

Independent Evaluation Office

# Annual Report 2003



International Monetary Fund

2002



Established by the IMF's Executive Board in July 2001, the Independent Evaluation Office provides objective and independent evaluation on issues related to the IMF. The office operates independently of IMF management and at arm's length from the IMF's Executive Board. It enhances the learning culture of the IMF, promotes understanding of the IMF's work, and supports the IMF's Executive Board in its governance and oversight. Further information on the office and its work program can be found on its website ([www.imf.org/ieo](http://www.imf.org/ieo)).

*Photographs:*

Top: IEO Director (center) and staff at a press briefing in Washington.

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Center: IEO staff meeting at its offices in Washington.

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Bottom: Participants at an IEO workshop in Berlin.

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Independent Evaluation Office

# Annual Report 2003



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The following symbols have been used in this report:

– between years or months (e.g. 2002–03 or January–June) to indicate the years or months covered, including the beginning and ending years or months;

FY to indicate a fiscal (financial) year. FY2003 is May 2002 to April 2003 and FY2004 is May 2003 to April 2004.

“Billion” means a thousand million.

Some of the documents cited and referenced in this report were not available to the public at the time of publication of this report. However, under the current policy on public access to the IMF’s archives, some of these documents will become available five years after their issuance. They may be referenced as EBS/YY/NN and SM/YY/NN, where EBS and SM indicate the series and YY indicates the year of issue. Certain other documents are to become available ten or twenty years after their issuance, depending on the series.

## Message from the Director



**T**he Independent Evaluation Office (IEO) was established by the Executive Board in 2001 with a view to increasing transparency and accountability and strengthening the learning culture in the International Monetary Fund. This first *Annual Report* summarizes the activities of the IEO from its establishment through the first full year of operation.

The report provides a summary of the main findings and recommendations of the first three evaluation projects on the prolonged use of IMF resources, the role of the IMF in recent capital account crises, and the role of fiscal adjustment in IMF-supported programs. It also indicates the status of ongoing evaluation projects on the IMF's experience with Poverty Reduction Strategy Papers (PRSPs) and the Poverty Reduction and Growth Facility (PRGF); the role of the IMF in Argentina, 1991–2002; and IMF technical assistance. The report also discusses, in Chapter 4, several common themes emerging from these evaluations.

The effectiveness of the IEO in achieving its stated objectives will depend critically upon the quality and credibility of its evaluations and this in turn depends upon the quality of human resources, the independence of the office, and the transparency of its procedures. I believe the IEO has made good progress on all three counts. We have succeeded in assembling a high-quality international team of experts, with the right mix of insiders and outsiders, to undertake the difficult and complex task of evaluating the activities of the IMF. We have been given an exceptional degree of independence, while receiving unfettered access to IMF internal documents and access to staff.

To ensure that our procedures live up to expected standards of transparency, we have developed practices, described in detail in the report, which provide opportunities for interested stakeholders to interact with the IEO at various stages, including defining the work program and determining the detailed terms of reference of individual studies. Opportunities are also provided for submitting substantive inputs on items included in the terms of reference of each study.

The IEO website ([www.imf.org/ieo](http://www.imf.org/ieo)) provides a valuable opportunity to inform interested stakeholders of our work and to receive comments. We welcome feedback from concerned stakeholders on both our ongoing work and our future work program.

A handwritten signature in black ink, which reads "Montek S. Ahluwalia". The signature is written in a cursive style.

Montek S. Ahluwalia

# Abbreviations

CCL	Contingent Credit Line
CSO	Civil society organization
DAC	Development Assistance Committee
ECG	Evaluation Cooperation Group
EFF	Extended Fund Facility
ESAF	Enhanced Structural Adjustment Facility
FSAP	Financial Sector Adjustment Program
FSSA	Financial System Stability Assessment
FSU	Former Soviet Union
HIPC	Heavily indebted poor country
HRD	Human Resources Department
IEO	Independent Evaluation Office
IFI	International financial institution
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee
JSA	Joint Staff Assessment
NGO	Nongovernmental organization
OECD	Organization for Economic Cooperation and Development
OED	Operations Evaluation Department
PEM	Public expenditure management
PIN	Public Information Notice
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
PSI	Private sector involvement
ROSC	Report on the Observance of Standards and Codes
SBA	Stand-By Arrangement
SRF	Supplemental Reserve Facility
TA	Technical assistance
VAT	Value-added tax

# The Independent Evaluation Office: Objectives and Modes of Operation

Independent evaluation is widely regarded as an essential requirement in international financial institutions, contributing to increased transparency and accountability and strengthening the process of learning from experience. The IMF had a long tradition of internal evaluations of its operations and policies that were regularly submitted to the Executive Board and led to new directions on policy and procedure. However, it did not have a mechanism for independent evaluation of its activities until the establishment of the Independent Evaluation Office (IEO) by the Executive Board in the second half of 2001.

This chapter provides a review of the background in which the office was created, outlines the main objectives as set forth in the terms of reference, and describes the operational modalities that have been developed by the IEO to achieve these objectives.

## Historical Background

The establishment of the IEO was the culmination of several years of deliberation on the need for independent evaluation. The process began in 1992, when the Managing Director set up a task force to examine the case for establishing a separate office to conduct independent evaluations of various aspects of the IMF's activities to supplement internal evaluation. The task force concluded that the IMF would benefit from a systematic appraisal of its activity by well-qualified people who could stand back from the day-to-day operations of the institution. This led to a proposal by management to establish a separate evaluation office in the IMF which would report to the Managing Director, but with provisions to ensure that the Executive Board would play a substantive role in guiding its activities. The proposal was considered by the Executive Board on January 22, 1993 but no consensus was reached at the time.

The need for independent evaluation was again highlighted at the time of the Mexican crisis in 1994, especially in the wake of a report by an outside expert which identified weaknesses in IMF surveillance of Mexico. This led to a broad understanding on the

need for expanding the evaluation process along three fronts: continuing with self-evaluation; conducting internal evaluations by the Office of Internal Audit; and, as a new departure, undertaking two or three independent evaluations per year by groups of outside experts. In the period 1996–99, the Office of Internal Audit and Inspection conducted a review of the resident representative program and a review of IMF technical assistance.<sup>1</sup> The Executive Board also commissioned external experts to undertake three studies on the IMF's experience with its Enhanced Structural Adjustment Facility (ESAF), on IMF surveillance, and on the research activities of the IMF.<sup>2</sup>

The crises in East Asia in 1997 and in Russia and Brazil in 1998 led to widespread criticism of the effectiveness of IMF procedures and policies, and this refocused attention on the need for independent evaluation on a more systematic basis to improve transparency and increase accountability. The issue was extensively discussed in nongovernmental fora, including the academic community and civil society organizations (CSOs). Against this background, the experience with the expanded approach to evaluations was again reviewed in early 2000.<sup>3</sup> Key nongovernmental inputs which fed into the review were the report of the special study group convened by the Center of Concern<sup>4</sup> and a joint paper produced by the Bretton Woods Project and Friends of the Earth US.<sup>5</sup>

<sup>1</sup>"Review of Fund Technical Assistance" (EBAP/99/59 and Supp. 1, 5/17/99), prepared by the Office of Internal Audit and Inspection.

<sup>2</sup>"External Evaluation of the Enhanced Structural Adjustment Facility" (EBS/98/32, 3/2/98), "External Evaluation of Fund Surveillance" (EBAP/99/86, 7/15/99), and "External Evaluation of the Fund's Economic Research Activities" (EBAP/99/85, 7/15/99).

<sup>3</sup>See "Review of Experience with Evaluation in the Fund" prepared by the Evaluation Group of Executive Directors, March 14, 2000 (<http://www.imf.org/external/np/eval/2000/031400.HTM>).

<sup>4</sup>Jacques J. Polak, *IMF Study Group Report: Transparency and Evaluation* (Washington: Center of Concern, 1998).

<sup>5</sup>Angela Wood and Carol Welch, "Policing the Policemen—The Case for an Independent Evaluation Mechanism for the IMF," Bretton Woods Project and Friends of the Earth US, April 1998 (<http://www.brettonwoodsproject.org/article.shtml?cmd%5B126%5D=x-126-16312>).

Following this review, the Executive Board decided to establish an independent evaluation office in the IMF, a decision that was welcomed by the International Monetary and Financial Committee (IMFC) in its April 2000 communiqué. The operational modalities of the IEO were subsequently outlined in a background paper which was considered by the Executive Board in August 2000.<sup>6</sup> The paper was also posted on the IMF website to provide an opportunity for public comment. On the basis of the August discussions and inputs received from the public, terms of reference for the IEO were prepared outlining its purpose, scope, and basic modalities, as well as its relationship to management and the Executive Board (see Appendix 1). These were approved by the Executive Board and endorsed by the IMFC in its meetings in September 2000.

The Executive Board, in July 2001, appointed Montek Singh Ahluwalia, who was at the time Member of the Indian Planning Commission and had earlier served as Finance Secretary in the Government of India, as the first Director of the IEO. The office was fully staffed by early 2002 and embarked on its work program for FY2003.<sup>7</sup>

## Purpose of the IEO

The purpose of the IEO, as outlined in the terms of reference, is to systematically conduct objective and independent evaluations “on issues, and on the basis of criteria, of relevance to the mandate of the Fund.” The terms of reference further elaborate that the IEO is intended to:

- Serve as a means of enhancing the learning culture of the IMF.
- Strengthen the IMF’s external credibility.
- Promote greater understanding of the work of the IMF throughout its membership.
- Provide independent feedback to the Executive Board in its governance and oversight responsibilities over the IMF.

The work of the IEO is envisaged as complementing the review and evaluation work being conducted within the IMF and is expected to improve the IMF’s ability to draw lessons from its experience and to integrate more quickly improvements into its future work.

<sup>6</sup>See “Making the IMF’s Independent Evaluation Office Operational: A Background Paper” prepared by the Evaluation Group Directors, August 7, 2000 (<http://www.imf.org/external/np/eval/evo/2000/Eng/evo.htm>).

<sup>7</sup>The IMF’s financial year begins on May 1 and ends on April 30.

## Independence

Independence is critical for the credibility of evaluation and this aspect was greatly emphasized in the Executive Board discussions which led to the establishment of the office. The terms of reference explicitly state that the “IEO will be independent of Fund management and staff and will operate at arm’s length from the Fund’s Executive Board.” The following provisions are designed to achieve this objective:

- The Director of the IEO is appointed solely by the Executive Board; IMF management, while it may be consulted in the selection process, is not involved in making the selection.<sup>8</sup> The Director is specifically precluded from appointment or reappointment to an IMF regular staff position at the end of the term of office.
- With a view to ensuring that the IEO is staffed with independent and highly qualified individuals, the Director of the IEO is solely responsible for the selection of IEO personnel, a majority of whom must come from outside the IMF.<sup>9</sup> IEO staff report exclusively to the Director of the IEO and not to IMF management.
- The budget of the IEO is prepared by the Director and submitted directly to the Executive Board for approval. Management is not involved at any stage of the process.
- The IEO’s work program is determined by the Director in the light of consultations with members of the Executive Board and other interested stakeholders, from both inside and outside the IMF. The work program determined by the Director is presented to the Executive Board for review, but is not subject to the Board’s approval.

The terms of reference of the IEO provide that within three years of the launch of IEO operations, the Executive Board should initiate an external evaluation of the IEO to assess its effectiveness and to consider possible improvements to its structure, mandate, operational responsibilities, or terms of reference. The review is expected to solicit broad-based input from outside the official community.

## Budget and Staffing

The IEO’s current budget is calibrated to allow the office to achieve a steady-state level of output equiva-

<sup>8</sup>The terms of reference provide for a four-year term, renewable for a second term of up to three years.

<sup>9</sup>The maximum length of appointment for full-time staff in the IEO is six years.

### Core Set of Topics for the IEO's Medium-Term Program

1. Fiscal adjustment in IMF-supported programs.
2. A group of three capital account crisis cases, that is, Indonesia, Korea, and Brazil.
3. Repeat use of IMF resources.
4. The experience of the IMF with the Poverty Reduction Strategy Papers (PRSPs) and the associated Poverty Reduction and Growth Facility (PRGF) (to be undertaken jointly with the World Bank's Operations Evaluation Department (OED)).
5. The IMF's advice on financial sector restructuring after a crisis.
6. Structural conditionality in Fund-supported programs.
7. The role of IMF surveillance in crisis prevention.
8. The IMF's advice on exchange rate policy.
9. The experience with Financial Sector Adjustment Programs (FSAPs) and the associated Financial System Stability Assessments (FSSAs).
10. IMF technical assistance.
11. Private sector involvement.
12. The IMF's approach to capital account liberalization.
13. The role of multilateral surveillance.
14. Additional country case (possibly Argentina or Turkey).
15. Low-income country case.

lent to four standard-size evaluations per year with the possibility of increasing the output to five evaluations per year at a later stage being kept open. The approved budget for FY2003 was about \$3.6 million and estimated actual expenditure was about \$3.3 million (Appendix 2). The approved budget for FY2004 is \$3.8 million. These amounts include staff costs, consultants, travel, outreach, and other miscellaneous costs. The IEO's budget is equivalent to 0.5 percent of the IMF's total administrative budget and is much lower than the percentages observed in the evaluation offices of other international financial institutions (IFIs), which average about 1.2 percent.

The IEO currently has 13 full-time staff positions, including the Director, the Deputy Director, nine professionals, and two administrative assistants. The majority of the staff have been recruited from outside the IMF and have wide experience in relevant areas. Since the IEO's evaluation work is expected to involve constantly changing topics, this implies a shifting need for expertise of different types. This requires a greater use of consultants than in other departments of the IMF, which also helps the IEO to maintain its independence and credibility. The budget for consultants is about a quarter of the IEO's full-time staff budget.

### The IEO Work Program

The terms of reference provide a very broad mandate for the work program of the IEO: it "should focus on issues of importance to the Fund's membership and of relevance to the mandate of the Fund taking account of current institutional priorities."

Choosing three to four studies per year from the very wide range of issues potentially eligible under the mandate necessarily requires careful prioritization. This has been achieved through extensive consultations with stakeholders inside and outside the IMF, and by using transparent criteria.

Immediately after its establishment in July 2001, a status note that identified a list of 34 possible issues for evaluation (see Appendix 3) was prepared, based on internal discussions within the IEO and some initial consultations with others. The status note was posted on the IEO website for comments and was also used in discussions with members of the Executive Board and other internal and external interested groups. Consultations were also held with representatives of civil society and academics in Washington, London, Paris, and Dakar (see Appendix 4).

On the basis of these discussions, an initial core set of 15 topics was identified (see box) from which the medium-term work program for the next three years could be drawn. The criteria used for selection gave priority to topics that (1) had been the subject of controversy or criticisms, (2) had the greatest interest for the wide range of the membership, and (3) had the greatest learning potential. Three topics were chosen from this list for the FY2003 work program:

- Prolonged use of IMF resources;
- The role of the IMF in three capital account crises: Indonesia, Korea, and Brazil; and
- Fiscal adjustment in IMF-supported programs.

All three reports have now been completed and have been discussed in the Executive Board. A brief

summary of the findings of the first three reports and the Executive Board's reaction is given in Chapter 2.

The work program for FY2004 was determined through a similar consultative procedure. A short list of five topics was identified as possible candidates for the work program from the 12 items remaining from the core set of topics for the medium term. A discussion paper outlining these five topics was posted on the IEO website on October 22, 2002 and discussed with members of the Executive Board and other groups. Based on these consultations and comments received online, the following topics were chosen for FY2004.

- The PRSP/PRGF experience based on full PRSPs;
- Country case study of Argentina; and
- The role of the IMF in providing technical assistance.

Since the evaluation of the PRSP/PRGF experience involves in-depth evaluation of six country cases and is effectively the equivalent of two projects, the work program for FY2004 corresponds to the four evaluations envisaged in planning the IEO's capacity.

Work on these projects began in the course of FY2003 and their status is presented in Chapter 3.

## Transparency and Accountability

For IEO evaluations to have credibility, it is important that they are conducted in a transparent manner, with adequate opportunity given to different stakeholders, especially those outside the IMF, to provide relevant inputs. To meet these objectives, the IEO has developed procedures which allow for extensive consultations in designing the evaluation project to begin with, and also for receiving substantive inputs during implementation.

To ensure consultation at the design stage, each evaluation begins with the preparation of an issues paper which identifies the questions to be addressed and, to the extent possible, the methodology to be followed. The IEO proactively seeks comments on this document from Executive Directors, IMF staff and management, member country governments (especially in the case of evaluations involving individual countries), and other interested observers. The issues paper is also posted on the IEO's website ([www.imf.org/ieo](http://www.imf.org/ieo)) to elicit comments from a wider set of interested external observers. Comments received in the process are taken into account in determining the final terms of reference for the study, which are also posted on the website.

The responsibility for the research undertaken and the conclusions reached must necessarily rest with

the IEO. However, in conducting its evaluations the IEO interacts extensively with concerned parties both inside and outside the IMF. A unique feature of IEO evaluations, distinguishing it from other external analyses of IMF activities, is that the IEO has access to internal IMF documents not normally made public and can also interview IMF staff concerned with the subject of the evaluation. For evaluations involving individual countries, consultations are held in the country concerned with both the authorities and a broad range of other interested parties, including civil society. Furthermore, the issues paper posted on the IEO website specifically invites interested parties to make submissions to the IEO on issues covered by the terms of reference, and some feedback has been received through this mechanism.

An important aspect of transparency and credibility is the assurance that IEO reports will be published and disseminated to a wide audience. The terms of reference provide that the reports, once they have been considered by the Executive Board, will be promptly published "unless in exceptional circumstances the Executive Board were to decide otherwise." All three evaluation reports prepared in the course of the first year have been published.

To ensure full transparency, IEO reports are published in the form in which they were submitted to the Executive Board, without being changed in any way in light of comments received from management.<sup>10</sup> Comments received on the evaluation report from IMF management, along with the IEO's reactions to those comments, if any, are submitted to the Executive Board as separate documents for the Board meeting at which the evaluation report is discussed. These documents are published together with the evaluation report and a summary of the Executive Board discussion. Once released to the public, the report is immediately posted on the IEO's website, followed by the publication of the print version.

## Outreach Activities

One of the objectives of the IEO is to promote greater understanding of the work of the IMF. Accordingly, once an evaluation report is made public, the IEO engages in external outreach to make the evaluation report and the Board's decisions on it available to a wider audience. To promote this objective, various outreach events are organized to discuss each report after publication. In addition, more easily readable summaries are prepared for a broader

<sup>10</sup>The only exception would be for purely factual corrections for which an errata page, identifying the specific corrections made, would be issued.

public and some of the IEO publications are also translated into local languages where appropriate.

During the last 18 months, the IEO participated in several outreach seminars and workshops, which are listed in Appendix 4.

### **Relations with Other Evaluation Offices**

Since independent evaluation is now a feature of all international financial institutions and there are evaluation offices in all bilateral donor agencies, there are networks of evaluation offices that exchange information on issues of mutual interest, including

methodological approaches. The IEO is a member of the Evaluation Cooperation Group (ECG), which consists of the evaluation offices of multilateral development banks and the IMF and aims to strengthen the use of evaluation for greater effectiveness and accountability as well as to share lessons and harmonize approaches (see [www.ecgnet.org](http://www.ecgnet.org)). The IEO also participates in the activities of the Development Assistance Committee (DAC) Working Party on Aid Evaluation, an international network for development evaluation experts and managers under the auspices of the Organization for Economic Cooperation and Development (OECD), which seeks to improve evaluation practice by sharing methods and experience and elaborating technical guidance.

## Evaluation Projects Undertaken in FY2002–03

This chapter provides a brief summary of the main findings and recommendations of the first three evaluation reports and the conclusions reached in the Executive Board discussion on each of these reports.

### Prolonged Use of IMF Resources

The IEO's first evaluation report focused on the phenomenon of countries having repeated access to IMF financing, which appears to conflict with the traditional perception of the role of the IMF primarily as a source of short-term financing with a

*"Prolonged Use of IMF Resources Prevents Their Proper Use"*

—*Asia Pulse*, September 26, 2002

*"IMF Lends Too Much, Too Long, says Monitor"*

—*Financial Times*, September 25, 2002

revolving use of resources. The report examined what factors account for prolonged use, whether this is necessarily a problem for either the country itself or the IMF, and if so what can be done to ameliorate the situation. A wide variety of analytical techniques were used, including cross-country analysis, detailed case studies of three prolonged users (Philippines, Pakistan, and Senegal), and desk reviews of two countries (Jamaica and Morocco) that had ceased using IMF resources after periods of prolonged use.

### How extensive is prolonged use and who are the prolonged users?

Although the issue of prolonged use has been considered earlier on several occasions, the IMF had never adopted an official definition of prolonged use. The report adopted a definition whereby any country engaged in an IMF-supported program for at least seven of the previous ten years would be classified as a prolonged user in that year. Under this definition as many as 51 of the 128 countries that borrowed in the period 1971–2000 were prolonged users at some time.

The report also found that prolonged use has increased over time. While most of the increase involved low-income countries eligible for the IMF's concessional financing, the bulk of the financial commitments to prolonged users came from the IMF's nonconcessional resources (see Figure 1). Prolonged use has also been persistent in the sense that relatively few countries "graduate" from such use. On average, prolonged users have IMF resources outstanding for 21 years (see table for a list of some of the most prolonged users).

### What causes prolonged use?

The report identified five factors which led to prolonged use, some of which represent a natural expansion of the role of the IMF in response to changing circumstances.

(1) *Broadening of the rationale for IMF program involvement.* Over time, it was accepted that many balance of payments problems, especially in low-income countries, arose from deep-seated structural problems that required more time for adjustment. This realization, which also led to the establishment of the concessional facilities in the mid-1980s, implied that IMF financing would be provided over a longer period, especially in low-income countries. However, some of the consequences of prolonged use were not explicitly recognized. As a result, a mismatch developed between the new tasks the IMF was being asked to perform and its operational approach, which is still focused on achieving a restoration of external viability within a relatively short time frame.

(2) *IMF lending as a "seal of approval" for other sources of financing.* Many donors and creditors require an IMF-supported program as a seal of approval for other aid flows such as adjustment loans from international financial institutions (IFIs), or grants from bilateral donors, or debt relief, and this contributes to expansion of prolonged use. The evaluation concluded that linking aid to IMF-supported programs can compromise the quality of programs and hence, the quality of the seal of approval. This is because this linkage raises the stakes of program negotiations to the point of putting strong pressure on

both country authorities and the IMF to reach an agreement, even though both parties may have doubts about the program's feasibility.

(3) *Programs as substitutes for surveillance.* Program involvement has at times been extended because of the judgment that surveillance was not a strong enough vehicle to achieve desired results, either in terms of signaling the soundness of the macroeconomic framework, or promoting desired policy changes. Recent efforts to make surveillance assessments more transparent, to focus more sharply on vulnerability issues, and to promote the observance of internationally agreed standards and codes help to strengthen surveillance compared to the situations for much of the evaluation period, but additional steps could be taken in this direction.

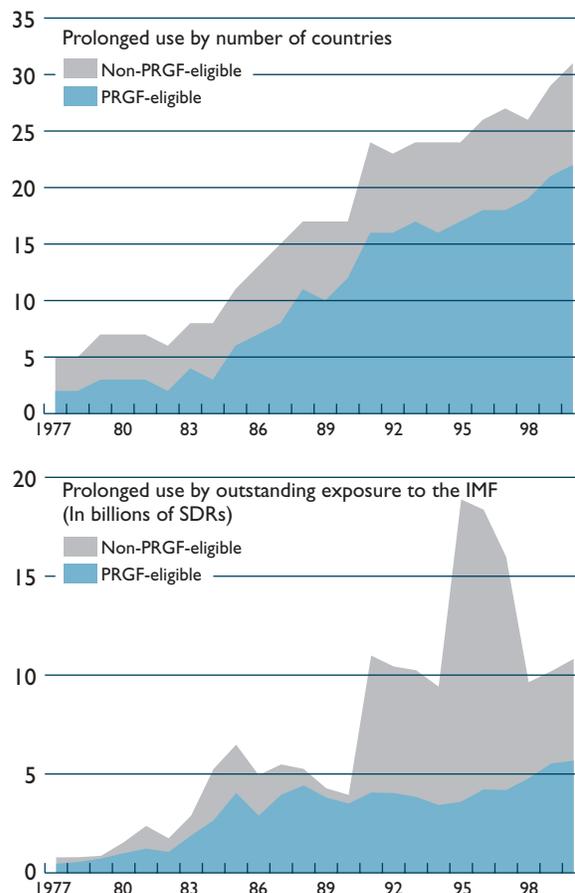
(4) *Weaknesses in program design and implementation.* Prolonged use is sometimes a reflection of program failure, possibly on account of weaknesses in program design, which leads to repeat programs. Many of the reasons why programs were ineffective were not unique to prolonged users:

- Programs are often overoptimistic in projecting real GDP growth, partly because insufficient attention was paid to analyzing how the real economy would respond to key policy measures or to assessing the expected sources of growth.
- Many programs had difficulty dealing with uncertainty, in part because there was limited ex ante discussion of the major risks and how policies would broadly respond to those risks.
- The risk to programs of weak ownership and lack of political commitment was often understated.
- There was insufficient political commitment to core policy adjustments, which is often much more important than the extent and structure of specific policy conditions in IMF-supported programs.
- Conditionality on structural policies was often exceedingly broad, without a clear order of priority among conditions, and its specification did not always ensure a good integration with program design (particularly as far as prior actions are concerned). As a result, compliance with a subset of these conditions was often sufficient for continued access to IMF resources even though it did not ensure that the most critical problems were being addressed.

(5) *IMF governance and other internal institutional factors.* Although the Executive Board has on various occasions approved the elements of a strategy to reduce prolonged use, including strengthened analytical and assessment efforts, more explicit “exit

### Figure 1. Prolonged Use Is on the Rise

Countries eligible for the IMF's low-interest (concessional) loans accounted for most of the increase in the number of prolonged users. However, nonconcessional loans accounted for most of the increase in outstanding exposure.



Sources: IMF Finance Department; and IEO staff calculations.  
PRGF = Poverty Reduction and Growth Facility.

strategies” spelling out the circumstances under which IMF support would no longer be provided, and a more proactive use of conditionality, these have not been implemented systematically. One reason for this was the absence of an explicit definition of prolonged use, which made it difficult to enforce due diligence requirements for identified cases. In addition, a number of factors related to IMF governance and procedures also contributed to prolonged use:

- Implementation capacity constraints that a program might face, related to political feasibility and ownership or to administrative capacity, are not given sufficient attention, leading to the failure of programs and repeat programs. Efforts were made to take account of these constraints

**Most Prolonged Users During 1971–2000<sup>1</sup>**

	Years Under IMF Arrangements	Number of Arrangements (of Which Precautionary Arrangements) <sup>2</sup>	Years with Outstanding Obligations Greater Than 100 Percent of Quota
Philippines	25	16 (1)	24
Panama	21	17 (10)	13
Pakistan	20	15 (0)	13
Haiti	20	15 (5)	5
Senegal	20	13 (0)	13
Guyana	20	14 (4)	12
Kenya	19	13 (1)	13
Uganda	18	9 (0)	8
Madagascar	18	11 (0)	9
Uruguay	18	16 (6)	3
Jamaica	18	12 (0)	19
Mauritania	17	10 (0)	5
Mali	17	9 (0)	4
Malawi	17	9 (0)	11
Togo	17	10 (0)	5
Argentina	16	10 (3)	19
Bolivia	16	8 (0)	5
Côte d'Ivoire	16	8 (0)	10
Ghana	14	8 (0)	8
Guinea	14	3 (1)	0

Sources: IMF Finance Department; and IEO staff calculations.

<sup>1</sup>Fifty-one countries met the definition of prolonged users at some point during the period 1971–2000. The table lists the 20 most prolonged users.

<sup>2</sup>Precautionary arrangements are arrangements where the member country's government has stated in its letter to IMF management that it does not intend to make drawings.

in best practice cases, but there are insufficient systemic incentives to ensure that such an approach is followed generally.

- Surveillance tends to be “crowded out” by program-related issues in prolonged use situations and this means there is insufficient opportunity to take a critical look at the adequacy of program design and to draw lessons from the experience of past programs. This leads to poor design of programs, contributing to repeat programs.
- Political considerations are also at the root of prolonged use in some cases. Political considerations are bound to enter into the decisions made by an institution where ultimate approval rests with shareholder governments, but the blurring of technical judgments and political considerations in such cases contributed to the dilution of accountability and lower credibility of those programs.

**Is prolonged use a problem?**

The report recognizes that prolonged use can be justified in cases where the simultaneous challenges of macroeconomic stabilization, institutional development, and structural reform take considerable time to resolve. That was the case, for example, in many

transition countries that have now “graduated” from IMF financial support and may also be true of many low-income countries. However, the evaluation suggests that prolonged use does involve significant costs that need to be borne in mind when considering the IMF’s long-term role. Specifically:

- Prolonged use may hinder the development of robust domestic policy formulation processes over time;
- There is an inherent tension between the quasi-permanent conditionality implicit in prolonged use and country “ownership”;
- Surveillance activities, and the identification of longer-term vulnerabilities, may be “crowded out” by short-term program issues;
- The perception that IMF resources would be available over the long term, despite policy slippages, may have weakened incentives to take decisive action to deal with the underlying adjustment problems; and
- Prolonged use in some cases reflects pressures on the IMF to agree to a series of weak programs. As a result, the effectiveness of these programs will be reduced and the credibility of all IMF-supported programs may suffer.

## IEO recommendations

The evaluation report made a number of recommendations covering program design, surveillance, and internal IMF governance issues which would help reduce prolonged use.

### *Institutional arrangements and rationale for IMF involvement*

The IMF should adopt an explicit definition of prolonged use as a trigger for enhanced “due diligence” (i.e., systematic ex post assessments and forward-looking consideration of “exit” strategies). Greater efforts should be made to identify whether countries are ready to implement credible programs, and the IMF should be more selective in extending financial support where there is insufficient evidence of commitment to a credible program. To mitigate the “seal of approval” pressures for continued programs, the IMF should aim to provide the international community with credible alternatives to IMF lending arrangements as a condition for other official flows. A differentiated rate of charge for prolonged users should be introduced as a signaling device.

### *Program design*

Specific operational procedures should be developed to maximize ownership, such as: (1) give the authorities the initial responsibility for proposing a reform program; (2) encourage a process whereby core program elements are subject first to a policy debate within the member’s own political institutions; (3) use surveillance to create a better understanding of what would be expected if a program should become necessary; and (4) undertake more explicit discussion of major uncertainties and how policies would be adapted if things turn out differently. Programs should place greater emphasis on key institutional changes and strengthening implementation capacity. This will require greater selectivity in program content and greater efforts to tailor the time frame of program design to the foreseeable length of a country’s adjustment needs.

### *Surveillance*

Steps should be taken to ensure that surveillance is not crowded out by programs in prolonged user cases. A case exists for greater operational separation between surveillance and program activities for prolonged users in the context of prolonged use.

### *Internal governance issues*

The ability of staff to analyze political economy issues should be strengthened and a review of internal incentives facing staff should be undertaken with

a view to minimizing staff turnover on countries and to foster increased candor and accountability.

## Executive Board response

The IMF’s Executive Board agreed with most of the IEO’s recommendations and the Managing Director established a staff Task Force to make specific proposals on how the issues raised could be addressed. The Task Force report was discussed by the Board in March 2003 and the broad strategy proposed by the Task Force was endorsed.<sup>11</sup> This entails implementation of the IEO’s recommendations to improve surveillance, conditionality, and program design—many of which were already under way through ongoing initiatives—and additional measures to strengthen “due diligence” for prolonged users. The latter will be triggered by an explicit definition of prolonged use (with a clear understanding that such use is not necessarily undesirable) and will involve ex post assessments of past IMF involvement and forward-looking consideration of the longer-term strategy for the IMF’s role in the country concerned.

While endorsing the approach recommended by the Task Force, Executive Directors stressed the importance of systematic implementation and asked for a timely monitoring of progress in implementing the recommendations.

### *Institutional arrangements and rationale for IMF involvement*

Directors saw merit in an explicit definition of prolonged use as a trigger for greater due diligence, but emphasized that prolonged use per se was not necessarily a problem and that the definition should not be interpreted as creating a new classification of member countries. The Board approved the definition proposed by the staff Task Force (for cases involving general IMF resources, seven or more of the last ten years under Stand-By or Extended Arrangements; for low-income countries, after a country has gone through two multiyear arrangements under concessional facilities). A semiannual report on the incidence of prolonged use will be prepared.

Directors also supported the call for greater selectivity in extending IMF financial support, based, inter alia, on assessments of implementation capacity and ownership. However, a number of Directors

<sup>11</sup>See International Monetary Fund, “Conclusions of the Task Force on Prolonged Use of Fund Resources,” February 4, 2003 as well as PIN 03/49, April 9, 2003, “IMF Concludes Discussion on Prolonged Use of Fund Resources”—both available at [www.imf.org](http://www.imf.org). An internal operational guidance note for assessments of countries with a longer-term program engagement has also been issued.

stressed that greater selectivity should not imply giving up on difficult cases. They endorsed the call for more explicit “exit” strategies in the case of prolonged users, which the staff Task Force proposed would be prepared as part of periodic ex post assessment and strategic planning exercises. Directors encouraged staff to continue to explore the scope for alternatives to IMF lending arrangements as signaling mechanisms. The broader role of signaling in low-income cases is being addressed as part of the ongoing review of the IMF’s role in low-income countries.

The Board did not support the proposal for a differentiated rate of charge for prolonged users.

#### *Program design*

Directors broadly agreed with the IEO’s recommendations and underscored that they should be seen as part of a continuing effort at improving program design to ensure greater effectiveness. Many of the recommendations are incorporated in the recently approved revised conditionality guidelines which provide the appropriate vehicle for putting them into practice. Further work on program design, including research effort, will also be needed, focusing in particular on the link between structural reforms/institutional capacity strengthening and program objectives. The regular reviews of conditionality by the Board will be the main vehicle for monitoring progress on these issues.

#### *Surveillance*

Directors agreed that priority should be given to increasing the effectiveness of surveillance, including the need to combine clarity and candor with recognition of social and political realities. They highlighted the importance of efforts to ensure that Article IV consultations in program countries “step back” from program context. Progress in strengthening surveillance, including by introduction of a fresh perspective, will also be addressed as part of the Board’s work program for FY2004.

#### *Internal governance issues*

Most Directors encouraged the staff to enhance its analysis and reporting of political economy issues in staff reports. Some Directors cautioned that the IMF should be careful in venturing into this area, given its comparative advantage in technical analysis and the need to avoid intruding on internal political matters. Directors also underscored the importance of distinguishing clearly between technical and political judgments and that staff should be candid in its assessment of risks.

On internal incentives facing staff, the Task Force took the view that while overall personnel policies do

not need to be changed, management should consider guidelines and incentives to reduce excess mobility in country teams.

## **The Role of the IMF in Recent Capital Account Crises**

The IEO’s second evaluation report examined the role of the IMF in three recent capital account crises, in Indonesia (1997–98), Korea (1997–98), and Brazil (1998–99), focusing on the effectiveness of IMF surveillance in identifying vulnerabilities in the precrisis period and the effectiveness of program design in restoring confidence. These crises have been extensively studied both inside and outside the IMF and a number of corrective measures have already been taken. The report made a number of additional recommendations building on steps already taken to further enhance the effectiveness of the IMF in both crisis prevention and crisis resolution.

*“...the IMF’s response...`was... inadequate in many respects,` the report says”*

*—“Post Mortems of Indonesia, Korea and Brazil Crises,” Business Times, Singapore August 4, 2003*

*“An Unusual Review of Mistakes Made by the IMF”*

*—Valor Econômico July 30, 2003*

## **Similarities and differences**

The three country cases shared several features common to capital account crises. In each case, the crisis was precipitated very quickly, followed by a sharp currency depreciation; contagion was a factor; and the initial IMF-supported program failed to achieve its objectives. However, there were also important differences. The Indonesian crisis was the most severe of the three, with GDP declining by 13 percent in 1998, accompanied by a large increase in poverty and only a slow return to normalcy thereafter. Korea also experienced a contraction, with GDP falling by 6.7 percent in 1998, but in this case growth rebounded to 10.9 percent in 1999. Brazil’s growth experience was better than expected, with GDP growing by 0.8 percent in 1999 instead of a decline of 1 percent as projected in the original program.

An important difference across the country cases concerned the degree of political commitment to the program. Indonesia suffered most in this regard, with an evident lack of political commitment not only to the original November 1997 program but also to the revised January 1998 program. This, combined with a high degree of political uncertainty and social con-

flict, led to an environment that diminished investor confidence. In sharp contrast, the authorities in Korea quickly displayed a high degree of political commitment following the presidential election. The situation in Brazil was somewhat mixed. There were initial setbacks to the program, but this was soon followed by a greater commitment to the revised program.

The manner in which vulnerabilities developed and the ensuing crises manifested themselves also differed across the country cases. In Brazil, vulnerabilities were mainly in the public sector, arising from the mix of loose fiscal policy and tight monetary policy. This led to a steady rise in public sector debt and a progressive overvaluation of the real. In contrast, in Indonesia and Korea, the private sector was the primary source of vulnerabilities, in the form of weak banking and corporate sector balance sheets. Because of these weaknesses, the crisis in these countries was a “twin” crisis in both the external and the banking sectors. Brazil’s crisis was not a twin crisis, reflecting the fact that its banking system was relatively sound, and this explains to a large extent its macroeconomic performance following the sharp currency depreciation.

## Major findings

The evaluation identified a number of specific weaknesses in surveillance, program design, and internal governance.

### Surveillance

IMF surveillance was generally successful in identifying macroeconomic vulnerabilities where they existed. In Brazil, for example, the IMF spotted the increasing vulnerability of the crawling peg exchange rate regime, especially in the face of fiscal weaknesses. However, in Indonesia, it underestimated the risks arising from financial sector and corporate balance sheet weaknesses and from the governance problems that contributed to those weaknesses. It also failed to recognize the macroeconomic impact of financial sector weaknesses in Korea, even though markets had begun to express concern on this aspect. The evaluation concludes that even when key vulnerabilities were correctly identified, the IMF’s role as confidential advisor was not very effective and suggests that the IMF probably could have been more effective at influencing policy if it had made its analyses public, thereby contributing to a wider policy debate.

### Macroeconomic framework and projections

In all three cases, macroeconomic outcomes turned out to be very different from program projections. In Indonesia and Korea, the initial projections were overly optimistic, leading to a design of macroeconomic policies in the programs that turned out to

be too tight. In contrast, the initial projections for Brazil in 1999 were too pessimistic, perhaps in reaction to the earlier overoptimism in East Asia. However, this meant that the fiscal adjustment achieved in Brazil, welcome though it was, was less than it should have been, given the more favorable growth outcome. In retrospect, in light of Brazil’s continuing adverse public debt situation, this represented a missed opportunity. To some extent, these problems arose because macroeconomic projections in an IMF-supported program are necessarily the outcome of negotiation. However, there were also analytical weaknesses associated with the failure to take sufficient account of the large currency depreciation which might occur in view of the possibility of multiple equilibria, and the severe balance sheet effects that might result in view of currency mismatches.

### Fiscal policy

All three programs initially involved fiscal tightening, albeit to different degrees: mild in Indonesia and Korea and fairly strong in Brazil. The evaluation does not support the claim that the fiscal tightening in Indonesia and Korea was the *cause* of the output collapse. The initial intention to tighten fiscal policy in Korea was probably not warranted, in view of the very favorable debt situation and the unexpected downturn in output, and the same consideration holds for Indonesia, although to a lesser extent. However, in both countries fiscal targets were relaxed quickly when the extent of output collapse became evident. The output collapse can be better explained by severe balance sheet effects arising from the currency collapse and (in the case of Indonesia) the negative effect of political developments on domestic investment. Brazil saw much stronger fiscal tightening, as was appropriate because fiscal sustainability was a major issue driving the evolution of the crisis. Sharply higher primary fiscal surpluses were achieved in line with program targets, but this turned out to be insufficient to achieve the objective of reducing the debt-to-GDP ratio.

### Monetary policy

The stance of monetary policy in all three countries was initially tight and there was an explicit recognition of the trade-off between higher interest rates and a weaker exchange rate. The outcome differed considerably across the three countries. In Indonesia, the maintenance of tight monetary policy envisaged by the program was initially not implemented because open-ended provision of liquidity to distressed banks led to a loss of monetary control. In Korea, the tight monetary policy envisioned in the initial program was implemented but this was not by itself sufficient to stabilize the exchange rate. It was

only after the rollover of external debt was achieved that conditions stabilized and interest rates were gradually lowered in early 1998. In Brazil, there was an easing of interest rates immediately after the program was approved—over the IMF’s objections—and this may have contributed to the timing of the collapse of the crawling peg. However, after the currency was floated in January 1999, there was a decisive tightening of monetary policy in March 1999 and this led to the restoration of stability in the foreign exchange market. The experience of the three countries does not provide a definitive answer to the ongoing debate on the effectiveness of high interest rates in stabilizing the exchange rate. However, it is clear that an interest rate defense on its own is unlikely to be sufficient, particularly when balance sheets are weak.

#### *Official financing and private sector involvement*

The inadequacy of the official financing package was a major weakness of the initial Korean program announced in early December 1997. The IMF was aware of the problem and brought it to the attention of the major shareholders, even suggesting that if financing was not available then a rollover of debt should be orchestrated. However, faced with reluctance on the part of the major shareholders to take an initiative on this matter, the IMF arbitrarily resorted to unrealistically high assumptions about rollover rates in order to match the programmed financing gap to the available financing. It sought to bolster the financing available with bilateral credit in the form of a “second line of defense” which would be available if needed. However, the availability of this financing was visibly uncertain to the markets, and the program quickly collapsed when the markets reacted adversely. In Indonesia, the size of the package was not relevant—the problem really arose because of weaknesses in program design, the lack of political commitment to the program, and the complicating factor of political uncertainty and instability and its impact on domestic investment. In Brazil again the problem was not the size of financing but the fundamental unviability of the crawling peg. In Korea and Brazil, the IMF’s role as crisis coordinator in organizing private sector involvement was limited by the initial reluctance of major shareholder governments to use nonmarket instruments to influence the behavior of private sector institutions and concerns that such action might precipitate an exodus of capital from emerging markets. However, in Korea, once a decision was made by the major shareholders to ask international banks to maintain exposure, the IMF played a useful role in facilitating information exchange and setting up systems for monitoring compliance.

#### *Bank closure and restructuring*

The experiences of Indonesia and Korea suggest that programs for bank closure and restructuring to deal with a distressed banking sector must be based on a comprehensive and well-communicated strategy in which transparent rules are consistently applied. The lack of such a strategy in Indonesia was a major cause of the collapse of the November 1997 program. The issue of whether a blanket guarantee for deposits should have been introduced in Indonesia in November 1997, instead of the partial guarantee actually offered, deserves careful consideration. The evaluation suggests that Indonesia’s banking crisis was not yet systemic in November, so that the partial guarantee was appropriate. The system collapsed for other reasons and as it happened, when a blanket guarantee was introduced in January 1998, it was subject to abuse and consequently raised the fiscal cost of bank restructuring.

#### *Structural reform*

While all three programs involved structural conditionality, the Indonesian and Korean programs (especially the January 1998 Indonesian program) contained a proliferation of structural reform measures. In contrast, the scope of structural conditionality in the Brazilian program was limited to structural fiscal reform and prudential regulation. This difference is partly due to the absence in Brazil of many of the distortions present in the two Asian cases. While measures to rehabilitate and reform the financial sector were necessary in Indonesia and Korea, many of the nonfinancial structural reform measures were not necessary to restore confidence, although they may well have been beneficial in the long run. The evaluation suggests that, particularly in Indonesia, the proliferation of nonfinancial structural conditionality led to a loss of focus on critical reforms in the banking sector, and also contributed to the lack of ownership at the highest political level.

#### *Communications strategy*

A program for restoring confidence must include a strategy to communicate the logic of the program to the public and the markets, in order to enhance country ownership and credibility. None of the three programs contained such a strategy initially.

#### *Human resource management*

The effectiveness of surveillance was reduced by the lack of sufficient incentives to make judgments that were frank and potentially unpopular with country authorities, resulting in a tendency for sharper elements of a diagnosis to be diluted in final Board papers. In crisis management, the quality of IMF response was compromised by a delay in the appro-

priate reallocation of staff resources and an insufficient utilization of available internal knowledge.

#### *The role of the Executive Board and the IMF's major shareholders*

The Board and major shareholders interacted closely with management at all stages. The evaluation recognizes that such close involvement is necessary when major decisions need to be made quickly, though contacts at multiple layers can be counterproductive. However, there is evidence that some decisions were subject to micromanagement and political pressure, contributing to a blurring of technical and political judgments.

#### *Collaboration with other international financial institutions*

Tensions sometimes developed over the role that different IFIs should play in an IMF-supported program, particularly in matters relating to the financial sector. While a good working relationship eventually developed, it depended too much on personalities, and not on a well-defined procedure.

#### **IEO recommendations**

The report recognizes that a great deal of learning has already taken place within the IMF and that new guidelines have been issued, or are being discussed, to incorporate that learning into policies and operational procedures. Nevertheless, the report makes a number of recommendations which would further enhance the initiatives already taken.

#### *Pre-crisis surveillance*

Surveillance should take a stress-testing approach to analyzing exposure to a potential capital account crisis. In particular, staff should itemize risks and assess their potential impact, and develop greater understanding of political constraints on policymaking and of market perspectives on policy, in part through wider dialogue.

#### *Increased transparency and incentives for candor*

To increase the impact of surveillance, staff assessments should be made more candid and more accessible to the public. In particular, there should be a presumption of publication for Article IV staff reports. Management could develop modalities for escalated signaling to provide the Executive Board with a vehicle for signaling when failures to address identified vulnerabilities have become an increasing source of concern. Escalated signaling would give member countries enough time to address underlying vulnerabilities, while also progressing toward greater candor as a means of increasing the effectiveness and impact of surveillance. Moreover, management and

the Board should explore the possibility of seeking “second opinions” from outside the IMF as part of the surveillance process when the authorities disagree with the staff’s assessment on issues that are judged to be of systemic importance. This would improve the degree of objectivity with which contentious issues are handled in the surveillance process and may enhance the impact of surveillance.

#### *Program design*

A comprehensive review of the IMF’s approach to program design in capital account crises should be undertaken. In particular (1) greater attention should be paid to balance sheet effects; (2) program design should allow for a flexible response, in case unfavorable outcomes materialize; (3) conventional financial programming–based conditionality should be reviewed and possibly adapted for capital account crisis circumstances; (4) parsimony and focus should be the basic principles of structural conditionality, and crises should not be used for pushing reforms that are not critical to crisis resolution, however desirable they may be in the long run; and (5) there should be an agreed communications strategy, characterized by a high degree of transparency.

#### *The IMF as crisis coordinator*

The IMF should ensure that the size of the financing package is sufficient to generate confidence and that its quality is such as to make it credible. In particular (1) packages should not rely on parallel official financing unless the terms of access are transparent and credible; and (2) terms for the involvement of other institutions providing parallel financing should be specified at the outset. The IMF should be proactive in its role as crisis coordinator. In particular, management should provide a candid assessment of the probability of success to the Executive Board and shareholders, and ensure that the technical judgment of staff is protected from excessive political interference. While the nature of private sector involvement will have to be determined on a case-by-case basis, the IMF should play a central role in identifying circumstances where concerted efforts can help overcome “collective action” problems.

#### *Human resource management*

Human resource management should be adapted to develop and better utilize country expertise, including political economy skills, and to establish “centers of expertise” on crisis management issues. In particular (1) the length of staff assignments should be monitored to ensure continuity of staff expertise, and a critical mass of expertise on each systemically important emerging market economy should be developed; (2) Resident Representatives

should play a more central role in surveillance and program design; and (3) internal procedures should be made to protect those who raise uncomfortable issues through proper channels, but consequently attract complaints from the authorities.

### Executive Board response

The Executive Board discussed the report in May 2003. Executive Directors welcomed the report as offering a comprehensive and thoughtful analysis of the Fund's role in capital account crises in the three cases and of the lessons to be learned. They considered it a useful complement to previous studies undertaken both within and outside the Fund (see Appendix 6 for more details).

#### *Surveillance, transparency, and candor*

Directors concurred with the overriding message of the report: to strengthen the effectiveness of IMF surveillance by extending and systematizing current guidelines for assessing vulnerabilities. They supported the call to itemize major potential shocks while emphasizing that stress-testing should not be mechanical but should focus on key risks facing a particular country. Most agreed that the IMF should develop greater understanding of political constraints on policymaking, although some cautioned that this could be counterproductive if it was seen as interference in domestic affairs. Most Directors saw great value in systematic discussions with the international financial community. Many Directors were not in favor of shifting from voluntary to presumed publication of staff reports, but some strongly supported presumed publication. Directors agreed with the need for greater emphasis on candor in staff reports. Reactions to the proposal for escalated signaling were mixed, with many Directors considering it an idea worth pursuing while a few felt it would undermine the IMF's role as a confidential adviser. On the related issue of second opinions, many Directors were not in favor, but some felt it may provide a fresh perspective.

#### *Program design*

Directors endorsed the IEO's recommendations on program design, and hoped that forthcoming staff papers on program design and balance sheet effects would give due attention to them.

#### *The IMF as crisis coordinator*

Directors generally agreed with the recommendations on financing packages, while noting limitations on the IMF's influence on other sources of financing. The Board stressed that the recently revised access policy must be observed and emphasized the importance of program credibility, not large financing

packages, as the heart of IMF involvement. The Board stressed that political judgments and decisions should be its exclusive domain and that it should be involved early in program discussions but without micromanaging operational details. Directors attached particular importance to the early involvement of the private sector.

#### *Human resource management*

Directors generally agreed on the need for institutional change to ensure that the IMF is in a position to respond rapidly to member countries facing crises. Many Directors supported the creation of centers of expertise; longer country desk assignments; a greater role for Resident Representatives; and modification of internal guidelines and human resource procedures. They also noted that human resource issues are management's responsibility.

It was noted that ongoing Board discussions would revisit specific operational aspects of the recommendations, particularly those endorsed by the Board. Biennial review of surveillance will be the main vehicle for assessing what has been done to address surveillance-related recommendations. Many of these and other issues would be discussed again by the Board in the context of discussions on transparency, financial soundness indicators, the balance sheet approach, reporting requirements, data standards, and sustainability assessments, and operational decisions will be taken by the Board in the context of those discussions.

Specific actions have already been taken by management in some areas addressed by the report, including the setting up of an Internal Task Force to review broad strategic issues relating to the IMF's Resident Representative program and the recent reorganization of the Monetary and Financial Systems (formerly Monetary and Exchange Affairs) Department.

### The Role of Fiscal Adjustment in IMF-Supported Programs

The third evaluation undertaken by the IEO in FY2003 dealt with fiscal adjustment in IMF-supported programs and focused on two sets of controversial issues. The first concerns the *quantitative* dimension of fiscal adjustment: whether, as some critics contend, fiscal adjustment in IMF-supported programs (1) suffers from a "one-size-fits-all" approach; (2) is insuffi-

*"IMF 'Too Optimistic' on Growth, says Watchdog Evaluation Report"*

*—Financial Times,  
September 10, 2003*

ciently flexible; and (3) is often unnecessarily contractionary. The second is the *qualitative* dimension: whether the efficiency, sustainability, and equity of fiscal adjustment could have been improved by using a different sequence and composition of policy measures on the revenue and expenditure side. To address these questions, the evaluation used a large cross-country sample of up to 169 programs in the 1993–2001 period, supplemented by more detailed desk studies of 15 specific IMF-supported programs including analysis by local experts in four cases.

### Quantitative aspects of fiscal adjustment

#### *Is there a “one-size-fits-all” approach?*

The evidence does not support the view that IMF-supported programs typically adopt a one-size-fits-all approach to fiscal adjustment, nor the perception that programs always involve austerity by targeting reductions in current account deficits, fiscal deficits, or public spending as a percent of GDP. In fact, 40 percent of the programs examined targeted a widening of the current account deficit as a percentage of GDP, while slightly over a third planned an increase in the primary fiscal deficit and primary spending as a percentage of GDP.

Variation across countries obviously does not establish that the targeted fiscal adjustment is appropriate in each case. The evaluation used cross-section analysis to examine factors underlying the observed variation and this revealed some patterns: the targeted adjustment in the fiscal deficit is higher when initial fiscal deficits are higher, when expenditure levels relative to GDP are high, and when proposed current account adjustments are large. However, these issues could not be pursued in the individual country programs examined because program documents do not indicate how fiscal adjustment targets are determined and how they are related to the specific assumptions made about the pace of recovery in private sector demand and short-term growth prospects. In the absence of such information, an evaluation of the appropriateness of the adjustment attempted in individual countries could only have been attempted by undertaking a detailed study, specifying an appropriate (counterfactual) program for each situation, and comparing the fiscal adjustment in that program with the targeted adjustment in the IMF-supported program. This was beyond the scope of the evaluation.

#### *How flexible are targets?*

The cross-country evidence does not support the view that IMF-supported programs are insufficiently flexible in an *ex post* sense, forcing a rigid pattern of fiscal adjustment that is insensitive to

changes in circumstances. In fact, many programs fail to meet initial targets, and these targets are revised to reflect reality.

On average, IMF-supported programs achieved only about one-half of the targeted improvement in overall and primary fiscal balances. However, there is significant variation around this average; about 60 percent of programs underperformed, with SBA/EFF-supported programs in nontransition countries registering the highest incidence of shortfalls, while SBA/EFF arrangements in transition countries had the smallest shortfalls. Moreover, almost all fiscal adjustment achieved in the first two years occurs in the first year of the program. Except in the transition country arrangements, programs were on average unable to achieve further fiscal gains during the second year of the program, in spite of relatively more ambitious fiscal targets for the second year.

As many as two-thirds of the programs studied incorporated revisions to their initial fiscal deficit targets by the time of the completion of the second program review. The revisions are asymmetrical—fiscal targets are often revised downward when growth is below expectations, but less often revised upward when growth is higher than originally projected. Interestingly, the evaluation found that program documents do not explain clearly the extent to which the fiscal shortfall observable at the review stage is due to a weaker policy effort or to the effect of exogenous developments.

#### *Is fiscal adjustment unnecessarily contractionary?*

This is one of the most controversial issues related to the design of IMF-supported programs and the evaluation revealed some interesting patterns. There is no evidence that growth rates in program years were systematically lower than the trend in the preceding decade. However, there is considerable cross-country variation around this average behavior. There were a number of cases, particularly the group of capital account crisis cases, where growth did slow down and in some cases even turned negative.

There is clear evidence of overoptimism in projecting investment rates and GDP growth. Actual investment rates in the second year of the program were below projections in 60 percent of cases and 5 percentage points of GDP or more below projections in about one-fourth of cases. Growth optimism is particularly evident in programs that started from an adverse situation. When growth was negative during the first year of the program, growth projections for the second year were on average twice as high as in reality. Programs were also generally reluctant to project a slowdown in growth and very rarely projected negative growth. This “reluctance to predict a

downturn” has potentially significant implications for program design, since it means that the need for countercyclical fiscal policy and its appropriate role is rarely discussed explicitly.

A tighter fiscal stance by itself cannot be called contractionary since it may be needed in situations where private investment demand is potentially buoyant and fiscal contraction is necessary to create room for financing private investment. However, it may not be appropriate when there is a sharp downward shift in the investment function, or when the level of private demand responds more sluggishly to the program than originally projected. In such cases, a demand stimulus may well be appropriate, calling for a less contractionary fiscal stance.

The lack of clear explanation of the rationale of the extent of fiscal adjustment in individual cases makes it difficult to determine whether the fiscal stance is indeed unnecessarily contractionary. A contractionary bias is most likely when both output and investment are below projections, the current account deficit is lower than programmed, and reserve accumulation is above the program target (indicating that external financing was not a constraint). In addition to the findings regarding output and investment optimism, the evaluation found overperformance on the external side in about one quarter of cases. Under these situations, it is possible that the adjustment planned was unnecessarily contractionary. However, even this conclusion needs to be qualified, because it focuses only on the impact of fiscal adjustment on aggregate demand. Where debt sustainability is an issue, a loose fiscal stance justified on countercyclical grounds may actually prove to be destabilizing if it is misread by markets as indicating a lack of commitment to macrostability, leading to a delayed return of confidence. Weighing these different considerations is difficult, but these issues need to be explicitly discussed and explained in program documentation, which is generally not done.

### Projections of aid flows in concessional programs

Concerns have been raised that IMF-supported programs in low-income countries unnecessarily squeeze spending because the aid projections are too conservative and assumed to “taper out” too quickly relative to what donors may be willing to provide. The evaluation shows that program projections of aid do tend to decline over the medium term, albeit at a moderate pace in most cases, but there is no evidence that projections have systematically underestimated actual aid flows for the outer years of programs. However, the evaluation did not address the issue of the scope for mobilizing additional aid flows

in support of more ambitious public spending linked to interventions to reduce poverty.

### Effect of IMF-supported programs on the level of social spending

Econometric analysis of 146 countries observed over several years with and without an IMF-supported program finds no evidence that the mere presence of an IMF-supported program leads to lower public spending in either health or education below the level that would have prevailed in the aftermath of a crisis if there were no program. Indeed, the evaluation found that public spending on health and education was actually about 0.3 to 0.4 percentage points of GDP higher compared to what it would have been without the program. This increase is sustained beyond the end of the program but diminishes over time.

The fact that social spending is higher than it would have been in a nonprogram situation does not establish that the most vulnerable groups are effectively protected from economic shocks during program years. Unless programs and budgetary mechanisms that provide such protection are effectively in place, it is difficult to ensure that additional resources devoted to this sector will reach target groups. IMF-supported programs generally operate in a time frame which is too short to create such instruments if they do not already exist, and in any case the IMF lacks the necessary expertise. An alternative framework is clearly required to address such issues.

### Social concerns in program design

At present, the treatment of social protection in non-PRGF countries is governed by the 1997 Guidelines on Social Expenditures, which call for the IMF staff to track health and education spending and encourage authorities to incorporate spending targets for these sectors in program objectives by relying on work by the World Bank. However, a detailed examination of the 15 sample programs shows substantial variation in how social expenditure issues are treated in practice. Trends in broad categories of expenditures such as education and health are noted, but only one-third of programs analyze these trends and identify priority social expenditures that need protection. In a more recent group of programs, half of the program documents analyze these changes, but few programs (outside the PRSP/PRGF countries) discuss how explicit monitoring and feedback systems could be established, or how to integrate these aspects with the work program of the World Bank.

Preserving budgetary allocations in critical areas to protect the most vulnerable groups from these shocks is not too costly, especially in middle-income

countries. However, this objective cannot be achieved simply by monitoring trends in broad social spending categories. Spending categories that are most critical to vulnerable groups are often squeezed out by other expenditures in the same broad category (in education, for example, basic medical or primary school supplies can be preempted by personnel expenditures).

### Fiscal reforms under IMF-supported programs

Implementing structural reform on the fiscal side is crucial because, in the absence of progress in this area, much of the fiscal adjustment that may be achieved in the short term is not sustainable in the longer term and does not strengthen the ability of the fiscal system to meet future shocks.

The evaluation found that the fiscal designs of programs make only limited gains in the structural area. They have generally focused more on the revenue side than on spending reallocations and reforms and the focus on the revenue side has been on introducing a value-added tax (VAT) or increasing rates, with relatively little attention paid to policy efforts aimed at reducing exemptions and evasion.

The VAT should remain as the cornerstone of a modern tax system. However, considerable improvements in collections could be achieved by curtailing discretionary exemptions and reducing tax evasion, particularly in customs duties and direct taxes (personal and corporate); even in the short run, these efforts could yield important revenue increases. Targeted efforts focusing on well-known groups or categories of taxpayers believed to be significantly underpaying can help generate revenues relatively quickly while avoiding the need for large increases in tax rates. The evaluation finds that efforts by the IMF in this area have not been forceful enough, particularly if they affect powerful vested interests. Tax administration reforms in IMF-supported programs have often focused on the technology side (such as computerization, training, etc.) rather than on the politically more difficult actions, such as legislation to empower tax agencies to pursue tax evasion forcefully or to make the system less prone to political interference.

On the expenditure side, conditionality has been concentrated on short-term quantitative targets to reduce public employment, or cap public sector wage increases, rather than focusing on the reorientation of public spending and medium-term civil service reform. As a result, the process has been inefficient and reversals have often occurred.

### Progress in implementing fiscal reforms

The sample of 15 programs showed that progress in implementing fiscal reform was limited. In no

given reform area was implementation rated satisfactory in more than 40 percent of cases. Measures to reduce the public sector wage bill, achieve civil service reform, and reform the social security system have been particularly difficult to implement. The lack of progress in implementation of reform measures is also the result of a mismatch of time frames: the short horizon of programs relative to the longer time needed to complete institutional reforms.

### Learning and the process of surveillance

The evaluation found that program requests do not make sufficient efforts to evaluate past fiscal performance or analyze policy failures under prior arrangements. Typically, programs tend to focus on fiscal performance during the last year prior to the program, with little attention to policy failures under previous arrangements.

The evaluation also examined surveillance during the three-year period prior to the program and its link to program design. Although there is variability across programs, in general efforts during surveillance to flag forcefully the need to accelerate reform have been limited. Surveillance is drawing too few lessons from past failures, and not contributing to defining the future paths for more complex reforms.

### Internal review process

An examination of the internal review process revealed that the scope and detail of review departments was greater at the stage of program implementation than at the stage of initial program design. The process tends to be reactive—with reviewers commenting increasingly as the programs unfold, instead of at the design stage. A comprehensive internal debate would have the greatest value added at an early stage of program formulation involving an exploration of alternative policy options.

### IEO recommendations

The evaluation made recommendations in five areas.

#### *Program documentation*

Program documentation should provide a clearer justification for the magnitude and pace of targeted fiscal adjustment and how it is linked with assumptions about the recovery of private sector activity and growth.

#### *Program review*

The internal review mechanism should place more emphasis on the early stages of the process, and the key briefing paper for program negotiations

should also articulate more clearly the basis for the fiscal program and its links with debt sustainability issues.

#### *Formulation and implementation of key institutional reforms*

Programs should make stronger efforts to specify those structural reforms which should be carried out during the program horizon as part of a broader road map of priority reforms that ideally should have emerged in the course of surveillance.

#### *Surveillance*

The surveillance process should be used to provide a domestically owned longer-term road map for fiscal reforms and also to assess progress achieved. The identification in advance of areas considered critical will foster greater domestic debate and encourage homegrown solutions and greater ownership while allowing the authorities flexibility in the timing and packaging of reforms.

The analysis should assess why important distortions were not addressed and what lessons were learned from past experience. This should include an effort to identify and unbundle the various constraints to critical reforms. Surveillance should include more systematic efforts to estimate the extent of tax evasion and tax exemptions, including the use of cross-country comparisons. Public debt sustainability could help anchor the road map of fiscal reform priorities proposed above and to assess trade-offs over time.

#### *Role of the IMF in social protection*

The IMF should clearly delineate the operational framework in which social issues will be addressed within program design in non-PRGF countries. This should include a clear indication of the IMF's responsibilities and activities in this area, which should include alerting the authorities about the need, in crisis situations, to protect those social programs and spending categories that are critical to the most vulnerable groups. Since this requires preparatory work, the IMF could invite the authorities, regularly during Article IV consultations, to suggest what existing critical social programs and social services they would like to see protected in the event of adverse shocks. On the basis of the priorities identified by the authorities, the World Bank and the IMF could agree with them on reform of public expenditure management (PEM) systems, specifically geared to protect the specified programs and spending categories. This would be a concrete application of the ongoing collaborative initiative by the IMF and the World Bank to strengthen PEM systems according to priorities set by the countries themselves.

#### **Executive Board response**

Executive Directors welcomed the report and agreed that the report has a number of constructive recommendations whose implementation would enhance the Fund's advice on programs in the fiscal area. Directors commented on the specific recommendations of the IEO report (see Appendix 7 for more details).

#### *Program design and internal review process*

Directors supported the recommendation that program documents should provide a more in-depth justification for the magnitude of the fiscal adjustment, and deemed that this initiative would instill greater discipline in program design, enhance transparency, and provide the public and the private sectors with a more convincing rationale for the program, thereby helping to overcome political obstacles to implementation. Nevertheless, they recognize that uncertainties regarding key macroeconomic variables particularly under crisis situations complicates this task. A few Directors cautioned against spurious precision in such justification. Directors looked forward to further staff analysis of the issue of growth projections in the context of the program design discussions.

Directors supported the recommendation that the internal review process should place relatively more emphasis on the early stages. They welcomed management's recent initiative in this area.

#### *Enhancing key institutional reforms and their links with surveillance*

Directors agreed that these reforms can be more critical for fiscal sustainability than short-term expenditure and revenue measures. However, they recognized that short-term measures are hard to avoid if the immediate objective is economic stabilization. Medium-term institutional reforms are particularly relevant in countries that have achieved macroeconomic stability and where "second generation" reforms are necessary. Some Directors agreed with the report's suggestion that reforms should be broken down into those that require executive action, legislation, and capacity building. Directors, however, pointed out that in crisis situations the pressing need to resolve a crisis may pose serious constraints on a medium-term approach. Careful judgment will continue to be needed to focus conditionality on reforms judged critical while at the same time ensuring that progress is made in addressing vulnerabilities and achieving programs' goals.

Most Directors agreed that Article IV consultations should play a stronger role in identifying long-term reform priorities and the causes of past failures, and that this analysis should inform subsequent program design. Nevertheless, they underscored that the ulti-

mate responsibility to develop a fiscal reform agenda resides with the individual country authorities, while the Fund should stand ready to provide advice.

#### *Role of the IMF in social protection*

Directors agreed that an important aim of program design should be to protect critical social expenditures. However, they stressed, as recognized in the report, that the Fund should not become involved in the detailed selection and design of social policy; this task is outside both the Fund's mandate and its expertise. A number of Directors supported the IEO's call for updating of the 1997 guidelines that direct IMF work in the social area, in order to improve their clarity and effectiveness as an operational tool in protecting the most vulnerable from economic shocks and budgetary retrenchment. Other Directors, however, viewed the existing

guidelines as adequate, and a few considered that the annual and medium-term budgets of non-PRGF countries already adequately identify critical social sector programs. These Directors recalled that the new framework for Bank-Fund collaboration on public expenditure issues should enhance countries' public expenditure reform strategies, including measures to protect critical social spending. Many Directors agreed with the recommendation that staff should inquire, during Article IV consultations, whether the authorities have identified social programs that they would like to protect in the event of a crisis, as they believed this would help dispel the criticism that Fund programs unduly curtail social spending. A few others considered this recommendation impractical, as it would create significant costs and pressures for the authorities with little benefit.

## Status of Ongoing Projects

Work on two of the three projects identified for the FY2003–04 work program commenced in the course of FY2002–03. The status of all three projects is summarized in this chapter.

### Evaluation of Poverty Reduction Strategy Papers (PRSPs) and the Poverty Reduction and Growth Facility (PRGF)

This evaluation focuses on the IMF's role in the PRSP process and the related IMF lending instrument, the PRGF. A parallel evaluation of the World Bank's experience with the PRSP is being undertaken by the World Bank's OED. The IEO and the OED have reached agreement on a broad division of labor that will enable them to conduct the studies while collaborating in some aspects.<sup>12</sup> The IEO will focus on the role of the IMF in the PRSP process and the experience with PRGF, while the OED study will focus on the World Bank's role in the PRSP process. The common element in the two evaluations is the PRSP process. The IEO evaluation will focus on issues in the area of expertise of the Fund and will not assess important issues where the primary responsibility lies with the World Bank.

The IEO evaluation will seek to address three broad sets of questions:

- Are the objectives of these initiatives suitably defined and is their design, with regard to aspects concerning the IMF, consistent with the achievement of sustainable progress?
- Is the IMF delivering on its commitments embedded in the PRGF/PRSP approach and with what results?
- What accounts for any shortcomings diagnosed (including systemic constraints) and what suggestions emerge from the evaluation about

how they can be remedied as far as the IMF is concerned?

The evaluation will focus on the experience of countries with full PRSPs, as this has the greatest potential for generating lessons of importance for the IMF's role in the future. At this stage of the process, the evaluation will not be able to cast much light on final outcomes for growth and poverty, which will only be known later. The focus of the evaluation will therefore be on inputs (the PRSP process and PRGF-supported programs' formulation), outputs (i.e., PRSP contents and PRGF-supported programs' design), and intermediate effects (i.e., institutional and policy changes).

The scope of the evaluation and the set of issues that it will cover are illustrated by the logical framework diagram (see Figure 2) that maps the broad stages of what the PRSP/PRGF process is meant to achieve. The evaluation will focus on only those elements of the first three stages (i.e., process, outputs, and effects) that directly concern the IMF's role.

- *Process issues to be evaluated* (see the terms of reference for a more comprehensive discussion) would include the extent to which the process of program formulation, including the IMF's internal procedures, have changed so as to align with the PRSP emphasis on country-driven, participatory approaches and to promote PRGF-supported programs that are embedded in home-grown strategies oriented toward growth and poverty reduction.
- *Outputs evaluated* would include assessing whether PRSPs (and related Joint Staff Assessments) have the main components expected of them in the areas of the IMF's responsibility, including with respect to the clarity of policy choices in macroeconomic and budgetary areas, and whether the programs supported by PRGF arrangements have been explicitly derived from the broader strategies for fostering growth and reducing poverty set out in the PRSPs.
- *Intermediate effects evaluated* will involve assessing how the PRSP/PRGF process has af-

<sup>12</sup>An approach paper for the OED's parallel evaluation is available on the OED's website at [www.worldbank.org/oed/prsp](http://www.worldbank.org/oed/prsp).

ected policy formulation and implementation in the countries concerned. For example, are PRSPs integrated into budget and public expenditure management frameworks, and has a more participatory, country-driven process altered the types of policy trade-offs considered and the actual content of policy implementation in key areas?

- It is too early for a systematic assessment of the impact of the PRSP/PRGF on *final outcomes*. However, the evaluation will collect available evidence on the evolution of various program outcomes (e.g., GDP growth and key macro indicators) compared, for example, with earlier ESAF-supported programs.

In evaluating the PRGF, the evaluation will assess performance in each of the seven key dimensions in which the PRGF was expected to improve upon earlier ESAF-supported programs:<sup>13</sup>

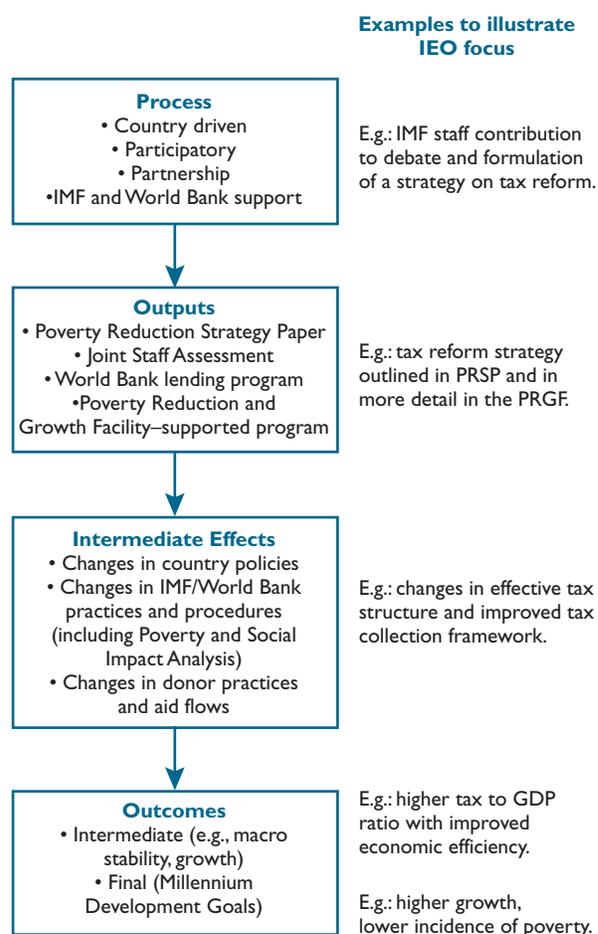
- Broad participation and greater country ownership;
- Embedding the PRGF-supported program in a broader set of measures set out in an overall strategy for growth and poverty reduction;
- Government budgets that are more pro-poor and pro-growth;
- Ensuring appropriate flexibility in fiscal targets;
-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

### Methodology and time frame

The evaluation will draw upon both detailed case studies and broader cross-country analysis. Six country case studies will be undertaken: Tanzania, Mozambique, Nicaragua, Tajikistan, Guinea, and Vietnam. The countries have been chosen to reflect diverse regional experiences and economic performance, and to offer a combination of recent and mature PRSPs and PRGF-supported programs, as well as of HIPC and non-HIPC countries. The case studies will involve both deskwork (including reviews of relevant IMF documentation, both published and unpublished, as well as reviews of external evaluative evidence) and field work. They will also seek

<sup>13</sup>See “Key Features of IMF Poverty Reduction and Growth Facility (PRGF) Supported Programs,” IMF (2000). Available on the IMF website ([www.imf.org/external/np/prgf/2000/eng/key.htm](http://www.imf.org/external/np/prgf/2000/eng/key.htm)).

**Figure 2. Schematic Logical Framework of the Evaluation**



the views of all relevant stakeholders through a combination of interviews and surveys. The studies will place particular emphasis on analyzing changes in the nature of the policy debate by following through several critical policy issues in each country and assessing how their treatment has evolved under the PRSP/PRGF initiative.<sup>14</sup>

*Cross-country analyses* will be undertaken on the full sample of 23 countries, which have a full PRSP as of December 2002. The purpose will be to test on a broader scale the relevance of the findings made in the case studies as well as to bring out other messages of general significance.

<sup>14</sup>The first four will be undertaken jointly with the OED and it is expected that a single country report will be prepared for each of these countries. In addition to the four joint country studies, the OED is also undertaking case studies of Albania, Cambodia, Ethiopia, and Mauritania.

The field work for the country case studies has been completed, and the country reports are being drafted. The cross-country analysis has been initiated. The timetable of the evaluation contemplates submission of the final report to the IMF's Executive Board around March 2004.

### The Role of the IMF in Argentina, 1991–2002

This evaluation focuses on the role of the IMF in Argentina during the period from 1991 to early 2002. In December 2001–January 2002, Argentina experienced a devastating economic crisis, leading to a collapse in output, high levels of unemployment, and political and social turmoil. This crisis has raised serious questions for the IMF not only because it occurred while the country's economic policies were under the close scrutiny of an ongoing IMF-supported program, but also because the IMF had also been continuously engaged in Argentina since 1991, when the "Convertibility Plan" fixed the currency at parity with the U.S. dollar. Over this period, the IMF approved four successive financing arrangements, and provided extensive technical assistance, dispatching some 50 missions between 1991 and 2002.

The evaluation will review the evolution of the IMF's advice and internal views on key areas of Argentina's economic policy, examine how the IMF came to certain decisions at critical junctures in its relationship with the country, and assess how reasonable the decisions were in light of information available at the time. The evaluation will also consider—albeit with the benefit of hindsight—if better outcomes could have been achieved had the IMF acted differently with a different set of decisions by the IMF. As is customary with all IEO evaluations, the primary focus will be placed on drawing lessons for the IMF.

The choice of the 1991 to early 2002 time period leaves out issues related to the role of the IMF during the sharp contraction of 2002 and the subsequent moves toward economic reconstruction and recovery, as the IEO's terms of reference do not allow an evaluation of issues directly related to the IMF's ongoing operations.

#### Issues for evaluation

There are competing explanations of the primary cause of the Argentine crisis, but there is general agreement that several factors were at play. These include: (1) an excessively lax fiscal policy; (2) excessive and unpredictable swings in the volume of global capital flows to emerging market economies; (3) the

slow pace of structural reform in some critical areas; (4) institutional and political factors; and (5) the rigidity of the convertibility regime itself, which limited the scope for real exchange rate adjustment. Against this background, some additional factors helped to trigger the crisis and to exacerbate the impact of these underlying weaknesses: (6) a series of adverse external shocks; (7) the impact of slow growth and high interest rates on the prospective path of the ratio of debt to GDP; and (8) in the final stage of the crisis, a weakening of prudential defenses in the banking system. The evaluation will examine how the IMF viewed each of these vulnerabilities in its surveillance activities, what the impact of its surveillance was, and how effectively it designed its adjustment programs to address them.

The overarching questions the evaluation seeks to answer include:

- What was the IMF's diagnosis of conditions in Argentina and how did it evolve over time?
- How was the IMF's diagnosis translated into program design, conditionality, and financing decisions?
- How effective were the IMF's policy advice and conditionality in influencing the policies actually pursued by the authorities?
- What were the roles of IMF staff, IMF management, and the authorities of large shareholder governments in the formulation of the IMF's decisions?

Specific issues to be addressed in the evaluation will be divided into two broad categories, corresponding to the two related but distinct phases of IMF involvement: first, the period of 1991–2000 before the latest crisis, and second, the crisis and its immediate aftermath, 2000–2002.

#### Methodology and time frame

The evaluation will rely on the IMF's internal and published documents, supplemented by interviews with IMF staff and other key decision makers in the IMF, current and former officials of the Argentine government and central bank, IMF shareholder governments, and the private sector; a review of the academic literature and public discussion; and data analysis, including a detailed review of fiscal accounts, cross-country analysis of fiscal policy, assessment of macroeconomic projections in program documents, and a simulation of debt dynamics. In order to obtain a broad perspective on issues, the views of interested parties in civil society will also be sought. The approach to be taken for the evaluation is explained in greater detail in the issues paper.

A draft issues paper was posted on the IEO website in June 2003, followed by the posting of the final issues paper in late July, both in English and Spanish. Extensive discussions were held in the early phase of the evaluation with IMF staff, members of the Board, former key Argentine policymakers, and other stakeholders, including those in Argentina. The report will be submitted to the Executive Board before the end of FY2004.

### Technical Assistance by the IMF

This project, which will evaluate the IMF's technical assistance (TA) activity, is at a very early stage. Work has commenced on preparing a draft issues paper, which will be circulated for comments (including via the website) from both inside and outside the IMF.

Some of the questions which the study will address are:

- How effective are internal IMF processes for identifying TA priorities at the country level and

for allocating resources across countries and subjects?

- Is there enough complementarity between TA and other major IMF activities, such as surveillance and use of IMF resources, and how are these activities integrated in practice?
- How effective has the IMF's TA been in building institutional capacity and fostering sustainable reforms and how could these effects be improved? How is absorptive capacity taken into account and how effectively is the policy advice tailored to the circumstances of each country? How is transfer of knowledge emphasized and what measures are taken to make TA more goal oriented?
- How effective are the Fund's internal evaluation procedures and have recent initiatives led to a reallocation away from places in which it is not being used effectively?

The methodology and time frame of the study will be spelled out in the issues paper, which will be available in October 2003. The evaluation report is expected to be completed within FY2004.

## Some Reflections

One full year of operations and three completed evaluation reports provide only a limited basis for reflection. Nevertheless, a number of issues have arisen in more than one evaluation which are worth highlighting, if only because they are likely to surface again in future IEO evaluations and will therefore need continuing attention.

### Surveillance

An important common message from all three reports is the need for greater candor to make surveillance more effective. Each evaluation identifies specific instances where surveillance was less candid than it could have been and where greater candor would have been desirable. This issue is not new; it has often been discussed in the IMF, and these discussions have produced agreement in general terms on the need for greater candor. However, it is not easy to create an incentive structure which encourages candor in practice, especially if transparency is also important.

If surveillance is viewed solely as an instrument for enabling the IMF to act as a confidential adviser, candor does not present serious problems because transparency is not a major issue. However, once surveillance is expected to perform the function of generating peer pressure through the Executive Board, or the broader function of informing markets, transparency becomes essential and this can discourage candor. The authorities are likely to be concerned that highlighting vulnerabilities which are at best probabilistic could precipitate adverse market reactions which would not have occurred otherwise; insistence on candor in such situations is likely to strain relations with the IMF. The Brazil case study shows that the desire to retain influence in the advisory role can lead to moderation of concerns on policy, which can reduce the effectiveness of surveillance. There is no simple solution to this problem, but if the broader role of surveillance is indeed to be strengthened, as has been increasingly emphasized in recent years, it is necessary to find ways of raising the standards of both candor and transparency.

The linkage between surveillance and program design is another important issue surfacing in all three reports. The prolonged use evaluation indicates that programs have tended to crowd out surveillance activities, thus reducing the potential contribution of surveillance to improving program design, while the fiscal adjustment evaluation suggests that surveillance has drawn too few lessons from past failures. The capital account crises evaluation suggests that forcing wide-ranging reforms during a crisis, when these have not been adequately discussed earlier in the course of surveillance, can weaken ownership. The common message is that surveillance can help in future program design if it provides a frank assessment of critical weaknesses which need to be addressed and encourages the authorities to develop a road map of reforms to address these weaknesses. This would increase ownership of policy changes which may be included in future programs.

The evaluations show that one reason why it is difficult to ensure that conditionality in IMF-supported programs is consistent with longer-term objectives is the mismatch between the time frame of IMF-supported programs and the much longer time frame needed for structural reforms. For example, reforming the tax system often calls for structural and administrative reforms which take considerable time to implement, and it may not be possible to devise appropriate prior actions or performance criteria which would ensure genuine progress towards this longer-term objective within the short time frame of IMF arrangements. In fact, the need to achieve quick fiscal improvements may even generate adverse incentives, focusing attention on actions that are more easily quantified and monitored but are less important for longer-term sustainability. The fiscal adjustment report provides examples of such actions: raising tax rates rather than broadening the tax base or, on the expenditure side, imposing wage cuts rather than undertaking deeper civil service reform.

The mismatch problem could be overcome if the structural and institutional components of IMF-supported programs were drawn from a longer-term strategic framework, which is owned by the country.

In principle, the PRSP process provides a mechanism for low-income countries which could provide such a framework and the ongoing PRSP/PRGF evaluation will throw light on how far this is achieved in practice. It is not clear what mechanism, if any, can serve this purpose for other countries. The fiscal adjustment evaluation, in the context of protecting critical social programs, suggests that surveillance could be used to invite the authorities to spell out their reform objectives and the IMF (and where appropriate the World Bank) could assist the authorities in working out reform programs if requested to do so. However, this approach could raise apprehensions that it would make surveillance potentially more intrusive. The idea of using the surveillance dialogue to achieve an understanding on the appropriate framework for longer-term structural reforms is clearly appealing. How to do it in a manner which keeps the country in the driver's seat to ensure ownership poses a major challenge.

### Program Design and Uncertainty

All three evaluations highlight the difficulty in dealing with uncertainty in program design. Uncertainty is a familiar problem for all types of policy-making but, arguably, it presents greater difficulties in the design of macroeconomic programs where outcomes depend upon the interaction of several factors, many of which are subject to large degrees of uncertainty. For example, the state of investor expectations that influences the level of private investment, or the state of market confidence that affects the availability of external financing, are difficult to quantify, and investors' response to different types of policies is even more difficult to predict. Yet programs depend critically upon assumptions about how these factors will behave in response to exogenous developments and policy changes.

Since uncertainty is inescapable, programs have to be based on probabilistic assessments which may turn out to be wrong, but it is important to avoid excessively optimistic assumptions. However, all three evaluations suggest a systematic bias toward overoptimism with some undesirable consequences. For one, it leads to unrealistic conditionality—for example, overoptimistic fiscal targets are adopted based on overoptimistic revenue forecasts arising from overoptimism about growth and about the short-term impact of tax reforms. In certain circumstances, it can also lead to inappropriate program design, as when overoptimism about the pace of recovery of private investment encourages excessive fiscal tightening to make room for private investment which does not materialize as quickly as expected. Although program targets are adjusted in practice, in

the light of developments, this is clearly not a substitute for making more realistic assumptions in the first place. Underperformance in growth and frequent revisions of targets can undermine the credibility of IMF-supported programs.

Realism is desirable but it may not be enough, since even realistic forecasts may not materialize. It is therefore important to ensure that the risks to programs are explicitly considered and there is sufficient flexibility in program design to deal with unexpected developments. All three evaluations undertaken thus far suggest that programs typically do not have well-defined contingency plans worked out in advance to take account of uncertainty. This can be especially problematic in capital account crises, where countries can experience a sudden shift from a “good” to a “bad” equilibrium, in which case what is needed is not merely a marginal recalibration of policies, but possibly a radical alteration in program design.

Explicit contingency planning to deal with such situations would help achieve flexibility, but there may be resistance to this approach if it is felt that contingency plans may become widely known, which could lead markets to overreact to possible risks. In certain circumstances, this could trigger destabilizing behavior and actually undermine the probability of success of the original program. The problem is particularly acute in capital account crises, where the impact on confidence in the early days of the program is often critical and there is an understandable desire to downplay the possibility of unfavorable but hypothetical outcomes.

Even if explicit contingency planning is not undertaken, it should be possible to identify the critical assumptions (including assumptions about policy responses) on which the program depends, and to monitor events closely so that program redesign is triggered as early as possible if needed. This calls for greater transparency about the underlying assumptions and rationale of program design. The fiscal adjustment evaluation shows that in many cases the underlying rationale is not made sufficiently clear in program documents. This is clearly an area where practice can be greatly improved, and it should be the focus of subsequent evaluations.

### Conditionality and Ownership

All three evaluation reports suggest that the specific structure of conditionality is much less important than the underlying domestic political commitment to core policy adjustments. This is exemplified by the experience in Pakistan, where conditionality extended to introducing taxation of agricultural income, or in the Philippines in con-

nection with reforms on tax administration. The fiscal adjustment evaluation refers to instances where lack of commitment to reduce widespread evasion forces programs to rely on increasing tax rates in existing “easier to collect” taxes. Another example is the experience of Indonesia where complex conditionality structures, which were ostensibly accepted publicly by the authorities, failed to impress markets because political commitment was perceived to be lacking.

If strong domestic ownership is essential for success, it follows that there will be circumstances in which countries may not be ready to undertake all the adjustment and reform that may be needed, which raises the issue of how the IMF should respond in such cases. The prolonged use evaluation argues that the IMF must be willing to consider “second-best” adjustment programs which are not ideal, but nevertheless meet a minimum standard of acceptability. How to establish the minimum standards which would enable the IMF to respect considerations of ownership, while ensuring a sufficient degree of sustainability and also preserving incentives for stronger adjustment, is a major challenge.

A corollary of this approach is that where minimum standards are not met, the IMF must be willing to hold back from financing. As the prolonged use evaluation points out, this approach can lead to interruption of other flows and this is sometimes a factor which encourages the IMF to continue lending. The trade-offs clearly involve very difficult choices and it is difficult to envisage rules that can be mechanically applied. However, it should be easier to make judgments about sustainability if

a clearer picture of reform road maps were developed through surveillance.

### **Selection Bias**

Finally, it is important to recognize that because the IEO does not evaluate all programs or surveillance cases, IEO evaluations are necessarily selective and some selection bias is therefore inevitable. Cases chosen for evaluation are likely to be those where programs ran into difficulties, if only because these are precisely the cases which attract the greatest attention and public comment. Ex post evaluation of such cases is obviously necessary for accountability and can contribute to learning. However, this does imply that IEO evaluations are less likely to focus on successful programs even though there is surely much to learn from success stories.

This bias is less likely to arise in the case of thematic studies, where the IEO evaluation covers a much larger range of experience. This is evident from the fiscal adjustment evaluation, which illustrates the wide variety of experience under IMF-supported programs. This suggests that the IEO should ensure a reasonable balance between country and thematic studies in its work program.

As stated at the beginning of this chapter, these reflections emerge from a limited set of studies and it would be premature to present them as firm conclusions. They are presented only as common themes that have surfaced from more than one evaluation and which will need continuing attention in the future.

# Appendix I Terms of Reference of the IEO

## Purpose

The Independent Evaluation Office (IEO) has been established to systematically conduct objective and independent evaluations on issues, and on the basis of criteria, of relevance to the mandate of the Fund. It is intended to serve as a means to enhance the learning culture within the Fund, strengthen the Fund's external credibility, promote greater understanding of the work of the Fund throughout the membership, and support the Executive Board's institutional governance and oversight responsibilities. IEO has been designed to complement the review and evaluation work within the Fund and should, therefore, improve the institution's ability to draw lessons from its experience and more quickly integrate improvements into its future work.

## Structure and Accountabilities

IEO will be independent of Fund management and staff and will operate at arm's length from the Fund's Executive Board. Its structure and modalities of operation must protect its operational independence—both actual and perceived.

A Director, to be appointed by the Executive Board, will head IEO. The Director's term of appointment will be for a period of four years renewable for a second term of up to three years. The Director's appointment may be terminated at any time with the approval of the Executive Board. At the end of the term of service, the Director will not be eligible for appointment or reappointment to the regular staff of the Fund. The Director will be responsible for the selection of IEO personnel (including external consultants) on terms and conditions to be determined by the Board with a view to ensuring that the office is staffed with independent and highly qualified personnel. The majority of full-time IEO personnel will come from outside the Fund.

## Responsibilities

The Director of IEO will be responsible for the preparation of the Work Program. The content of the Work Program should focus on issues of importance to the Fund's membership and of relevance to the mandate of the Fund. It should take into account current in-

stitutional priorities, and be prepared in light of consultations with Executive Directors and management, as well as with informed and interested parties outside the Fund. The Director will present IEO's Work Program to the Executive Board for its review.

IEO, through its Director, will report regularly to the Executive Board, including through the preparation of an Annual Report. It is also expected that the IMFC will receive regular reports on the activities and findings of IEO.

With respect to individual evaluations, staff, management, and—when appropriate—the relevant country authorities will be given an opportunity to comment on the assessments being presented to the Executive Board.

The Director of IEO, in consultation with Executive Directors, will prepare a budget proposal for IEO for consideration and approval by the Executive Board. Its preparation will be independent of the budgetary process over which management and the Office of Budget and Planning have authority, but its implementation will be subject to the Fund's budgeting and expenditure control procedures. IEO's budget will be appended to that of the Executive Board within the Fund's Administrative Budget.

If requested by the Executive Board, IEO will provide technical and administrative support for any external evaluations launched directly by the Executive Board.

## Consultation, Publication, and External Relations

In carrying out its mandate, including in the preparation of its Work Program, IEO will be free to consult with whomever and whichever groups it deems necessary, both within and outside the Fund.

IEO will have sole responsibility for drafting IEO evaluations, Annual Reports, press releases, and other IEO documents or public statements.

IEO's Work Program will be made public and there will be a strong presumption that IEO reports will be published promptly (within the constraints imposed by the need to respect the confidentiality of information provided to the Fund by its members), unless, in exceptional circumstances, the Executive Board were to decide otherwise.

Publication of evaluations will be accompanied by comments from management, staff, and others, including relevant country authorities, where appropriate, along with the conclusions reached by the Board in considering the evaluation report.

### **Relations with Fund Staff and Management**

In conducting its work, IEO should avoid interfering with operational activities, including programs, or attempting to micro-manage the institution.

### **Review of Experience with IEO**

Within three years of the launch of IEO operations, the Executive Board should initiate an external evaluation of IEO to assess its effectiveness and to consider possible improvements to its structure, mandate, operational modalities, or terms of reference. Without prejudging how that review would be conducted, it should be understood that the review would include the solicitation of broad-based input from outside the official community.

## Appendix 2

### Budget of the Independent Evaluation Office for FY2003 and FY2004<sup>1</sup>

(In U.S. dollars)

	FY2003		FY2004
	Budget	Actual	Approved budget
Regular staff	2,431,000	2,413,361	2,615,420
Total discretionary budget	1,121,100	934,403	1,202,222
Experts and contractuels	610,000	629,561	630,000
Business travel budget	319,000	243,937	344,000
Outreach seminars	180,000	54,618	190,000
Other	12,100	6,287	12,500
Total	3,552,100	3,347,764	3,817,642

<sup>1</sup>FY2003 is May 2002 to April 2003 and FY2004 is May 2003 to April 2004.

## Appendix 3 Initial Broad Menu of Potential Topics for Evaluation by IEO

The following subjects were identified in the first stage of developing the work program.

### Surveillance

1. The IMF's role and effectiveness in crisis prevention based on an examination of recent Article IV reports, including all the recent capital account crisis cases. Are "early warning" procedures effective, and do they influence the Fund's advice and countries' policies?
2. Review of Financial System Stability Assessments (FSSAs). What lessons can be learned from the experience of the first two years? Are they identifying the key vulnerabilities and proposing remedies in a cost-effective manner?
3. Follow-up to the 1999 external review of surveillance. Specifically, the review could focus on how the recommendations agreed to by the Executive Board have been implemented.
4. Effectiveness of IMF surveillance of industrial countries. Is the scope of surveillance appropriate and what is its value added?
5. The IMF's role in multilateral surveillance, including the World Economic Outlook and the International Capital Markets Report exercises.
6. Role and effectiveness of regional surveillance (e.g., European Community, other regional groupings).
7. The IMF's approach to liberalization of the capital account. Possible topics include whether the Fund's policy advice on the pace of capital account liberalization and its sequencing with other reforms, especially vis-à-vis the financial sector, have been appropriate and consistent across countries. How has policy changed in the light of experience with capital account crises?
8. The IMF's work on standards and codes of good practice (in collaboration with other agencies). Is the approach effective in building institutional capacity and reducing vulnerability in member countries?

### IMF-Supported Programs and Related Issues

#### Review of individual country programs

1. Capital account crises (e.g., Argentina, Brazil, Ecuador, Indonesia, Korea, Thailand, Turkey). Some stakeholders have suggested that IEO should evaluate all programs where exceptionally large access to Fund resources is involved.
2. Low-income/highly indebted cases (possible cases include Bolivia, Burkina Faso, Cameroon, Honduras, Mozambique, Nicaragua, Niger, Senegal, Tanzania, Uganda, Vietnam, Zambia).
3. Transition countries (Bulgaria, Hungary, Poland, Russia, Ukraine, other FSU countries).
4. Selected countries that have had repeat programs could be chosen (e.g., Bolivia, Madagascar, Philippines, Zambia). Are there problems with program design that contribute to such repeat usage?

#### Review of broad policy issues cutting across programs

1. Exchange rate policies in IMF-supported programs and the Fund's policy advice on exchange rates as part of surveillance. Has the Fund's policy advice on exchange rate regimes and associated policies been consistent across countries? Has the design of exit strategies from exchange rate pegs been appropriate? Have the contractionary consequences of devaluations, stemming from their balance sheet consequences, been underestimated in program design? Has financial program design adapted effectively to inflation-targeting regimes?
2. Fiscal adjustment in IMF-supported programs. Does fiscal adjustment take sufficient account of longer-term goals (e.g., for growth, poverty reduction) and is it implemented in a sustainable manner? Has the potential, immediate adverse impact of programs on particular vulnerable groups been adequately assessed and taken into account in program design?

3. Policies toward financial sector stability and financial sector restructuring. In addition to the effectiveness of IMF policy advice in helping member countries avoid financial crises (also discussed above under surveillance), possible issues could include whether the design of financial sector restructuring packages has been appropriate, how the fiscal consequences have been handled, and how the macroeconomic consequences of corporate restructuring were taken into account in program design.
4. Debt reduction and debt sustainability issues. Possible issues (either in the context of the heavily indebted poor country (HIPC) cases or more generally) could include whether the approach to assessing the sustainability or unsustainability of debt positions (external or public debt) has been appropriate and consistent across countries; whether debt sustainability analyses in surveillance reports have been adequate; what use has been made of the sustainability analysis; and what can be learned from “best practice” approaches.
5. Has IMF support of a country’s program had a positive “catalytic effect” in terms of generating additional external financing flows within a specific time frame? Are there objective measures of this catalytic effect? What factors influence the impact on market credibility?
6. The nature and effectiveness of conditionality and issues involving the “ownership” of national/IMF-supported programs. Also, IMF policy toward structural conditionality has been modified recently; a review of the impact of the new policy could be undertaken at the end of the first two-year experience (i.e., in FY2004).
7. Why do many IMF-supported programs remain uncompleted and what difference does it make? Are there particular aspects of program design (e.g., optimism of projections, extent of conditionality) that have a strong influence on the probability of completion? Do outcomes depend on the extent to which programs are completed and what lessons can be learned from incomplete programs?
8. Conditionality with respect to trade policies. Has the IMF adopted a consistent approach to trade policies in the design of conditionality? Is the approach consistent between the surveillance stage and the program stage?
9. Private sector involvement (PSI) in crisis resolution. This is a growing area of concern in which policy is still evolving but there are lessons to be learned from experience thus far. Does the existing experience suggest that some forms of PSI are likely to be more successful

than others? Many of the questions involved are also closely related to the size of the IMF financial support, including through the Supplemental Reserve Facility (SRF) for countries undergoing crises that are centered primarily in the capital account.

10. Experience with privatization in IMF-supported programs. Possible questions to be addressed could include: was the sequencing with regard to implementation of regulatory frameworks appropriate? How realistic was the time frame for privatization? What was the impact on prices for services and investment in the privatized sectors? And what was the social impact?

### Review of experience with particular lending facilities and related issues

1. The role of the Poverty Reduction and Growth Facility (PRGF) and the need to evolve special procedures to overcome problems in achieving stated objectives in countries with PRGF-supported programs have been much discussed. Although an internal review is currently under way, there is scope for an independent review beginning perhaps in late FY2003. The review could address such issues as: Have all of the lessons from the ESAF reviews and “best practices” on particular policy issues been incorporated into PRGF adjustment strategies? Has the increased emphasis on country ownership resulted in real changes in the approach to negotiations? Has program design effectively incorporated the analysis of the social impact of major reforms? Have program design and monitoring improved the targeting of spending in key sectors relevant to growth and poverty reduction? Have resources been effectively channeled to social sectors?
2. An external review of the enhanced HIPC Initiative would be important once a “critical mass” of countries reach their completion points.
3. The Contingent Credit Line (CCL) would also be a candidate for evaluation, but only after there is sufficient concrete operational experience with country cases.
4. The strategy vis-à-vis member country arrears to the IMF.
5. The IMF’s role in countries emerging from conflict.

### Technical Assistance and Training

1. A follow-up to the 1999 internal review of technical assistance. This could include an assessment of whether there are effective and consistent inter-

nal systems for evaluating technical assistance advice and for setting priorities.

2. Does technical assistance help improve national ownership of Fund-supported programs? Has it been effective in improving program implementation or in enhancing crisis prevention?
3. Assessment of the effectiveness of technical assistance in areas such as:
  - Tax policy and revenue administration;
  - Expenditure policy and expenditure management;
  - Banking supervision/financial stability; and
  - Debt and external reserve management.

### Internal IMF Processes and Governance

1. Are the IMF's internal review systems adequate? For example, are there adequate mechanisms for

early internal reassessments of the adequacy of program design?

2. Is World Bank–IMF collaboration effective? How can it be improved, given their distinct operational approaches and objectives? Is the division of labor/degree of overlap between the two institutions appropriate?
3. Do staff papers on country programs contain the necessary information and analysis for the Board to make an informed judgment on the probability of success?

### Research

Since the Research Department was being restructured when the work program was prepared, this was not viewed as a high-priority area for review. However, a follow-up on the recommendations of the 1999 External Evaluation of Research Activities could be considered for the longer term.

## Appendix 4 IEO Outreach Seminars and Workshops

*August 2001, London, United Kingdom*

Consultations on IEO's work program with non-governmental organizations (NGOs), academics, and other stakeholders.

*September 10–12, 2001, Dakar, Senegal*

Meetings on IEO's work program at PRSP/PRGF seminar.

*September 13, 2001, Paris, France*

Meeting on IEO's work program with NGO representatives.

*January 28, 2002, Tokyo, Japan*

Outreach seminar on the IEO with Tokyo-based academics, NGOs, and government officials.

*January 29, 2002, Tokyo, Japan*

Workshop on the capital account crises evaluation with Tokyo-based experts.

*February 9–10, 2003, Rome, Italy*

Briefings on the IEO with various officials.

*April 18, 2002, Washington, D.C., United States*

Briefing on the IEO with NGO representatives.

*July 1 and 2, 2002, Berlin, Germany*

Joint IEO/German Foundation for International Development (DSE) workshop, including academics and various NGOs on the three initial evaluation projects.

*August 5, 2002, Recife, Brazil*

Meeting on the capital account crises evaluation with NGO representatives.

*September 30, 2002, Washington, D.C., United States*

Briefing on the IEO with NGO representatives.

*October 29, 2002, Cambridge, Massachusetts, United States*

Workshop with the National Bureau of Economic Research on all three projects.

*November 7, 2002, Tokyo, Japan*

Workshop at the ADB Institute on the prolonged use of IMF resources evaluation and the capital account crises evaluation.

*November 8, 2002, Chiba, Japan*

Outreach seminar at the Institute for Developing Economies on the prolonged use of IMF resources evaluation.

*November 25, 2002, London, United Kingdom*

Workshop with the Overseas Development Institute on both the prolonged use of IMF resources and PRSP/PRGF evaluations.

*January 23, 2003, Manila, Philippines*

Workshops on the Philippine case study in connection with the prolonged use of IMF resources evaluation with the Asian Institute of Management and government officials.

*April 9, 2003, Washington, D.C., United States*

Meeting on the update of the IEO work program with NGO representatives.

*May 6, 2003, Dakar, Senegal*

Outreach workshop on the prolonged use of IMF resources and PRSP/PRGF evaluations with government officials, civil society, and donors.

## Appendix 5

### Evaluation of Prolonged Use of IMF Resources: Recommendations, Executive Board Response, and Subsequent Follow-Up

IEO Recommendation	Executive Board Response <sup>1</sup>	Staff Task Force Recommendations <sup>2</sup>	Follow-Up <sup>3</sup>
<b><i>Institutional arrangements and rationale for IMF involvement</i></b>			
<p>Adopt an operational definition of prolonged use, as a trigger for enhanced “due diligence” (i.e., ex post assessments and forward-looking consideration of “exit” strategies). The criterion could distinguish between general and concessional resources.</p>	<p>Directors saw merit in a definition to trigger greater due diligence. Many Directors noted that a definition should carefully differentiate low-income countries relying on concessional resources. Several Directors cautioned that a definition should not be interpreted as creating a new classification of member countries and that there should not be an a priori judgment that prolonged use necessarily implies a problem.</p>	<p>For general resources cases, prolonged users should be defined as countries that have spent seven or more of the last ten years under stand-by or extended arrangements, including precautionary arrangements, which was the definition used in the IEO evaluation.</p> <p>For concessional resources, enhanced assessment and strategy procedures would be triggered after a country has gone through two multiyear arrangements under concessional facilities.</p>	<p>Definition adopted.</p> <p>Semiannual reporting of the incidence of prolonged use to take place on this basis.</p>
<p>Make greater efforts to judge whether countries are ready to implement credible programs and be more selective in extending financial support. Use of Fund resources proposals should contain an explicit and frank assessment of the readiness of borrowers to implement programs.</p>	<p>Directors supported the recommendation that staff papers be more candid in assessing institutional capacity and ownership. They emphasized the importance of explaining downside risks and avoiding any bias towards over-optimism. Implementation of initiatives relating to ownership would be an ongoing process, sometimes involving difficult judgments, in particular regarding more selectivity in the provision of IMF financial assistance, where strong country ownership is lacking. A number of Directors stressed that greater selectivity should not imply giving up on difficult cases.</p>	<p>Efforts to improve program design should be accompanied by greater selectivity in extending IMF financial support, based in part on the assessment of implementation capacity and ownership.</p>	<p>Principal case-by-case follow-up will be through the internal review process and Board review of individual country cases, with periodic assessments as part of the regular conditionality review.</p>
<p>Aim to provide the international community with credible alternatives to IMF lending arrangements as a condition for other official flows.</p>	<p>Directors noted that it would be desirable to develop credible alternatives to indicate to the outside world the IMF’s approval of members’ policies and looked forward to a discussion of the signaling function. They noted need for care in preparation and consultation, including with the Paris Club.</p>	<p>The IMF should have effective ways to signal its views on policies to a country’s donors and creditors outside a Fund-supported program. Article IV staff reports, Public Information Notices, and “assessment letters” provide important vehicles. This topic should be taken further in the review of the IMF’s role in low-income countries. Donors’ and other lenders’ concerns about burden sharing should not lead to inappropriate lending decisions by the IMF.</p>	<p>The issue of signaling was taken up in the Board’s subsequent discussion on “Signaling Assessments of Members’ Policies,” although this did not address all the relevant issues addressed by the evaluation. This review resulted in the discontinuation of Staff Monitored Programs for signaling purposes. The broader role of signaling in low-income cases is being addressed as part of the ongoing review of the IMF’s role in low-income countries. Directors encouraged staff to continue to explore the scope for alternative signaling mechanisms.</p>

<p>Programs for identified prolonged users should include an explicit exit strategy.</p>	<p>Directors stressed the desirability, where appropriate, of the elaboration of corrective measures as part of a conscious “exit strategy.”</p>	<p>The proposed assessment and strategic planning exercises (see below) would include an explicit “exit strategy” where appropriate for ending prolonged use. An element of such a strategy would include helping countries widen their options for external financing.</p>	<p>Policy adopted, with an explicit definition of prolonged use as the trigger (see above).</p>
<p>Introduce a differentiated rate of charge for prolonged users as a signaling device.</p>	<p>The Board did not support a differentiated rate of charge for prolonged users.</p>	<p>Not recommended.</p>	<p>Recommendation rejected. No follow-up necessary.</p>
<p><b>Program design</b></p>			
<p>Specific operational procedures should be developed to ensure greater emphasis in program design on the domestic policy formulation process, in order to maximize ownership: (1) modify procedures towards the authorities having the initial responsibility for proposing a reform program; (2) encourage a process whereby core program elements are subject first to a policy debate within the member’s own political institutions; (3) surveillance should help create a better understanding of what would be expected if a program should become necessary; and (4) more explicit discussion of major uncertainties and how policies would be adapted if things turn out differently.</p>	<p>Directors broadly agreed with the recommendations. Many Directors underscored that they should be seen as part of a broader effort to ensure greater effectiveness of programs. They saw a need for continuing effort at improving program design, which would draw on the fresh perspectives provided by the report.</p>	<p>IEO’s recommendations were consistent with lessons emerging from recent country experience. The revised conditionality guidelines<sup>4</sup> incorporate many of the recommendations and provide the appropriate vehicle to put them into practice.</p>	<p>The regular conditionality reviews will be the main vehicle for monitoring progress on this and other recommendations on program design.</p>
<p>Programs should emphasize key institutional changes and strengthening implementation capacity more.</p>	<p>Directors underscored the importance of increasing the effectiveness of technical assistance in support of institutional capacity building.</p>	<p>The Task Force recommended that ongoing efforts to address these issues in operational work should be enriched by future work on program design, including the research effort, focusing on links between structural reforms and program objectives.</p>	<p>Regular conditionality reviews will monitor progress.</p>
<p>Greater selectivity in program content with: (1) further strengthening collaboration with the World Bank; (2) a more differentiated use of conditionality; (3) greater efforts to tailor the time frame of program design to a foreseeable length of reform and adjustment; and (4) more in-depth analysis of real economy responses to key policy elements and less attention to fine-tuning financial programming.</p>	<p>Directors were encouraged that recommendations on streamlining of Fund conditionality and need for more effective collaboration with the World Bank were already being internalized as part of the review of conditionality.</p>	<p>Agreed with recommendations, many of which were already incorporated into the revised conditionality guidelines.</p>	<p>Directors stressed importance of continued efforts to improve program design, including improved collaboration with the World Bank. Directors looked forward to further work by the staff on the relationship between external financing, adjustment, and sustainability; on the analytic framework for program design; on trade-offs between macroeconomic and structural policies; and on the parameters for assessing program success.</p> <p>Principal case-by-case follow-up will be through the internal review process and Board review, with periodic assessments of progress as part of the regular conditionality reviews.</p>

## Appendix 5 (concluded)

IEO Recommendation	Executive Board Response <sup>1</sup>	Staff Task Force Recommendations <sup>2</sup>	Follow-Up <sup>3</sup>
<p>Systematic ex post assessment of programs, with priority to identified prolonged users and key messages reported to the Board. Key internal database on program targets and outcomes (MONA) should be upgraded to facilitate such assessments.</p>	<p>Directors endorsed the recommendations.</p>	<p>The Task Force proposed that a process of ex post assessment and strategic planning would take place for all prolonged users, with lessons presented to the Executive Board.</p>	<p>The operational guidance note on assessment of countries with a longer-term program engagement has been posted on the Internet and about five or six ex post assessments are projected to be completed by end-2003.</p> <p>The MONA database is being upgraded.</p>
<p><b>Surveillance</b></p>	<p>Regular IMF surveillance of program countries should reassess economic developments and strategy from a fresh perspective.</p>	<p>Agreed with the overall thrust of IEO recommendations. Best addressed through continuing implementation and refinement of recently revised surveillance guidelines. These proposed that surveillance should assess more carefully social and political realities; reach out more widely to legislative bodies and line ministries and ensure that timing of consultations is such as to enable them to influence policy.</p>	<p>Directors concurred with the priority given to increasing effectiveness of surveillance, including the need to combine clarity and candor with recognition of social and political realities. They highlighted the importance of efforts to ensure that Article IV consultations in program countries “step back” from program context. Progress in strengthening surveillance, including by introduction of a fresh perspective, will also be addressed as part of the Board’s work program for FY2004.</p>
<p><b>Internal governance issues</b></p>	<p>Most Directors encouraged the staff to enhance its analysis and reporting of political economy issues in staff reports. Some Directors cautioned that IMF should be careful in venturing into this area, given its comparative advantage in technical analysis and the need to avoid intruding on internal political matters.</p>	<p>Task Force recommended an effort to enhance reporting and analysis of political issues, when it has important implications for economic policy. Staff capacities could be strengthened through a modest investment in training.</p>	<p>Training courses in political economy have now been established.</p>
<p>Procedures should be evolved to help avoid the appearance of political interference in determining whether programs deserve support. All programs should be prefaced by an explicit assessment of implementation risks. When management suggests risks are high, the Executive Board should be given an opportunity to express on the record its own assessment of the trade-offs.</p>	<p>Directors underscored the importance of distinguishing clearly between technical and political judgments and that staff should be candid in its assessment of risks.</p>	<p>Task Force noted that there can be no question about the responsibility of management for recommending, and the Executive Board for considering and approving, all requests for the use of Fund resources. Staff nonetheless has an important responsibility for providing candid technical assessment of risks and trade-offs, and should continue to strengthen both substance and presentation of this material.</p>	<p>Some indication that greater candor on risks is being adopted in presentations to the Executive Board. For example, the Managing Director’s statement for the 2003 transitional program with Argentina emphasized the risks to the IMF, including the political risks to implementation.</p>

A review of internal incentives facing staff should be undertaken with a view to minimizing turnover of staff working on countries and to foster increased candor and accountability.

Recommendations are largely management responsibility. They have important implications for internal governance and deserve careful consideration.

While overall personnel policies do not need to be changed, management should consider guidelines and incentives to reduce excessive mobility in country teams. The best way to guard against excessive mobility would be to reestablish spare staff capacity to absorb changing demands.

The Human Resources Department (HRD), at the request of management, is developing a more centralized approach to mobility. As part of an effort to ensure appropriate incentives, HRD, in collaboration with departmental senior personnel managers, provides career counseling that emphasizes the acquisition of new competencies rather than frequent mobility.

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<sup>1</sup>This column summarizes the reaction of the Executive Board on each recommendation as reported in the summing up by the Acting Chair. Although care has been taken to ensure accuracy, readers are invited to refer to the full text of the summary of the discussion which is included in the published version of the report and can be accessed from the IEO website ([www.imf.org/ieo](http://www.imf.org/ieo)).

<sup>2</sup>Conclusions of the Task Force on Prolonged Use of Fund Resources, February 4, 2003. Available at [www.imf.org/external/np/pdr/ufr/2003/020403.htm](http://www.imf.org/external/np/pdr/ufr/2003/020403.htm).

<sup>3</sup>Including Board Discussion of Task Force conclusions. The column on follow-up is meant to provide factual information on additional steps taken after the Board discussion. It is not intended to be an evaluation of any follow-up by management or the Executive Board.

<sup>4</sup>"Guidelines on Conditionality," September 2002. Available at [www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm](http://www.imf.org/External/np/pdr/cond/2002/eng/guid/092302.htm).

## Appendix 6

### Evaluation of the Role of the IMF in Recent Capital Account Crises: Recommendations, Executive Board Response, and Subsequent Follow-Up

IEO Recommendation	Executive Board Response <sup>1</sup>	Follow-Up <sup>2</sup>
<p><b><i>Precrisis surveillance</i></b></p> <p>Article IV consultations should take a stress-testing approach to a country's exposure to a potential capital account crisis, extending and systematizing existing approaches. Staff should assess the potential impact of itemized risks. Staff should develop greater understanding of political constraints on policy, in part through wider dialogue. Market views and political economy analysis should be reflected in staff reports.</p> <p>Management and the Executive Board should take additional steps to increase the impact of surveillance, including through making staff assessments more candid and more accessible to the public. In particular, there should be a presumption of publication for Article IV staff reports. A clear presumption of publication for country-related staff working papers should also be established. Biennial reviews of surveillance should focus on assessing the impact of surveillance on key systemic issues in major emerging market economies.</p>	<p>Directors concurred with the overriding message of the report for surveillance: to strengthen the effectiveness of IMF surveillance by extending and systematizing current guidelines for assessing vulnerabilities. They supported the call to itemize major potential shocks. Directors emphasized that stress testing should not be overgeneralized and mechanical, but should focus on key risks facing a particular country. Most agreed that the IMF should develop greater understanding of political constraints on policy while cautioning that this should not lead to interference in domestic affairs. A number cautioned that this could be counterproductive if it causes staff to lose focus and press for policies and reforms that are not macro-critical. Most Directors saw great value in systematic discussions with the domestic and the international financial and business communities—but emphasized that the staff would need to assess private sector views critically.</p> <p>Directors strongly supported greater candor in the assessment of country risks and vulnerabilities in staff reports, building on the increase in candor that has already occurred. Nevertheless, Directors expressed a range of views regarding the potential conflict between candor and transparency, and the implications of the proposed shift from voluntary to presumed publication of staff reports. Many Directors warned that greater candor could adversely affect both the Fund's dialogue with countries and market confidence in the context of the publication of staff reports. Some of these Directors felt that what really matters is candor in face-to-face consultations with the key decision makers in a country, rather than in the staff report. Many other Directors strongly supported presumed publication. These Directors believed that concerns about candor are overstated, and that surveillance would be more effective in building ownership and influencing policy if Fund analyses and recommendations are made public. It was agreed that the Board would return to the issue of presumed publication of staff reports during the discussion on transparency. Many Directors were not in favor of shifting from voluntary to presumed publication of staff reports, but a number strongly supported presumed publication.</p>	<p>Ongoing Board discussions of strengthening surveillance will revisit specific operational aspects. Biennial review of surveillance will be the main vehicle for assessing what has been done to address these and other surveillance-related recommendations.</p> <p>The Board had a subsequent discussion of strengthening surveillance on August 20, 2003. Directors took note of efforts to boost publication of staff reports, indicating that transparency was critical to allowing the public to develop informed views on the Fund's activities, which could then feed back into the Fund's work. However, some Directors drew attention to the potential trade-offs between transparency and candor.</p>

The Executive Board should agree on a systematic plan to provide institutional incentives for greater candor in the assessment of country risks and vulnerabilities, possibly including measures to give greater independence to surveillance teams.

Escalated signaling should be used when key vulnerabilities identified over several rounds of surveillance are not addressed. Such a policy would help strike the necessary balance between the role of the IMF as confidential advisor and its role as a vehicle for transmitting peer reviews on members' policies and for providing quality information to markets.

Management and the Board should explore the possibility of seeking "second opinions" from outside the IMF as part of the surveillance process when the authorities disagree with the staff's assessment on issues that are judged to be of systemic importance. This would also serve as a building block for the idea of escalated signaling.

### **Program design**

A comprehensive review of the IMF's approach to program design in capital account crises should be undertaken. In particular (1) greater attention should be paid to balance sheet interactions and their consequences for aggregate demand; (2) program design should allow for a flexible response, in case unfavorable outcomes materialize; (3) conventional financial programming-based conditionality should be reviewed, and possibly adapted for capital account crisis circumstances; (4) parsimony and focus should be basic principles of structural conditionality, and crises should not be used for pushing reforms that are not critical to crisis resolution, however desirable they may be in the long run; and (5) there should be an agreed communications strategy, characterized by a high degree of transparency.

Directors encouraged the provision of institutional incentives to the staff to facilitate candor.

Many Directors considered escalated signaling to be an idea worth pursuing. A number of these Directors reserved judgment on the suggestion until they had more information about how it would work. A few Directors felt that escalated signaling would undermine the Fund's role as confidential advisor, and doubted that it would help in preventing crises or designing more effective programs.

Many Directors were not in favor of inviting second opinions from outside the Fund. Whereas some Directors considered that a second opinion would bring a fresh perspective that could help resolve differences of opinions with the authorities, many were concerned that it could encroach on the role of the Board, and undermine the work of the staff. A few Directors also noted that this approach has been tried and has failed.

Directors endorsed these recommendations and hoped forthcoming staff papers on program design and balance sheet effects would give due attention to them. They endorsed the report's focus on the restoration of confidence, and the importance of balance sheet effects on key macroeconomic variables. The balance sheet approach should be closely linked to debt sustainability analysis. There should also be more work on twin (banking and capital account) crises. Directors agreed that design should allow for a flexible response to unfavorable developments; that the conventional financial programming conditionality should be reviewed; and that there should be an agreed communications strategy. Nevertheless, a few Directors cautioned against excessive emphasis on risks and alternative scenarios in program documents, since it would be difficult to know all risks up front and since such emphasis could erode the program's effectiveness in building confidence in the chosen action plan.

Biennial reviews of surveillance will be the main vehicle for assessing progress.

A sequence of staff papers on program design and conditionality is planned for discussion at the Executive Board during the next few months.

## Appendix 6 (concluded)

### IEO Recommendation

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

### Follow-Up<sup>2</sup>

#### ***The IMF as crisis coordinator***

The IMF should ensure that financing packages provided in response to capital account crises are sufficient to generate confidence and be of credible quality. In particular (1) packages should not rely on parallel official financing unless the terms of access are transparently linked to the IMF-supported strategy; and (2) terms for the involvement of other institutions providing parallel financing should be specified at the outset.

The IMF should be proactive in its role as crisis coordinator. In particular (1) management should provide a candid assessment of the probability of success to the Executive Board and shareholders; (2) management should ensure that the technical judgment of staff is protected from excessive political interference; and (3) the nature of private sector involvement should be determined on a case-by-case basis. The IMF should play a central role in identifying circumstances where concerted efforts can help overcome “collective action” problems, based on meaningful dialogue with the private sector.

#### ***Internal governance issues***

Human resource management should be adapted to develop and better utilize country expertise, including political economy skills, and to establish “centers of expertise” on crisis management issues. In particular (1) the length of staff assignments should be monitored to ensure continuity of staff expertise, and a critical mass of country expertise in each systemically important emerging market economy should be developed; (2) Resident Representatives should play a more central role in surveillance and program design; and (3) internal procedures should protect those who raise uncomfortable issues through proper channels, but consequently attract complaints from the authorities.

The Board agreed with the recommendation, while noting that there are limitations on the IMF’s influence on other sources of financing. The Board stressed that the recently revised access policy must be observed and emphasized the importance of program credibility, not large financing packages, as the heart of IMF involvement. Directors fully supported the idea of moving toward more explicit procedures for collaboration with regional development banks and others and clear delineation of responsibilities, while noting that such procedures do not by themselves guarantee effective coordination.

The Board endorsed the recommendations. Political judgments and decisions should be the exclusive domain of the Board. While Directors were in favor of early involvement of the Board in program discussions, a number of them observed that the Board and major members should not seek to micro-manage the operational details of programs or influence Fund missions in the field. Directors attached particular importance to the early involvement of the private sector as an integral element of crisis resolution.

The Board generally agreed on the need for institutional change to ensure that the IMF is in a position to respond rapidly to member countries facing crises. Some Directors supported the creation of centers of expertise in crisis management, whereas others put greater emphasis on mechanisms for drawing upon available expertise and experience in the event of a crisis. A number of Directors favored longer country desk assignments, while others noted the importance of staff mobility in broadening the experience and perspectives of the staff and maintaining its impartiality. Most Directors favored a greater role for Resident Representatives, with a few noting that only relatively senior Resident Representatives would be sufficiently acceptable to the authorities to play such a role; Directors supported modification of internal guidelines and human resource procedures. They also noted that human resource issues are management’s responsibility.

Staff noted that the recommendations of the IEO are consistent with ongoing steps to strengthen the capacity of the IMF in this area. For example, the new framework for exceptional access decisions provides a mechanism for encouraging more systematic early consideration of circumstances in which the success of a program would be enhanced by voluntary efforts to address collective action problems among private creditors and where steps to address an unsustainable debt burden need to be part of a strategy to restore growth and financial viability.

The Monetary and Financial Systems Department (formerly Monetary and Exchange Affairs Department) has been reorganized, with steps taken to provide a center of expertise on banking crisis resolution issues.

An Internal Task Force has been established to review broad strategic issues relating to the IMF’s Resident Representative program.

<sup>1</sup>This column summarizes the reaction of the Executive Board on each recommendation as reported in the summing up by the Acting Chair. Although care has been taken to ensure accuracy, readers are invited to refer to the full text of the summary of the discussion which is included in the published version of the report and can be accessed from the IEO website ([www.imf.org/ieo](http://www.imf.org/ieo)).

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# Appendix 7

## Evaluation of Fiscal Adjustment in IMF-Supported Programs: Recommendations, Executive Board Response, and Subsequent Follow-Up

IEO Recommendation	Executive Board Response <sup>1</sup>	Follow-Up <sup>2</sup>
<p><b>Program design and internal review</b>            Program documentation should provide a more in-depth and coherent justification for the magnitude and pace of programmed fiscal adjustment and how it is linked with assumptions about the recovery of private sector activity and growth. It will also facilitate the review process and discussions at the Board, as well as provide external audiences with a more convincing explanation for the rationale for the program and identify possible risks and subsequent corrective measures.</p>	<p>Directors supported this recommendation, and deemed that this initiative would instill greater discipline in program design, enhance transparency, and provide the public and the private sector with a more convincing rationale for the program, thereby helping to overcome political obstacles to implementation. Nevertheless, they recognized that uncertainties regarding key macroeconomic variables, particularly in countries in crisis, and concern about the implementation of policy measures and reforms complicate this task. A few Directors cautioned against spurious precision in such justifications, and others noted that the magnitude and pace of programmed fiscal adjustment may also reflect political constraints. Several Directors stressed the importance of better integrating debt sustainability analyses into program work. Directors looked forward to further staff analysis of growth projections in the context of program design discussions.</p>	<p>IMF management has indicated that a report will be submitted to the Executive Board on how the IEO's recommendations might be addressed and followed up in the period ahead.</p>
<p>The internal review mechanism should place more emphasis on the early stages of the process. A more intensive process of brainstorming is needed at the time of the initial brief, and the brief should also articulate more clearly the basis for the fiscal program, and its links with debt sustainability issues.</p>	<p>Directors supported this recommendation. They welcomed management's recent initiative aimed at enhancing the effectiveness of the review process, which, inter alia, encourages early consultation between departments.</p>	<p>See above.</p>
<p>Programs should give greater emphasis to the formulation and implementation of key institutional reforms in the fiscal area, even if (as is likely) they cannot be fully implemented during the program period. Programs should make stronger efforts to specify those structural reforms which should be carried out during the program horizon as part of a broader road map of priority reforms. This road map, and its prioritization, should ideally have emerged in the course of surveillance and be updated regularly as outlined below.</p>	<p>Directors agreed that key institutional reforms can be more critical for fiscal sustainability than short-term expenditure and revenue measures. However, they recognized that short-term measures are hard to avoid in many cases, especially if the immediate objective is economic stabilization. Medium-term institutional reform may be of particular relevance in countries that have achieved macroeconomic stability and where "second generation" reforms are necessary to foster growth and reduce longer-term vulnerabilities. Some Directors agreed with the report's suggestion that reforms should be broken down into those that require executive action, legislation, and capacity building.</p> <p>Directors, however, pointed out that in crisis situations, the pressing need to resolve the crisis may pose serious constraints on a medium-term approach. They reiterated the conclusion of the discussion on the Evaluation of the Role of the Fund in Recent Capital Account Crises (BUFF/03/125) that a crisis should not be used as an opportunity to force long-awaited reforms, however desirable they may be, in areas that are not critical to the resolution of the crisis or to address vulnerability to future crises. Careful judgment will</p>	<p>See above.</p>

## Appendix 7 (concluded)

IEO Recommendation

Executive Board Response<sup>1</sup>Follow-Up<sup>2</sup>

### Surveillance

The surveillance process should be used more explicitly to provide a longer-term road map for fiscal reforms and to assess progress achieved.

- In collaboration with the authorities, the IMF should clearly identify in surveillance reports the most critical distortions in a country's public finances from the perspectives of equity and efficiency.
- Such an analysis would provide a road map for fiscal reform in the future, with a clear sense of priorities. It would help to provide the basis for identifying critical reforms—particularly in areas where these reforms have been lagging—that would need to be addressed should IMF financing be required in the future.
- The identification in advance of areas considered critical will allow the authorities flexibility in the timing and packaging of reforms which is often lost if these reforms are flagged at the last minute in the context of a crisis situation. This approach would also help foster greater domestic debate on key reforms and hence would encourage homegrown solutions and greater ownership. Early and clear prioritization of reforms is also consistent with streamlining objectives—it will avoid last-minute bunching of reforms under crisis situations.
- The analysis of fiscal reform priorities should be accompanied by an assessment of why certain important distortions were not addressed in the past and what lessons have been learned from past experience. This should include an effort to identify and unbundle the various constraints to critical reforms, including lack of technical capacity, areas where additional legislative action is necessary, and areas where key decisions from the executive branch are required.
- Surveillance should include more systematic efforts to estimate the extent of tax evasion and tax exemptions, including the use of cross-country comparisons.
- Public debt sustainability could help anchor the road map of fiscal reform priorities proposed above and to assess trade-offs over time. At the same time, debt analysis provides a check of cumulative progress in improving fiscal systems that could also be reported in successive surveillance reports.

continue to be needed to focus conditionality on those reforms judged critical while at the same time ensuring that adequate progress is made in addressing vulnerabilities and achieving the program's goals during the period of the arrangement, thus safeguarding the Fund's resources.

Most Directors agreed that Article IV consultations should play a stronger role in identifying longer-term reform priorities and the causes of past failures in addressing fiscal problems, and that these analyses should inform subsequent program design. In this respect, the various initiatives to distinguish Article IV surveillance from program work are aimed at providing fresh perspectives. Some Directors considered the current framework of surveillance to be adequate for achieving the objectives of the IEO's recommendation. Directors also called for staff reports to set out in more detail the progress in implementing the recommendations of ROSC and technical assistance missions, as well as key reform priorities. Nevertheless, they underscored that the ultimate responsibility to develop a fiscal reform agenda resides with the individual country authorities, while the Fund should stand ready to provide advice.

Directors also stressed that, consistent with the Fund's mandate, surveillance needs to focus on key issues of macroeconomic relevance, which will be different in each country, and should draw on the expertise of other institutions as appropriate. They encouraged the use of cross-country experiences and comparisons, including inputs from regional and multilateral surveillance, to assist in program design. Most Directors viewed Article IV consultations as the appropriate vehicle for staff to identify countries in need of an in-depth fiscal review, stressing that this identification process should be applied uniformly to all member countries of the Fund. In most cases, these needs could be accommodated through technical assistance and ROSCs.

See above.

### **Role of the IMF in social protection**

The IMF should clearly delineate the operational framework in which social issues will be addressed within program design in non-PRGF countries. This should include a clear indication of the IMF's responsibilities and activities in this area.

The objective should be to assist middle-income countries to prepare and improve their institutional framework to allocate resources to critical social programs and to establish mechanisms to protect the most vulnerable groups in the face of external shocks and budgetary retrenchment.

- The IMF could invite the authorities regularly during Article IV consultations to identify the existing critical social programs and social services that they would like to see protected in the event of adverse shocks. Participation on the part of the authorities would clearly be voluntary.
- Successful implementation will depend heavily on having better and more transparent expenditure monitoring systems. On the basis of the priorities identified by the authorities, the IMF and the World Bank could join their accelerated efforts to reform public expenditure management (PEM) systems, specifically geared toward the social area, with a view to protecting the specified programs and spending categories.
- This concrete application of the PEM initiative is particularly important because in many cases where there is an IMF-supported program the World Bank is also active with adjustment lending supporting the budget.
- Surveillance would routinely report on these initiatives and their progress over time.

Directors agreed that an important aim of program design should be to protect critical social expenditures. However, they stressed, as recognized in the report, that the Fund should not become involved in the detailed selection and design of social policy; this task is outside both the Fund's mandate and its expertise. A number of Directors supported the IEO's call for updating of the 1997 guidelines that direct IMF work in the social area, in order to improve their clarity and effectiveness as an operational tool in protecting the most vulnerable from economic shocks and budgetary retrenchment. Other Directors, however, viewed the existing guidelines as adequate, and a few considered that the annual and medium-term budgets of non-PRGF countries already adequately identify critical social sector programs. These Directors recalled that the new framework for Bank-Fund collaboration on public expenditure issues should enhance countries' public expenditure reform strategies, including measures to protect critical social spending. A majority of Directors agreed with the recommendation that staff should inquire, during Article IV consultations, whether the authorities have identified social programs that they would like to protect in the event of a crisis, as they believed this would help dispel the criticism that Fund-supported programs unduly curtail social spending. A few others considered this recommendation impractical, as it would create significant costs and pressures for the authorities with little benefit.

See above.

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