are proving extremely problematic to pass through Congress. The exigencies of the PRGF have placed the Government of Honduras in a fiscal and political equilibrium that may prove very difficult to maintain.

Rwanda

Rwanda provides an interesting illustration of what might be 'best practice' in fiscal flexibility. However it is also evident that this position has not emerged without a struggle (see Section 5.3 on PSIAs). In 2003 Rwanda could not meet the targets for the fiscal deficit due largely to the higher than projected costs of the elections and lower than anticipated donor disbursements. The Government also agreed to finance a hotel-building project, which has had serious implications for the 2004 budget. This led the PRGF off track after its 1st review in June 2003. It got back on track in mid-2004 and most donors viewed 2003 as an aberration in an otherwise healthy track record.

The target for the domestic fiscal deficit by end-2003 was 4.4% whereas the actual outcome was 5.5%. In the original PRGF, the anticipated domestic fiscal deficit for end-2004 was 1.1% of GDP. In the new programme, the anticipated domestic fiscal deficit is 7.8% for end-2004. This remarkable change in a core target illustrates an appreciation of the economic constraints facing Rwanda and the social fragility of this post-conflict society.

The IMF maintain this increase in the fiscal deficit target is to accommodate the authorities' drive to support the roll-out of its PRS programmes and to allow it to invest in critical infrastructure which prohibits development of the private sector and acts as a deterrent to investment, e.g. electricity generation. It is clear the IMF felt the Rwandan Government was acting in good faith, illustrated by the fact that in the first quarter of 2004 it had managed to assert control over macroeconomic indicators.

One factor which may have influenced the eventual outcome was the sensitivity of the IMF Resident Representative to the local context. The Resident Representative and other staff showed a willingness to take a risk in pushing for a flexible programme which defies normal IMF incentives. This is particularly interesting given that Rwanda is a country which is out of favour with many powerful Board members. While criticised at times for maintaining excessively conservative positions on aid absorbtion and the debt ratios, many donors in Rwanda found the IMF unusually open.

The fact that IMF staff managed to push through a more reasonable programme for Rwanda illustrates that there is a need for the incentives for staff to be changed away from 'safe' positions and towards more nuanced programmes which take account of the local political economy.

4.2 A critique of the IEO's conclusion on fiscal flexibility

The above analysis indicates there may be a wide variation between countries in how the IMF implements the key PRGF feature of fiscal flexibility. It appears that Rwanda had its fiscal problems addressed quickly and the fiscal targets modified in accordance with the key features. On the other hand Honduras and Zambia have not enjoyed this kind of flexibility and their ability to meet the tight PRGF fiscal targets is still in question. What is not in question is the continued negative impact of these adjustments on the social sector and poverty indicators.

The findings in this paper differ substantially from the broad finding on fiscal flexibility in the 2004 IEO review of the IMF's implementation of the PRSP / PRGF initiatives (IEO 2004a, p.78 – 84).

The IEO's evaluation examined whether the transition from ESAF to PRGF had resulted in increased fiscal flexibility in IMF programmes. When looking at the aggregate figures the IEO found that the IMF's fiscal projections had remained largely identical to those under ESAF. This mirrored Eurodad findings (2003).

However, the IEO subsequently disaggregated the figures and examined the composition of the fiscal targets. This showed that the IMF had allowed more room for spending but had compensated for this by projecting higher revenues (accompanied by structural reforms on tax regimes). This led the IEO to conclude that fiscal targets have become more flexible. The finding is undoubtedly true from a statistical point of view, e.g. when looking at a broad sample of countries as the IEO did. However, it would be arguably more useful to analyse the individual experiences of countries, particularly those which have had a difficult programme relationship with the IMF.

Our case studies suggest that wide discrepancies exist with regard to the degree of fiscal austerity imposed on different countries. Whereas countries with a good track record with the IMF might enjoy more flexibility, countries with a history of failed programmes are kept in a financial straightjacket.

Both the IMF staff and the Board of Directors welcomed the overall conclusion by the IEO that fiscal flexibility had increased. However, further country-specific analysis is needed to identify how the IMF responds to the unique problems

BOX 10

A critique of the IEO's methodology

The IEO's methodology leading to the conclusion of increased fiscal flexibility can be contested. The analysis takes a non-differentiated approach in examining a pool of 47 ESAFs and 41 PRGFs to derive their conclusion. They do not draw supplementing examples from their case studies and most importantly, they do not distinguish between 'poor performers' and 'good performers'. This is interesting because it differs from other parts of the analysis where appropriate use is made of the detailed country case studies. A case in point here is the analysis of streamlining structural conditionality where a broad assessment is supplemented by noting that *'these patterns varied considerably among countries, as is evident in our case studies'* (IEO 2004a, p. 95). This is also the case for the fiscal targets. There is only one limited acknowledgement of country discrepancies on fiscal targets, where it is noted that *'the initial fiscal balance was found to be a key determinant of targeted fiscal adjustment under both ESAFs and PRGFs and the nature of the relationship has not changed much'*. (*ibid.,* p.82).

Moreover, the IEO's methodology compares fiscal projections between ESAF and PRGF and asks whether any change can be identified. This analysis does not provide us with a clear understanding of the degree of flexibility. As it is clear that there was very little fiscal flexibility under ESAF-supported programs, a marginal positive change does not indicate that the level of flexibility in PRGF-supported programs has improved sufficiently. Again this differs from other parts of the evaluation where the IEO takes a more normative stance. Essentially, the IEO does not try to determine whether the IMF provides sufficient fiscal flexibility in its PRGF-supported programmes which is an unfortunate failing in its analysis.

facing different countries and to what extent the fiscal projections have become more flexible and more achievable.

The IEO presents a tremendously powerful conclusion based on seemingly limited analysis. This risks pre-empting further debate on the issue and encourages IMF missions to pursue a standard programme response in countries such as Honduras and Zambia. Therefore this paper urgently requests the IMF to review the broad conclusion reached by the IEO on this issue.

Finally an interesting conclusion in the IEO's evaluation is that PRGFs appear to have resulted in greater fiscal adjustment outcomes than ESAFs. This could indicate that, in real terms, budgets are under more constraint now than ever. This may be related to the fact that countries are under more pressure to deliver on tight fiscal targets because of the need to achieve HIPC debt relief. The HIPC context had certainly become very constrained as the resources to fulfil HIPC obligations were not forthcoming from donors. The recent struggle to achieve topping up in Ethiopia and Niger attests to this.

4.3 Budgets that are more pro-poor and pro-growth

As we have seen above countries with a poor track record with the IMF have not enjoyed the degree of fiscal flexibility that might have been anticipated under the key features of the PRGF. In this section the PRGF key features which require the IMF to promote budgets that are pro-poor and pro-growth are examined. In particular, we investigate what the cost of fiscal adjustment has been in the case study countries, in light of the commitment to pro-poor and pro-growth budgets.

Zambia

The key objective promoted by the IMF and the World Bank in Zambia is to close the financing gap and lower the fiscal deficit. This is to be achieved by imposing a ceiling on public sector wages of 8.7 percent of GDP in 2003 and 8.1 percent of GDP in 2004.

In 2003 the Government of Zambia responded to pressure from trade unions and granted an increase in public sector wages and a housing

Table 3: Basic needs vs. public salaries in Lusaka

Costs	Kwacha	US$ (approx.)
Basic food items for a family of six in Lusaka	456,400	100
Cost of essential non-food items	657,500	140
Total basic basket	1,113,900	240
Monthly Wages (take home pay)		
Teacher	407,000 – 913,000	88 – 196
Secretary in civil service	390,000 – 791,000	84 – 170
Nurse	461,000 – 489,000	99 – 105
Police officer	120,000 – 300,000	26 – 65

Source: JCTR (2004): Basic needs basket for Lusaka, www.jctr.org.zm

allowance to compensate workers for a wage freeze that had been in place since 1998.[15]

The fiscal repercussions *'sent the PRGF substantially off track'*, according to one donor representative (interview, Lusaka, May 2004). The IMF replaced the PRGF with a staff monitored programme (SMP) introducing the above-mentioned ceiling on public wages. The government was obliged to revisit its policy and it decided not to pay the housing allowance originally negotiated.

Freezing public sector salaries is not an appropriate way to achieve fiscal adjustments in a context such as Zambia. Nor does it generally represent an approach which will deliver pro-poor and pro-growth budget outcomes. This is partly based on the fact that public sector employees in countries such as Zambia barely earn a living wage. Furthermore, these individuals are extremely important in terms of delivering fundamental (and growth enhancing) public services such as education, healthcare and security, particularly to the poorest and most vulnerable groups.

Civil servants in Zambia are grossly underpaid. The Jesuit Centre for Theological Reflection calculate that a basic basket of food and non-food items in Lusaka costs US$240. As can be seen in Table 2, average wages fall far below this level of income.[16]

The IMF Resident Representative acknowledges that underpayment is a problem, which he refers to as a general 'micro-macro problem' for Africa (interview, Lusaka, May 2004). The micro problem is that the employees are underpaid and the macro problem is that the country has insufficient resources to increase salaries but the salary bill takes up a large portion of GDP nonetheless.

Fiscal austerity in Zambia has had a direct negative impact on education. Indeed, until recently education provided one of the few success stories in the implementation of the Zambian PRSP. In the context of general dissatisfaction with the implementation of the PRSP, donors have found that progress had been made in this sector. The government's PRSP progress report shows that more schools have been built and that the gross enrolment rate rose by 4 per cent in 2003. The downside of this however, is that the pupil-teacher ratio has increased from an already high 46 in 2002 to 52 in 2003.

The explanation for this development is crystal clear and deeply regrettable:

> *'The number of basic school teachers increased from 37,793 in 2001 to 40,488 in 2002, but then fell back to 38,891 in 2003,* ***after the Ministry of Education applied a hiring freeze in order to remain within its wage bill ceiling'*** (Government of Zambia, MoFNP 2003, p.4)[17]

A large number of recently qualified teachers remain unemployed due to the wage and hiring freeze at a time when the Ministry of Education has identified about 9000 teacher vacancies, mainly in the rural areas (ibid.). Thus there is both supply of and demand for new teachers, yet the wage and hiring freeze is blocking progress in education.[18]

The IMF and the World Bank have fiercely denied any responsibility for this situation. A representative of the World Bank stated that it is not *'technically correct'* that the wage and hiring freeze means that the Government cannot

[15] Zambian Minister of Financing and National Planning (MoFNP), interview, Lusaka, May 2004

[16] This situation is confirmed by a study by Situmbeko and Zulu (2004)

[17] Emphasis added by the authors.

[18] The number of teachers unemployed is estimated to be about the same as the number of vacancies identified by the Government of Zambia.

employ more teachers (interview, Lusaka, May 2004). However, as seen above, the Ministry of Education has stopped employing new teachers as a consequence of the wage and hiring freeze, despite an identified need.

The concern about the impact of the wage and hiring freeze on reaching the MDGs is shared even by the donors who are most supportive of the position of the IMF in Zambia. One donor representative pointed to the inherent conflict in freezing employment when there is a need for more teachers. However, these donors must share some responsibility for the situation, unless they challenge the IMF's position.

Honduras

During 2003 and the first half of 2004 the IMF focused on reducing public sector salaries as the main avenue to reducing the fiscal deficit in Honduras. A prior action in the February 2004 PRGF required the National Congress to approve a salaries bill *'to achieve the targeted decline of the government wage bill'* (IMF 2004b). The ceiling the IMF has imposed on public sector wages is 9.1 percent of GDP.

This focus on public sector salaries ignores the regressive tax system that exists in Honduras and ultimately forces the burden of fiscal adjustment to fall on middle and low-income earners in the economy. This is indicative of the IMF's tendency towards excessive concentration on short-term means of achieving financial targets without adequate analysis of the social and political situation.

Within the broader group of public employees teachers were specifically targeted by the IMF. While teachers in Honduras are by no means wealthy as a result of their state salaries, as a public sector they hold a privileged position. For example, teachers do not pay taxes and have benefited from a series of pay increases over previous years that other sectors, such as the police force and nurses, have not enjoyed. This is due to longstanding political legacies, some dating as far back as the 1970s, and other more recent agreements made by the Flores administration.

Extending similar pay increases to other sectors would have been fiscally unsustainable. In addition, teachers are charged with poor performance, corrupt practices and absenteeism, which has resulted in the profession being blamed for the general poor state of the education system and being identified as the principal cause of the fiscal deficit. The government is absolved of their responsibilities in terms of supervision, selection and their complicity in corrupt practices.

Thus, the Maduro administration has been saddled by the IMF with the task of renegotiating wage contracts with a highly organised and belligerent sector. But the topic is further complicated because the issue of teachers' salaries is highly politicised, and is not simply a case of civil society facing down the government.

There were divisions within civil society, congress and ministries relating to the issue, on many levels. These included, as well as the privileged position outlined above, the management of the education sector by the government and low capital investment in schools; the apparent attack by the government, backed by the IMF, on a social sector; and the failure to give other factors influencing the fiscal deficit the same priority – such as cancelling internal debt, the misuse of funds and political favours.

The IMF therefore has directly interfered in a sensitive political issue in Honduras to effect fiscal discipline. The unions were portrayed in an extremely negative light, little attention was paid to the government's poor management of the sector and there is evidence that a new wage deal with teachers is a precursor to a broader privatisation agenda for the education sector.

The social unrest, the disruption caused by the protests and the protracted and fraught negotiation process in 2003 and 2004 has affected governance, damaged the credibility of the government and negatively impacted on the chances of reaching the MDG and Fast Track Initiative targets on education.[19] An agreement was finally reached in early July 2004, whereby the teachers accepted a reduction in the previously agreed increases and are prepared to see payments spread over a longer period of time.

Financing this deal, estimated to be worth US$93 million, implied major trade-offs and four ministries were closed or demoted in order to pay for it. SEDCO, a technical cooperation

[19] Honduras is part of the Education for All – Fast Track Initiative. Currently one in three Honduran children do not complete primary school. Under this initiative, the Government has committed itself to reducing this number to 25% by 2005 and to ensuring that all children complete primary school by 2015.

agency was closed, the Ministries for Culture and Development were demoted and funding for an important environmental regulatory body was cut. These measures will have a direct impact on poverty reduction policies.

The costs of the pay deal, both directly in keeping public wages low and indirectly in terms of the trade-offs involved, indicate once more that the measures required to meet the PRGF conditions seriously hamper progress towards the poverty reduction targets of the PRSP. In addition, such involvement by the IMF in the political dynamics in Honduras endangers the possibility of consensus support for the PRSP, and hinders the movement towards a more pro-poor budget structure. This type of interference by the IMF through the PRGF-supported programme is still continuing, with difficulties in passing the financial sector reforms through congress, and it will continue to plague the Maduro administration.

Rwanda

As noted in section 3.1, the IMF proposed that the Government of Rwanda revise its 2004 budget expenditure estimates in an attempt to deal with its significantly increased deficit. This was to be done by scaling back on a number of programmes from the 2004 budget, unless external grant financing could be found to cover the cost of these programmes. There was unanimous agreement among government and donors[20] that this was unlikely to occur before the end of year, when the World Bank may begin to disburse a Poverty Reduction Support Credit (PRSC). This would still mean that the programmes planned for 2004 would be deferred, at best, to 2005. The total amount of funding required was estimated by officials to be around US$25 million.

The list of affected projects included the labour intensive public works initiative which aims to recapitalise the rural economy and create badly needed employment. This programme supports the most vulnerable in Rwandan society, particularly widows.

A number of government and donor spokespersons attribute these cutbacks to a lack of institutional preparedness to implement the programmes effectively. However this was disputed by key officials and government staff feel there should have been an agreement to allow at least first-phase implementation rather than effectively cancelling the programmes or at best deferring them to 2005 (interviews, Kigali, May 2004).

The key incentive for the Government of Rwanda to reduce spending and curtail borrowing is to keep the debt ratios low. Rwanda is due to reach HIPC II Completion Point by end-December 2004. Borrowing – even to fund programmes which are fundamental to poverty reduction and linked to the core objective in the PRSP – would send the wrong signal to the Boards of the BWIs and compromise Rwanda's chances of increased debt relief.

This illustrates the counter-intuitive nature of the HIPC debt relief process and the PRGF. Poverty reducing expenditure is constrained even in situations where it is necessary and effective. Where grant funding is available, the IMF retains a right of veto through insisting that grants can only be used if they do not affect monetary conditions (see Section 3.1).

4.4 The negative impact of fiscal austerity on pro-poor and pro-growth expenditures

Evidence from the case studies suggests that fiscal austerity has had a negative impact on pro-poor and pro-growth expenditures. In the cases of Honduras and Zambia, the IMF has consistently failed to take the local political economy into account, leading to repeated derailing of PRGF arrangements.

It is clear that the IMF's insistence on the reduction of public sector wage bills is excessively shortsighted in terms of poverty reduction. Depriving these sectors of funding is not an appropriate response. Even if they account for a significant percentage of government expenditure, employees in this sector play an important long-term role in poverty reduction (providing health care and education to the poorest and most vulnerable groups). Moreover, the IMF's approach is narrow, failing to recognise and act on the other factors determining fiscal imbalances, such as high-level corruption and patronage. The IMF fails to take a pro-poor approach, allowing regressive tax regimes to continue in highly unequal societies such as Honduras.

20Interviews, Kigali, May 2004

BOX 11

PRSP / MDG costing assessments needed

In October 2003 the World Bank and United Nations Development Group published a 'Joint Iraq Needs Assessment' that was carried out with assistance from the IMF (World Bank 2003). According to the Director of the Earth Institute at Columbia University Jeffrey Sachs, the assessment was done at America's request. He notes that such an assessment has never been done for Africa who have rather been told to 'live within their means' (Sachs 2004).

This paper argues that if Iraq is to receive support in assessing infrastructural and poverty reduction needs, all countries that have invested time and effort in the formulation of a poverty reduction strategy should receive equal support. External agencies such as the UNDP and the World Bank, as well as bilateral donors, have a role to play in supporting such analysis. Most PRSP countries do not currently have adequately costed PRSPs, as highlighted by IEO and OED evaluations.

Poverty reduction needs assessments should be based on an MDG-compliant scenario, where countries identify the progress they aim to make towards the MDGs and the means they intend to employ to get there. The objective of the costing exercise should be to analyse how, in the context of sound public expenditure management, internal and external resources can be raised to close the financing gap in an equitable and socially just manner.

The IMF has a serious challenge in terms of changing the way it deals with 'poor performers'. Instead of imposing standard fiscal austerity measures, it must take a more nuanced and differentiated approach. The IEO has pointed out that the difficulties in analysing macroeconomic policies should not be overstated. This has two implications:

- At a minimum the IMF should ensure independent PSIAs are carried out on its own fiscal reform proposals.
- At a broader level, the IMF's role in analysis of micro-macro linkages should involve working with government alongside other partners to provide analysis where requested of the macro economic trade-offs associated with different policy choices. It should feed into but not dominate the choice and execution of analysis on macroeconomic topics.

Finally, IMF staff have been directed in PRGF policy documents to present normative projections of grants and concessional loans and to demonstrate efforts to seek higher aid commitments in cases where needed and appropriate. Clearly the IMF does not have the competence to cost poverty reduction programmes or to assess aid absorbtion capacity. This should be led by government and involve actors such as the World Bank and the UNDP (see Box 11). However, the IMF's role should certainly encompass securing increased resource commitments in order to support implementation of pro-poor budgets, which aim to deliver on country-specific MDG targets.

Key Recommendation 6:
A comprehensive external review of the IMF's performance on fiscal flexibility should be carried out. The review should examine the IEO's findings that fiscal flexibility has generally improved and subject them to more rigorous analysis. The analysis should be disaggregated in order to allow an assessment of IMF flexibility in countries which are poor performers.

Key Recommendation 7:
The IMF should make the assumptions and rationale underpinning its proposed fiscal targets open to public scrutiny and subject its proposed fiscal reforms to independent PSIAs.

Key recommendation 8:
The IMF's broader role in analysis of micro-macro linkages should be to work with government, along with other partners, and to provide analysis where requested of the macro-economic trade-offs associated with different policy choices.

Key Recommendation 9:
The IMF should fulfil its commitment to seeking increased resource commitments from other donors in order to support implementation of pro-poor budgets and country-specific MDG targets. It should support, but not dominate, processes to cost MDG / PRSP targets in low-income countries.

5. Other neglected PRGF promises – evidence from country case studies

'The cost of attaining macroeconomic stability and balancing the budget should not be borne by the poor children in Zambia.'

Catholic Commission for Justice, Development and Peace, Zambia*

'Prospects for transparent and effective public expenditure management seem, on balance, much brighter for countries that have passed through a democratic transition and where the institutional framework for adequate parliamentary and public oversight of the public sector have been put in place'

Adrian Fozzard and Mick Foster, 2004

This chapter highlights the remaining commitments the IMF made when the PRGF was introduced. This includes the following PRGF key features: streamlined or more selective structural conditionality; an emphasis on measures to improve public resource management / accountability; and social impact analysis of major macroeconomic adjustment and structural reforms (see Box 1).

This chapter does not apply the country evidence in the same detail as in former chapters. Instead it provides examples which illustrate the outstanding challenges the IMF still has to fulfil in these areas.

* In response to the budget, February 2004.

[21] Other types of structural conditionality include structural performance criteria which a country has to implement to stay on track and structural benchmarks which are seen as important but not essential to keep a programme on track.

[22] Including: what constitutes a sound basis for a PRGF loan (IEO 2004a, p.66); what is the rationale for a proposed fiscal path (ibid., p. 110); and what constitutes 'progress' in the PRSP 'Progress in Implementation' reports (ibid., p.30).

5.1 More selective structural conditionality

The IMF and the IEO both declare there has been progress in streamlining structural conditionality. The IEO mentions one notable exception to this record, namely in the use of prior actions which has seen no change. This is significant because prior actions rank highest in terms of intrusiveness in the domestic policy agenda. These represent actions governments have to undertake before any disbursements are made.[21]

Definition of 'critical' structural conditionality

The IEO analysis states that the streamlining initiative aims to limit structural conditionality to the IMF's core areas of competence, except when structural measures are deemed critical to the success of the program. In some IMF policy papers a structural reform's relevance is determined by its significance for macroeconomic stability.

However, the IEO does not analyse whether the IMF uses an adequate mechanism to assess how and when a structural condition can reasonably be deemed 'critical'. In fact, the IEO finds that the IMF fails to make its assumptions and rationale explicit in a wide range of areas.[22]

Failure to make this information public has left many CSOs with the impression that whenever the IMF is keen on a structural reform it will always become 'macro-relevant'. The IEO would have found evidence for this in their case study on Vietnam, in which it is evident that the IMF was heavily involved in pushing a structural reform agenda even though there was little macroeconomic justification for this approach (IEO 2004b).

It is imperative therefore that the forthcoming IEO Review of Structural Conditionality includes a comprehensive review of the conditions under which structural reforms can be deemed 'critical' to the success of the IMF's macroeconomic reform programs.

Is 'streamlining' really happening?

Both Honduras and Zambia provide examples of the difficulty in identifying a change in the IMF's way of doing business in streamlining structural conditionality. In both countries the IMF, as we have seen, advocates civil service reform through imposing a ceiling on government spending on public wages. In Honduras the ceiling is 9.1 percent of GDP and in Zambia it is 8.1 percent of GDP. In Honduras this has led to the perception of cross-conditionality between the IMF and the World Bank. The overall objective appears to be the privatisation of education through making communities responsible for paying teachers' salaries. Potentially this could have a huge cost in terms of the sustainability and quality of the education (FOSDEH 2004a).

Although the World Bank is taking the technical lead on implementing civil service reform, this could hardly be fulfilled without the IMF's hard stance on a wage ceiling. In this sense the distinction between civil service reform which is beyond the IMF's core area of competence and fiscal policies which are within it, becomes largely irrelevant. The streamlining exercise becomes meaningless.

Indeed, it is hard to believe that the IEO/OED were unable to assess what had happened to aggregate Bank / IMF structural conditionality in the evaluations of the PRSP and PRGF approaches, despite having carried out joint country case studies.

The IEO find that databases to track conditionality are not just mutually incompatible but also internally inconsistent. One of the reasons given for the lack of coherence in the BWIs' approaches to client countries is that, quite simply, assessing aggregate conditionality has not been an objective.

This is a fundamental flaw which at a stroke negates much of the positive ground gained by the World Bank and IMF under the PRSP approach. Clearly, both the World Bank and the IMF need to be held more accountable for the impact of their aggregate conditionality. The proposed review in 2005 of the PRSP approach should take this element on board. Board members should exercise their oversight function more closely, remembering that their taxpayers and the poor pay for this appalling lack of coherence.

As a first step, documentation of all structural conditionalities across World Bank and IMF programs should be streamlined and made easily accessible to the public. In addition, in its forthcoming Review of Structural Conditionality, the IEO must examine the degree of overlap between World Bank and IMF conditionality.

5.2 Emphasis on measures to improve public resource management / accountability

The importance of public and political oversight has been highlighted in recent research which concludes that *'prospects for transparent and effective public expenditure management seem, on balance, much brighter for countries that have passed through a democratic transition and where the institutional framework for adequate parliamentary and public oversight of the public sector have been put in place'* (Fozzard and Foster, 2004, p.9).

Budget monitoring and advocacy is a priority for many CSOs who often find their governments' approaches to budgeting to be inefficient, opaque, and anti-poor. They may therefore look to the IMF for support to remedy this situation. This expectation was enhanced with the inclusion of the emphasis on measures to improve public resource management / accountability as one of the key features of the PRGF.

In 2004, the Zambian organisation CCJDP published a paper '*Austerity without injuring the poor'*, which calls for enhanced budgetary controls by the Ministry of Finance. The authors of the paper *'are dismayed by the lack of financial discipline shown by government spending agencies.'* (CCJDP, 2004, p.10) Amongst other things, CCJDP recommend the government reallocate funds from presidential trips to employment of teachers, emphasising that *'the cost of attaining macroeconomic stability and balancing the budget should not be borne by the poor children in Zambia.'* (ibid, p.11)

Donors share the concerns about budget management and one donor representative described the budget as 'the battleground'. It is acknowledged by donors however that while this is a complicated and politically difficult process the budget analysis and advocacy undertaken by CCJDP, CSPR and others is a crucial contribution in the public discussions of fiscal policies in Zambia (interviews, Lusaka, May 2004).

When the Government of Zambia suspended an independent monitoring group on HIPC spending the IMF had a golden opportunity to demonstrate that it was now ready to take a proactive stance on budget and HIPC transparency.

BOX 12

The HIPC monitoring group in Zambia

The HIPC monitoring group was originally formed as a highly innovative forum where representatives of civil society organisations and professional bodies such as auditors and accountants worked jointly to monitor the use of HIPC debt relief. The forum was very effective, producing incisive and timely reports on the allocation of funds that were meant to be used for poverty reduction.

In early 2004, information implicating top government leaders in the misuse of HIPC resources in one of Zambia's provinces was released to the public. The government decided to suspend the group, citing legal technicalities around the establishment of the group. The government also noted that there was duplication of work between the group and the auditor general's report. However, the auditor general's reports can be delayed by several years and therefore have a less immediate role holding the government to account.

The HIPC monitoring group remains suspended (September 2004) and it is a key priority for civil society organisations to have it re-established. This concern is shared by most donors.

According to the IMF Resident Representative, the IMF was aware of the suspension of the HIPC monitoring group and was concerned about this development, as other donors were. Nevertheless it chose not to push the government to address the issue but give it a 'fair chance' to deal with the problem (interview, Lusaka, May 2004).

According to a number of donor sources the management of HIPC resources in Zambia has been very problematic and the IMF should focus its attention on this issue rather than on freezing public employees' wages. In order to address such issues the IMF must become more partnership-oriented, working with donors and non-government stakeholders in support of domestic processes for accountability.

5.3 Social impact analysis of major macroeconomic adjustments and structural reforms

It is widely acknowledged that the IMF has not done enough to address the social impact of its policies. The 2004 PRSP Progress in Implementation report must be the sole document, internal or external to the BWIs, to confidently assert that *''For the IMF, PSIA is used to assess the poverty and social impact of key reform measures contained in PRGF-supported programs'* (World Bank / IMF 2004, p.26).

Needless to say, no examples are given.

The newly-created PSIA unit in the IMF is a welcome development. Regrettably, the team faces constraints on its work from the outset which, unless removed, will severely limit its effectiveness. The aim of the team is to help integrate PSIA into the design and implementation of PRGF-supported programs. They will primarily draw on PSIAs which already exist to assess the likely impact of program measures on vulnerable groups.

It would be arguably more important however, to have independent ex-ante PSIAs carried out on actual reforms which the IMF proposes for specific countries. Under the current arrangement, the PSIA team will have the facility to do this only in very limited circumstances ('where resources permit'). Bilateral donors with a commitment to poverty reduction have an important role to play in supporting increased numbers of PSIAs in contested areas of IMF policy. Box 13 gives an example from Rwanda of how PSIAs can be used to open up space for policy dialogue.

At a more fundamental level however, PSIAs must be given additional weight in the IMF not just in determining policy for individual country programmes, but to feed into a fundamental rethink of the overall direction of IMF policy. It is readily apparent from the experience of our case study countries that the IMF is not willing to depart from its standard model of macroeconomic policy.

The IMF therefore needs to develop a learning culture around its overall macroeconomic model, drawing on the wealth of analysis in existence already and the PSIAs which are carried out on its own policy programmes. For this to be effective, the IMF's PSIAs should focus on fundamental policy models, rather than choices around sequencing of reforms or social safety nets. An independent group of external advisors should be set up to feed into the PSIA team's choice of PSIAs and to make recommendations to PDR and IMF Board members about their implications for overall IMF macroeconomic policy.

BOX 13

Rwanda, the IMF and the PSIA

In the period leading to the approval of the PRGF in 2002, the IMF and the Government of Rwanda had serious policy differences over the level of fiscal deficit which the government could sustain. The Government asked donors (notably DFID) to support a PSIA on the fiscal deficit to see whether (a) a more expansionary fiscal policy would be helpful in reducing poverty; (b) would the potential gains from increased investment in poverty reduction be undermined by the potential macro-destabilisation.

Several donors (UNDP, DFID) were supportive of the PSIA and its findings – that is, the fiscal restraint should be relaxed if grant financing were available and that Rwanda should be allowed to take on more concessional borrowing. The IMF had vehemently opposed increased flexibility for Rwanda and was intractable in its response to the PSIA, barely recognising that it had been carried out (see Section 3.3).

The IMF ultimately accommodated some of the government's demands by allowing for 'exceptional expenditures', which stretched the fiscal deficit. These were primarily post-conflict expenditures, for example costs related to withdrawal from DRC and troop demobilisation, costs for the 'gacaca' genocide trials, election expenditures in 2003 etc.

Failure by the IMF to concede such expenditures could have been interpreted as undermining the tentative moves towards peace in the region. This allowed the IMF to back down quietly, without admitting to the usefulness of PSIAs and the manner in which this PSIA so explosively opened up public debate on fiscal policy.

Key Recommendation 10
The forthcoming IEO Review of Structural Conditionality must include a comprehensive review of the conditions under which the IMF deems structural reforms critical to the success of the IMF's macroeconomic reform programs. The degree of overlap between World Bank and IMF conditionality must also be reviewed.

Key Recommendation 11
Both the Bank and IMF need to be held more accountable for the impact of their aggregate conditionality. As a first step, documentation of all structural conditionalities across Bank and IMF programs should be streamlined and made easily accessible to the public. This should be carried out in the context of the 2005 PRSP review process.

Key recommendation 12
The IMF must become more partnership-oriented, working with donors and non-government stakeholders in support of domestic processes to strengthen government accountability for public expenditure management, including carrying out joint advocacy with local stakeholders.

Key Recommendation 13
The IMF should strengthen the IMF's PSIA team to allow it to carry out ex-ante assessments on actual reforms which the IMF proposes for specific countries. Funding should be sought from the IMF's internal resources and from other donors. An independent group of external advisors should be set up to feed into the PSIA team's choice of PSIAs and to make recommendations to PDR and Board members about their implications for overall IMF macroeconomic policy.

6. An alternative role for the IMF in low-income countries

In this chapter we look at issues with relevance for the IMF's role in LICs beyond the PRGF approach and outline an alternative role for the IMF in these countries.

6.1 Signalling in countries with poor track records

The IMF holds a critical, if unsought, role as a gatekeeper for HIPC debt relief and budget support. This issue has been addressed above as it cuts across all other elements of the IMF's role in LICs. In this section this issue is explored in more depth. The IMF is in this position because the broader donor community requires assurance that a country has its macroeconomic situation under control if it is to receive financial assistance.

The IMF is poorly placed to play this role, given its lack of staff on the ground and its limited expertise on the constraints facing developing countries, notably in terms of political economy. Furthermore, the IMF cannot be held accountable if the policies its staff recommended should fail.[23] This clearly undermines the IMF's legitimacy as gatekeeper.

The IMF's gatekeeper role was criticised in the IEO's first evaluation on prolonged use (IEO 2002). Little has happened to address the problem since then.

The problem with signalling is that the IMF exercises excessive influence on policymaking in low-income countries where macroeconomic stability is often a problem, but is far from the only issue at stake. Low-income countries are locked into an unhealthy on-off relationship under restrictive PRGF-supported programmes. This disrupts resource flows and undermines ownership of macroeconomic policies. As illustrated in the box above, countries such as

BOX 14

The price of going off track

Honduras:	
Off track:	2 years
Estimated cost:	US$400 million
Expected CP[i]:	January 2005
	(DP[ii] June 2000)
Zambia:	
Off track:	1? year
Estimated cost:	US$50 million
Expected CP	June 2005
	(DP November 2000)

i HIPC II Completion Point
ii HIPC II Decision Point

Honduras and Zambia have lost millions of dollars in budget support and interim debt relief as a result of going off-track.

Proposal for reform of the IMF's signalling role

Clearly, the IMF's role as gatekeeper has to be radically reformed. The PRGF 'on/off' signal should be replaced by a country-specific agreement between all donors and government on the conditions which would result in aid reduction or suspension.

This should be built into a joint government / donor performance assessment and harmonisation matrix.

Such a matrix must be based on core targets in the PRSP and should include all macroeconomic conditions. Donors, including the IMF, would commit not to impose conditionalities unless they appear in the agreed matrix. Tranche-release systems for budget support should ensure that resource flows for poverty reduction programmes are not disrupted.

Ultimately, civil society and parliament should contribute to and monitor the implementation of such a performance assessment and harmonisation matrix. Such an instrument should be an accountability mechanism both for national governments and donors.

Delink the PRGF from HIPC while maintaining accountability

Low-income countries need access to HIPC debt relief and donors require an accountability mechanism for those resources. From the above

[23] Unlike the World Bank and the multilateral development banks the IMF has no independent inspection mechanism which can investigate complaints from people whose living conditions have been adversely affected by IMF programmes.

analysis, it is clear that the PRGF instrument does not primarily monitor government commitment to poverty reduction. Therefore it is not an appropriate mechanism to assess whether a government should receive debt relief. The HIPC / PRGF link should be broken. Monitoring mechanisms for debt relief disbursement should be based on local accountability mechanisms.

African parliamentarians and civil society have called for increased parliamentary control over loans (Afrodad / Christian Aid 2004). Donors have a role in helping countries to develop such systems. Indeed, several countries already have statutory instruments for debt management which can be used as models. Tanzania's May 2003 Government Loans, Guarantees and Grants (Amendment Act), is an example. It establishes a Debt Management Committee and requires government to present an annual debt strategy and semi-annual implementation report to parliament.[24]

6.2 Financing

Much of the IMF's attention in the review of its role in LICs has focused on the question of the organisation's financial involvement in those countries. The paper on the IMF's role in LICs concludes that the IMF *'needs to remain engaged in assisting low-income countries over the long term'* (IMF 2003, p.8). It is not clear from this quote whether this involves financial support.

Shortly afterwards, however, it is noted that '*the overall objective of IMF policy advice as well as technical and financial assistance is to help low-income members move to a point where they can rely predominantly on private sources of financing'* (ibid, p.9). Later in the paper, staff explain the rationale behind IMF financing: *'…an IMF-supported program can be used to buttress internal commitment to reform that may be weak, uneven within the government, or besieged by special interests or political pressures.'* (ibid, p.14).

As noted above, IMF policy advice might serve a useful purpose but the IMF should not be in a position where it can exert near-absolute power over the reform path. Some of the interest groups referred to in the above quotation probably have more legitimacy than the IMF in exerting pressure over political decisions (e.g. local trade unions).

IMF financing under the PRGF is provided in the form of loans with limited concessionality. The interest rate is 0.5 percent and the loans have to be repaid over a period of 10 years (with 5 years' grace). This compares poorly to other types of development-oriented loans with much higher concessionality levels.

Currently the IMF lends approximately SDR 1 billion (US$1.45 billion) per year through the PRGF. This amount is envisaged to shrink over the coming years as the PRGF is supposed to become self-sustainable from 2006. According to IMF estimates this would imply a reduction in IMF lending to approximately SDR 600 million per year (US$870 million). Staff find that this is insufficient to meet future requirements for IMF financing in LICs.

In the paper 'The Role of the IMF in Low-Income Countries' the IMF highlights the importance of distinguishing between long-term development financing, adjustment financing and financing to help countries cope with external shocks. The IMF emphasises it only provides the latter two (IMF 2003, p. 23).

This paper proposes the IMF should decrease its financing to low-income countries progressively and eventually bring it to an end as part of a general move from adjustment financing towards long-term development financing, delivered by other donors (see also Section 3.2 and Box 8).

Adjustment lending has proven inefficient over the last two decades in enabling low-income countries to initiate sustainable economic recovery and to address their massive poverty problems. Moreover IMF resources are expensive compared to other sources of financing and the lack of mechanisms to hold the IMF accountable in cases of failure enhances the necessity of such a change.

The IMF should disengage from adjustment lending activities in LICs over a time horizon of about 10 years. Moving to a self-sustained PRGF could be a first step in this direction. Pro-poor growth has to be approached in a framework of long-term development rather than short-term adjustment. The IMF's disengagement from adjustment lending would have to be counterbalanced by an increase in the availability of long-term development finance (including debt cancellation).

[24] Debt Relief International, 2004, p. 11.

The IMF could also maintain a resource envelope to assist countries cope with external shocks, provided that the parameters for engagement in lending in such situations clearly identify a graduation strategy.

6.3 Ex-post assessments

Ex-post assessments on the design and implementation of IMF-supported programmes have recently been introduced in response to the IEO's evaluation of prolonged use of IMF resources. The responsibility for conducting these assessments should be transferred to the Independent Evaluation Office and remain with this office until IMF programme relationships are phased out (in line with the recommendation above).

It is evident that as long as ex-post assessments are undertaken by staff involved in negotiating and reviewing existing programmes they generally won't critically address failures caused by the IMF. A case in point here is the recent ex-post assessment of the IMF's programme in Zambia (IMF 2004i). This assessment raises virtually no critical questions about the IMF's role and responsibility for three decades of economic decline and the failure of two continuous IMF-supported programmes (both the 1995 – 1997 ESAF and the 1999 – 2002 ESAF/PRGF expired while being off track). The IMF failed to meet its objectives of bolstering economic development and thereby reducing impoverishment.

The ex-post assessment for Zambia does not address issues such as participation or alignment. It touches briefly on ownership, but only in a defensive manner. The public concerns about privatisation and fiscal austerity are related to *'popular misgivings over economic reforms and the role of the IMF'*, not to the disastrous experience with the privatisation of mining activity to KCM and RAMCOZ[25] or having to bear the burden of 'adjustments' when living on a wage that does not cover basic needs. The assessment does not consider whether the reforms were unrealistic from a political economy perspective. The IMF's 'solution' to the lack of ownership is reflected in the following quote:

> *'…the authorities' advocacy of the chosen policy path assumes a particular importance in demonstrating ownership at the highest levels of government and convincing a sceptical public and often hostile local press that policies are not 'imposed' from the outside.'* (IMF 2004i, p.14)

Ownership is apparently not about genuine commitment to a reform programme but only about *demonstrating* ownership of it. Rather than being included through consultation the public and the press should be *convinced* about the feasibility of the programme and told that the IMF is not responsible for its content.

The prioritisation of communications over domestically-owned policy content is not an isolated incident. This is illustrated in the IMF staff response to the IEO report (see Section 3. 4), which proposes that the government communicate its 'ownership' to other partners and domestic stakeholders and proposes to 'explain' why the PRGF differs from the PRSP (IMF 2004e, p.7-9).

The IEO is well positioned to take on the responsibility for conducting ex-post assessments. The office has access to internal IMF policy papers, staff at all levels, and an appreciation of the IMF's culture. On the other hand the office has demonstrated an independent view on the challenges facing the IMF and the IEO. Conducting the assessments would therefore not be perceived entirely as an 'inside job'. The IEO should continue to conduct overall evaluations but its mandate (and resource envelope and number of staff) should be extended to carry out ex-post assessments of programmes.

In 2005 the IEO has programmed a country case study that will *'provide an illustration of the scope for learning from a systematic ex-post assessment of IMF operations in a country'* (IEO 2004c). This should mark the first step in the direction of the IEO taking the full responsibility for these assessments.

With regard to the forthcoming IEO evaluation of an ex-post assessment, this paper recommends that the IEO looks at a low-income country with a history of a difficult relationship with the IMF, such as Honduras or Zambia.

[25] A few months after having taken over operations, KCM pulled out citing failing copper prices on the international markets. In the case of the Luanshya mine, the company that took it over (RAMCOZ) turned out to not have any experience in mining. The takeover was motivated by an interest in selling the company's assets. In both cases this imposed huge costs on the government which had to step in to try to solve a potentially catastrophic political and social situation.

6.4 A more partnership-oriented IMF

This paper fully endorses the IEO recommendation that the IMF should become more partnership-oriented: *'strong coordination elements rather than 'stand alone' approaches need to be built in from the outset, whether it be with respect to PSIA, conditionality, or decisions on overall external financing'* (IEO 2004a, p.24).

In Section 6.5 a partnership-based framework that provides a progressive way forward for the IMF and other stakeholders in the PRSP approach is outlined. Firstly a number of partnership-specific issues the IMF has to address in the ongoing review of its role in low-income countries are discussed.

Real policy advice

A more partnership-oriented IMF would play an advisory role only (except in the case of shocks) and focus on trying to maximise the finance available for development, rather than being responsible for turning aid flows on and off and prioritising the safeguarding of its own resources over poverty reduction.

Staff would have to engage in public debates about macroeconomic policies without being able to force a solution through. This would require country-specific, evidence-based arguments for policy choices and better linkages with non-governmental stakeholders. In this vein the IMF could potentially become a proactive player in democratising macroeconomic policymaking.

Stronger presence on the ground

For this new role to be effective the IMF would have to decentralise and strengthen its presence on the ground. A recurrent theme among donors and CSOs in the countries this study has looked into is that the lack of staff presence makes it hard to build a day-to-day working relationship with the IMF.

Other IFIs, donors, and NGOs realised the value of decentralisation a long time ago. The OED report noted that country authorities found *'decentralisation of Bank staff and authority to country offices was especially helpful because staff in the country office are more effective than sector missions from Washington at considering alternative viewpoints and ceding control to the ministry'*, (OED 2004, p.11).

Currently, the IMF country presence is limited to a Resident Representative, which means there is little capacity for substantial involvement with civil society organisations or the donor community. PRGF-supported programmes are negotiated following a process of internal discussions in Washington during which an IMF position is reached. Thereafter, a mission arrives in the country and typically negotiates for up to two weeks. The intensity of the mission leaves little time for discussing the broader political and economic context with government representatives outside the ministry of finance, or with donors and civil society.

A stronger resident mission would be better equipped to carry out surveillance; feed in to Poverty and Social Impact Assessments; provide timely and relevant policy advice to the government; and participate actively in different fora (donor coordination, macroeconomic working groups, public fora etc.). This would be a prerequisite under the 'alternative architecture for alignment' proposed below.

More interdisciplinary IMF

The IMF should cultivate a less mono-cultural approach to its core area of competence. The IMF has previously experimented with employing 'poverty experts' and has included staff with such a profile in country missions. This way of working should be mainstreamed by engaging more staff with interdisciplinary skills. The main purpose of this would be to bridge the gap in understanding between what Ravi Kanbur has described as 'finance ministry groups' and 'civil society groups' (Kanbur, 2001).

In the same vein the IMF should adopt a specific recruitment policy of employing people with an academic background in development economics and with experience of working in developing countries.

Allocation of staff resources

It ought to be self-evident that the IMF has to invest more resources in servicing its low-income country members if it is to deliver on its promises to strengthen its approach and capacity to assist reducing poverty. However it is astonishing to learn from the IEO report that this has not been the case so far.

> *'The share of total IMF administrative expenses devoted to PRSP / PRGF issues was 11.5 percent in FY2003, only slightly higher than the 10.8 percent allocated to ESAF*

activities in FY1999. PRGF countries in Africa appear to have received even less staff resources than other PRGF countries: on average of 2? full-time equivalent (FTE) staff-years per annum as against 3? staff-years for non-African countries.' (IEO 2004a, p.119).

This is possibly one of the IEO's most important findings as it provides a clear picture of the IMF's real concerns. It could be interpreted from this information that the IMF is not truly concerned about poverty. The immense investment in improving the organisation's image as being 'pro-poor' has not been balanced by any serious changes in the allocation of staff resources towards the organisation's servicing of its low-income country members.

The finding is a serious indictment of the IMF's support for the PRSP approach and it is an issue that will have to be addressed immediately. This paper calls upon the International Monetary and Financial Committee, the highest authority of the IMF, and on its Chairman Gordon Brown in particular, to address this issue within the financial year 2005 and to introduce a substantial change in the allocation of resources to low-income countries and African countries in particular.

6.5 An Alternative Architecture for Alignment

One of the critical questions asked in the IEO paper was: what happens when the macroeconomic framework in the PRSP is an insufficiently clear or strategic guide to policy making? What are the implications for the IMF in terms of alignment to country-owned policy?

In the 2004 Progress in Implementation report, staff say that *'BWI activities, including lending operations, would continue to be based on PRSPs'* (World Bank / IMF 2004, p.43).

However, as our analysis shows, IMF programs are not based on PRSPs at present, particularly in countries which are most critically in need of stabilisation and external finance.

As demonstrated, the problem with aligning PRGFs with PRSPs is not merely a transitional issue. The lack of willingness to align demonstrates the IMF has not moved beyond its traditional way of doing business in LICs. It continues to use its powerful position as gatekeeper for finance to impose conditionality which has not been subject to the promised PSIAs, continues to promote traditional neo-liberal policy measures and does not take local political constraints onto account.

An 'alternative architecture' is therefore proposed, which would draw the IMF into a partnership framework designed to strengthen the design and implementation of macroeconomic policies which reduce poverty, create sustained growth and are genuinely country-owned.

It should be noted though that a structural solution will not change the current PRSP dynamics as long as the IMF continues to promote a narrow macroeconomic model and holds a gatekeeper role which allows it to impose this model. Therefore, PSIA work on IMF analysis is critical (see Section 5.3). It must be given additional weight in the IMF in determining not just policy for individual country programmes, but to feed into a fundamental rethink of the overall direction of IMF policy. In addition, independent research, which can input into policy advice to governments, is also critical and should be supported by donors in a non-directive manner.

Alignment: a long-term framework

Over the medium-term, the role of the IMF must be to work in partnership with the authorities, donors and other stakeholders to develop a PRSP framework for decision-making, including macroeconomic policy. Where **new PRSPs** are being prepared, the process outlined here should be applied.

Donors (including the World Bank and IMF), government, civil society and the private sector would come together in macroeconomic working groups or roundtables to:

- analyse the implications of the broad PRSP objectives for macro-economic policy;
- assess the need for and implications of PSIA-type analysis in different areas;
- determine intermediate objectives;
- outline key institutional processes for achieving those objectives;
- identify capacity and / or resource gaps for achieving the objectives;
- identify how to fill those gaps in a coordinated manner, including domestic and external resource mobilisation.

This would also involve agreement on a set of commitments, including:

- on the donors side - a conditionality matrix which does not extend beyond agreed objectives and targets and which includes PRGF conditionality;
- on the civil society side - agreeing parameters for wage agreements and other fundamental public policies impacting on the fiscal balance;
- on the government's side - commitment to transparency and accountability, directed primarily at domestic stakeholders (parliament, civil society etc.).

Conditionality, including macroeconomic conditionality, should be determined under a donor / government partnership agreement. All conditionality should be clearly outlined in a joint conditionality matrix and should be derived from the PRSP. The conditions under which donors would reduce or suspend aid should be agreed between all donors and the Government, replacing the IMF's **signalling** role. Civil society and parliamentarians should have a rule- and rights-based role in inputting to and monitoring this conditionality / performance assessment framework.

While somewhat complex, such a system is not unfathomable. Indeed, it may build on what already exists in many countries, such as donor consultative group meetings, donor Performance Assessment Frameworks or PRSP macroeconomic working groups.

From 'Joint Staff Advisory Notes' (JSANs) and 'Annual Progress Reports' (APRs) to Joint Partner Approaches

In the 2004 Progress in Implementation Report the IMF and Bank staff propose changing the Joint Staff Assessments to 'Joint Staff Advisory Notes'. The BWIs state that the purpose of the JSAN will be to give feedback to both the country authorities and the Executive Directors of the Bank and IMF. However, under this proposal the feedback to authorities will be nothing more than a warning to implement existing conditions or prepare for forthcoming ones.

Under the above partnership system however, the functions which the BWIs refer to could easily be fulfilled without sacrificing country ownership. The 'partnership forum' could carry out a collective review of the macroeconomic section of the PRSP and its implementation, identifying weak areas and follow up actions with accountabilities for all stakeholders.

The resulting 'Joint Partner' report or assessment would update external actors on progress, and could include annexes giving the particular views of individual actors, including the BWIs. It would replace both the JSAs and APRs and would provide a report for BWI Boards (according to domestic timetables), while the feedback to authorities would take place within the partnership forum.

Rules of the Game

The major implications of this proposal for the IMF's way of business are relinquishing control and sharing responsibility with a group of partners in a genuine sense.

The IEO highlighted the lack of clarity of the roles different actors were to play under the PRSP approach. We support the IEO proposition that country-specific 'rules of the game' should be developed to outline precisely the commitments from each stakeholder. These should be developed in the above-described multi-stakeholder economic forum or, ideally, a broader forum under the PRSP framework.

Given the nature of the IMF's work in responding to crises, an agreed procedure for entering lending arrangements in emergency situations without compromising the tenets of a nationally agreed macro-framework or the agreed conditionality matrix would have to be agreed. This would also be included under the 'rules of the game'.

Short-term: aligning the PRGF with weak PRSPs

Recognising that moving towards such an approach would take time however, some minimum interim steps around the negotiation of PRGF-supported programmes must be taken. In order to address the issue of PRGF alignment with weak PRSPs, it is proposed that the *principles* underpinning the PRSP process are applied to developing a macroeconomic framework for the PRGF.

(i) Aligning new PRGFs to existing PRSPs: The IMF should open up PRGF processes on the basis of PRSP principles. That is:

- draft PRGF documents should be released to all stakeholders in a timely fashion to allow informed debate on the government's options;

- IMF staff should outline the rationale and assumptions behind their policy proposals and illustrate how they are derived from the PRSP;
- independent PSIAs should be carried out on any contested areas;
- the HIPC initiative should be delinked from the PRGF to allow debt relief and donor resources to be disbursed.

No new PRGF should be finalised until it has gone through this process.

(ii) Aligning existing PRGFs to new PRSPs: In situations where a PRGF is in place before a second generation PRSP is developed, the existing PRGF should be subject to a fundamental review. The following steps should be followed in a macroeconomic working group led by government and including donors, civil society, the private sector and other stakeholders.

This group would:

- analyse the implications of the PRSP objectives for macroeconomic policy;
- assess the need for and implications of PSIA-type analysis in different areas;
- debate and agree intermediate objectives;
- outline key institutional processes for achieving those objectives;
- identify capacity and / or resource gaps for achieving the objectives;
- identify how to fill those gaps in a coordinated manner, including domestic and external resource mobilisation;
- revise the PRGF to fit within the parameters and targets agreed by the forum.

7. Conclusions and Recommendations

7.1 Conclusion

The IMF has a large unresolved agenda to address before it can claim that it has made the transition to becoming a genuine partner in eradicating poverty.

This paper finds that progress in implementing the key features of the PRGF has been slow and uneven across countries. In countries facing unstable political situations and economic governance problems, such as Honduras and Zambia, the IMF has not changed its way of operating and has not been willing to explore alternatives to its standard neo-liberal policies.

This paper analysed the implementation of the key features of the PRGF in Honduras, Zambia and Rwanda. On alignment, it finds that the PRGF determines the macroeconomic framework for countries which rely on the PRGF to send a positive signal to other donors and to get access to debt relief. Whereas the macroeconomic framework in the PRGF was supposed to be driven by the PRSP, the reverse happens in reality. This is not a transitional problem, but one which is being repeated as second generation PRSPs fall due in Honduras, Zambia and Rwanda.

Ownership has been undermined by the imposition of macroeconomic policy through conditionalities which are not rooted in the local political context and which do not take account of poverty and social impacts. The IMF has failed to grasp important opportunities to engage in policy debate. More importantly, evidence from the staff response to the IEO review suggests that staff are not prepared to open up debates on the PRGF to broader participation.

Flexibility in fiscal targets has been extremely limited for countries which face local political opposition to austere macroeconomic and structural reform. There is no evidence that the IMF has supported pro-poor budgets in countries which have difficulty in meeting its macroeconomic targets. As a result, countries such as Honduras and Zambia repeatedly fail to fulfil PRGF conditions, go off track and experience disruption in donor aid flows for poverty reduction. This has enormous costs in terms of disruption to already weak budgetary processes.

A fundamental problem with the IMF's approach is that it has been largely unwilling to take challenges to its neo-liberal macroeconomic model on board and show more openness to alternatives. PSIA work on IMF analysis is critical and must be given additional weight in determining not just policy for individual country programmes, but to feed into a fundamental rethink of the overall direction of IMF policy.

The PRGF cannot be claimed to be a 'good fit' for low-income countries, contrary to the assertion in the IMF's September 2003 paper: '*Role of the Fund in Low-Income Member Countries over the Medium Term*'. This is particularly true for countries facing domestic and economic instability.

For most low-income countries, fiscal deficits are structural and long-term in nature. This paper advocates radical reform of the PRGF instrument therefore, as it is an expensive and inappropriate approach to returning such countries to stability. The IMF should cease to engage in adjustment lending to low-income countries. IMF adjustment lending should be replaced by predictable multi-annual aid flows from other donors. Donors should provide support to improve public financial management and provide consistent, long-term support to civil society to build capacity for analysis, monitoring and advocacy on public expenditure and debt management.

This paper therefore strongly encourages the IMF to review its conclusion that the PRGF is an appropriate instrument and that lending to LICs should continue in the current vein over the medium-term.

At a broader level, the framework around the PRSP needs to be radically reformed on the basis of partnership and ownership. This paper outlines a long-term 'alternative architecture' for the PRSP approach, in which the IMF would play an equal role with other donors and focus on providing policy advice only, except in the case of shocks. The paper proposes to replace the IMF's signalling role with country-based agreements on the conditions under which aid would be suspended or reduced.

In conclusion, the IMF should reform its role over the medium-term in line with the recommendations outlined throughout this paper and summarised below.

7.2 Summary of Recommendations

7.2.1 Alignment with the PRSP approach

Alignment: a long-term framework

Over the medium-term, the role of the IMF must be to work in partnership with the authorities, donors and other stakeholders to develop a PRSP framework for decision-making, including macroeconomic policy. Donors (including the Bank and IMF), government, civil society and the private sector would come together in macroeconomic working groups as part of the PRSP process to:

- analyse the implications of the broad PRSP objectives for macroeconomic policy;
- assess the need for and implications of PSIA-type analysis in different areas;
- determine intermediate objectives;
- outline key institutional processes for achieving those objectives;
- identify capacity and / or resource gaps for achieving the objectives;
- identify how to fill those gaps in a coordinated manner, including domestic and external resource mobilisation.

This would also involve agreement on a set of commitments, including:

- on the donors side - a conditionality matrix which does not extend beyond agreed objectives and targets and which includes IMF conditionality;
- on the civil society side - agreeing parameters for wage agreements and other fundamental public policies impacting on the fiscal balance;
- on the government's side - commitment to transparency and accountability, directed primarily at domestic stakeholders (parliament, civil society etc.).

All donor conditionality should be derived from the PRSP and should be clearly outlined in a matrix, including macroeconomic and structural reforms. These should be agreed under a joint donor / government 'harmonisation and performance assessment' framework. This framework should include accountability mechanisms for all actors.

The conditions under which donors would reduce or suspend aid should be agreed between all donors and the Government in such a 'harmonisation and performance assessment' framework, replacing the IMF's **signalling** role. Civil society and parliamentarians should have a rights- and rule-based role in inputting to and monitoring this conditionality / performance assessment framework.

As recommended by the IEO, 'Rules of the Game' must be drawn up at country-level, clearly outlining the roles and responsibilities of each stakeholder.

Alignment with weak PRSPs: immediate measures

As a short-term measure, the paper proposes that the principles underpinning the PRSP approach be applied to the development of any new PRGF. That is, all stakeholders who should ordinarily participate in a PRSP macroeconomic working group, or similar structure, should be brought together to feed into the PRGF debate. Then:

- the IMF should release draft PRGF documents to all stakeholders in order to allow informed debate on the government's options;
- IMF staff should outline the rationale and assumptions behind their policy proposals for PRGF programmes;
- independent PSIAs should be carried out on any contested policy proposals;
- no PRGF should be finalised until it has gone through this process.

In order to address the signalling problem, the joint donor / government 'harmonisation and performance assessment' should be put in place in the immediate term. IMF staff at headquarters should promote this amongst potentially reluctant donors and local staff.

7.2.2 Recommendations for operational changes

Lending policy and financing

- Over the medium-term, the IMF should cease to engage in adjustment lending to low-income countries and concentrate on providing policy advice uncompromised by conditionality.
- The IMF's lending role should be limited to short-term mitigation of the impact of shocks, with a clear graduation strategy and a commitment to seek longer-term finance from other donors.
- The PRGF / PRSP should be delinked from the HIPC initiative to allow debt relief resources flow. The IMF should ensure that its

technical support strengthens public expenditure management and government accountability to national stakeholders, including through supporting domestic parliamentary and public oversight processes.
- The IMF should fulfil its commitment to seeking increased resource commitments from other donors in order to support implementation of pro-poor budgets and country-specific MDG targets, based on costing by competent non-IMF actors.

Policy direction and advice

- The assumptions underpinning the IMFs standard macroeconomic policies must be subject to internal and external challenge. As a contribution to this, an independent group of external advisors should be set up to feed into the PSIA team's choice of PSIAs and to make recommendations to PDR and Board members about their implications for overall IMF macroeconomic policy.
- The IMF should work with authorities based on their own identification of needs. It should limit its advice to its core areas of competence (e.g. fiscal, monetary, exchange rate policy). This should be an advisory role only.
- The IMF's role in analysis of micro-macro linkages should be to contribute macro-economic analysis in its core areas of competence to collaborative work with other stakeholders, e.g. on the trade-offs and impacts associated with different economic policy choices.

Transparency and analysis

- The IMF should make draft PRGF documents, background analysis and staff reports available to the public in a timely and accessible manner;
- The IMF should make the assumptions and rationale underpinning its proposed fiscal targets and structural conditionality open to public scrutiny;
- The IMF should subject proposed fiscal and structural reforms to independent PSIAs by enabling the PSIA team to contract out independent analysis. It should mobilise funding from within the IMF or from other donors for this purpose.
- In cases of resource constraint, the IMF should prioritise PSIAs on reforms that are contested by national governments or other legitimate stakeholders (trade unions' congresses, parliamentary bodies, national civil society networks etc.).

Review of Structural Conditionality

- The forthcoming IEO Review of Structural Conditionality must include a comprehensive review of: the IMF's definition of when structural reforms can be deemed critical to the success of the IMF's macro-economic reform programs and the degree of cross-conditionality or overlap between Bank and IMF programs.
- Documentation of all structural conditionalities across Bank and IMF programs should be streamlined and made easily accessible to the public.

Review of Fiscal Flexibility

- A comprehensive review of the IMF's performance on fiscal flexibility should be carried out by the IEO. The review should examine the IEO's recent findings that fiscal flexibility has generally improved and subject them to more rigorous analysis. The analysis should be disaggregated in order to allow an assessment of IMF flexibility in poor performers.

Ex-Post Assessments

- The responsibility for conducting ex-post assessments of PRGF-supported programs should be transferred to the Independent Evaluation Office, whose mandate, resource envelope and number of staff should be extended to meet this task.
- In 2005 the IEO's programmed country case study should examine a low-income country with a problematic relationship with the IMF (for example, Honduras or Zambia).

Human resources

- The International Monetary and Financial Committee should instruct staff and management to reverse the decline in allocation of personnel to the needs of low-income members, and sub-Saharan African countries in particular, within the financial year 2005.
- The IMF should transfer increased staff and decision-making authority to country offices.
- The IMF should adopt a specific recruitment policy of employing people with an academic background in development economics and with experience in working in developing countries.

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