# The Road to Middle-Income Country Status:
## Evaluation Lessons about the Role and Performance of the IMF in Assisting Low-Income Countries

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1. Good morning. It is an honor and a privilege to be here with you today. I greatly appreciate your having invited me.

2. Distinguished speakers at this Symposium are later to address the important contributions of fiscal policy and the business climate to the generation of adequate levels of investment.

3. I intend to touch upon some of those same themes, albeit from a different perspective—as Director of the IMF's Independent Evaluation Office (or the IEO, for short)—drawing on the findings of recent evaluations that the IEO has carried out.

4. I will organize my brief remarks today around three broad headings.

- First, I will provide a bit of background on the IEO itself and some of its evaluations that have the most relevance to the Symposium.

- Second, I will use those evaluations as a prism for examining the Fund's role and performance in three areas that are relevant for low-income countries' pursuit of middle-income status—the acceleration of growth needed to cross the middle-income threshold; the management of aid (both scaling it up and, later, scaling it down); and the transition to emerging market status.

- Third, I will draw out several implications for your consideration.

***Turning then to the IEO and recent IEO evaluations…***

5. You may know that the IEO is young, independent, and small.

- The IEO was established in July 2001 as a means of providing objective and independent evaluations of IMF activities. I sometimes say that we undertake the Article IV on the IMF itself.

- It is our mission to enhance the learning culture within the IMF, to strengthen the IMF's external credibility, to promote greater understanding of the work of the IMF, and to support institutional governance and oversight.

- The IEO is independent—totally independent of IMF Staff and Management. And it operates at arm's length from the Board of Executive Directors, representing the 185 member countries of the IMF.

- This independence gives IEO a comparative advantage over internal reviews which may not be as dispassionate. And because of our unfettered access to all internal documents, it gives us a comparative advantage over outside watchdogs. We are the Fund's own "ruthless truth teller".

- The IEO is small—by design we basically produce two or three reports per year. This means that to be effective, we must be very strategic, which we try to be and I believe we are increasingly succeeding.

- It is a tribute to the strength and governance of the IMF that it has created such an independent body to provide critical (and sometimes controversial) advice to assist the Fund in strengthening its performance.

6. In this context of a small and strategic program, I want to share with you my thoughts on recent IEO evaluations, and what light they may shed on the issues before us today.

- Of course, as originally designed and executed, these evaluations did not per se focus on the transition from low-income to middle-income status.

- But, I believe, they do contain important evidence and analysis of relevance to today's topic.

- And while my remarks may at times appear critical or raise questions about IMF actions, I want to stress that our evaluations have found many, many examples of very good practice and strong commitment by Fund staff. However, to paraphrase Cassius in Julius Caesar, my job is not to praise the Fund, but to identify problems where it needs to—and can—do better.

7. Very briefly, then, I will draw on five IEO evaluations, including (in the order in which I will discuss them) the evaluations of:

- *The Financial Sector Assessment Program* (FSAP), which looked at the FSAP program for quality of analysis, partnership with the World Bank, and impact on the policy dialogue with the authorities. It relied on 25 country case-studies, including for Cameroon, Ghana, and South Africa.

- *Fiscal Adjustment in IMF-Supported Programs*, which looked at fiscal policies in all IMF programs between 1993 and 2001 with detailed case studies in 15 countries, including two in Sub-Saharan Africa—Senegal and Tanzania.

- *The IMF and Aid to Sub-Saharan Africa* (SSA), which looked at more recent IMF policies and practices with respect to analyzing, catalyzing, and mobilizing aid to low-income SSA countries. It drew on data and evidence from the 29 SSA countries with programs supported by the

Poverty Reduction and Growth Facility (PRGF), during 1999 through 2005.

- *The IMF's Exchange Rate Policy Advice*, which covered the entire membership, including all Sub-Saharan African countries, examining perceptions about the IMF's role in the provision of exchange rate advice and the quality of that advice.

- *The IMF's Approach to Capital Account Liberalization*, which looked at public and internal documents from 27 countries, including South Africa.

8. The activities in the five evaluated areas cover a mix of IMF functions:

- from the provision of member services, such as advice on financial sector and capital account policies;

- to the design of conditionality in Fund-supported operations, such as for fiscal policy, and aid to Sub-Saharan Africa; and

- to the exercise of surveillance, such as on exchange rate policy.

All are relevant to the Ghanaian experience—and to the challenges that low-income countries more generally face in progressing to middle-income country status.

***Let me now turn to the emerging themes. Looking across these five evaluations, what are the lessons learned from them of most relevance for low-income countries' transition to middle-income status and the IMF's role and performance in helping countries to make that transition?***

9. To help set the stage, first a few words about "income," using the example of Ghana:

- On current growth rates, Ghana will cross the middle- income threshold within the next 10 years.

- For example, the current operational cut-off for countries to be able to access the World Bank's concessional IDA window is gross national income per capita of $1065. This compares with $520 (on the same definition—the Bank's so-called Atlas methodology) for Ghana.

- What is required to increase income per capita to the middle-income level? What will be needed to ensure that the objective is met, and met as soon as possible?

10. Of the many complexities that will affect Ghana's and other countries' quest for middle-income status, I would like to highlight three dimensions, on which IEO evaluations may be able to shed some light:

- The first such dimension is the increase in the quantity and quality of investment needed to increase labor productivity and in turn real wages, incomes, and growth. How can financial sector and fiscal policies and institutions best guide those processes?

- The second such dimension is the effective management of aid. How can scaling it up and improving its utilization support a country's overall growth strategy? How should its inevitable scaling-down be managed?

- The third such dimension is the effective management of the transition to emerging market status. How can exchange rate and capital account policies promote external competitiveness (in both in trade and investment) and accelerated growth while avoiding destabilizing volatility?

11. **Starting with the first dimension—financial sector and fiscal policies for growth—what do the IEO evaluations (on FSAP and fiscal policy) have to say about how and how well the Fund has contributed in these areas?**

12. The FSAP evaluation generally found high quality staff analysis that usefully diagnosed financial sector strengths and weaknesses, affecting both financial stability and development issues. That's good news for low-income countries aspiring to middle-income status.

13. The bad news is that the evaluation found too little attention to the analysis and integration of cross-border issues, clearly an important consideration for would be emerging-market economies. More generally, the evaluation recommended that the Fund pull together its cross-country findings into a compendium of lessons learned from FSAPs, which we felt would be useful to countries at all income levels. Let me amplify with a few specifics:

- The evaluation found variations in how well FSAPs addressed stability and development issues in an integrated manner. FSAPs were generally more successful in identifying priorities for reforming *existing* segments of the financial system with direct bearing on growth and development. They were less successful in identifying opportunities for new segments of the financial system designed to promote growth, or to provide financial services to underserved or excluded groups.

- The evaluation found that Bank-Fund collaboration was effective on FSAPs—in line with the FSAP mandate as a joint Bank-Fund program. And in some cases, the division of labor was especially well done—for example the Ghana progress report, which focused primarily on development issues, was led by the Bank.

- However, both we and our colleagues in the Bank's evaluation department (who conducted a parallel evaluation) found that despite the strong country ownership of FSAPs—as participation is voluntary—there was inadequate follow-up in the IMF's Article IV consultations—for which there continues to be weaknesses in linking financial sector issues to surveillance and technical assistance - as well as little follow-up in the Bank's country programming.

- Though the Bank and the Fund did not always follow-up on FSAPs, we did find evidence that FSAPs were used by the rating agencies, which increases their importance for middle-income aspirants seeking to establish or improve their creditworthiness for sovereign borrowing.

14. The fiscal evaluation also explored elements of the stability vs. development equation. In so doing, it found some things that surprised Fund critics (and maybe even some fans).

- First, it found that (contrary to the stereotype) the Fund did not apply a one-size-fits-all fiscal adjustment model. Rather it found that fiscal adjustment tended to be larger in programs in countries with more severe imbalances, and that the degree of programmed fiscal adjustment had been declining over time. We followed up on these findings in the Africa evaluation, and I'll come back to them momentarily.

- Second, the fiscal evaluation found that IMF-supported programs tended to be overoptimistic in projecting the recovery of private investment. However, this led to the programming of stronger fiscal adjustment than necessary to avoid macro overheating. In some such cases, more expansionary fiscal policy could have played a constructive countercyclical role, especially if additional spending was directed at high-return investments in capital projects and operations and maintenance.

- Of course, prudence is essential, especially where debt sustainability and market creditworthiness are issues. In such settings, a loose fiscal stance justified on countercyclical grounds could be destabilizing if misread by markets as indicating a lack of commitment to macro stability. Hence, in many cases, the authorities face a difficult trade-off in their fiscal policy stance. But even taking that need for prudence into account, we found that IMF policy advice regarding this tradeoff tended to take the side of caution—no real surprise there.

- Third, and this *may* surprise you—it certainly surprised Fund critics—was the evaluation's finding that Fund-supported programs generally protected social spending. Indeed, the evaluation's cross-country analysis for all programs between 1993 and 2001 showed that social spending did not decline under IMF programs, even when there was substantial fiscal adjustment. But something had to give—you can't constrain overall spending and favor one component without squeezing something else. In many cases that *something* was infrastructure, a topic that is also quite relevant to the aid story…

15. **To which I now turn—as the second dimension to be considered in the transition from low-income to middle-income status. Clearly the challenge here is maximizing the gains from aid in progressing towards middle-income status, while preparing to live without *it* (or at least with *less* of it) once that status is achieved. How (and how well) has the Fund done? What are the lessons from evaluation?**

16. For this question we have one main evaluation—of the IMF and aid to SSA. This evaluation, which relied on evidence from PRGF programs, found:

- That the Fund generally didn't do what it said it was going to do, when it introduced the PRGF in late 1999 as a new way of working, to replace the previous ESAF (the Enhanced Structural Adjustment Facility). Initially, the Fund did do some things differently, but then it stopped, reverting to "business-as-usual," although the rhetoric of change continued.

- This applied to the Fund's engagement in the PRSP process, the analysis of funding requirements for meeting the MDGs, and the mobilization of the needed additional aid. The evaluation thus reported a finding of "ambiguity and confusion" about institutional policies and practices and urged the Fund to clarify them, and be more straightforward and honest in communicating them.

- *Let me emphasize that these findings are very troubling from the perspective of institutional governance and integrity, given the serious implications for Fund credibility and reputational capital. Going forward, we will be keeping a close watch on Fund actions to clarify and communicate its policies and practices as part of evaluation follow-up.*

- This said, from the perspective of countries pursuing middle-income status, many of the evaluation's other findings are more benign. The evaluation found that if inflation is under 5-7 percent and international reserves are above 2.5 months of imports, the Fund generally programs aid increases to be fully used—and conversely.

- Vis-à-vis the fiscal evaluation's finding that the magnitude of adjustment has diminished over time, the Africa evaluation clarified that at least for PRGFs, the Fund has not changed its basic formula, but simply that improved country performance—thanks to many people in this room—has allowed more countries to meet the cut-offs and qualify for the full use of aid.

- Also, as in the fiscal evaluation, the Africa evaluation found that the Fund has protected social sector spending. We heard repeated complaints to this effect from African authorities when we were conducting the evaluation last year—complaints that the IMF pendulum has swung too far in *favor* of social sector spending—and away from infrastructure (again)...

- This leads to what is arguably the evaluation's most troubling finding from the perspective of the countries making the transition to middle-income status—namely, that PRGF program design was not informed by serious analysis of countries' absorptive capacity for increased aid or by the composition of aid.

- To be sure, the World Bank is the lead 19th Street agency dealing with compositional issues—whether of aid or public expenditures—but these issues have major implications for the economy's supply response and growth, and in turn for the macroeconomic aggregates and so should be (but usually aren't) factored into the design of Fund-supported financial programs.

- The evaluation called for better Bank-Fund collaboration, especially on the macro/sectoral interface, echoing a recommendation of the Malan Committee Report, which was released just after our report.

17. **This brings me to the third dimension of the transition to middle-income status—the challenges countries face en route to "emerging market" status. What light do the evaluations shed on what and how well the IMF has done in this area? Two evaluations provide relevant material—the most recent on exchange rate policy advice and an earlier evaluation on capital account liberalization.**

18. The exchange rate evaluation found that the IMF was not as effective as it needs to be in both its analysis and advice, and in its dialogue with member countries.

- It found that the Fund's advice tended towards the generic, text-book variety, typically urging greater flexibility, while showing little familiarity with the practical considerations that countries face in actually managing their exchange rates.

- It also found that the Fund failed to cross-fertilize among countries—an important sin of omission especially important for low-income countries struggling to make middle-income status.

- This failure has been a recurring complaint that we have heard from country interviews in *all* our evaluations. In the Africa evaluation, for example, we heard from Ministry of Finance colleagues in several countries about their requests to the Fund for comparator analysis of wage-bill ceilings and tax effort, but with little success.

- But the criticism was most vocal in the exchange rate evaluation. We heard from country after country, especially among the emerging markets, about their unmet requests for the lessons learned from other countries' experience, including on the practical challenges of managing more flexible or floating exchange rate systems.

- Finally, the evaluation identified "silo problems" and difficulties in the integration of the latest thinking and experience from inside and outside the Fund into its front-line advice.

19. The evaluation on capital market liberalization found something similar—a tendency for the Fund to take generic positions, inadequately informed by country-specific constraints.

- We found that, prior to the mid-1990s, the IMF's analysis emphasized the benefits to developing countries of greater access to international capital flows (true), while paying comparatively less attention to the risks inherent in their volatility (potentially significant). This limited the practical usefulness of its advice on the transition to middle income status.

- More recently, however, the IMF has paid greater attention to various risk factors, including the linkage between industrial country policies and international capital flows as well as the more fundamental causes and implications of their boom-and bust cycles.

- Still, in the country work that we looked at, there were gaps in the IMF's advice on capital account issues, for example, on sequencing—an issue of critical importance in the transition to middle-income status.

***What are the implications of all this…?***

20. Looking across the three dimensions of the transition to middle-income status—financial sector and fiscal policies for growth, aid macro-management policies, and exchange rate and capital market policies—where do we come out?

- Clearly these are all extremely important issues for where these countries want to go.

- It's hard to imagine policies in any sphere that matter more.

- In turn, this means that within the international financial and development architecture for helping countries make the transition to middle-income status, the Fund has a critical and central role.

21. And how has the Fund done?

- On balance, Fund performance has been mixed.

- The evaluations show that the Fund has done well—but not as well as staff believed in recent surveys; and clearly with some problems.

22. The Fund can and *must* do better. At a minimum, it needs to be more systematic; carry through its analytic findings into the policy dialogue and operations; work pro-actively with the Bank to get the analysis it needs.

23. Looking at the common features of the five evaluations, for the guiding principles that drive Fund positions, three propositions stand out. These are:

- *Market processes trump managed processes*—the implicit rule guiding Fund advice.

- *Social spending trumps other investments*—the implicit rule governing Fund advice on spending composition, at least in HIPCs.

- *Stability trumps everything else*—the implicit rule for the Fund's position on the stance of macro policy.

24. I confess that I do not have a problem with these three propositions. They generally accord with my own values, developed over a long career at the Canadian Ministry of Finance, the OECD, and the Fund as an Executive Director.

- That is, with one exception—I have some difficulty with the fact that *growth is never trump at the Fund*.

- This, I believe, may need to change—especially in the Fund's work with low-income countries with hard-won stability gains that are aspiring to middle-income status and to meet the MDGs.

- Stability, and the credibility that comes with it, are hard won and easily lost. Yet, I believe the time has come to more openly discuss the trade-offs that authorities of LICs aspiring to be MICs face in balancing growth and stability.

- Indeed, accelerated growth is essential if you are aiming to reduce poverty in any substantial way. A bigger slice of social sector spending out of a fixed pie simply won't do it. We all know that.

25. I believe the evaluations also highlight several overarching priorities—all of which loom large in upcoming IEO evaluations:

- First, the Fund needs to do more to look *across* its work areas from the client's perspective. Though the Fund is often perceived as a monolith, the insider view shows that it is not — that there are key departments that champion particular issues—whether it be the financial sector, exchange rate policy, aid, or fiscal policy. Preparing for today brought home to me how useful it would be for Fund "clients" to have all the relevant cross-country experience pulled together.

- Second, and closely related, the Fund needs to strengthen the links between research and operational advice. Not more research; but *more-connected* research. We found shocking results in the staff survey for the Africa evaluation—for example, that zero percent (!) of polled operational staff used the findings of the IMF research department in their operational work. Also, as I mentioned, in the exchange rate evaluation, we found intellectual "siloism" rampant.

- Finally, the Fund needs to reaffirm its commitment to professionalism and its core mandate over politics and political correctness. Should the Fund be taking a position on spending composition, as between social and infrastructure? (Clearly it helps with Fund critics and some shareholders/donors, but is this Fund business? Shouldn't this be a country matter?) Should the Fund be advertising that it is helping to mobilize donor support for the MDGs, when its Board of Directors is divided on the Fund's role in this area and Fund policy is undefined and its practice is actually ad hoc? (Clearly, this is politically correct and helps with public relations with some stakeholders, but what about the truth?) On exchange rates, should the Fund be taking the position *the more flexible the better*? (Of course, this is the position of some important shareholders, but is it borne out by the analysis and research?)

26. How to make this happen. How do we address these issues and get the growth card into play at the Fund?

Low-income countries, as important Fund members need to speak out – to staff, to management, and to the other members represented at the Board. This is an important element of voice.

Will the Fund listen? I would expect so. A frank exchange on policy issues can only lead to a better understanding on both sides which in turn can be better communicated to other stakeholders.

But equally important, be aware that African countries are among the best friends the IMF has. This is what the IEO surveys tell us. African members can and should leverage their friendship, whenever you see the need to do so,

27. Thank you.