

INTERNATIONAL MONETARY FUND

**Macroeconomic and Operational Challenges in Countries in Fragile Situations<sup>1</sup>**

Prepared by the Strategy, Policy, and Review Department

In consultation with other Departments

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**ABBREVIATIONS AND ACRONYMS**

AfDB	African Development Bank
ARTF	Afghanistan Reconstruction Trust Fund
BRS	Budget Reporting System
CAP	Common Approach Paper
CPIA	Country Policy and Institutional Assessment
CSO	Civil Society Organizations
DAC	Development Assistance Committee
DFID	Department for International Development
DSA	Debt Sustainability Analysis
ECF	Extended Credit Facility
EFF	Extended Fund Facility
ENDA	Emergency Assistance for Natural Disasters
EPCA	Emergency Post-Conflict Assistance
ESAF	Enhanced Structural Adjustment Facility
ESF	Exogenous Shocks Facility
FAD	Fiscal Affairs Department
FCS	Fragile and Conflict-Affected States
FDI	Foreign Direct Investment
FIN	Finance Department
FMIS	Financial Management Information System
FRY	Federal Republic of Yugoslavia
GEMAP	Governance and Economic Management Program
GMR	Global Monitoring Report
GoA	Government of Afghanistan
GRA	General Resources Account
HIPC	Heavily Indebted Poor Countries
IDA	International Development Association
IFC	International Finance Corporation
IFIs	International Financial Institutions
IFS	International Financial Statistics
ILO	International Labor Organization
INCAF	International Network on Conflict and Fragility
INS	IMF Institute
JSAN	Joint Staff Assessment
LEG	Legal Department
LICs	Low-Income Countries
LICUS	Low-Income Country under Stress
MCM	Money and Capital Markets Department
MDBs	Multilateral Development Banks
MDGs	Millennium Development Goals
MDR	Multilateral Debt Relief
MDTF	Multi-Donor Trust Fund
MENA	Middle East and North Africa
MFD	Monetary and Financial Systems Department

MICs	Middle-Income Countries
MIGA	Multilateral Investment Guarantee Agency
MONA	Monitoring of Fund Arrangements
NGO	Nongovernmental Organization
NTGL	National Transitional Government of Liberia
OBP	Office of Budget and Planning
ODA	Official Development Assistance
OECD	Organization for Economic Cooperation and Development
PA	Palestinian Authority
PBC	Peace Building Commission
PCBS	Palestinian Central Bureau of Statistics
PFM	Public Financial Management
PNP	Palestinian National Plan
PRGF	Poverty Reduction and Growth Facility
PRGT	Poverty Reduction and Growth Trust
PSI	Policy Support Instrument
PSRP	Poverty Reduction Strategy Paper
RAP	Regional Allocation Plan
RCF	Rapid Credit Facility
RDB	Regional Development Bank
ROSC	Report on the Observance of Standards and Codes
RSN	Regional Strategy Note
SBA	Stand-By Arrangement
SDDS	Special Data Dissemination Standard
SDR	Special Drawing Rights
SMP	Staff-Monitored Program
SPR	Strategy, Policy, and Review Department
STA	Statistics Department
TA	Technical Assistance
TRS	Time Reporting System
UCT	Upper Credit Tranche
UNDP	United Nations Development Program
WBG	West Bank and Gaza
WEO	World Economic Outlook
WDR	World Development Report

## EXECUTIVE SUMMARY

**There is broad recognition that countries in fragile situations face unique challenges.**

While fragility may afflict countries at different levels of income and capacity, common features of fragile states are institutions that are seen to be weak and lack legitimacy, as well as a fractious political setting, which in turn elevates the risk of violence. Fragilities impose large costs and hardships on local populations that can spill over to neighboring countries—directly through conflict, crime, and disease, but also through economic linkages.

**Considering these unique challenges, the international community is developing forms of engagement that stress peacebuilding, social cohesion, and statebuilding.** They incorporate recognition of the need for sustained engagement, a willingness to take calculated risks in uncertain environments, fuller attention to the political economy of reforms and capacity constraints, and coordination of donor efforts. The World Bank is in the process of adapting its operational modalities in fragile states, drawing on the findings of the *2011 World Development Report: Conflict, Security, and Development*.

**The Fund has engaged extensively in fragile states, including through Fund-supported programs, technical assistance, and training.**

- *Engagement with the Fund has, on the whole, been beneficial for fragile low-income countries (LICs):* macroeconomic policy frameworks have been strengthened; economic outcomes have improved over time; institutional and human capacity has gradually been built up; and fifteen LICs in fragile situations have received debt relief under the Heavily Indebted Poor Countries (HIPC) and Multilateral Debt Relief (MDRI) Initiatives.
- *Nevertheless, the implementation of Fund-supported programs in fragile LICs has been bumpy, possibly reflecting too bold reform agendas or too optimistic assessments of implementation abilities.* The mode of engagement with LICs in fragile situations has overwhelmingly been through the Poverty Reduction and Growth Facility (PRGF)/Extended Credit Facility (ECF) and conditionality in programs with fragile states has been relatively ambitious. Such programs have been affected by frequent interruptions.
- *Engagement with fragile middle-income countries (MICs) has also been generally beneficial.* Usually, early progress in building capacity allowed a transition to upper-credit-tranche arrangements, which fostered improved macroeconomic prospects. This said, capacity constraints were severe in some instances, and program reviews were subject to significant delays in some cases.

**A number of changes to Fund policies and practices are proposed:**

- For fragile LICs, consistent with the 2009 reform of LIC facilities, *fuller use of the Rapid Credit Facility (RCF)* to support a more flexible approach to adjustment and

reforms where needed. Under this approach, the RCF would continue to serve as a bridge to ECF arrangements.

- For fragile MICs, *establishment of a unified, RCF-like, nonconcessional facility for emergency assistance*, which would provide greater flexibility than existing GRA emergency facilities. This would allow a similar approach to sequencing of Fund financial support in MICs as in LICs.
- *A moderate increase in the cumulative access limit for the RCF and comparable access limits for the nonconcessional facility for emergency assistance* to permit more extended use when warranted with appropriate safeguards.
- *Greater flexibility built into program design*, while being mindful of applicable conditionality standards, to reflect better fragile states' limited implementation capacity, as well as the importance of delivering "quick wins" to populations. Programs in fragile states should also pay particular attention to job creation, the need for inclusive growth, and contingency planning.
- *Promotion of mechanisms to strengthen the catalytic role of Fund engagement*. Over the medium to long term, financing needs of fragile states should largely be met by highly concessional donor resources, with Fund financing tapering out. One option would be to incorporate a budget support component linked to Fund-supported programs (or Fund monitoring) in country-specific Multi-Donor Trust Funds (MDTFs).
- *Fuller attention to the political context in fragile situations*. Staff reports would explain how program design has been tailored to the political and social context, informed by an assessment of the political situation.
- *Closer coordination with donors, particularly in the field*, to help foster prioritization on key objectives, participate in the process of identification of "quick wins," and assess the financial implications of such priorities, including the identification of financing gaps.
- *Continued efforts to plan for technical assistance over a medium-term horizon and to provide "boots-on-the-ground."* Recent initiatives, including topical trust funds and programmatic management of externally financed projects, have moved in that direction. Continued training of country officials is also essential.
- *Attention to staff resources devoted to fragile states*. Within the Fund's overall budget envelope, the allocation of resources to fragile states and the incentives for suitably talented staff to work on fragile states are worth further consideration.

## I. INTRODUCTION

1. **The international community has recognized that the problems of fragile states present distinct challenges and warrant well-targeted approaches.**<sup>2</sup> There is broad recognition that while some countries have been able to transition out of fragility, many others have not been successful in supporting a sustained transition to a less fragile situation. This has brought to the fore concerns about the preservation of peace and security in fragile states, as well as the risk of spillovers of deteriorating security conditions to neighbors. Such concerns have led the international community to expend considerable efforts to develop effective paradigms for engagement in these countries.

2. **In 2008, the Fund reviewed its experience and discussed options to enhance the quality of its engagement with fragile states.**<sup>3</sup> The Board observed that this engagement had borne broadly favorable results, albeit with gaps in some areas. Looking ahead, while there was no consensus on the proposal to create a new facility dedicated to fragile states, Directors saw merit in a “graduated, flexible, medium-term programmatic approach” to improve the Fund’s capacity to assist fragile low-income countries (LICs).

3. **This paper seeks to identify how the Fund’s engagement with fragile states may be strengthened, taking into account recent experience and the evolving thinking in the international community.** To this end, Section II discusses the characteristics of fragility and Section III the principles and guidelines for effective engagement in fragile states. Section IV assesses the effectiveness of the Fund’s engagement and, drawing on the insights from the preceding sections, Section V explores areas for enhancing the Fund’s ability to deliver support to fragile states. Finally, Section VI concludes and presents issues for discussion. The first three appendices discuss definitions of fragility, characteristics of real GDP growth in fragile LICs, and the work of the international community in fragile states. Appendix 4 contains case studies illustrating key elements of the Fund’s engagement experience: (i) a detailed case study of a LIC (Liberia) and a middle-income country (MIC) (Iraq); (ii) engagement without financial support (Sudan and West Bank and Gaza); and (iii) engagement where donor financing has been limited (Yemen and the Central African Republic).

4. **This paper recognizes that fragile situations may exist in both LICs and MICs.** As indicated in various sections of the paper, the main elements of the proposed approach to enhance Fund engagement with fragile states apply both to LICs and MICs. However, since

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<sup>2</sup> Throughout this paper the terminology “fragile state” will refer to the existence of a fragile situation in a country, in the sense that the country exhibits the characteristics of such situations described in Section II. This should, however, not be taken to imply that any state is permanently fragile.

<sup>3</sup> See IMF (2008).

fragile situations are especially common among LICs, the paper's analytical work, including the detailed analysis of country experience, is confined to LICs.

## II. CHARACTERISTICS OF FRAGILITY

5. **There is broad acceptance that fragility has a number of dimensions that have a bearing on the engagement strategy.** Common characteristics of fragile states are institutions that are seen to be weak and governments that are perceived to lack legitimacy, all of which elevate the risk of violence. Thus, as described below, the basic approach to engagement in fragile states emphasizes peacebuilding, social cohesion, and statebuilding. This said, fragile states differ in terms of financial and capacity constraints. While many fragile states face severe financial and capacity constraints that lock them in bad equilibria for prolonged periods, some are well endowed with natural resources and some others, especially among MICs, have substantial administrative capacity. Such country-specific characteristics of fragility need be taken into account in defining the engagement strategy.

6. **Virtually all existing definitions of fragility incorporate a measure of institutional weakness.** Such institutional weaknesses encompass the political, security, and economic domains. For the analytical work and background research presented in this paper, we use the group of LICs identified by the World Bank as fragile under its Fragile and Conflict-Affected States (FCS) Initiative, based on their low Country Policy and Institutional Assessment (CPIA) score (which captures the quality of economic and sectoral policies and institutions) and existence of conflict in recent years.<sup>4</sup> Other international organizations also use broadly similar definitions (Appendix 1).<sup>5</sup> All existing definitions have strengths and weaknesses, and there is no universally accepted list of fragile states (and this paper avoids constructing a Fund-specific list). This said, there is considerable overlap in the lists of countries considered fragile under these various definitions. The approach to engagement outlined in this paper is applicable to countries that are not considered explicitly in the analytical work but that show the characteristics of fragility outlined in this section.

7. **Fragile LICs are often but not always characterized by severe domestic resource constraints.** In fragile LICs, on average, per capita GDP is roughly 60 percent lower than

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<sup>4</sup> The World Development Report (WDR) 2011 notes that even though the CPIA indicators do not include a direct measurement of political and security institutions and policies, there is a striking correlation between "fragility," as defined by the CPIA scores, and the incidence of major episodes of organized violence.

<sup>5</sup> For instance, the OECD (2007) describes fragility as follows: "States are fragile when state structures lack political will and/or the capacity to provide the basic functions needed for poverty reduction, development and to safeguard the security and human rights of their populations." Mata and Ziaja (2010) provide a number of other broadly similar definitions of fragility and a discussion of the most prominent cross-country fragility indices.



that of other LICs, while domestic revenues lag by some 5 percentage points of GDP.<sup>6</sup> Such an environment of constrained resources can exacerbate a fractious political context, by creating a situation in which the state is unable to meet the most pressing needs of its population.

8. **For many fragile LICs, limited aid has added to the already severe resource constraints that they face.** It is now well established that aid alone cannot lead to a transition from fragility—some commentators have even argued that too much financial assistance at an early stage can impede progress in transitioning out of fragility.<sup>7</sup> Nonetheless, it is also well accepted that, in light of the severe domestic resource constraints in fragile LICs, official development assistance (ODA) remains a critical component of any successful intervention. Aid provided to fragile LICs has increased in recent years but, in per capita terms, these countries received less aid than other LICs during the last decade (Table 1). The distribution of such aid is also highly skewed to a few countries.

9. **Aid provided to fragile LICs is typically more volatile than aid to other LICs.** Post-conflict LICs typically receive the most aid in the period immediately following a conflict.<sup>8</sup> Yet, at this stage of their transition, the capacity to absorb aid is not at its optimal level and progress in implementing reforms is often slower than expected by the international community. Slow progress on reforms, as well as the easing of conflict-related imperatives, often cause aid flows to drop-off. Thus, as countries transition to stages where they may be able to better utilize aid, the aid available to them declines.

Table 1. Some Results on Aid to LICs, 2000–2009

	Fragile States	Non Fragile LICs
Net ODA in percent of GNI		
Average	16.2	9.8
Maximum	57.7	26.3
Minimum	2.8	0.2
Per Capita Net ODA		
US \$ average 2000-2009 per country	73.1	86.0
US \$ median	40.7	53.1
Average growth rate	27.4	16.0
Aid Volatility		
Average volatility - growth rates of per capita net ODA	60.9	48.2
Average volatility - per capita net ODA	34.6	31.5

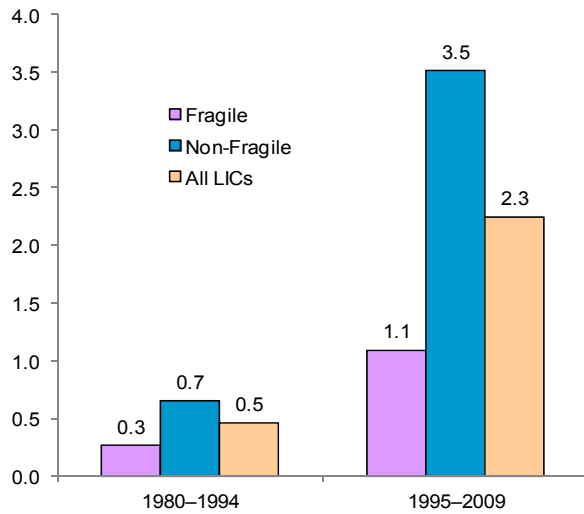
Sources: OECD/DAC and Fund staff estimates.

<sup>6</sup> Based on data for 2009 and excluding oil producing LICs, Somalia, and Solomon Islands.

<sup>7</sup> See Chauvet and Collier (2008) and Box 2.

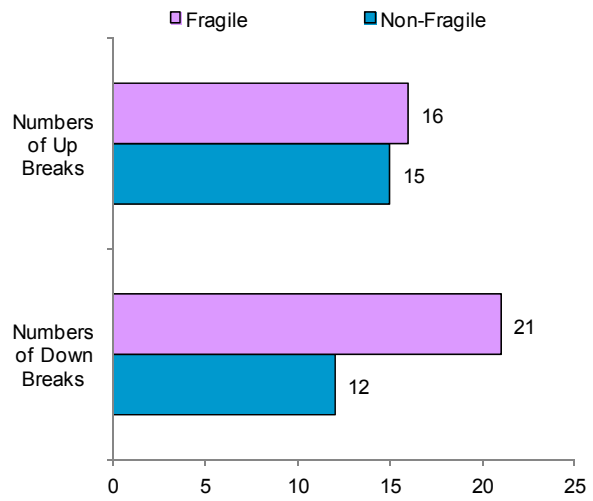
<sup>8</sup> Aid appears to peak about two years after the end of the conflict and then tapers off after about five years. Budget aid, however, is very limited and countries have difficulty in meeting routine government expenditures.

Figure 1. Average Per Capita GDP Growth



Sources: WEO, and Fund staff estimates.

Figure 2. GDP Growth Breaks, 1960-2009



Sources: WEO, and Fund staff estimates.

**10. For fragile LICs, vulnerability to shocks is a major impediment to development, resulting in lower and more volatile growth.<sup>9</sup>**

- Fragile LICs have experienced lower real GDP growth than other LICs. This is especially evident in the period since the mid-1990s (Figure 1).
- On average, fragile LICs have experienced a broadly similar number of growth accelerations as non-fragile LICs. However, downturns in growth in fragile LICs have occurred considerably more often than in non-fragile LICs (Figure 2).<sup>10</sup>
- Downturns in growth in fragile LICs are also significantly more persistent than in non-fragile LICs (Appendix 2).

**11. Fragile states are more prone to political stress.** Where the state, unable to meet the pressing needs of the population, has lost legitimacy, its actions face constant challenges. This complicates launching an initial transition from a fragile situation because of the population's low trust in the capacity of the state to deliver the promised benefits of the

<sup>9</sup> See Appendix 2 for a detailed analysis of real GDP growth in LICs in fragile situations.

<sup>10</sup> Up breaks and down breaks refer to sustained periods of high or low growth identified based on the econometric methodology of Berg, Ostry, and Zettelmeyer (2008).

transition.<sup>11</sup> However, on occasion, especially following a major conflict, there may be a “window of opportunity” to pursue major reforms and re-establish the state’s credibility.<sup>12</sup>

**12. Many fragile states are experiencing elevated levels of violence, or are at high risk of doing so.**<sup>13</sup> While fragile states are not limited to in-conflict, or even post-conflict states, the evidence indicates that fragile LICs were nearly twice as likely as other LICs to experience civil conflicts.<sup>14</sup> More specifically, there is evidence to suggest that economic shocks, in particular, food and energy price shocks, can increase the risk of conflict.<sup>15</sup> Recent research also suggests that where economic shocks are mitigated by appropriate political institutions, the risk of conflict is reduced.<sup>16</sup> The recent events in the Middle East too suggest that where the benefits of development do not accrue equitably to the entire population—including, in some cases, because of cronyism or widespread corruption—the risk of conflict can quickly be elevated.

**13. In fragile states, the process of reform may itself temporarily elevate the risk of violence.** Reforms, which are often associated with a shift in the balance of power, could face violent resistance from powerful entrenched interests. Research has indicated that, in a number of countries, rapid reform efforts were associated with an increase in political instability.<sup>17</sup>

**14. Fragile states often have adverse spillover effects on their neighbors.** The economic collapse, breakdown of law and order, and disease associated with conflict in a country are typically not confined to its borders. By some estimates, the cost of a typical civil

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<sup>11</sup> See the WDR 2011 for a detailed discussion of the trap of low expectations.

<sup>12</sup> Collier (2007) reports that the probability of a major reform initiative being launched is at its highest in the period following the cessation of civil conflict. However, on account of capacity constraints, the likelihood of such reforms being sustained and resulting in a transition from fragility is very low. Where capacity constraints are not particularly severe, post-conflict situations, or situations with regime change, could offer good prospects for significant progress.

<sup>13</sup> While violence is often associated with civil war, the WDR 2011 argues that outbreak of violent crime is equally detrimental to a country’s development prospects.

<sup>14</sup> Similar comparative information on the prevalence of violence more broadly defined is not readily available, but the existence of violent crime in fragile LICs, and the inability of law and order institutions that lack in legitimacy to rein in such crime, is commonplace.

<sup>15</sup> See Miguel, Satyanath, and Sergenti (2004).

<sup>16</sup> See Besley and Persson (2010 and 2011).

<sup>17</sup> WDR 2011 suggests that rapid reforms make it difficult for actors in the post-conflict society to make “credible commitments” with each other since they do not know how the reforms will affect the “balance of power.”

conflict on the country and its neighbors is about \$64 billion. Moreover, even when fragile states are at peace, they have an impact on their neighbors on account of their policies and governance. The cost to the typical fragile state and its neighbors, over the entire history of its fragility, has been estimated to be about \$100 billion.<sup>18</sup>

### III. PRINCIPLES AND GUIDELINES FOR EFFECTIVE ENGAGEMENT IN FRAGILE SITUATIONS

15. **In recent years, there has been broad international recognition that persistent conflict and fragility are the key impediments to development in many countries.** With the objective of finding solutions to reduce the risk of such conflict and promote transition from fragility, a number of fora consisting of donors, international agencies, as well as fragile and conflict-affected states themselves have emerged (Appendix 3).

16. **In these fora, a broad consensus has been achieved that peacebuilding and statebuilding are central to effective engagement in fragile states.** Thus, a multidimensional engagement is needed spanning efforts to improve security and establish appropriate political institutions, improve governance, undertake significant investment in rebuilding infrastructure and human capital, and set up institutions for sound macroeconomic management and sustained economic growth. Based on this insight, a number of studies have developed the key elements of an approach to effective engagement in fragile situations, which are encapsulated in the OECD's "Principles for Good International Engagement in Fragile Situations" (Appendix 3). Such studies have been complemented by country level consultations in many fragile and conflict-affected states conducted under the auspices of the International Dialogue on Peacebuilding and Statebuilding.<sup>19</sup> Similar principles and ideas are put forward in the World Bank's comprehensive World Development Report (WDR) 2011. The subsequent discussion draws on that report, as well as the other studies noted above.

17. **Because it entails such institution building, transition from entrenched forms of fragility is typically a lengthy process.** WDR 2011 reports that even for the fastest transforming countries, improving institutional quality from the level of a country like Haiti to that of Ghana, took in the range of 15–30 years.<sup>20</sup> Collier (2007) estimates the probability

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<sup>18</sup> See Collier (2007) Chapters 2 (page 32) and 5 (page 74), and Chauvet and Collier (2005) for a discussion of the costs cited in this paragraph. Collier (2007) labels these countries as "failing states," and uses a definition based on the World Bank's CPIA index that is similar to the capacity criterion in the Bank's FCS Initiative.

<sup>19</sup> See for instance INCAF (2010), OECD (2010b and 2011), and UN (2010). In addition, the United Kingdom's Department for International Development (DFID) has developed its guidance for engagement in fragile situations around the OECD principles for good international engagement in fragile situations.

<sup>20</sup> Based on Pritchett and de Weijer (2010) using World Bank Governance Indicators, it reports data on transitions in six categories of state and institutional capability for a sample of states in fragile situations. In that sample, the minimum time required by a country to achieve rule of law was 17 years. Proceeding at the average pace of the fastest 20 countries, it took on average 36 years to achieve government effectiveness, and 41 years to achieve rule of law.

of a sustained turnaround starting in any year to be just 1.6 percent, implying an average time of 59 years to transition from fragility. In countries with better capacity and resources, faster transition is possible, but resolving the social tensions in a manner that helps establish the government's legitimacy may still be challenging.

18. **With these stylized facts in mind, the pace of reforms needs to be calibrated to the capacity of the country.** The adoption of an overly ambitious reform strategy risks creating unrealistic expectations that could further damage the legitimacy of the state. Furthermore, given the conditionality framework employed by donors, it may lead to interruptions in engagement and impede the progress of transition from fragility. Also, as some authors have noted, forcing the pace of reform leads to a situation in which *de jure* policy changes have little or no impact on actual performance.<sup>21</sup> Finally, change that is too rapid makes it harder to implement measures to offset the incentives that losers have in this process to revert to conflict.

19. **The international community needs to be prepared to engage continuously over the long timeframes needed to establish the legitimacy of the state.** This requires sustained progress on reforms and clear evidence of the state delivering on its obligations over the entire period of transition. Each stage of the transition process entails its own unique challenges that have to be overcome. For these reasons, and also because states in fragile situations are particularly vulnerable to shocks—macroeconomic and/or political—disengaging too early is not conducive to effective engagement.

20. **Strict prioritization of objectives with a view to delivering “quick wins” is a critical element of successful engagement in fragile states.** In fragile states, it is very important to deliver early successes in order to build support for the process of reform.<sup>22</sup> Especially in LICs, given severe capacity constraints, very strict prioritization of objectives is needed. Important areas for early intervention emphasized in the literature are jobs, security, and justice. In particular, early initiatives focused on job creation (e.g., public works programs) or demobilization of soldiers are likely to have a high payoff. The benefits of early

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<sup>21</sup> Borrowing from evolutionary theory, Pritchett and de Weijer (2010) refer to this phenomenon as “isomorphic mimicry”—the new institutions adopt the camouflage of capable organizations, but without any of the drive for results. An example of this phenomenon noted in Manuel, Gupta, and Ackroyd (2011) is the time spent on making legislative changes when the objectives can be achieved more quickly and easily by administrative changes, especially since the implementation capacity often does not exist to back up the legislation.

<sup>22</sup> Practitioners have noted that the window of opportunity to start changing people's perceptions of the state's reform credentials is about six months from the start of the reforms. Thus, in Liberia, the reforms promised and adopted in the first 150 days have been viewed as having been important in allowing the government to signal its intentions (Appendix 4).

reforms must accrue not only to the poor, but also to the middle class and elites who are often instrumental in shaping public opinion in favor of the reforms.<sup>23</sup>

21. **Working through the state is of crucial importance.** For the state to acquire legitimacy, its capacity to respond to the population’s needs must be developed in order to make the process of transition sustainable. This said, in the short run, the state may not have the capacity to address all of the urgent needs. Budget institutions may not also provide the required level of accountability. In such circumstances, donors may need to conduct some of their work through non-state channels (e.g., local civil society organizations (CSOs)).

22. **External assistance to improve governance is important to manage the risks of engagement in fragile states.** It is important for development partners—including the Fund—to recognize that engagement in fragile states entails heightened security, program, and fiduciary risks. Such risks need to be understood and managed in order for assistance to work effectively. Efforts aimed at improving governance, and public financial management (PFM) are especially important in this regard (Box 1).<sup>24</sup>

23. **Recent research and experience has also provided useful insights on content and sequencing of external interventions in fragile states** (Box 2). Although there is substantial variability in experiences depending on particular country circumstances, recent research suggests that technical assistance (TA), financial assistance, and a relatively stable macroeconomic environment are all needed for successful reform. In terms of sequencing, the evidence points toward the need for heavy involvement of the international community in providing TA early on, as well as a focus on sound macroeconomic policies. Some financial assistance can also be useful early on to build initial support for the transition out of fragility.<sup>25</sup> A higher level of financial assistance is particularly useful once basic capacity building has taken place and a modicum of macroeconomic stability has been achieved.

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<sup>23</sup> For instance, the reporting from the Middle East seems to indicate that the discontented middle class were crucial in mobilizing support during recent events.

<sup>24</sup> Such efforts could entail TA to build capacity, as well as assistance to actually implement a superior governance regime.

<sup>25</sup> For instance, delivering the “quick wins” related to unemployment programs or demobilization of soldiers requires donor support. Financial assistance is also likely to be required to meet on a timely basis routine government expenditures, such as paying civil service wages. If these are not forthcoming in suitable volumes, the country may face uncomfortable trade-offs with the pace at which it pursues macroeconomic stability necessary for long-term growth.

### **Box 1. Improving PFM in Fragile Situations 1/**

There is no best way to sequence PFM reforms—these are context specific. Nonetheless, given the limited capacity of many fragile states, PFM reform should be kept simple and “do the basics first.” Past experience suggests the following broad lessons.

- The initial emphasis should be on budget execution to establish the credibility of the budget, ensure development programs are executed, and keep the money moving. For instance, in Kosovo after the conflict, rapid progress was achieved by targeting some basics such as the establishment of a Treasury single account with no off-budget funds, and an integrated financial management system with a common chart of accounts used by all spending agencies at all levels of government. In due course, in order to permit country authorities to take full control of their development strategy, one can move to developing the budget planning process as a policy tool and introducing performance-based budgeting to link allocations to results.
- Capacity substitution and supplementation approaches (e.g., where TA experts perform routine civil service functions) supported by donors have been pivotal to the implementation of PFM reforms. Capacity substitution has been used not only to fill a skills gap, but also as a fiduciary measure, especially in Afghanistan, Kosovo, and Liberia.
- Reforms to enhance transparency and accountability need to be initiated early, particularly since they take time to take hold. In this regard, appropriate state audit institutions and parliamentary accountability has been noted as being crucial in a PFM system. To strengthen accountability, transparent publication of budgetary data is essential. In countries with significant natural resource wealth, participation in international initiatives that certify government revenues is very helpful.
- PFM reforms should target not just the Ministry of Finance, but also line ministries and subnational governments responsible for service delivery. Many commentators have noted that delegating project implementation to local levels produces effective service delivery. Simple PFM mechanisms to track the money spent at the local level is needed.
- A recent study finds that reform of the legal framework for PFM has not formed an essential starting point for PFM rebuilding. Legal reforms occurred most frequently three to four years after the start of reforms, and took a minimum of two years to complete. An appropriate legal framework, while important, is only useful when basic respect for legal procedures has been established and adequate capacity to implement the legal provisions is in place. Many problems can be solved without recourse to legal reform, relying instead on administrative procedures.
- Finally, there are close links between PFM reforms and civil service salaries. In the absence of competitive salaries, retaining qualified staff is very difficult.

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1/ This box draws heavily on Manuel, Gupta, and Ackroyd (2011) and Fritz, Hedger, and Fialho Lopes (2011).

### **Box 2. Explaining Turnarounds in Fragile States**

Chauvet and Collier (2008) have tested empirically the factors that contribute to countries escaping from fragility. The empirical evidence indicates that technical assistance (TA) in the early years of turnaround has a statistically positive and significant effect on the probability of transitioning from fragility. By contrast, intensive TA prior to the start of a turnaround has little effect on the probability of transition. Similarly, donor aid is helpful when a minimum level of human, economic, and political capital has been reached—there is weak evidence of negative effects of early external financing on turnarounds. 1/

Building on the probit estimation method, background research for this paper tested factors that influence the probability of growth down breaks—as noted earlier, in fragile situations, the significantly higher number of down breaks interrupts episodes of growth. Consistent with the existing literature, it is shown that the effect of financial aid is insignificant, while TA significantly reduces the probability of having downturns in fragile states. This result is robust to adding other structural variables such as education, and macroeconomic variables such as inflation, which are also significant in the estimation.

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1/ This is not to deny the importance of aid to meet critical budgetary expenditures, but rather that large development projects may not have the expected payoffs in the absence of improvements in capacity.

24. **Successful engagement in fragile states requires that support to reform efforts be well coordinated across all donors.** In this regard, there is broad agreement that such coordination needs to be improved in a number of dimensions. Lack of prioritization of initiatives, resulting from donors working individually, has been noted as an important problem. Given the capacity constraints of fragile LICs, this has resulted in less progress on concrete goals than could have been achieved with better prioritization.<sup>26</sup> Furthermore, the proliferation of funding arrangements that occurs when donors distribute aid in a disaggregated fashion to individual departments of government risks distorting political processes and developing tensions among national partners. Following the specific aid modalities of each donor also places a great administrative burden on the authorities of recipient countries. These factors have prevented governments of countries in fragile states benefitting fully from the assistance provided by donors.<sup>27</sup>

#### **IV. THE FUND’S ENGAGEMENT IN FRAGILE SITUATIONS**

25. **The Fund has had considerable engagement in fragile situations through its macroeconomic policy advice, and financial and TA, and training.** This section briefly discusses the role that the Fund can play to help members transition out of fragility, and takes stock of how the Fund has engaged in fragile LICs, focusing on Fund-supported programs and TA. It then seeks to assess how this engagement has conformed to the principles set out

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<sup>26</sup> For instance, the country level consultations synthesized in OECD (2010b) notes the “lack of realistic assessment of capacity and politics—in particular by donors” among the main reasons for the low rate of implementation of national strategic plans.

<sup>27</sup> See for instance, OECD (2010c) which, in addition to the factors discussed above, also expresses concern about the persistently high levels of earmarking in situations of conflict and fragility that largely limits the flexibility of donor funding.



above.<sup>28</sup> The Fund has also engaged in helping resolve fragile situations in MICs as and when they have occurred. This is covered briefly in subsection C below.

### A. Role of the Fund in Fragile States

26. **The Fund is well placed to play an important role in concerted international efforts to help countries transition out of fragility.** This role is widely acknowledged by the international community (see for instance, references to the Fund in the INCAF draft guidance (Appendix 3), and has several elements:

- *Promoting macroeconomic stability:* Economic development is a key component of transition out of fragility. Sustainable employment opportunities generated by the private sector are vital in this regard. This requires a stable macroeconomic environment.<sup>29</sup> The Fund's program support has an essential role to play in helping countries' efforts in this area.
- *Building capacity:* The Fund provides TA targeted to institutional capacity improvements in fragile states. In particular, TA on PFM, revenue mobilization, central banking and payment systems operations, and basic macroeconomic statistics—all core areas of Fund expertise—are critical to transition efforts. The Fund also provides training on macroeconomic, fiscal, and financial issues to enhance the returns of institutional capacity building.
- *Catalyzing donor support:* Fund engagement in fragile states helps catalyze donor assistance. Disbursement of donor budget aid typically requires an assessment by the Fund of good macroeconomic performance. In addition, multilateral and bilateral debt relief, that has played an important role in improving the long-term financial position of LICs, is very closely linked to good performance under a Fund program.
- *Financial assistance:* The Fund's own financial assistance can help countries meet balance of payments needs, and can quickly scale up support in case of shocks. The Fund has also provided debt relief to eligible LICs, including many fragile states.

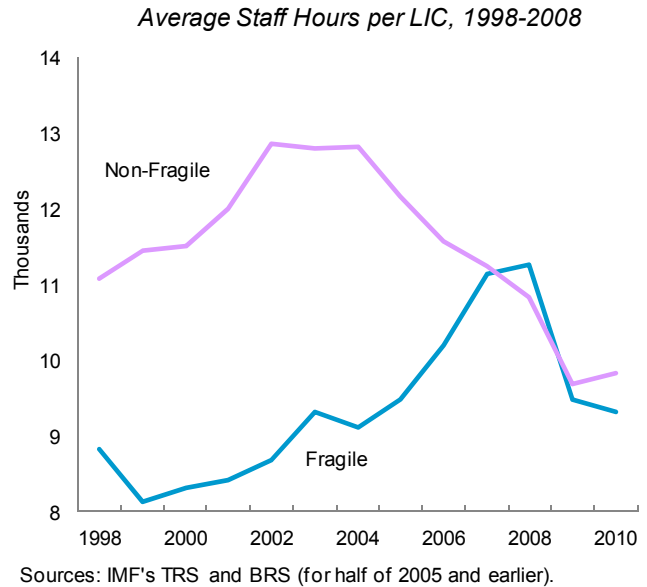
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<sup>28</sup> The focus on LICs stems from the following factors: Most fragile states that occur are LICs; implementing the methodology adopted in this paper to MICs, i.e., comparing Fund-supported program performance in fragile and non-fragile countries, would not be feasible given the small sample size. The Fund has also engaged intensively with some countries under staff-monitored programs (SMPs). However, information on the nature and extent of conditionality in such programs is not readily available.

<sup>29</sup> UNDP (2008) notes that the analysis of a broad sample of post-conflict cases suggested that there was some flexibility about the pace of progress toward macroeconomic stability in the early years of transition, but that thereafter stability had to be established. In particular, they report that inflation rates were in fact higher, and declined more slowly, in countries that over the long-run grew faster. However, within three to four years after the end of conflict, inflation rates declined, and were maintained, at low rates.

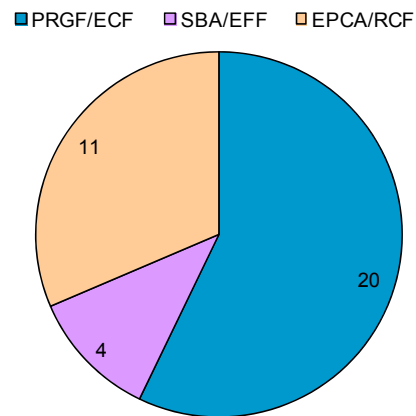
## B. Program Engagement with Fragile LICs

27. **The Fund has engaged extensively with fragile LICs.** Over the last decade, there have been some 37 Fund-supported arrangements with 21 such countries. The Fund has also provided emergency assistance on 11 occasions, and support to macroeconomic policy implementation under staff-monitored programs (SMPs) and other informal arrangements when a borrowing arrangement has not been feasible.<sup>30</sup> It has devoted considerable staff resources to its work on fragile LICs. An increase in such resources through 2008 (see chart) was a welcome development that points to an enhanced role of the Fund in helping promote macroeconomic stability and build capacity in fragile LICs.<sup>31</sup>



28. **The Fund's program engagement with fragile LICs has overwhelmingly been through support under the Poverty Reduction and Growth Facility (PRGF)/Extended Credit Facility (ECF).** While the Fund had, during this period, an instrument to provide emergency post-conflict assistance (EPCA), the use of this instrument was limited to typically one or two disbursements in the immediate post-conflict period. Thereafter, the mode of support shifted to the PRGF for LICs and the Fund's General Resources Account (GRA) for non-LICs. Furthermore, the use of the EPCA was also

*IMF Financial Assistance to Fragile States, 2005-2010*



Source: MONA database.

<sup>30</sup> For instance, the Fund had SMPs for extended periods of time with Sudan and Liberia (see below), and in the special case of the West Bank and Gaza provides advice on the macroeconomic framework, against which donors disburse (Annexes 4 and 5).

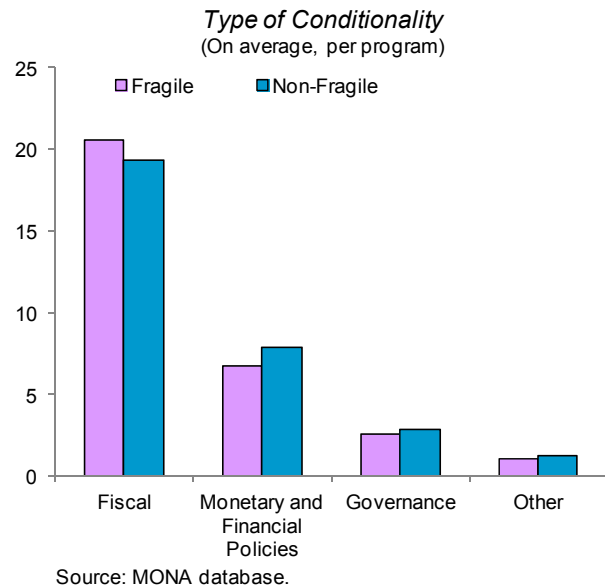
<sup>31</sup> The decline since 2008 possibly reflects the downsizing of the Fund and the global financial crisis. The time spent on fragile LICs as a share of resources allocated to all LICs has remained broadly unchanged.

limited to post-conflict situations whereas, as has been argued above, fragile situations persist long after conflict ends or even in the absence of actual conflict.

29. **SMPs have also served an important role in the Fund’s engagement in fragile LICs.** In two important cases—Sudan and Liberia—arrears to the Fund prevented engagement supported by the Fund’s financial facilities. Instead, SMPs implemented over an extended period of time, served as an effective vehicle to provide policy advice and organize the extensive TA that was provided to these countries. It also paved the way for Liberia to reach the decision point under the Heavily Indebted Poor Countries (HIPC) Initiative. SMPs have also been used in numerous instances to help countries establish track records that allowed them to move to Fund-supported programs.

30. **Fund-supported programs in fragile LICs have been associated with improved macroeconomic outcomes.** Over the last two decades there have been clear improvements in macroeconomic outcomes in fragile LICs, as evidenced by the evolution of real GDP growth, inflation, overall government balance, exports and current account balances, external reserves, and foreign direct investment (FDI) (Figure 3). Within this group, improvement has been fastest in countries that had the most intensive program engagement.<sup>32,33</sup>

31. **Programs have also been associated with gradual improvements in state capacity in areas within the Fund’s domain of expertise.** In line with the needs of fragile LICs, considerable emphasis has been put on fiscal (PFM and revenue mobilization) reforms in Fund-supported programs, as evidenced by the composition of structural conditions. Appropriately, reforms to improve central banking have also received significant attention. Recent studies have found evidence of improvements in PFM capacity.<sup>34</sup>

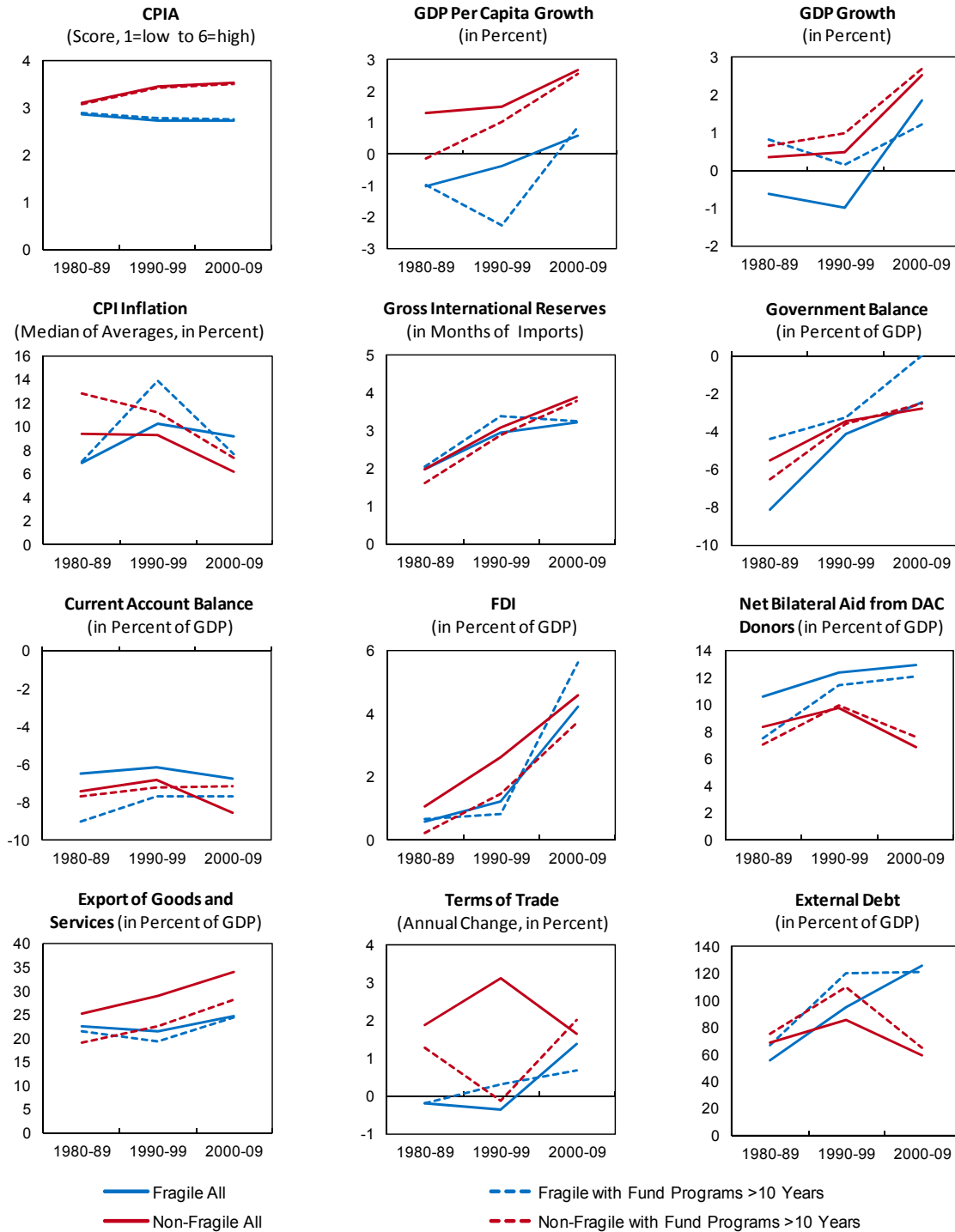


<sup>32</sup> These findings are similar to those reported in IMF (2009a), although the sample of countries and time period considered is somewhat different.

<sup>33</sup> Intensive program engagement is defined as engagement totaling more than 10 years during the period 1988–2010.

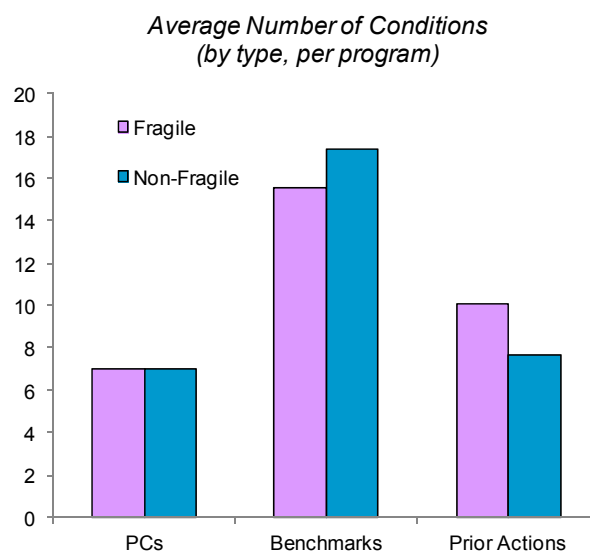
<sup>34</sup> For instance, Manuel, Gupta, and Ackroyd (2011) and Fritz, Hedger, and Fialho Lopes (2011) have found that there has been considerable progress in improving PFM systems in some fragile states, including Afghanistan, Kosovo, and Sierra Leone, and moderate progress in Cambodia and Liberia. The Fund, together with other donors, has participated in providing TA to these countries, and emphasized such reforms in its program conditionality.

Figure 3. Long-Term Macroeconomic Performance of LICs

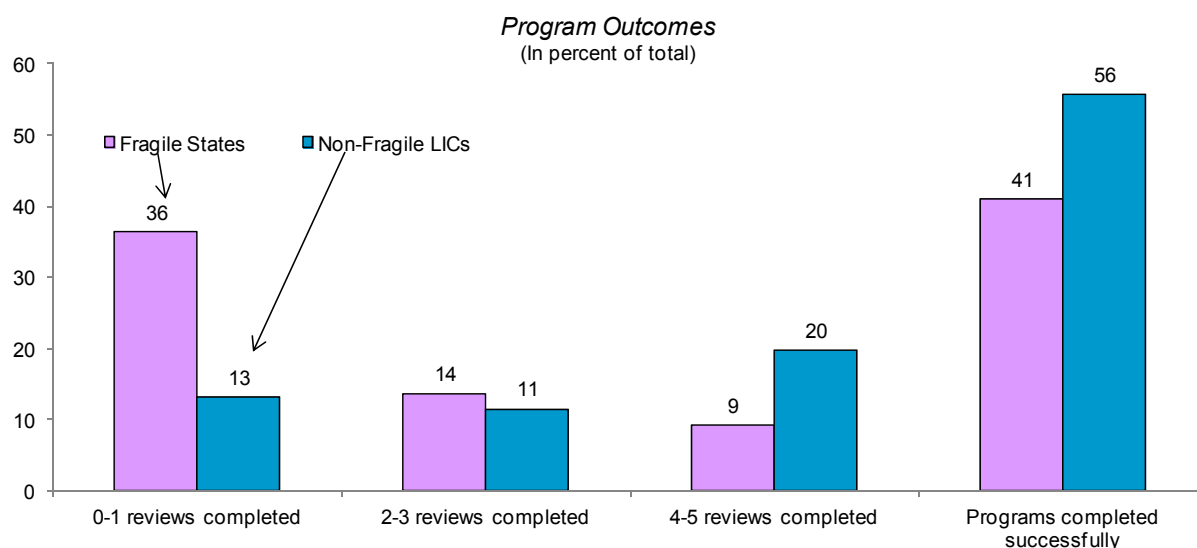


Sources: International Monetary Fund; WEO, IFS, World Bank Databases; and IMF Staff estimates.  
 Note: Unweighted averages, including for countries with IMF financial arrangements in place for more than 10 years since 1988. Excludes fuel-exporters (Angola, Azerbaijan, Republic of Congo, Nigeria, Sudan, and Yemen) and countries with inadequate historical data series (Afghanistan, Albania, Armenia, Georgia, Kyrgyz Republic, Moldova, Mongolia, Somalia, Tajikistan, Timor-Leste, and Uzbekistan).

32. **Program engagement has allowed around fifteen LICs in fragile situations to receive debt relief under the HIPC Initiative and the multilateral debt relief initiative (MDRI).** This has been aided by the greater flexibility exercised by the IMF and the World Bank under the Initiatives, including in the case of the Fund amendments to increase flexibility (e.g., to include upper credit tranche (UCT)-quality SMPs among the qualifying programs to reach the decision point).<sup>35</sup>



Source: MONA database.



Source: MONA database.

33. **The number of conditions per Fund program has been similar in fragile and non-fragile LICs.**<sup>36</sup> Including all forms of conditionality—prior actions, performance criteria, and structural benchmarks—Fund programs in LICs have had on average some

<sup>35</sup> Indeed, the large potential payoff from debt relief was probably a strong incentive to move countries to UCT arrangements at an early stage.

<sup>36</sup> Ideally, ambition in Fund programs would be assessed on the basis of the difficulty of the conditions. However, such an assessment is highly context-specific and not amenable to a cross-country exercise.

30 structural conditions. In view of the somewhat fewer reviews completed in fragile LICs, the average number of conditions for each review was higher in fragile LICs.<sup>37</sup>

**34. Program implementation in fragile LICs has, however, been bumpy.**

- Achievement of structural objectives in fragile LICs has been difficult, as demonstrated by the fact that just about 33 percent of structural benchmarks were met (including on time, with delay, or partially). In non-fragile LICs, about 39 percent of benchmarks were met.
- Less than half of UCT-standard programs with fragile LICs were completed successfully, i.e., with all six reviews completed, compared with about 56 percent for non-fragile LICs.
- In fragile LICs, more than one-third of the programs went off-track almost immediately (i.e., one or fewer program reviews could be completed), compared to just 13 percent for non-fragile LICs.
- In programs with the weakest outcomes, i.e., where less than half of the scheduled reviews were completed, program interruptions are largely explained by policy slippages. While such policy slippages may themselves reflect the authorities' inability to deliver on programmed reforms in the particular political context, an on-track program was interrupted because of actual political instability in just a quarter of such cases. External economic shocks do not appear to have been an important reason for program interruption in these cases.
- In the last decade, only two fragile LICs had successive PRGF arrangements without an interruption. Program reviews for active arrangements were also often delayed (Figure 4).<sup>38</sup>

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<sup>37</sup> Fragile LICs were, on average, required to observe 8.8 structural conditions, compared to 6.8 structural conditions for other LICs.

<sup>38</sup> A review is considered here as not being completed when seven months have elapsed since the test date associated with that review.

Figure 4. Completion of Reviews Under Concessional Fund Arrangements, 2000–2010 1/

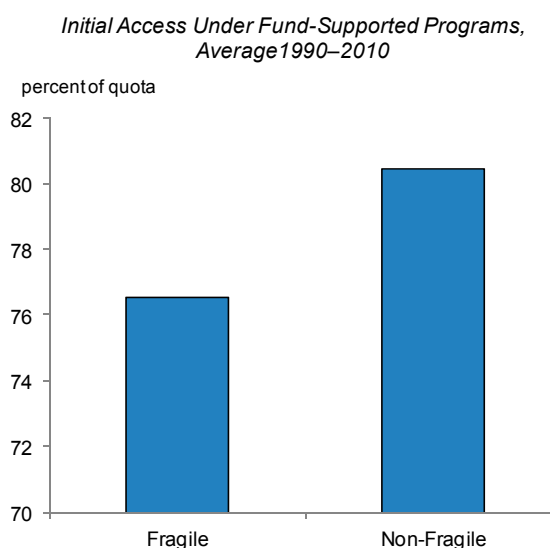


Source: MONA database.

1/ Information is presented only for PRGF and ECF arrangements in members classified by the Bank as fragile and conflict-affected states. SMPs have also been an important mode of engagement in some LICs, notably Liberia (2006–2008) and Sudan (continuously since 1997), but there is no concept of formal reviews in these cases.

**35. As a result of frequent interruptions, Fund disbursements under programs with fragile LICs were, on average, lower than under programs with other LICs.**

- The initial access granted to fragile LICs under PRGF-supported programs was in line with that provided under similar programs with non-fragile LICs. Such access was guided by the indicative norms for the use of PRGF resources set at 90 percent of quota for first time users and 65 percent of quota for second time users in place during most of this period.<sup>39</sup>
- However, fragile LICs have received fewer disbursements than non-fragile LICs. During the period 1988–2010, the median number of years that a fragile LIC received a disbursement under a Fund-supported program was 8 years, compared to 15 years for non-fragile LICs.<sup>40</sup>



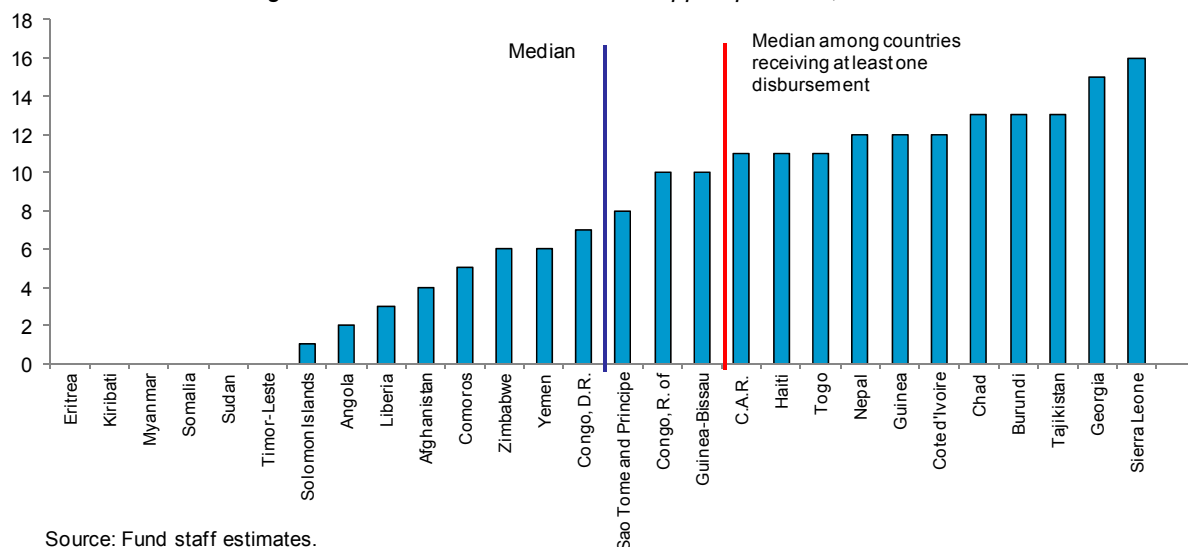
Source: Fund staff estimates.

<sup>39</sup> In 2004, the tapered access norms were extended also to third time PRGF access and beyond. See IMF (2004) for details.

<sup>40</sup> The results reported here refer to support provided under UCT-, EPCA-, or RCF-supported Fund programs. A number of fragile LICs have never had a Fund-supported program on account of their nonmember status, their arrears to the Fund, because their natural resources have obviated the need for Fund financial support, or because they have been unwilling to undertake the adjustment entailed under a Fund program. Excluding these countries from the sample does not change the basic finding, however: the median number of years that a fragile LIC received a disbursement from the Fund rises slightly to 10 years.



*Fragile States: Years of IMF financial support provided, 1988–2010*



36. **These findings suggest that Fund program engagement in fragile LICs has been beneficial, but that the forms of engagement may not have sufficiently taken into account the specific characteristics of fragile situations.** In fragile LICs, the Fund has essentially relied on its “work horse,” i.e., PRGF/ECF arrangements, which—commensurate with the level of Fund financing under those facilities—require a level of policies consistent with a UCT conditionality standard.<sup>41</sup> The Fund has recognized the inherent risks of engaging in fragile states, but has sought to manage such risks through ambitious programs. Given the capacity constraints of fragile states, this has led to programs frequently not being completed and, thus, in a policy engagement that has been less continuous than desirable.<sup>42</sup> The implications of this for future operations will be taken up in Section V.

### C. The Fund’s Engagement in Fragile MICs

37. **The Fund has also engaged in fragile middle-income states.** Ethnic divisions, regimes that have been perceived to lack legitimacy, and economic disenfranchisement of the population have all been reasons for instability in MICs. In some fragile states, it has been possible to resolve relatively quickly the underlying reasons that led to sudden and acute episodes of political instability or violence. In other instances, addressing the cause of

<sup>41</sup> This has been a long-standing approach at the Fund.

<sup>42</sup> This is not to suggest that program reviews should be completed at any cost but that helping country authorities design programs that reflect capacity and political constraints, while meeting applicable conditionality standards, is especially important in fragile states.

fragility has been challenging and the risk of violence has remained elevated for a longer period of time (see for instance Appendix 4). In all cases, as in LICs, economic development has been perceived to be an important component of the process of transition from fragility.

**38. Performance in middle-income fragile states supported by the Fund has been broadly satisfactory.**<sup>43</sup> Programs with such fragile states include Bosnia and Herzegovina (since 1995), Federal Republic of Yugoslavia (2000), Iraq (2004), and Lebanon (2007–2008). Initial Fund engagement with the member took the form of one or more disbursements under EPCA. In general, progress in building policy capacity allowed the Fund to transition to support under a UCT arrangement.<sup>44</sup> Performance under these successor arrangements has typically been satisfactory, creating the conditions for improved macroeconomic prospects and in some cases contributing to a more stable political context. However, in some instances, program reviews were completed with very substantial delays, while in others program design had to be adapted to the prevailing capacity constraints.

**39. The Fund has also been able to provide policy advice and TA to non-Fund members and in special cases such as the West Bank and Gaza, and in so doing, support efforts of the international community.** In the West Bank and Gaza, the Fund has helped the authorities in establishing and improving capacity at the Palestinian Monetary Authority, in revenue administration and PFM reforms, as well as in setting the macroeconomic framework. IMF staff reports reviewing progress in implementing reforms, with a focus on the macroeconomic and fiscal areas, have been taken into account by donors in their disbursement decisions. In Kosovo, from 2000 to 2008, the Fund participated in a concerted international effort to help it overcome its crisis through its macroeconomic policy advice and TA.<sup>45</sup>

**40. Capacity constraints were severe in some instances.** As discussed in Appendix 4, institutional and human capacity building was a particularly important objective of Fund engagement in Iraq and West Bank and Gaza. This was also the case in Bosnia and Herzegovina. Good coordination among area and functional departments, as well as with donors, was particularly important. A more flexible approach to program design also helped. This was aided, perhaps, by the clear recognition that in a very difficult security environment, the scope of reforms would need to be limited.

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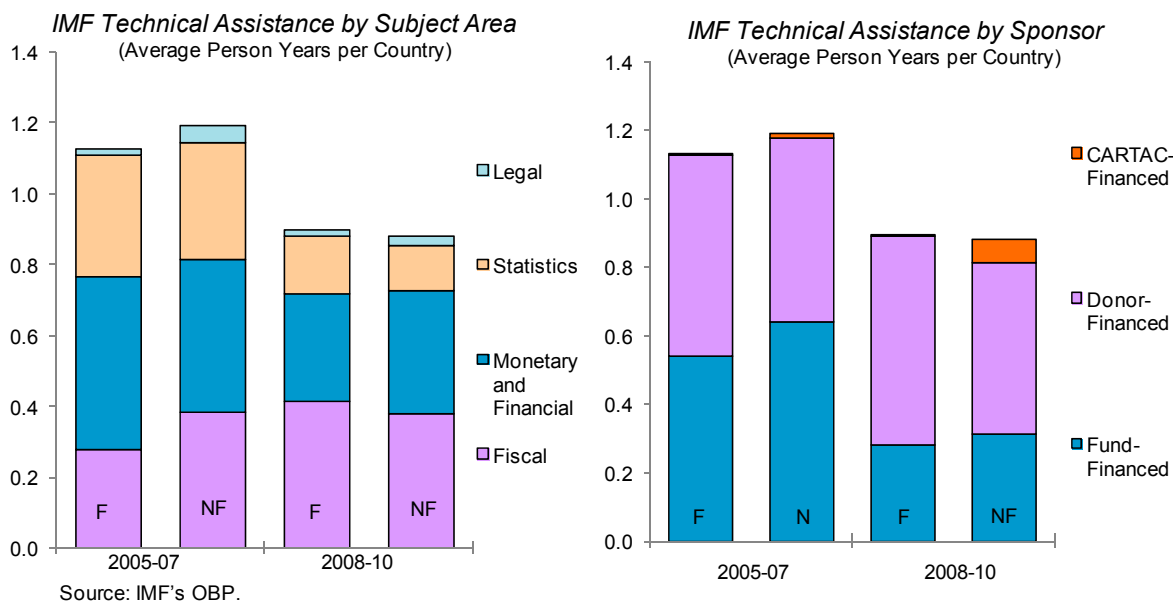
<sup>43</sup> Bosnia-Herzegovina was eligible for concessional assistance (i.e., considered to be a LIC) at this time. However, this was because its conflict had temporarily depressed its per capita GDP. GDP levels soon exceeded the IDA-cutoff level and in due course both countries graduated from LIC status.

<sup>44</sup> Bosnia-Herzegovina transitioned to an ESAF (a precursor to the ECF) arrangement. Among these four cases, Lebanon was the only instance in which initial Fund support was not followed by a UCT successor arrangement. Federal Republic of Yugoslavia and Iraq moved to a stand-by arrangement (SBA).

<sup>45</sup> Kosovo became a Fund member in 2009. Its first SBA was approved in 2010.

## D. Technical Assistance and Training

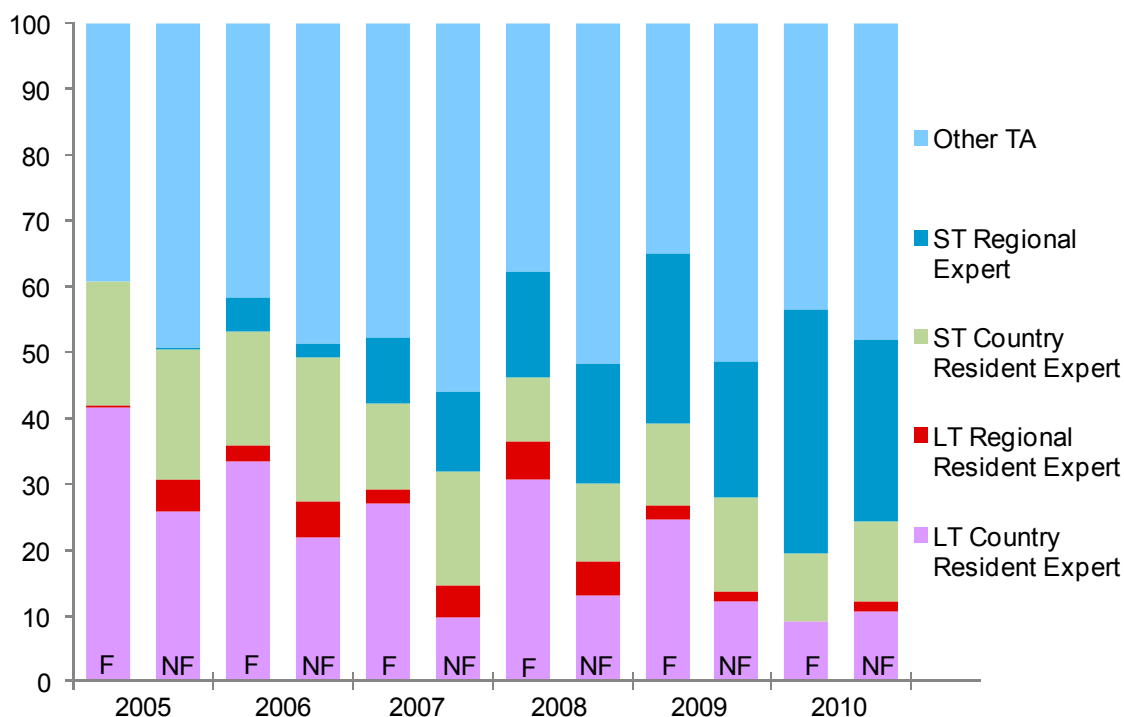
41. **Helping build the institutional capacity of the state is one of the key elements of the Fund's engagement in fragile states.** The Fund has played a critical role in providing TA to help countries build capacity in macroeconomic management encompassing central banking and fiscal operations in both low- and middle-income fragile states. Its assistance in the PFM area is particularly important to address governance problems that compromise the legitimacy of the state.



42. **Fund TA is provided as part of a broader international effort.** In particular, post-conflict TA from the Fund has tended to be smaller and more focused than the large scale interventions of bilateral and multilateral donors. Indeed, the effectiveness of Fund TA often depends on complementary assistance provided by other donors, and the training offered. A significant proportion of Fund TA is also financed by major donors.

43. **LICs in fragile situations have received broadly similar levels of TA as other LICs in recent years.** On average, this was about one person year per country, and was appropriately targeted at the typical weaknesses observed in fragile situations. While the empirical evidence indicates that TA is a strong predictor of sustained turnarounds and lowers the probability of growth down breaks, fragile states also face constraints on their absorptive capacity. Appropriately, relative to other LICs, a larger share of TA to LICs in fragile situations has been delivered by resident advisors (Figure 5).

Figure 5. Technical Assistance by Type of Delivery, 2005–2010



Source: IMF's OBP.

44. **Ad hoc consultations with external donors and fragile states suggested that Fund TA was highly valued but also pointed to the need for additional help “on the ground.”**

In particular, in initial phases of transition out of fragility, providing support to implement policies, rather than simply providing advice on policies, was seen as particularly important. Experience has shown that such TA (and indeed the need for TA more generally) is also important in MICs. For instance, in the early years of transition in Bosnia and Herzegovina, the appointment of an international expert as the central bank governor was crucial to the successful introduction of the new national currency.

45. **The Fund has engaged with donors to place donor-financed resident advisors in fragile states.** Specifically, the UK’s Department for International Development (DFID) is financing one such initiative to place advisors in MCD countries. To date, some five advisors have taken up their posts. The role of such experts, mostly macroeconomists, is to work with the mission team and resident representatives to coordinate and follow-up on TA delivered by functional departments and other donors, thus assisting in capacity building.

46. **The Fund has also provided extensive training to country officials from fragile states to consolidate institutional capacity building.** For instance, over the past five years, more than 2,500 officials have attended Fund training courses offered by IMF Institute (INS), FAD, MCM, and STA. The INS has been particularly active in the Middle East and North Africa (MENA) region where, from 2005 to April 2011, nearly 1,800 officials attended

courses offered by the INS. During the same period, 12 national courses, which were offered to officials from places such as Afghanistan, Iraq, and West Bank and Gaza, attracted nearly 350 officials.

### **E. Donor Coordination**

47. **The modalities of the Fund’s collaboration with donors in fragile states is broadly similar, albeit more intensive, than that in other LICs or MICs.** As elaborated below, collaboration mainly consists of information sharing, rather than joint formulation of an integrated strategy. This broadly reflects the practice that donors use among themselves—an approach which has been recognized by both donors and fragile states themselves as not being well adapted to engagement in such environments. In informal surveys, Fund mission chiefs have indicated that they spend significantly more time in collaborating with donors in fragile states. This is particularly true where engagement has been in the context of an EPCA (an especially important mode of engagement in MICs), which requires concerted action by the international community.

48. **The Fund’s closest collaboration is with the World Bank and the regional development banks (RDBs).** With the World Bank, this consists of close interaction at headquarters between the respective country teams in producing work that is done jointly (Joint Staff Assessments (JSANs) of Poverty Reduction Strategy Papers (PRSPs), Debt Sustainability Analysis (DSAs), HIPC-related work), but also in formulating broad strategy and in sharing information on progress in their respective spheres of operation. In some instances, representatives of RDBs participate in Fund missions, but limit their focus to very specific issues.<sup>46</sup> While the Fund does not routinely produce work jointly with other RDBs, it does exchange work-related information. In particular, the World Bank and the RDBs request a formal assessment of satisfactory macroeconomic policy implementation from the Fund before they approve new operations.<sup>47</sup>

49. **Contacts with bilateral donors are more informal.** Fund missions routinely visit donors to collect information on their disbursement plans and mission chiefs typically brief donors at the end of the mission. The Fund also participates in consultative group meetings, where it offers an assessment of the macroeconomic situation, and some bilateral donors also request such assessments prior to approving disbursements (especially of budget support). In some instances, Fund mission chiefs also directly engage with bilateral donors at their headquarters to brief them on the Fund’s work.

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<sup>46</sup> For instance, Asian Development Bank staff often participates in missions where DSAs are prepared.

<sup>47</sup> This is one way in which Fund engagement helps catalyze financing from other donors.

50. **Resident representatives play an especially important role in donor coordination.** Resident representatives, who are typically in close contact with their counterparts from multilateral and donor agencies, including through their participation in regular local donor meetings, provide timely information on donors’ activities and any changes in their plans that might be in the offing. Such contacts also yield valuable information on the local political situation, especially when resident representative contacts extend to persons engaged in non-development activities.

## V. WHAT CAN THE FUND DO TO IMPROVE ITS ENGAGEMENT

51. **Lessons from the Fund’s own experience and that of the broader international community point to some key elements that are necessary for successful engagement with fragile states.** In a nutshell, effective support means engaging at an early stage and being prepared to stay engaged over the long haul, embracing a philosophy of carefully sequenced reforms tailored to improvements in capacity, helping country authorities deliver “quick wins” to the population, and, in this process, building the legitimacy of the state.<sup>48,49</sup> Such an approach entails risks: the authorities may be unable to deliver on the reforms and programs may go off-track. These risks need to be managed in a way that takes account of what a fragile state can realistically achieve in a given timeframe, while respecting the applicable conditionality standards and other general Fund policy requirements. They also need to be weighed against the risks of providing international support that is too timid, thus limiting the chance of helping countries progressively emerge out of fragility with all attendant consequences for fragile countries themselves and for other countries affected by negative spillovers. In addition, successful engagement in fragile situations entails multidimensional efforts (e.g., encompassing security, political stability, and economic development). Each international partner, including the Fund, must then act within a coherent framework of initiatives pursued by the international community.

52. **The international community has embarked on a number of initiatives with a view to implementing this approach (Appendix 3).** The International Network on Conflict and Fragility (INCAF) is in the process of finalizing its guidance to enable a well-coordinated response of the international community in fragile states, and the World Bank has developed a set of proposals to implement the findings of the WDR 2011. The World

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<sup>48</sup> While the approach outlined below is tailored to the challenges of the most entrenched cases of fragility in resource-constrained LICs, many conclusions have sufficiently broad support to be borne in mind by country teams operating across a wider range of fragile situations. These include more instances of fragility occurring in countries that face less severe capacity and resource constraints.

<sup>49</sup> The expression “build the legitimacy of the state” here and hereafter does not signify that the Fund is, or should be, involved in supporting and building the legitimacy of any particular government. Rather, following the terminology commonly used in the literature on fragile states, it refers to building citizens’ confidence in the ability of state institutions and structures to deliver the services expected of them.

Bank and the African Development Bank (AfDB) have prepared a Common Approach Paper (CAP) on the efficacy and modalities of budget support. Consistent with these broader efforts of the international community, this section discusses possible changes in a variety of areas that could make the Fund's engagement in fragile states more effective. Most of these changes would not require modifications of Fund policies but rather better use of the flexibility allowed under existing policies.

53. **To contribute effectively to this concerted effort, the Fund should focus on its core competencies and apply its tools in a way that recognizes the unique challenges of fragile states.** As discussed above, regular Fund engagement with fragile states to help them develop well-designed macroeconomic programs can play an important role in reducing economic vulnerabilities over the longer term. Reliable program support and TA are critical elements in this effort. The Fund can also play an important role in helping meet urgent balance of payments needs. At the same time, the Fund should use its tools judiciously and flexibly in recognition of the unique challenges of fragile states, in particular low capacity, risk of domestic instability, as well as large and often long-lasting financing needs. As the Fund is not well placed to meet statebuilding and longer-term development financing needs, it is particularly important to consider ways in which the Fund can leverage its unique tools and areas of expertise, while collaborating effectively with other institutions and donors.<sup>50</sup>

54. **The proposed approach described below would apply to Fund members assessed to meet the following criteria.** First, a member country exhibits a preponderance of the relevant characteristics of fragility discussed in Section II, specifically: (a) significant institutional and policy implementation weaknesses, assessed using the World Bank's CPIA or other relevant information;<sup>51</sup> (b) a fractious political context, as evidenced by recent political conflict or instability, or where pertinent information supports an assessment of an elevated risk of political instability; (c) severe domestic resource constraints; and (d) vulnerability to shocks. Second, effective engagement can reasonably be anticipated, as evidenced by (a) the authorities' firm commitment to policy reform and strengthening capacity, including government ownership of the reform package; and (b) the concerted support of the international community.

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<sup>50</sup> Such an approach is consistent with the views expressed by Directors at the March 2008 discussion on fragile states (Public Information Notice 08/43). Specifically, Directors noted that "Fund support to fragile states should be tailored to their evolving macroeconomic prospects and implementation capacities, contribute to the concerted international effort to address their needs, and adhere strictly to the Fund's mandate."

<sup>51</sup> While the World Bank uses an average score of 3.2 and below of the CPIAs produced by itself and the AfDB to classify a state as fragile, teams could in some instances present the need for a more flexible approach even if a country has a higher CPIA score. Where a CPIA score is not available, such as in MICs, the assessment that institutional and policy implementation capacity is weak would have to be made on a case-by-case basis.

55. **Such an assessment would entail a substantial degree of judgment.** At any given point in time, there is a continuum of fragile situations from most to least fragile and individual characteristics of fragility manifest themselves in different degrees across fragile states. In addition, for any given country, the characteristics of fragility evolve over time and in fragile countries, as in all countries, an assessment of the authorities' policy commitments and engagement of the international community is complex.

#### **A. Use of the Rapid Credit Facility (RCF) and a Reformed Nonconcessional Emergency Facility**

56. **For LICs, among which most fragile states can be found, the recent overhaul of the Fund's concessional-lending toolkit and changes to the conditionality framework has enhanced the Fund's ability to engage more flexibly in fragile situations.** In particular, the newly created RCF can help provide tailored support when a traditional ECF-type medium-term arrangement is not yet suitable.<sup>52</sup>

- The RCF was designed *inter alia* for circumstances where UCT conditionality is “not feasible, for instance in cases where institutional and policy capacity is highly constrained (as may be the case in countries emerging from conflict or other episodes of fragility or instability).” In such cases, member countries “would be expected to make efforts to move to a UCT program (typically under the ECF), in which case the transition could be supported through repeated use of the RCF.”<sup>53</sup>
- Consistent with this policy, but contrary to past practices (marked by a rapid switch from subsidized EPCA support to PRGF arrangements), greater use could be made of the RCF to help meet urgent balance of payments needs during the initial transition phases in many cases of entrenched fragility in LICs.<sup>54</sup>
- Fuller use of the RCF could tailor conditionality more closely to the implementation capacity of fragile members. By facilitating a build-up in capacity before a transition to arrangements with UCT conditionality occurs, it could reduce the likelihood of breaks in program engagement that are particularly detrimental to effective policy dialogue with countries in fragile situations. Further use of the RCF could also help in situations where prior efforts to initiate a transition out of fragility had failed and a renewed attempt is being made with concerted support of the international community.

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<sup>52</sup> For detailed information on the RCF, see IMF (2009b and 2009c).

<sup>53</sup> See IMF (2009b), paragraph 62.

<sup>54</sup> As noted in Appendix 3, INCAF views this as an area in which the Fund can fill an important need for which donor resources are often not available in suitable abundance.



- As was the case previously with the EPCA, RCF disbursements may take place in appropriate cases even in the context of arrears to bilateral creditors.<sup>55</sup> Such arrears should also not impede grant assistance from donors, the most appropriate form of financing for fragile LICs. On a case-by-case basis, the Board may also approve the implementation of an RCF-supported program to count toward members' track-record for the HIPC Initiative's decision point.

**57. Under such an approach, the RCF would continue to serve as a bridge to the ECF, which would remain the “workhorse” of the Fund’s engagement in fragile states.** The duration over which an RCF would be used would depend on country circumstances. Staff should be alert to recognize situations where particularly severe policy implementation constraints might dictate the need for a sequence of RCFs;<sup>56</sup> by permitting a more gradual build-up to an ECF, such a sequence would improve the prospects for its successful implementation.<sup>57</sup> Thereafter, as the transition to an ECF is made, fragile states may still face capacity constraints that are more severe than in non-fragile LICs. Thus, while recognizing the imperative to have UCT-quality policies, program design will need to be mindful of country-specific realities.

**58. In the case of non-LICs, the establishment of an RCF-like facility for general emergency assistance would enhance GRA emergency facilities and permit a similar approach to the sequencing of Fund financial support.** While the EPCA should generally no longer be needed by LICs, given the more flexible RCF, it was retained (in unsubsidized form) mainly for members not eligible for the Fund’s concessional facilities (i.e., non-LICs).<sup>58</sup> However, its usefulness is limited by the stipulation that it can be used only in post-conflict situations. Non-LIC members that are in fragile but not post-conflict situations, and are in need of Fund financial assistance, would therefore normally have to seek support under

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<sup>55</sup> Tacit approval of an official bilateral creditor has been sufficient to satisfy the Fund’s arrears policy on certain occasions. These cases have more commonly arisen in the context of some official sector concerted action, falling short of a formal Paris Club Agreed Minute, where the anticipation has been that the “programs” under the RCF or EPCA would advance normalization of relations with official creditors in time for regular treatment in a Fund arrangement. In cases where Paris Club Agreed Minutes are not anticipated, the Fund has adopted the practice of informing the Paris Club in advance of requests for RCF disbursements.

<sup>56</sup> While in many instances the need for a sequence of RCFs would become evident only as anticipated improvements in capacity fail to materialize, in some cases it may be clear up-front that the required capacity-building would take time.

<sup>57</sup> As per current policy, the use of an RCF would be permissible only if Fund resources were needed to fill an urgent balance of payments need not caused by the withdrawal of donor support. The member would also be required to establish a track record of adequate macroeconomic policies.

<sup>58</sup> While the EPCA, like all other GRA financing, remains available to LICs, the RCF represents a more attractive financing option for PRGT-eligible countries.

a stand-by (UCT) arrangement from the outset.<sup>59</sup> In some cases, this could entail challenging policy commitments relative to the member's current implementation capacity that elevates the risk that the program may not be successfully implemented. The establishment of such a facility was presaged in the paper on the reform of LIC facilities which noted that consideration could be given to abolishing EPCA and Emergency Natural Disaster Assistance (ENDA) and replacing them with a nonconcessional RCF-like GRA facility that would provide financing for a broad range of emergency needs.<sup>60</sup> Such a nonconcessional facility could have the following features: (i) a broader range of qualifying circumstances; (ii) higher access (as discussed further below); (iii) rebranding to clarify its purposes; (iv) outright disbursements with safeguards to address capacity or political economy concerns; and (v) standard GRA lending terms.

### **Implications for Access Policy**

59. **To permit more extended use of the RCF, a modest increase in the RCF's cumulative access limit could be considered.** As discussed above, transition from fragility can be an extended process, improvements in capacity take place only very gradually, and policy reversals happen (caused by external or domestic factors). For members emerging from fragility, with annual access at its ceiling of 25 percent of quota, and given a current cumulative access limit of 75 percent of quota, support under the RCF would be limited to three years. While, in most cases, this would seem *ex ante* a sufficient period to achieve the improvements in capacity or institutional development that would allow a country to implement a UCT-standard program, there may well be *ex post* instances—particularly, where fragile states are hit by large external shocks or unexpected domestic turbulence, where this transition may take longer. A modest increase in the cumulative RCF access limit to, say, 100 or 125 percent of quota, would allow more time for a member to make the transition to ECF support, while keeping an unchanged annual access limit.

60. **This proposed modification is consistent with the principles governing Fund financial support to LICs, as discussed during the 2009 reform of LIC facilities.** Use of a sequence of RCF purchases and subsequent ECF arrangements would assist fragile LICs in achieving a stable and sustainable macroeconomic position consistent with strong and durable poverty reduction and growth. The modified access policy would continue to strike a balance between meeting members' financing needs and preserving the Fund's scarce concessional resources. In particular, access sublimits applying to the RCF would continue to

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<sup>59</sup> If the member had no outstanding GRA credit, it could draw initially under the first credit tranche (which is not subject to a requirement for UCT-quality policies) provided the member is making reasonable efforts to solve its problems.

<sup>60</sup> See IMF (2009b).

be significantly below global annual and cumulative limits under poverty reduction and growth trust (PRGT) facilities, given the absence of a UCT-quality program.

61. **Under the proposed modification, total Fund financing would not be expected to increase, but its phasing would be better aligned with implementation capacity.** Annual access permitted under an RCF is typically lower than that available under the ECF.<sup>61</sup> Furthermore, if the full (higher) access under the RCF is utilized, the access norm under the subsequent ECF arrangement would amount to 75 percent of quota (instead of the 120 percent of quota that could apply with lower outstanding access under the RCF).

62. **For non-LICs, a comparable cumulative access limit for a nonconcessional RCF-like facility would be worth considering.** For instance, doubling the current cumulative EPCA access limit to 100 percent of quota would provide members greater flexibility to undertake the necessary reforms to move to a UCT arrangement. Modifying annual access limits may be worth considering as well, reflecting *inter alia* the specific factors generating balance of payments needs in MICs.

63. **The proposed increase in the cumulative access limits for the RCF and the proposed new facility should not significantly enhance risks to the Fund.**<sup>62</sup> While the conditionality standard attached to the RCF is lower than the ECF's UCT standard, the more appropriate phasing of Fund financing and limited size of the proposed increase in cumulative access limits are mitigating factors. In addition, appropriate safeguards can be re-affirmed, including the need for the Fund to act in the context of a concerted international response to the country's needs (implying an appropriate sharing of risks among creditors and donors), the need for members seeking repeated use of the RCF or the new facility to show a track record of adequate macroeconomic policies, and the need to demonstrate that higher access to Fund financing does not pose serious risks to debt sustainability.

## **B. Greater Flexibility and Realism in Policy Design**

64. **Key tradeoffs related to the exigencies of fragile situations need to be carefully considered when designing Fund-supported programs (or providing policy advice).** In the medium term, macroeconomic stability is clearly vital to transition from fragility. However, in the short term, there may be an urgent need to meet security-related expenditures (e.g., demobilization of soldiers, labor work programs for young males) or to deliver tangible benefits to the population (so-called "quick wins"). Policy advice needs to

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<sup>61</sup> Annual access under the RCF is capped at 25 percent of quota, compared to an average annual access of 40 percent of quota under an ECF based on the 120 percent norm that applies to arrangements with members with cumulative access under all facilities below 100 percent of quota.

<sup>62</sup> A fuller assessment of the risks to the Fund would be provided in the follow-up work in which the specific decisions on access limits would be presented to the Executive Board for approval.

give due consideration to such needs in deciding on the appropriate pace of progress toward macroeconomic stability.<sup>63</sup> Such trade-offs may be easier to manage under an RCF or a GRA emergency facility, which does not require UCT conditionality. This said, even after a transition to an ECF arrangement (the most likely route for a LIC member), a gradual and realistic approach to reforms consistent with country capacity should be maintained, while being mindful of the need to adhere to the UCT conditionality standard. In MICs, where circumstances in some cases may permit fragility to be overcome more quickly, and where macroeconomic stability has not been seriously compromised, programs should be especially mindful of identifying and delivering on “quick wins.” In other cases, where capacity has been severely depleted, the preferred engagement strategy will more closely resemble that in LICs.

**65. Programs in fragile states should also pay particular attention to the following issues:**

- *Job creation and the need for inclusive growth.* In fragile states, the quality, sources, and distribution of growth and employment are particularly important, and indeed can be critical to sustaining political stability. Making best use of the expertise of other institutions, particularly the World Bank, in these areas, staff should strive to pay attention to these issues in its analysis and policy advice.
- *Contingency planning.* In fragile states, where economic and political shocks and policy slippages are a common occurrence, Fund-supported programs need to include explicit plans for key contingencies.

**66. For fragile states, scarce implementation capacity makes it imperative to have aggressive prioritization of structural reforms.** A more streamlined policy agenda, focused on key areas of statebuilding, could be expected to improve the chances of essential reforms being implemented.<sup>64</sup> Such prioritization would normally imply fewer structural benchmarks in the corresponding Fund-supported programs than in non-fragile cases, at least during the initial transition phase. However, on occasion there may be “windows of opportunity” where the authorities’ commitment, the population’s acceptance of a need for change, and a concerted donor effort make more ambitious reforms feasible.

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<sup>63</sup> This does not mean that long-term structural measures should be eschewed, but that a demonstration of the benefits of reform, even in the short term, is important. Indeed, front-loaded and ambitious reforms, such as the successful PFM reforms in Afghanistan, can trigger a virtuous circle of institutional reforms.

<sup>64</sup> For instance, upfront improvements in economic governance are important to ensure donor financing.

### C. Additional Modalities to Catalyze Donor Resources

67. **The challenging environment in many fragile countries results in levels of financial assistance which, in some cases, are insufficient to meet their needs.** Financing needs of fragile states are often higher than those of other countries with comparable income levels, given the generally more protracted macroeconomic imbalances and their higher vulnerability to shocks. At the same time, donors face significant obstacles to providing substantial levels of aid, reflecting the high degree of country risk, weak institutions, and a difficult policy dialogue. Moreover, in many small fragile states, donor support tends to be fragmented, with often limited representation on the ground. As a result, overall aid, and in particular budget support, can often fall well short of countries' needs.<sup>65</sup>

68. **The Fund could explore ways to enhance the catalytic role of its engagement in fragile states, in particular with respect to donor budget support.** Fund program engagement can play a critical role in facilitating budget support from donors, by guarding against poor macroeconomic management and helping to monitor and improve PFM. For some bilateral donors, associating their support closely with a Fund-supported program could help mitigate the “transactions costs” of providing aid in fragile situations, where the fiduciary burden for an individual donor, acting alone, is likely to be high relative to the amounts of aid involved. For the recipient country authorities, replacing an overlapping but differentiated conditionality framework of multiple donors with a uniform set of policy actions would also be beneficial, in particular in light of the severe capacity constraints.

69. **One option that could be considered is having a budget support component linked to Fund-supported programs in country-specific multi-donor trust funds (MDTFs).**<sup>66</sup> At present, such MDTFs, which have an almost exclusive development focus, have been established in a handful of countries. Donors are aware of the many problems that have been experienced with the deployment of MDTFs.<sup>67</sup> But they have, nonetheless,

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<sup>65</sup> See *Aid Risks in Fragile and Transitional Contexts*, OECD, 2011.

<sup>66</sup> This would be similar to the Afghanistan Reconstruction Trust Fund (ARTF) which has both, a Recurrent Window and an Investment Window. The Recurrent Window finances recurrent budget expenditures based on the Government of Afghanistan's (GoA) macroeconomic and budget framework that is reviewed by the IMF and the World Bank. Disbursements cover costs related to the basic functioning of government, including items such as the delivery of basic services (e.g., healthcare and education) and the payment of civil servants' salaries. Disbursements are based on eligibility criteria that have been agreed with the government in line with the broader fiduciary framework for government expenditures, including broadly successful implementation of the GoA's program. The experience with linking ARTF Recurrent Window disbursements to Fund programs could inform how such mechanisms might work in the future.

<sup>67</sup> There are a number of well known problems in establishing MDTFs: (a) donors often have conflicting interests; (b) in practice MDTFs have taken a long time to establish; and (c) disbursements from MDTFs have often been subject to stringent PFM conditions.

reached the view that in fragile situations, MDTFs may be the best vehicle to ensure an appropriately coordinated response, and are consequently considering how their use could be expanded. Incorporating a budget support component in such MDTFs, to be managed by the World Bank or some other international organization but linked to performance under a Fund-supported program, would better integrate the Fund's engagement with the efforts of other donors. In cases where countries are transitioning out of conflict, instability and/or international isolation, the initial focus of donors (and potentially the IMF) would be emergency assistance. Budget support from MDTFs would most likely kick in later, specifically once the country has made sufficient progress in stabilizing the economy and improving PFM so as to use scaled-up donor resources effectively. As the economic situation continues to improve, the MDTF budget support would typically complement continuing financial assistance from the Fund. Once the need for Fund financing has diminished, budget support from MDTFs could be linked to Fund support provided through low-access or precautionary arrangements. Eventually, as the country transitions out of fragility, MDTF support might continue to be provided in the context of surveillance or in conjunction with a policy support instrument (PSI). To avoid undue disruption to aid flows in the event of slippages in program implementation, MDTF funds initially allocated for budget support could be disbursed through other channels (perhaps with a lag).<sup>68</sup> Since country-specific MDTFs encompass a broad range of donor-financed activities, it should be feasible to implement such shifts in the modes of aid delivery.<sup>69</sup>

**70. Where country-specific MDTFs are not established, there would have to be greater reliance on standard options that loosely associate donor financing with Fund programs.** A model could be the approach that has been adopted in the case of West Bank and Gaza (Annex 5), where the Fund provides the macroeconomic policy framework in support of which donors disburse. Such financing mechanisms would need to be carefully designed in order not to introduce too much aid volatility. One drawback, relative to the more formalized support that an MDTF could provide, is that some members may not be able to attract grants or highly concessional resources in the required volumes, or that donor disbursements may be delayed. The adverse effects of such occurrences in fragile states are particularly severe.<sup>70</sup> Thus, Fund staff, in coordination with the World Bank, would need to

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<sup>68</sup> For instance, the money could be disbursed instead in the form of sectoral or program support, or to a nongovernmental organization (NGO) that would be tasked with undertaking a service that would otherwise have been provided by the government. This would address the potential objection that tying a large share of donor support to a Fund-supported program could aggravate aid volatility.

<sup>69</sup> This could be one mechanism to implement the recommendation in WDR 2011 for donors to modulate their modes of aid delivery in order to preserve incentives to use aid effectively, while maintaining their overall volume of assistance, so as not to jeopardize poverty reduction objectives.

<sup>70</sup> In the West Bank and Gaza, the latter led to the emergence of arrears.

be proactive in making donors aware of the risks to sustaining adjustment resulting from inadequate financing.

#### **D. Understanding the Political Context**

71. **A proper understanding of the political context is necessary to judge the risks of engagement.** While this is true of engagement with any member, it is particularly important in fragile states that parties to the transition acquiesce to the process of change, as this lowers the risk of conflict and improves the prospect for successful engagement. Thus, judging the extent of such support and how it may evolve, including through the work of other donors, is critical to an appreciation of the risks of engagement. Fund engagement should also be informed by a deeper understanding of the risks and political nuances associated with the specific fragile situation, including knowledge of a country's recent history, and account for the specific exigencies of such situations in designing its own programs.

72. **Tracking progress on indicators of fragility in staff reports could be helpful in this regard.** For instance, these could include indicators of violence or reports of surveys on the perception of the state as these become available with higher frequency. The Fund could also collaborate with the International Labor Organization (ILO) and other institutions engaged in producing labor market statistics to help countries produce more reliable data on employment. A number of commentators have noted the importance of tracking employment in addition to overall GDP growth.

73. **Staff reports should clearly explain how the design of the policy program has been tailored to the political and social context.** Thus, reports could discuss how the political settlement, the main fault lines in society, broad social expectations, and the capacity of the state have influenced the main structural measures of the program, as well as the mix between financing and adjustment. In this regard, staff would need to draw on published analysis conducted by donors in the context of their own work. Fund staff, especially resident representatives, should also be encouraged to conduct their own evaluation of the political situation and report this to headquarters on a regular basis.<sup>71</sup> While such analyses would sharpen the staff's appreciation of political issues, it may not be possible to report all such information in Board papers on account of its sensitive nature.

#### **E. Boosting Cooperation with Donors**

74. **The proposed model of engagement described in this paper will require very close coordination with the donor community.** Reflecting dissatisfaction with their own

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<sup>71</sup> A number of area departments have, at various times, required their resident representatives to prepare monthly reports for the respective department director in which they were encouraged to touch on a broad range of issues, including on the political situation in the country.

collaboration efforts thus far, donors themselves are considering a new model of coordination in which they envisage the participation of the Fund (Appendix 3). Within this framework, the Fund, with its knowledge of the resource envelope, can usefully play the following roles:

- *Prioritization*: Fund staff can keep donors focused on the resource envelope and help ensure that a few key objectives are prioritized with a view to facilitating achievement of such objectives.<sup>72</sup>
- *Quick wins*: Many of these initiatives are likely to be outside the Fund's core areas of responsibilities, and have to be implemented by other partners. However, the Fund should participate in the process where decisions on the need for key measures are taken to ensure that the financing implications are taken into account.

75. **Closer coordination with donors would help the Fund appreciate better the political context.** While resident representatives already play a critical role in keeping the Fund informed about the political situation, engaging in a more structured discussion on the need for key initiatives to address political economy concerns will sharpen the Fund's knowledge of political constraints.

76. **The modalities for more effective coordination will have to be developed by donors themselves.** It is encouraging that the INCAF, on which most large donors are represented, is considering this issue and has proposed a mechanism to improve coordination at the country level.

77. **For the Fund to engage fully with donors under their emerging modalities of intervention in fragile states, it will need to have a more effective field presence.** This may entail a more frequent presence in the field by mission chiefs than quarterly or semi-annual missions. It may also require resident representatives to work more proactively with donors to develop creative solutions to fragile states' problems.

## F. Technical Assistance

78. **In fragile states, coherent and adequately-resourced plans for capacity building are essential to support policy actions under a Fund-supported program or facilitate adoption of Fund policy recommendations under surveillance.** Such plans should recognize that, given serious capacity constraints, the pace at which recommendations are adopted may be slower than in other members.

79. **TA needs assessments should seek to identify instances when boots-on-the-ground may be needed to implement key good practice recommendations** (suitably

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<sup>72</sup> More prioritization will also allow greater buy-in of the agenda by country authorities and allow them to play a more active role in coordinating the reform agenda.



adapted to local conditions) at the early stage of transition. Resident advisors can not only assist country officials with implementation on a day-to-day basis, but also transfer knowledge and build capacity more intensively than mission-based support. As discussed above, the Fund has placed donor-financed resident advisors in fragile states to assist country authorities with the implementation of macroeconomic policy advice, as well as to coordinate and follow up on TA recommendations. Efforts to expand the use of such donor-financed advisors should be continued.

**80. Recent initiatives to adopt a medium-term horizon for Fund TA to meet the long-term capacity building needs of fragile states should continue.** Recent new initiatives that have moved in this direction include Topical Trust Funds and Fiscal Affairs Department's (FAD) management of all externally financed projects on the basis of a medium-term programmatic approach. Adoption of a multiyear Regional Allocation Plan (RAP)/Regional Strategy Note (RSN) horizon should also be considered.<sup>73</sup> At the same time, reduction of internal resources for TA has cut back on flexible funding available for fragile states when the political dynamic changes and opportunities for engagement arise. A new Topical Trust Fund for Fragile States could help fill this gap. Further expansion of country-specific TA trust funds could also be considered.

### **G. Human Resources Issues**

**81. A number of changes in internal operating procedures might also be helpful in strengthening the Fund's capacity to assist fragile states both in program and surveillance contexts.** Within the Fund's overall budget envelope, a number of steps could be considered: (i) increasing the size of staff teams assigned to fragile states; (ii) prioritizing resident representatives' assignments in fragile states, including the provision of hands-on advice to help in policy implementation; and (iii) attracting high quality staff to work on and be located in countries in fragile situations. As regards this last item, it is important to recognize that the skill set for operating effectively in fragile situations may go beyond the standard macroeconomic and interpersonal skills emphasized by the Fund. In particular, such skills will need to be supplemented by knowledge and appreciation of the local context and an ability to appreciate the subtleties and nuances of alternative political contexts. The Fund should also consider preparing guidance and developing appropriate training modules to prepare staff for working in fragile contexts.

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<sup>73</sup> In developing capacity-building plans and to improve the effectiveness of TA, it is important to obtain the commitment of regional TA Centers and to involve key donors early in the process.

82. **Attracting suitably talented persons to work on fragile states may require a change in incentives.**<sup>74</sup> A review of the Fund's benefits system may be warranted to ensure that it provides suitable incentives for staff to accept assignments that involve living and working in the difficult circumstances prevailing in many fragile states. Additional incentives for headquarters-based staff could also be considered, such as additional compensatory leave for staff traveling to less safe destinations or career-related incentives. A clear signal that the institution values the work done on fragile states, including by favorably recognizing such work in promotion decisions, is also essential.

## VI. CONCLUSIONS, ISSUES FOR DISCUSSION, AND NEXT STEPS

83. **Bringing about changes to the Fund's work in fragile situations will require the institution to change its mindset about engagement in such settings.** As an institution, the Fund has not hesitated to venture into very difficult situations, but has sought to manage risks by advocating bold reforms. In fragile states, the Fund will need to come to terms with the reality that effective engagement is a lengthy process, that the risks involved cannot easily be shed, but that the Fund has an important role to play in helping realize the very sizeable benefits of successful transition. Also, in its work, the Fund's traditional focus has been on macroeconomic stability with structural reforms mandated to be macro-critical. While such a focus on narrowly defined macroeconomic issues may be efficient in a non-fragile context that permits such compartmentalization, in a fragile situation macro-criticality needs to be informed also by the political economy of reforms.

84. **Broad institutional support will be needed to change the Fund's operations.** In this regard, it will also be important to bear in mind that mistakes will be made and that the process of engagement in fragile situations, even more than in other spheres of operation, will involve learning-by-doing.

85. **What are Executive Directors' views on:**

- the assessment of the Fund's engagement in fragile states presented in Section IV; and
- this paper's proposals to enhance the effectiveness of the Fund's engagement in fragile states, as described in Section V, which include greater reliance on the RCF and a reformed nonconcessional emergency finance facility, modifications to access limits under the RCF and the reformed GRA facility for emergency assistance, greater flexibility in program design, better use of MDTFs to catalyze donor

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<sup>74</sup> Insecure environments, adverse working conditions, high levels of stress, and the perception that there is a lack of recognition and career prospects are among the obstacles that are often cited to attract staff to work on fragile states.

resources, greater focus on the political context, closer coordination between donors and Fund staff, provision of TA, and human resource issues?

86. Depending upon Executive Directors' views, next steps could include (i) Board papers presenting specific proposals and decisions on RCF access and a reformed nonconcessional emergency finance facility; (ii) an operational guidance note on the proposals endorsed by the Board; and (iii) further internal work on incentives to work on fragile states.

## Appendix 1. Definitions of Fragility, Cross-Country Indices, and Country Classifications

87. Conceptually complex and multidimensional, fragility has prompted many definitions that differ widely (see Table 2), but nevertheless share a common notion. This is reflected in the basic consensus within the policy and donor community summarized in the OECD (2007) Principles for Good International Engagement in Fragile States and Situations: “*States are fragile when state structures lack political will and/or capacity to provide the basic functions needed for poverty reduction, development and to safeguard the security and human rights of their populations.*”

Table 2. Definitions of Fragile States

Producer	Definition
WB (2011b)	<b>“Fragile states” is the term used for countries facing particularly severe development challenges: weak institutional capacity, poor governance, and political instability. Often these countries experience ongoing violence as the residue of past severe conflict.</b>
OECD (2008)	A fragile state [is] unable to meet its population’s expectations or manage changes in expectations and capacity through the political process [...]. Questions of legitimacy, in embedded or historical forms, will influence these expectations, while performance against expectations and the quality of participation/the political process will also produce (or reduce) legitimacy.
EC (2007)	Fragility refers to weak or failing structures and to situations where the social contract is broken due to the State’s incapacity or unwillingness to deal with its basic functions, meet its obligations and responsibilities regarding service delivery, management of resources, rule of law, equitable access to power, security and safety of the populace and protection and promotion of citizens’ rights and freedoms.
DFID (2005)	DFID’s working definition of fragile states covers those where the government cannot or will not deliver core functions to the majority of its people, including the poor. [...] DFID does not limit its definition of fragile states to those affected by conflict.
USAID (2005)	USAID uses the term fragile states to refer generally to a broad range of failing, failed, and recovering states. [...] the strategy distinguishes between fragile states that are vulnerable from those that are already in crisis.

88. **Cross-country fragility indices, in turn, operationalize these definitions in various ways.** They typically build on the performance of core state attributes, such as: (i) *effectiveness* (fulfillment of state functions); (ii) *authority* (enforcement of a monopoly on the legitimate use of force); and (iii) *legitimacy* (public, non-coercive acceptance of the state). Yet various indices draw on different sets of measurable indicators of these state attributes, mainly owing to different normative orientations.<sup>75</sup> These result in including

<sup>75</sup> See Mata and Ziaja (2010), who also offer a discussion of the most prominent cross-country fragility indices, such as the Bertelsmann Stiftung’s *Bertelsmann Transformation Index State Weakness Index*, Carleton University’s *Country Indicators for Foreign Policy Fragility Index (CIFP)*, The World Bank’s *Country Policy and Institutional Assessment (CPIA)*, Fund for Peace’s *Failed States Index*, Institute for Economics and Peace’s *Global Peace Index*, Harvard University’s *Harvard Kennedy School Index of African Governance*, Brookings Institution’s *Index of State Weakness in the Developing World*, University of Maryland’s *Peace and Conflict*

(continued)

different conceptual dimensions (i.e., security, political, economic, social, and environmental) and using different aggregation methods (e.g., simple versus weighted averages).

89. However, despite these definitional and methodological differences, fragile state classifications are broadly similar. In fact, country lists based on resulting index scores display a large degree of overlap (see Table 3).

Table 3. Lists of Fragile States

	2011 WB Fragile and Conflict Affected Countries List 3/	2010 OECD DAC List 4/	2009 EC SSA List 5/
<b>Total number</b>	<b>33</b>	<b>43</b>	<b>29</b>
Afghanistan	x	x	
Angola	x	x	x
Bosnia & Herzegovina 1/	x		
Burundi	x	x	x
Cameroon		x	x
C.A.R	x	x	x
Chad	x	x	x
Comoros	x	x	x
Congo, D.R.	x	x	x
Congo, R. of	x	x	x
Cote d'Ivoire	x	x	x
Djibouti		x	x
Equatorial Guinea 1/		x	x
Eritrea	x	x	x
Ethiopia		x	x
Gambia, The		x	x
Georgia	x		
Guinea	x	x	x
Guinea-Bissau	x	x	x
Haiti	x	x	
Iraq 1/	x	x	
Kenya		x	x
Kiribati	x	x	
Korea, D.R. 2/		x	
Kosovo 1/	x		
Liberia	x	x	x
Mauritania			x
Myanmar	x	x	
Nepal	x	x	

*Instability Ledger*, The Economist Group's *Political Instability Index*, George Mason University's *State Fragility Index*, and The World Bank's *World Governance Indicators, Political Stability and Absence of Violence*.

	2011 WB Fragile and Conflict Affected Countries List 3/	2010 OECD DAC List 4/	2009 EC SSA List 5/
Niger		x	x
Nigeria		x	x
Pakistan		x	
Papua New Guinea		x	
Rwanda		x	x
São Tomé & Príncipe	x	x	x
Sierra Leone	x	x	x
Solomon Islands	x	x	
Somalia	x	x	x
Sudan	x	x	x
Tajikistan	x	x	
Timor-Leste	x	x	
Togo	x	x	x
Tonga		x	
Uganda		x	x
West Bank & Gaza 2/	x	x	
Western Sahara 2/	x		
Yemen, R. of	x	x	
Zimbabwe	x	x	x

1/ Not a PRGT-eligible country.

2/ Not a Fund member.

3/ The World Bank's criteria are: (a) a harmonized average CPIA score of 3.2 or less; (b) the presence of a UN and/or regional peacebuilding mission during the previous three years (see World Bank 2011c for the list).

4/ Compiled from the bottom two quintiles of the World Bank's 2008 CPIA, the Brookings ISWDW 2008, and the CIFP 2008 lists (see OECD 2010 for the list).

5/ Compiled from the bottom two quintiles of the World Bank's 2007 CPIA, the Brookings ISWDW 2008, and the CIFP 2007 lists (see EC 2009 for the list). Includes only sub-Saharan African countries.

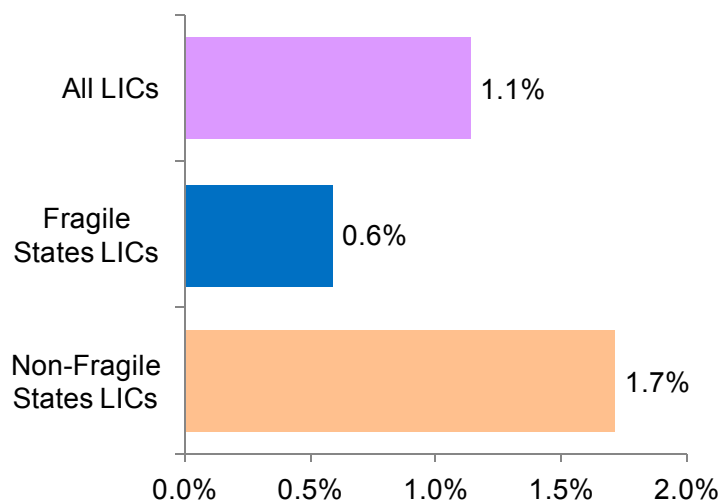
## Appendix 2. Analytical Work with Emphasis on Macro Fragility<sup>76</sup>

90. **Fragile states suffer from political and macro fragility.** Using a sample of 72 countries (of which 40 are fragile states) this analysis argues that fragile states in addition to facing political fragility, characterized by weak institutional capacity, poor governance, and conflict, also face severe macro fragility, characterized by a slow and abrupt growth pattern.

Figure 6: Growth Rate of Real GDP, mean, 1970–2009

91. **Fragile states experienced significantly lower average growth than other LICs (Figures 6 and 7).**

To better understand the state and causes of these countries' poor economic performance this section takes a first look into how different these countries are from the rest of LICs. While growth rate of real per capita GDP over the period 1970–2009 in non-fragile states LICs averaged 1.7 percent, it only reached 0.6 percent for fragile states.



92. **The growth gap increased markedly in the mid-1990's with the start of trade and financial globalization.** The growth difference between fragile states and non-fragile states was only 0.8 percent during 1980–1994, increasing to 2.4 percent over the next 15 years (1995–2009). This remarkable transformation suggests that although non-fragile states have taken advantage of the positive economic environment initiated by the new wave of globalization and reforms in the mid-1990s, fragile states benefited only modestly.

<sup>76</sup> This appendix uses a sample of fragile states with CPIA less than or equal to 3.3 (rather than 3.2 in the standard definition used by the World Bank) in order to obtain the necessary degrees of freedom for the empirical analysis. This is not out of line with definitions used elsewhere in the literature on occasion. For instance, Chauvet and Collier (2008) define a sustained transition as a country's CPIA exceeding 3.5 for a period of five consecutive years.

Figure 7: Growth Rate of Real GDP over Time, Percent

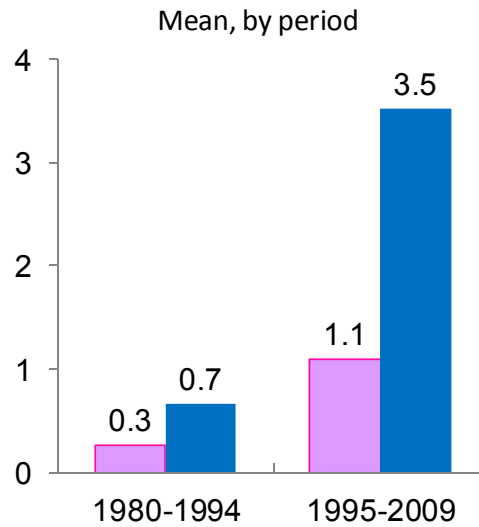
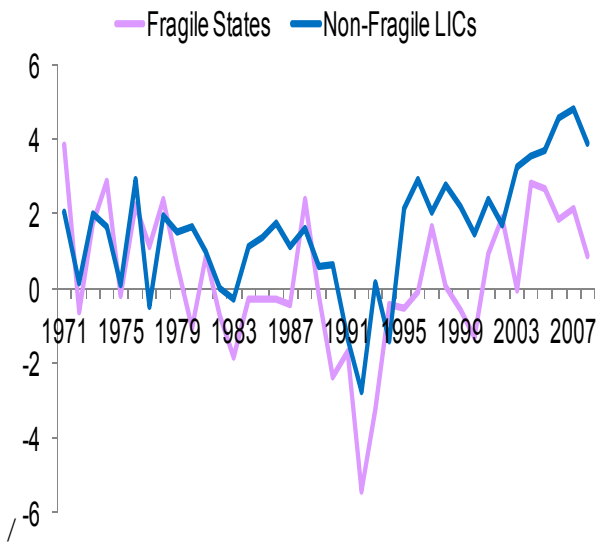
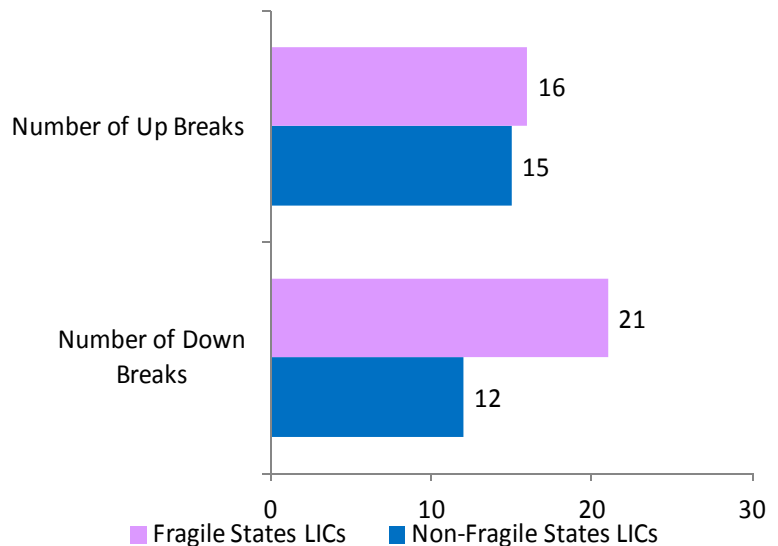


Figure 8: GDP Growth Breaks, 1960–2009

**93. The low growth performance in fragile states is characterized by many episodes of growth deceleration.**

Using the methodology of Berg, Ostry, and Zettlemeyer (2008), we characterize periods of sustained high and negative growth as up and down breaks in growth trends of countries. Figure 8 shows that fragile states and other LICs have experienced a number of accelerations and decelerations over the last half century. However, it is remarkable that while fragile states have had broadly the same number of up-breaks (sustained periods of high growth) as non-fragile LICs, they have also experienced almost double the number of down breaks (21 compared to 12). Thus, this analysis suggests that the low average growth rate experienced by fragile states is primarily due to sharp and sustained periods of retarded or even negative growth, rather than their being stuck in a slow-growing “bad equilibrium”.



**94. A broad range of indicators demonstrates that the preconditions for growth in fragile states are less favorable than in other LICs.**

Figure 9 illustrates how fragile states compare to other LICs in terms of their initial conditions, their level of economic development, and macroeconomic stability. By definition, fragile states have weaker institutions captured by a lower CPIA and lower Public Investment Management Index



(PIMI; see Dabla-Norris and others (2011)). They also suffer from a less stable political environment reflected in a greater number of civil conflicts. The geography variable reflects fragile states' higher percentage of coastal area which, while conferring a comparative advantage for trade, also renders these countries more vulnerable to natural disasters. Finally, fragile states are less diversified in exports. It is very clear that fragile states have disadvantages in all initial conditions, most notably in their institutional capacity and high probability of civil conflict engagement (top panel; Figure 9).

95. **The middle panel of Figure 9 provides a comparison between the fragile states and other LICs in terms of the three classical growth model variables, initial per capita GDP, investment, and human capital (years of education and health).** The results are particularly notable in the areas of investment, education, and health, in which fragile states lag far behind the other LICs. Specifically, in fragile states, on average only 10 percent of the population attends secondary school and the infant mortality rate is very high at 9.6 percent. Considering that all LICs as a group suffer from very poor indicators with respect to these four variables, the especially low levels of these variables in fragile states is alarming.

96. **Finally, the bottom panel of Figure 9 illustrates how the two groups compare in terms of basic macroeconomic variables; namely, inflation, reserves, and debt-to-GDP ratios.** It demonstrates that fragile states experience a substantially higher level of macroeconomic instability than in other LICs. For example, the central government debt to GDP ratio in fragile states is three times that in other LICs, and reserves too are lower in fragile states. The average inflation during the period 1970–2007 was, however, broadly similar: 15 percent for fragile states compared to 14 percent in other LICs.<sup>77</sup>

97. **The effect of major shocks on fragile states output levels is substantially worse than in other LICs.** Our analysis employs an impulse-response-function methodology, which involves using an autoregressive model of output growth rates augmented by several shock dummies, as in Cerra and Saxena (2008).<sup>78</sup> Using data from a panel of LICs we examine the impact of a broad range of relatively common shocks to fragile states, including economic and political shocks. The impulse response functions to a single shock are shown with a one-standard-error band drawn from a thousand Monte Carlo simulations (Figure 10).

98. **Fragile states have historically experienced severe output losses and such output losses have had a more lasting impact in these countries than in other LICs.** For instance, four years after experiencing a shock to terms of trade, fragile states experience

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<sup>77</sup> The inflation rate here only keeps inflation rate within three deviations around the mean, which means some extreme cases are excluded.

<sup>78</sup> Specifically, Cerra and Saxena (2008) test the statistical relationship between growth and several types of shocks by estimating a univariate autoregressive model in growth rates, which accounts for the nonstationarity of output and serial correlation in growth rates.

about a 5 percent output loss, while in non-fragile LICs output declines by close to 2 percent. In the case of FDI shocks, fragile states experience an even sharper and more persistent output decline of around 10 percent. A political shock (a rise in unconstrained executive power), also leads to output losses of 15 percent in fragile states compared to 5 percent in other LICs. In sum, the results from the impulse response analysis shows substantially larger and more highly persistent output losses associated with political and economic variables in fragile states compared to other LICs.

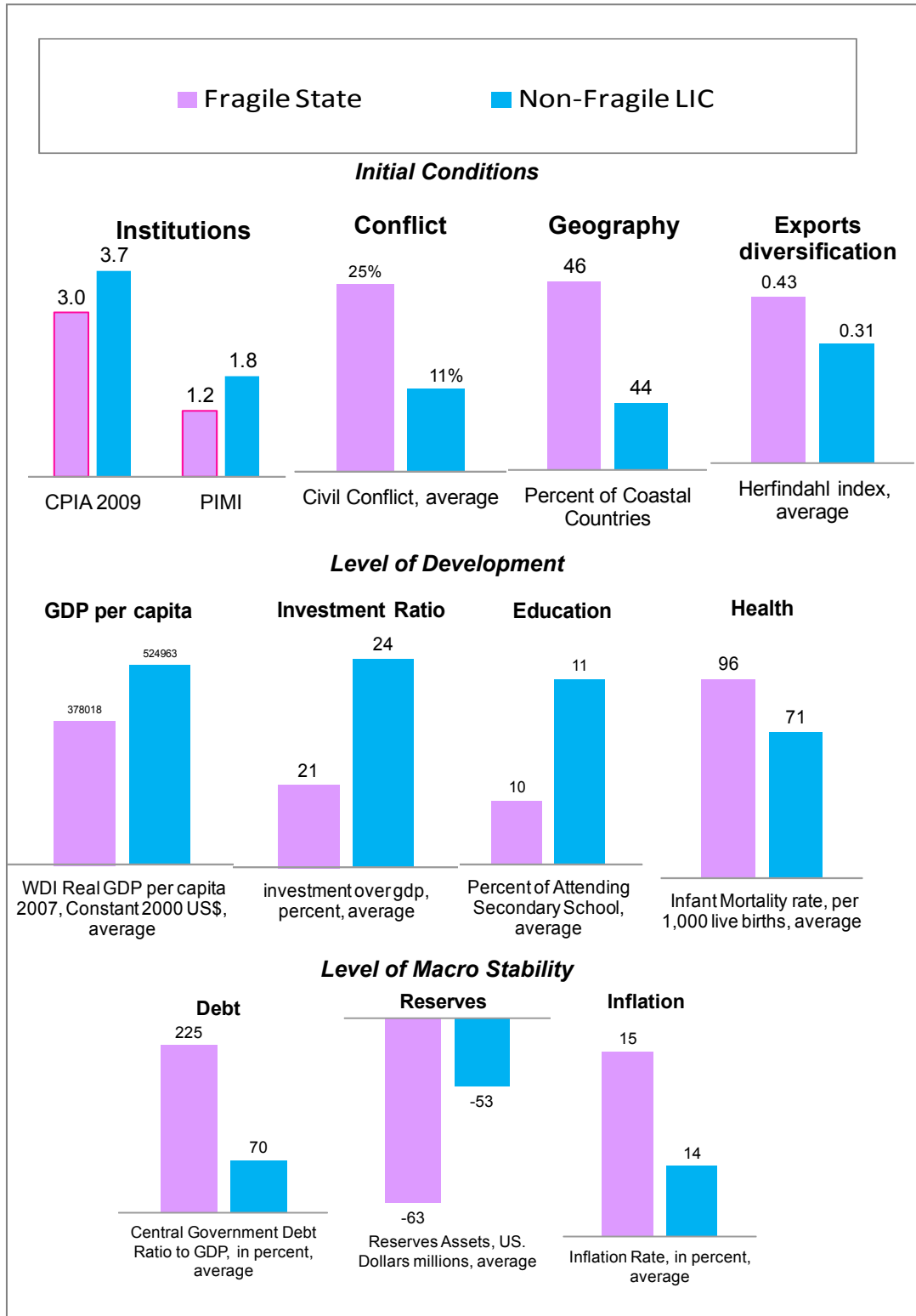
99. **Technical assistance, financial aid and macroeconomic policy reform could all contribute to turnarounds in fragile states, but need to be correctly sequenced.** While providing external aid to fragile states is considered crucial, getting the ordering of aid right, i.e., the sequencing of TA, financing, and policy reforms, may be more important to strengthen economic conditions and help spur growth.<sup>79</sup> Recent work by Chauvet and Collier (2008) examines the preconditions for turnarounds in a set of fragile states (defined based on their CPIA scores). Specifically, using a Probit regression model, in which the dependent variable is the probability of the commencement of a turnaround, these authors find that while appropriate donor intervention via TA can radically shorten state failure, large volumes of financial aid could have the opposite effect.

100. **The evidence thus far points to a strong contribution of TA in increasing the probability for political and macrofragility turnarounds.** Motivated by our finding that fragile states have more down breaks than other LICs, we extend the Collier-Chauvet Probit regression analysis to test for determinants of the probability of down breaks. More specifically, we try to explore different features of down breaks and their relationship to financial aid, and TA. Column 1 of Table 4, reports the baseline results from Chauvet and Collier (2008) in which TA significantly increases the probability of escaping political fragility (measured as a jump in the CPIA index). Column 2, reports results from our analysis suggesting that once again TA can reduce the probability of having a down break in fragile states. These results are robust to inclusion of other variables including conflict, education, and population growth, indicating that TA may be the most powerful form of aid to fragile states in initiating a turnaround.

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<sup>79</sup> Earlier work by Collier and Hoeffler (2004) focusing specifically on countries that have emerged from civil war shows that donors should have phased in aid gradually during the first four years after conflict. However, they have tended to do the opposite by providing large amounts of aid soon after the conflict and then “tapering [aid] out just when [it] should have been tapering in.”

Figure 9: Preconditions of Growth in Fragile States

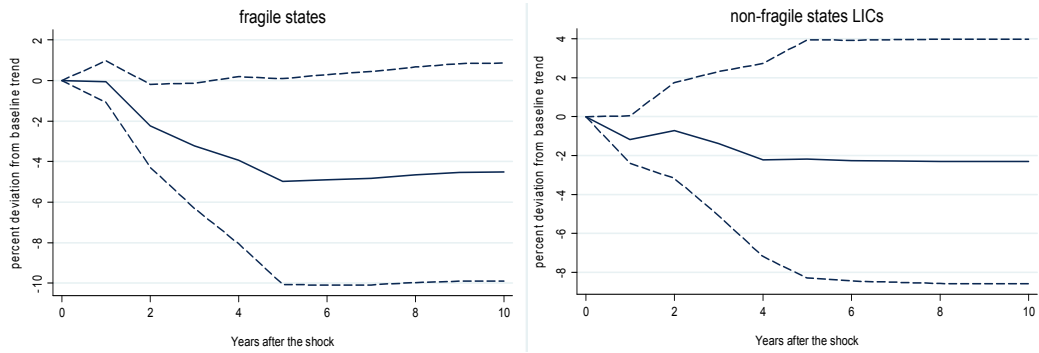


Source: WEO database; Fund staff calculated.

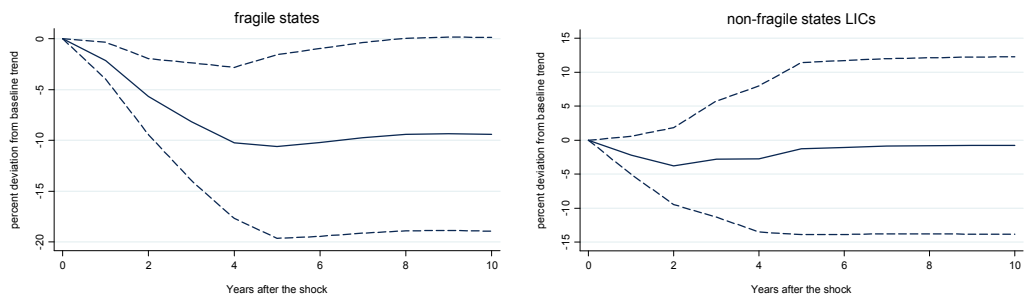
Note: If not specified, then the data is computed with period 1970 to 2008.

Figure 10. Response of Output Loss to Shocks

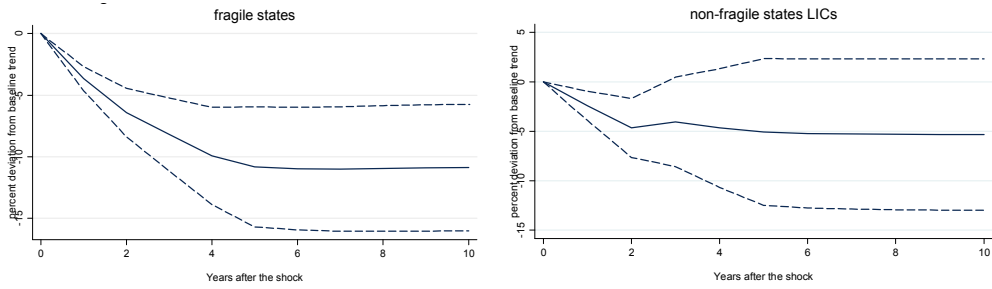
**Terms of Trade Shocks**



**FDI Shocks**



**Increase of Authoritarian Regime**



Note 1: Number of countries: 34; Number of observations: 1063

Note 1: Number of countries: 17; Number of observations: 391

Table 4. Probit Regression Results of Fragile States

VARIABLES	Start of Sustained Turnaround (From 2.5 to 3.5)	Downbreak
Secondary schooling	0.161*** (0.0645)	-0.0445 (0.0390)
Resource rent (% GDP)	-4.565** (2.589)	1.696 (1.320)
Ln population	0.298** (0.158)	-0.0491 (0.0914)
Aid (% GDP), lagged	-0.0583* (0.0359)	-0.00495 (0.0217)
Tech. assist. (% GDP), lagged	0.219** (0.127)	-0.225*** (0.0974)
Constant	-4.884**** (1.533)	-1.112 (0.895)
Observations	344	579

Robust standard errors in parentheses

\*\*\*\* p<0.01, \*\*\* p<0.05, \*\* p<0.1, \* p<0.15

### Appendix 3. The Work of the International Community in Fragile States

#### International Fora on Fragile and Conflict-Affected Situations

101. A number of fora have been established to help the international community harmonize its approach in fragile situations. Some of the most prominent are:

- *International Network on Conflict and Fragility (INCAF)*: The INCAF was established in 2009 by the OECD as a subsidiary body of the Development Assistance Committee (DAC). In promoting a whole-of-government approach, INCAF seeks to bring together diverse experts from governments and international organizations on issues of peace, security, governance, and development effectiveness.
- *Peace Building Commission (PBC)*: Created in 2006, the United Nations PBC supports peace efforts in countries emerging from conflict. It is mandated to bring together all relevant actors to marshal resources and to advise on the proposed integrated strategies for post conflict peacebuilding and recovery. It seeks to help ensure predictable financing for early recovery activities and sustained financial investment over the medium to long-term, and to develop best practices on issues in collaboration with political, security, humanitarian and development actors.
- *International Dialogue on Peacebuilding and Statebuilding*: The International Dialogue engages multiple stakeholders in an open and frank exchange with the aim of improving peacebuilding and statebuilding efforts in fragile and conflict-affected situations. The International Dialogue provides a platform for participants to: (i) share peacebuilding and statebuilding experiences; (ii) gather and discuss good practices and constraints to delivering effective international assistance in support of peacebuilding and statebuilding; (iii) identify a realistic set of objectives for peacebuilding and statebuilding that could guide national and international partners; and (iv) build trust between participating countries and organizations. An important feature of the dialogue is the participation of the fragile and conflict-affected states through the g7+.
- *g7+*: The g7+ is the first (and thus far only) independent and autonomous forum of fragile and conflict-affected countries and regions that have united to form one collective voice on the global stage. Their goal is to (i) promote urgent reforms on global policy; (ii) encourage better international partnerships by implementing and influencing global policy; (iii) change the way international actors engage with and in fragile and conflict-affected nations; and (iv) achieve formal recognition and become engaged in global dialogue in which g7+ countries and regions have traditionally been exempt.

### OECD Principles for Good International Engagement in Fragile States<sup>80</sup>

- **Take context as the starting point.** Sound political analysis is needed to adapt international responses to country and regional context.
- **Do no harm.** International decisions to suspend aid-financed activities must be carefully judged for their impact. Increased transparency in transactions between partner governments and companies needs to be a priority.
- **Focus on statebuilding,** by supporting the legitimacy and accountability of states, and strengthening the capacity of state structures to fulfill their core functions.
- **Prioritize prevention.**
- **Recognize the links between political, security, and development objectives.** A “whole of government” approach is needed, involving those responsible for security, political, and economic affairs, as well as those responsible for development aid and humanitarian assistance.
- **Promote non-discrimination as a basis for inclusive and stable societies.** International interventions in fragile states should consistently promote gender equity, social inclusion, and human rights.
- **Align with local priorities** where governments demonstrate political will to foster development. Where it is not possible, consult with a range of national stakeholders and seek opportunities for partial alignment at the sectoral or regional level.
- **Agree on practical coordination mechanisms between international actors.** Initiatives can take the form of joint donor offices, an agreed division of labor among donors, delegated cooperation arrangements, MDTFs, and common reporting and financial requirements.
- **Act fast, but stay engaged long enough;** and improve aid predictability.
- **Avoid pockets of exclusion** (aid orphans) through coordination of field presence, determination of aid flows in relation to absorptive capacity, and mechanisms to respond to positive developments in these countries.

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<sup>80</sup> See OECD (2007).

### Key Elements of INCAF's Guidance on Transition Financing

102. The INCAF has been mandated by the OECD's DAC and the UN Secretary-General to develop a common vision and approach for bilateral and multilateral actors' engagement in fragile states. It identifies donors' fragmented and uncoordinated operations as an impediment to the identification, signaling, and achievement of key priorities. It also points to the need for a more risk-tolerant approach based on an understanding of what can realistically be achieved in transition contexts. To this end, it advances a wide range of proposals to implement a new paradigm for aid delivery in fragile and conflict-affected contexts. Specifically, it proposes the idea of a Transition Compact (used for example in Afghanistan) which would establish a formalized partnership between different actors (national and international) based on a mutual accountability framework in support of statebuilding and peacebuilding objectives.

#### Key proposals that have implications for Fund's role include:

- *Prioritization of objectives*: Strict prioritization and sequencing of objectives, based on annual planning cycles for the first several years, have the highest potential to address urgent priorities in a flexible manner.
- *Strengthened coordination and leadership at the country level*: In view of the capacity constraints that countries may face, improved donor coordination is needed to achieve such prioritization. This process could be facilitated by a donor with the trust and confidence of the government, or one that has the capacity to take the lead in the discussions with the authorities. The Guidance envisages close coordination with the World Bank and the Fund in view of their key roles.
- *Improve aid instruments*: The Guidance recognizes pooled funding mechanisms as being particularly well suited to defining a coordinated and flexible donor engagement. However, as past experience has shown, it takes several years to establish MTDFs, and other forms of assistance would also be needed at various stages of the transition process, in particular, at the outset. Recognizing that the RCF is available to meet urgent balance of payments needs of PRGT-eligible countries, the Guidance also considers that the IMF's financial support can play a useful role in helping many fragile states meet the recurrent costs of transition.<sup>81</sup>

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<sup>81</sup> Fund programs, in many instances, through central bank lending to the government, or even directly, make Fund resources available to the budget. Fund lending must, however, be justified by a balance of payments need.



### **Reforms at the World Bank to Implement the WDR Approach**

103. The World Bank has recently adopted procedures to implement the approach to engagement in fragile states outlined in WB (2011). Implementation is expected to be a long-term effort, though some actions can be taken in the near term (next 12 months).

- *Managing Risk*: The Bank aims to be more tolerant of the risk inherent in operating in fragile states (including by adopting fiduciary standards in procurement that are better suited to fragile contexts), it will seek to ensure that there is greater awareness of the political context, and that risks in this regard are conveyed to the Board in order to promote better informed decision making.
- *Inclusive growth*: The Bank recognizes the particular importance of inclusive growth and the need to create jobs. To this end, the International Finance Corporation (IFC) is expected to increase investment in fragile states and the Multilateral Investment Guarantee Agency (MIGA) is developing an instrument to insure against risks in these situations.
- *Human Resources*: To implement an approach adapted to the needs of fragile states, the Bank recognizes the need to adopt changes to its human resources policy. It sees a need to offer appropriate career incentives and training (including on areas such as political economy, diplomacy, and security) to staff working in fragile states, while emphasizing knowledge of the local context and political economy skills in its recruitment efforts.
- *Improved Coordination*: The Bank recognizes the need to have a better coordinated approach across all its areas of engagement in order to be effective. Accordingly, it has initiated the establishment of a Fragile States Hub in Nairobi, which will also allow it to better coordinate with other actors engaged in fragile states.
- *Flexible Financial Instruments*: The Bank is also moving to adapt and expand the scope of its financial instruments for FCS, and in the medium term to introduce more flexible rules for financial allocations to FCS.

### **Providing Budget Aid in Situations of Fragility: A World Bank-African Development Bank Common Approach Paper**

104. The paper (CAP) sets out a “common approach” that aims at improving coordination and the pooling of risk management in the provision of ‘budget aid’ in situations of fragility, among the World Bank and AfDB, in collaboration with the European Commission and IMF. The goal is to better help countries in fragile situations to embark on a path of stability and resilience. A key premise is a need for more predictable and targeted budget aid aimed at addressing the root causes of fragility and conflict.

*The paper conveys three main messages:*

- Rather than viewing *budget aid* as simply a transfer of financial resources to the country's budget, and with a narrow focus on PFM, it *should be considered as a key element of an aid package* that consists of evidence-based policy dialogue, analytical work, TA, and capacity building activities, as well as financial transfers. This package *should be more explicitly geared at addressing the underlying causes of fragility and supporting the transition toward resilience*. This can be done by highlighting the role that budget aid can play in: stabilizing the macrobudgetary framework and allowing the state to carry out basic functions to cement its legitimacy and contribute to maintaining political stability; supporting the longer-term endeavors of peace and statebuilding; and contributing to strengthening the capacity of recipient countries by channeling aid through national systems.
- *The risk elements surrounding the provision of budget aid need to be analyzed more deeply and shared more widely amongst the three institutions*. Working together to pool risk is a critical source of added value resulting from improved coordination of approaches. The risk of not engaging should be set against the benefits that can be reaped by successfully stabilizing a country, including the positive regional (and global) externalities that may be generated.
- *It is important to consider more systematically the choice and complementary nature of policy-based budget support lending and grants, as well as other instruments to support recurrent expenditures, such as MDTFs*. Donors could fine tune the mix of instruments and sources of financing at their disposal depending on their exposure to risk to avoid negative consequences for countries resulting from the delay or withdrawal of disbursements through one mechanism.

105. The paper includes a number of recommendations for: improving donor coordination; reinforcing the rationale of budget aid; improving knowledge of the political economy; undertaking a more comprehensive analysis of risk; considering nontraditional focus areas e.g., security sector reform, rule of law and justice; addressing aid predictability and effectiveness (use a balanced mix of instruments/sources of financing of the budget, and move toward programmatic support where possible with a series of single-tranche operations); and improve monitoring and evaluation systems.

## Appendix 4. Country Studies

### Fund Engagement in Liberia 2003–2010: Opportunities and Challenges

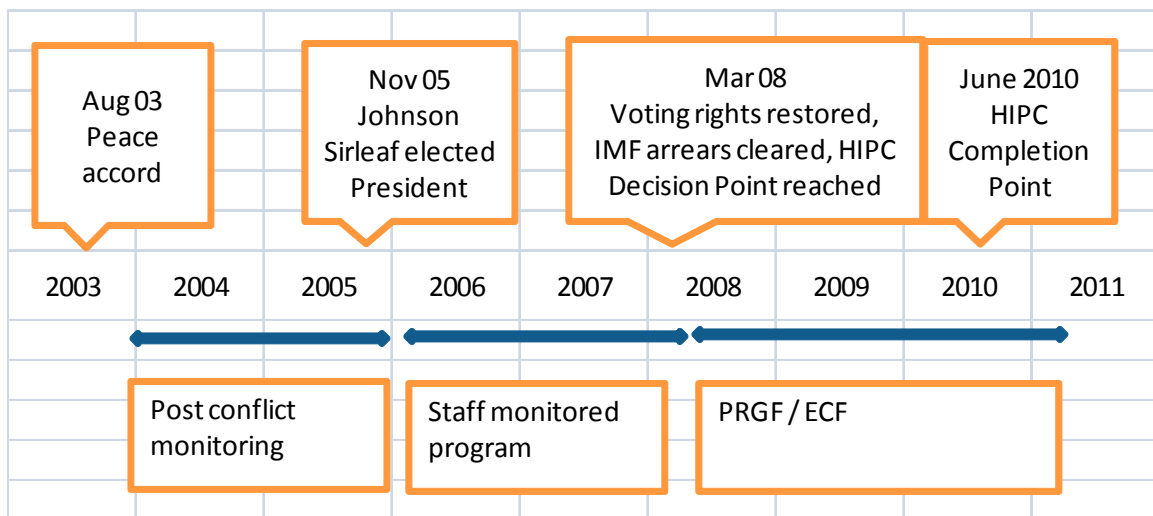
#### I. Background

106. **As a result of deep political fissures, Liberia experienced prolonged periods of civil war** between several primarily ethnically-based factions over the past two decades. The conflicts of 1989–1996 and 2000–2003 destroyed almost all economic infrastructure, commercial and government property, and resulted in 250,000 deaths—equivalent to over 5 percent of the population—while income per capita declined by about 80 percent. During the conflict, Liberia transitioned from a MIC, albeit with significant macroeconomic imbalances, to a LIC with a huge debt-to-GDP ratio of over 700 percent. With the end of the civil war in 2003, a National Transitional Government was appointed with representatives of the factions and other political figures. Thereafter, elections were held in October–November 2005 and President Ellen Johnson Sirleaf took office in January 2006.

107. **Since 2006, the political situation has remained stable but fragile with some developmental progress.** However, overcoming the legacy of conflict with very limited capacity and resources has proven very challenging for the Liberian authorities, notwithstanding their strong commitment to reform.

#### II. Timeline of Fund Engagement From 2003

Figure 11. Timeline of Fund Program Engagement with Liberia, 2003–2011



108. **The Fund responded early, re-engaging quickly after the signature of the 2003 Peace Treaty (Figure 11).** In October 2003, a National Transitional Government of Liberia (NTGL) was established as a power-sharing arrangement to prepare for elections in October 2005. The Fund sent a mission to report on the postconflict situation in December 2003 in

parallel with TA needs missions from FAD, Monetary and Capital Markets Department (MCM)—at that time Monetary and Financial Systems Department (MFD), and Statistics Department (STA).

109. **The immediate postconflict engagement focused on defining TA needs and on providing policy advice.** Staff outlined a TA program and assisted the authorities in crafting fiscal policies for January–June 2004. The policy performance in the first half of 2004, the elaboration of a suitable 2004/05 budget, and improving the provision of data were seen by Fund staff as being crucial to the prospects for an SMP. In discussions on the postconflict situation by the Executive Board in February 2004, some Directors favored an early SMP while others cautioned against moving too quickly.

110. **An SMP could only be put in place in 2006.** While the NTGL elaborated a two-year reform program for 2004–05 with the help of external partners, a number of slippages in macroeconomic performance and governance emerged from the second half of 2004 onward that precluded moving to an SMP. In particular, the staff concluded that there was a lack of unified support in the NTGL and that many new governance issues had emerged. Following the October 2005 elections and appointment of a new administration, an SMP was initiated in February 2006.

111. **Normalization of relations and the resumption of Fund financing entailed improved cooperation by the authorities and the adoption of a flexible approach by the Fund.** Performance on policies and on payments to the Fund improved considerably under the new administration.<sup>82</sup> However, Liberia’s unsustainable debt burden and its arrears to the Fund precluded new lending, and building a track record for debt relief from the Fund under the HIPC and MDR Initiatives.<sup>83</sup> A number of changes in the Fund’s policies had to be made to make such debt relief possible. Greater flexibility under the policies and the successful implementation of the SMP paved the way for the clearance of arrears to the Fund and Fund financial support under a three-year PRGF/Extended Fund Facility (EFF) arrangement in 2008 and reaching the HIPC Initiative decision point. Liberia reached the HIPC completion point and received comprehensive debt relief in mid-2010.

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<sup>82</sup> The Fund’s strategy in cases of members with overdue obligations entails the improvement of cooperation on policies and payments to the Fund that lead to a gradual de-escalation of the remedial measures applied by the Fund.

<sup>83</sup> To reach the decision point of the HIPC Initiative, countries were required to establish a track record under a UCT Fund borrowing arrangement, and a further track record was required to reach the completion point of the Initiative. Liberia’s arrears to the Fund precluded entering into a UCT arrangement. Furthermore, since Liberia would have had to clear its arrears to the Fund prior to reaching the completion point, it would not have had any MDRI-eligible debt.

**112. The improved policy performance from 2006 had several distinctive features.**

The Fund-supported economic program envisaged a balanced central government fiscal budget and a balanced central bank budget, and structural reforms in monetary and financial management and statistics. In particular, there was a strong focus on fiscal management, with international experts deployed to monitor transactions and strengthen capacity in revenue collecting agencies and other public institutions under the Governance and Economic Management Assistance Program (GEMAP). More generally, the new administration undertook a broad range of early confidence building measures, the so-called “150 Day Action Plan,” that targeted key measures under the four pillars of Liberia’s reconstruction and development strategy—expanding peace and security, revitalizing economic activity, rebuilding infrastructure and providing basic services, and strengthening governance and the rule of law. The implementation of the Plan was instrumental in establishing the government’s credibility within the country and with the donor community.

**113. Engagement through TA and resident Fund representatives and experts occurred in parallel to discussions on the program and normalizing financial relations**

(Figures 12 and 13). TA needs assessments were undertaken at the same time as the first postconflict monitoring mission in 2003. TA was provided to the transitional government during 2004–05, but increased substantially in 2006–07 with the newly elected government and in support of the SMP, including several resident advisers from 2006. A resident representative has been in place since April 2006. TA remained substantial during the ECF (formerly PRGF), including a resident adviser at the Central Bank as part of the GEMAP agreement of financial oversight.

Figure 12. Liberia – Fund TA Missions, 2000-2010

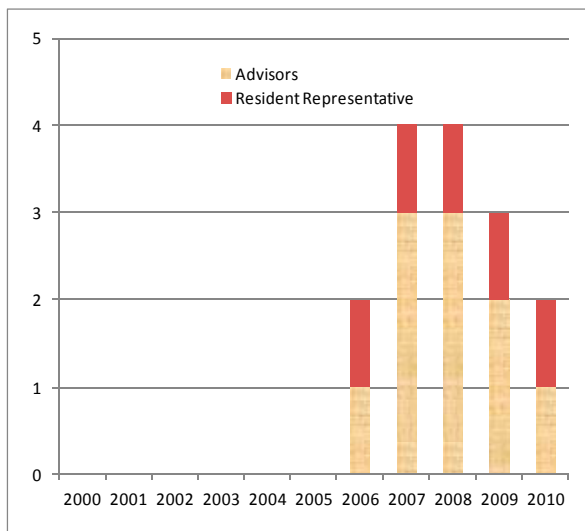
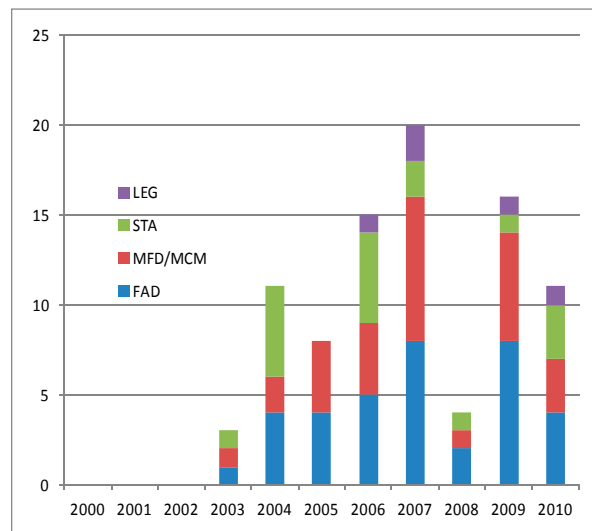


Figure 13. Liberia – Fund Resident Advisors and Representatives, 2000-2010



### III. Factors Critical For Fund Engagement

114. **Although the Fund had instituted remedial measures against Liberia, when an opportunity arose for policy advice and TA, it was quickly taken.** This was well illustrated in the brief period of peace between 1997 and 2000, when the policy dialogue developed into an SMP together with substantial TA. Fund re-engagement in policy advice and TA after the conflict was also rapid once the security situation had stabilized beginning in late 2003. While in both these cases the engagement did not lead to a de-escalation of remedial measures or the development of a satisfactory track record of policy implementation, the combination of dialogue and TA arguably set the foundation for later advances with a more committed administration.

115. **The arrival of the Johnson Sirleaf administration in 2006 was a critical factor that led to a deepening of Fund engagement.** The new government implemented the GEMAP agreement of financial oversight which strengthened governance and provided assurances to donors. The new government set comprehensive debt relief and macroeconomic stability as primary policy objectives, and this in turn supported generally good implementation of the SMP from 2006, the PRGF/EFF from 2008 and implementation of the HIPC triggers. While structural reform implementation was often slower than planned, it was primarily as a result of capacity weaknesses rather than reluctance to advance on reforms or a lack of political commitment.

116. **The provision of wide-ranging TA has been a very positive factor in Fund engagement with Liberia that likely hastened its normalization of financial relations with the Fund and thereby supported creditors' participation in debt relief.** TA was generally delivered on a timely basis, covered a wide range of urgent issues and included resident advisers to oversee implementation in the immediate postconflict period. The improvements to Central Bank governance, including safeguards, and the development of PFM reforms were critical to the eventual use of Fund resources. TA also hastened the implementation of HIPC triggers and comprehensive debt relief.

117. **The installation of a resident representative at the outset of the SMP greatly supported confidence building between the Fund and the authorities.** While physical conditions on the ground were initially difficult, the resident representative quickly helped build a relationship of trust between the authorities at both technical and policymaking levels, reversing the previous long period of difficult or non-existent relations.

### IV. Factors That Impeded Fund Engagement

118. **Liberia's ability to clear arrears to the Fund, embark on debt relief and request Fund financing was contingent on obtaining financing assurances for IMF and other creditors' provision of debt relief as well as developing a track record of policy implementation and payments to the Fund.** On the internal financing side, this was primarily an issue of raising SDR 550 million from the international community, as IMF debt

relief for arrears cases (Liberia, Somalia, and Sudan) had not been included in the financing arrangements for HIPC. Financing assurances from other creditors were also necessary. Internal and bilateral discussions on the financing options covered much of 2006 and 2007, with a decision on the modalities taken in September 2007 by the Fund's Executive Board with an additional six months needed to confirm members' participation. On the track record aspect, the Fund's policies on de-escalation of remedial measures would normally require an evaluation period of about two years prior to the restoration of voting and related rights, approximately the length of time that it took to secure financing assurances, although some flexibility exists in the policy that could have reduced the period of the track record.

119. **The Fund was unable to provide any financial support to Liberia in the first two years of postconflict engagement in contrast to other partners.** Many factors militated against Fund lending to Liberia, most importantly the existence of large arrears, the massive debt overhang, and because debt relief financing was not covered by existing HIPC resources. Many bilateral donors and some multilaterals, including the World Bank, provided substantial grant financing from 2006, though funds were disbursed and executed outside of the budget process, with few exceptions. Moreover, the authorities' financing needs were particularly acute in the immediate post-crisis period, with net foreign exchange reserves amounting to only US\$5 million in 2006.

120. **In the view of the authorities, the balanced budget policy followed during 2006-10 under the SMP and the PRGF/EFF was a significant fiscal constraint, particularly during 2009 and the global recession.** Initially, the authorities' debt burden clearly argued against any new borrowing. However, as progress was made in reducing the debt stock and implementing the HIPC completion point triggers, there could have been a case for modest financing to address external shocks, particularly during 2009. While the program was amended in 2009 to potentially allow concessional external borrowing for a macrocritical investment (the national port), there was no consideration of domestic financing, notwithstanding the considerable build-up of excess liquidity in the banking system, nor an augmentation of the arrangement. Nonetheless, the authorities supported the balanced budget policy as a necessary policy action given the need for the Fund's support in dealing with various creditors and as a tool to withstand internal fiscal pressures. Additional flexibility might have been possible, had it not been so difficult to mobilize sufficient support for financing debt relief in the first place.

121. **The terms of Fund financial support for acutely fragile states lack flexibility.** Liberia is expected to seek highly concessional sources of external financing when it restarts borrowing after the HIPC completion point to maintain low debt vulnerabilities. However, Fund financing under the ECF or other concessional facilities does not meet the minimum 35 percent grant element expected for external financing under the Fund-supported program, and is far from the 50 percent grant element provided by other multilateral agencies.

## Intensive Engagement Without Lending—Sudan and West Bank and Gaza

### *Sudan*

122. **Engagement under the first SMP was initiated against the background of a crisis in Sudan’s heavily managed economy.** Large fiscal deficits monetized by the Central Bank of Sudan had resulted in triple digit inflation and increasing spreads between the official and free market exchange rates constituted an implicit tax on exporters. The narrow export and revenue base was inadequate to meet the country’s balance of payment and expenditure needs, resulting in the build-up of very large external arrears.

123. **The authorities’ successful effort under the early SMPs in quickly turning around the economy and restoring stability was an important confidence-building measure.** By controlling the cash fiscal deficit and reducing lending to public enterprises the growth of money supply was contained, bringing down inflation. With real interest rates turning positive, the trend toward disintermediation and increased velocity of the mid-1990s was reversed. Moreover, with confidence in the currency restored, a controlled depreciation was able to eliminate the spread between the official and free-market exchange rate. In light of Sudan’s established oil resources, the authorities’ ability to stabilize the economy gave confidence to investors and set the stage for a rapid pick up in investment and growth.

124. **The SMPs also supported a more gradual, but nevertheless important, modernization and enhancement of Sudan’s tools for managing the economy.**

- Reforms focused on improving revenues, PFM, and tools of monetary management, all key capacity building requirements in fragile situations. Tax policy reforms addressed inequities and distortions in the system while broadening the tax base while reforms to modernize tax administration were undertaken. Significant efforts were also directed to improving PFM. The Bank of Sudan’s operational effectiveness was dramatically improved through capacity enhancements and the introduction of Shariah-compliant instruments of monetary management. Despite a heavy reform agenda in the early years—the 1998 SMP had, for instance, 52 structural benchmarks—the authorities successfully delivered on most of the conditions (albeit with delays on occasion).
- Program conditionality was appropriately targeted and sequenced, and well supported by extensive TA—significantly in excess of 100 TA missions visited Sudan over the period from 1998–2010. However, finding resident advisors has been more challenging. Extensive Fund TA was focused on the key weaknesses identified during program discussions. The assistance provided in establishing the tools of monetary management were an important example of adapting TA advice to the local context, namely a setting with Islamic banks.



125. **Despite this progress, some shortcomings in policy implementation point to difficulties in improving capacity and achieving consensus on difficult reforms in fragile situations.** The authorities have found it difficult to tackle the persistently large tax exemptions which have kept non-oil revenue-to-GDP ratios at a low level, and there have also been delays in forcefully addressing issues with problems in state-owned banks. Similarly, capacity improvements, especially in the area of PFM, have taken place very slowly, and been marked by periods when progress stalled, or even reversed. Thus, after over a decade of reforms, much remains to be done.

126. **Sudan’s inability to receive debt relief has been a source of great frustration for the authorities.** Sudan’s adjustment efforts have been undertaken against the background of economic sanctions and severe resource constraints. For this reason, achieving early debt relief was an important objective of the authorities. Not being able to achieve this objective, or even a viable strategy to this end, over the extended period during which SMPs have been implemented, has taken an enormous social toll on the population and led to “adjustment fatigue.”<sup>84</sup> This illustrates the critical importance of continuing to deliver on the benefits of transition in order to sustain the momentum for reforms.

127. **In light of the significant unfinished agenda, Executive Directors have clearly expressed a preference for close program-like engagement.** In considering the relative merits of future engagement in a surveillance mode or through SMPs, Executive Directors noted that there would be clear benefits to continuing the series of SMPs. They considered that SMPs could provide a macroeconomic framework and a structural reform agenda to address Sudan’s remaining vulnerabilities, as well as facilitate arrears clearance and debt relief, as and when financing assurances have been received. By contrast, a surveillance-based relationship would, in the absence of a clearly specified program, entail risks given the still-fragile fiscal and monetary positions.

### ***West Bank and Gaza***

#### *Background and Context*

128. **The IMF was first mandated to engage with the Palestinian Authority (PA) in 1994 under the Oslo Accords.** The Fund could not provide financial support to the West Bank and Gaza (WBG) as it was not a member state but has been providing policy advice in the macroeconomic, fiscal, and financial areas since 1994. It has also been providing TA on tax administration, public expenditure management, banking supervision and regulation, and macroeconomic statistics. Fund staff worked with the PA to develop the Palestinian Reform and Development Plan (PRDP) presented at the Paris Donors’ Conference in 2007 and

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<sup>84</sup> Sudan has been unable to obtain financing assurances from its creditors to provide debt relief, which has also held up progress toward normalizing relations with the Fund.

reviewed its implementation during 2008, 2009, and 2010. In 2010–11, Fund staff worked with the PA to develop a successor to the PRDP, the Palestinian National Plan (PNP) for 2011–2013.

129. **The Israeli-Palestinian conflict has been one of the most intractable and damaging conflicts in recent world history.** The Oslo Accords offered a hope for a peaceful resolution. Under the accords, the PA had the core task of building institutions and developing a policy and legal framework that could provide the basis for a future Palestinian state. Considerable progress was made toward these objectives, until the outbreak of the second “Intifada” in 2000. Despite efforts to revive the peace process, in 2006 the economic and political situation deteriorated, culminating with the election of the Hamas-led government, the subsequent Israeli blockade, and Hamas assuming political control of Gaza. Since 2007, macroeconomic conditions in the West Bank have improved owing to the PA’s reforms supported by donor aid while Gaza has declined until 2010 when it experienced a rebound due to the easing of controls on imports.

130. **Fund staff considers that the PA is now able to conduct the sound economic policies expected of a future well-functioning Palestinian state, given its solid record of accomplishment in reforms and institution-building in the public finance and financial areas.** These reforms have enabled the PA to tightly control expenditures, apply rigorous budget preparation and execution practices, and establish fiscal transparency and accountability in line with international standards. The Palestine Monetary Authority is able to fulfill the core functions of a central bank.

*What has worked?*

- **Program ownership and feasibility.** Fund staff worked closely with the PA to ensure that the envisaged measures are achievable given political and capacity constraints.
- **Coordination with functional departments.** Issues in policy and reform design benefited from discussions with Strategy, Policy, and Review Department (SPR). FAD and MCM provided critical inputs and TA for the design and implementation of structural reforms.
- **Simultaneous strong engagement with all stakeholders.** An unusual aspect of the WBG situation is the heavy dependence of the Palestinian economy on actions by Israel and donors, in addition to the PA. Fund staff maintained a strong and continual engagement on the ground with the three parties.
- **Board support.** The Board informally endorsed the PRDP in 2007. The endorsement raised the PRDP’s credibility in the eyes of donors.

- **Timely analysis.** Semiannual Fund reports, widely disseminated including through our website and at donor meetings, have provided timely and well-rounded analyses of the WBG's economic developments, policies, and prospects.
- **Raising the quality, transparency, and timeliness of the WBG's economic and financial statistics.** The Palestinian Central Bureau of Statistics (PCBS) aims to meet all the requirements of the Special Data Dissemination Standard (SDDS) in 2011.
- **Coordination with donors.** Donors highly value the Fund's analysis and take into account its findings when pledging and making disbursements. They also see the Fund as a valuable partner in delivery of TA. The Fund and DfID staffs have recently agreed on a joint medium-term agenda financed through the DfID initiative to assist fragile states.
- **Bank-Fund coordination.** Fund and Bank staffs have closely coordinated efforts to support the implementation of key structural reforms, particularly in the analysis of growth-related issues, pension reform, utility subsidies, as well as in the areas of PFM and financial sector development.

*What could have worked better?*

- **Donor-PA coordination.** The shortfalls and delays in disbursements of aid for both recurrent spending and development projects have contributed to a rise in domestic payment arrears and borrowing from commercial banks. This problem could be addressed through an enhanced donor coordination framework with better follow-up on timely fulfillment of pledges.
- **Faster implementation of a Financial Management Information System (FMIS), and cash management procedures** could have stemmed arrears accumulation early on. The delay was due to the Fatah-Hamas strife in 2006 and early 2007 which delayed TA for the FMIS until mid-2007.
- **Presence on the ground of Arabic-speaking TA experts.** The authorities have expressed a strong preference for Arabic-speaking TA experts to assist in reforms by the Ministry of Finance. Attracting such experts was made difficult by political and visa-related constraints.

## The Experience with Fragile Middle-Income Countries: Iraq

### *Background and Context*

131. **The Fund has been closely engaged with Iraq since 2003.** Initial work focused on providing policy advice, mainly on monetary and fiscal policies, and TA to rebuild essential economic institutions. In September 2004, the Fund approved EPCA for Iraq, which—in combination with a DSA—paved the way for an agreement with Paris Club creditors. Since then, Iraq successfully completed two (precautionary) Stand-By Arrangements (SBA) whose main objectives were to achieve macroeconomic stability, promote growth, and continue with the process of structural and institutional reforms. Iraq has made substantial progress since 2003.

132. **Despite a difficult security situation, the authorities have demonstrated their commitment and ability to implement sound macroeconomic policies and advance structural reforms.** Inflation has been reduced to single digits and the international reserves position has improved markedly. At the same time, domestic fuel prices were raised to eliminate direct fuel subsidies and the pension system was put on a sustainable footing, which created room for priority spending on investment and the social sectors. Several steps have also been taken to strengthen PFM, improve transparency in the oil sector and rebuild capacity at the central bank, and the authorities have initiated the restructuring of the two largest state-owned banks. Important advances have also been made in attaining long-term debt sustainability. In 2004, the Paris Club agreed to reduce Iraq's external debt by 80 percent in net present value terms. The third and final tranche of this debt relief was granted following the completion of the last review under the second SBA in December 2008. Bilateral debt agreements with several non-Paris Club creditors have already been concluded, but this process is yet to be completed.

133. **Serious challenges remain.** First and foremost is the continuing need to further improve security. It is also important to maintain a stable macroeconomic environment and improve the business climate to create a viable private sector in order to sustain economic growth and provide much-needed jobs for Iraq's labor force. In addition, many structural reforms have yet to be finished and governance needs to be strengthened, including in the areas of PFM and financial sector development.

134. **The current program aims to continue to support the reconstruction of Iraq in challenging times.** Following the successful conclusion of Iraq's second SBA program, the IMF's Executive Board approved a new two-year SBA program on February 24, 2010 that allows for disbursements of about US\$3.8 billion (SDR 2,376.8 million, or 200 percent of quota). The program provides a macroeconomic framework supporting ongoing reconstruction efforts during the political transition after the March 2010 parliamentary elections.

135. **The key objectives of the current SBA remain the same as in past programs: preserving macroeconomic stability and supporting the authorities' structural reform agenda, both with a view to ensure sustainable growth and poverty reduction.** In addition, the program provides access to Fund resources, if needed. The structural reform agenda is based on three key pillars: modernizing Iraq's PFM system, developing the financial sector, and strengthening governance in the fiscal, financial, and oil sectors.

*What has worked?*

- **Program ownership.** The Fund-supported programs consistently provided a valuable anchor for implementing macroeconomic policies and advancing structural reforms. Accordingly, the authorities implemented sound fiscal and financial policies, including by adopting government budgets that were based on more realistic assumptions and by safeguarding central bank independence. Similarly, albeit with frequent delays due to severe capacity and security constraints, the authorities were able to make steady progress in rebuilding key economic institutions.
- **Macroeconomic stability was achieved.** Inflation was reduced to low single digits, the exchange rate has stabilized, and Iraq's reserve position has strengthened. Growth has recovered, mainly reflecting developments in the oil sector.
- **Flexibility.** Program implementation was generally assessed based on performance relative to objectives and not a headcount of the number of PCs or structural benchmarks observed, in recognition of the weaknesses in capacity. In the same vein, program reviews under the current arrangement are on a semiannual basis, partly also reflecting the delays in data availability.
- **Coordination with functional departments.** Program design and major policy issues were discussed in early stages with functional departments, especially with SPR and Legal Department (LEG), which were very helpful. FAD, Finance Department (FIN), and MCM provided critical inputs for the design of the structural reform agendas of programs.
- **Information.** The Fund programs, with all documents published, have been a key source of consistent information on economic developments and policies in Iraq.
- **Donor support to finance Fund TA.** Donors have provided valuable financial support to fund much-needed TA to Iraq by contributing to a country specific TA trust fund.
- **Bank-Fund coordination.** Fund and Bank staffs have been working closely together to coordinate efforts to support the implementation of key structural reforms, particularly in the areas of PFM, financial sector development, and oil sector transparency. In addition, the Bank provided budgetary support in parallel to the current SBA; both operations were presented to the respective institutions' Boards at the same time.

*What could have worked better?*

136. The rebuilding of key economic institutions and implementation of structural reforms has generally been progressing slower than programmed or hoped for. While this largely reflects the very low levels of institutional capacity in Iraq, as well as poor security, it also reflected, at times, political constraints or insufficient understandings of the situation on the ground and how best to improve it. This could have worked better by ensuring:

- **In-country (technical) assistance.** Due to the security constraints, staff has not traveled to Iraq since the bombing of the UN headquarters in Iraq in 2003, and missions—both area department missions and TA missions—have taken place in third countries. This has particularly hampered the effective delivery of TA. Moreover, in light of the very weak administrative capacity, it would have made a large difference if it had been possible to station resident advisors particularly in the central bank and the ministry of finance. Similarly, it would have been helpful if the Fund’s resident representative could have been stationed in Baghdad. Besides the poor security situation itself, especially during 2005–07, the very high costs of mitigating the security risks, as well as the lack of a competitive benefits package for those working in risky situations, precluded this.
- **A greater focus on governance issues.** As key economic institutions are still in the process of being rebuilt, governance problems occur. While the programs’ strong focus on rebuilding institutions will help to improve governance, the lack of in-country presence has, at times, made it harder to detect governance issues.
- **Coordination of TA among donors.** Coordination with donors other than the World Bank has been less frequent than desirable, partly reflecting the lack of in-country presence of the Fund. At times, this resulted in a lack of information about other donors’ plans and activities.
- **Frequency of engagement.** Given the severe capacity constraints and the lack of in-country presence, more frequent missions, both from the area department and TA departments, would have been beneficial to ensure a faster pace of implementation of structural reforms, by offering more frequent explanations and support, and to keep the momentum going. The frequency of missions was constrained, however, by resource constraints on the side of the Fund, as well as by the burden that traveling to third countries imposes on the authorities.
- **Greater focus on overcoming data weaknesses.** Poor data quality and long lags in the availability of data complicate analysis and policy formulation. A stronger emphasis on improving data, with additional TA, would have been helpful.

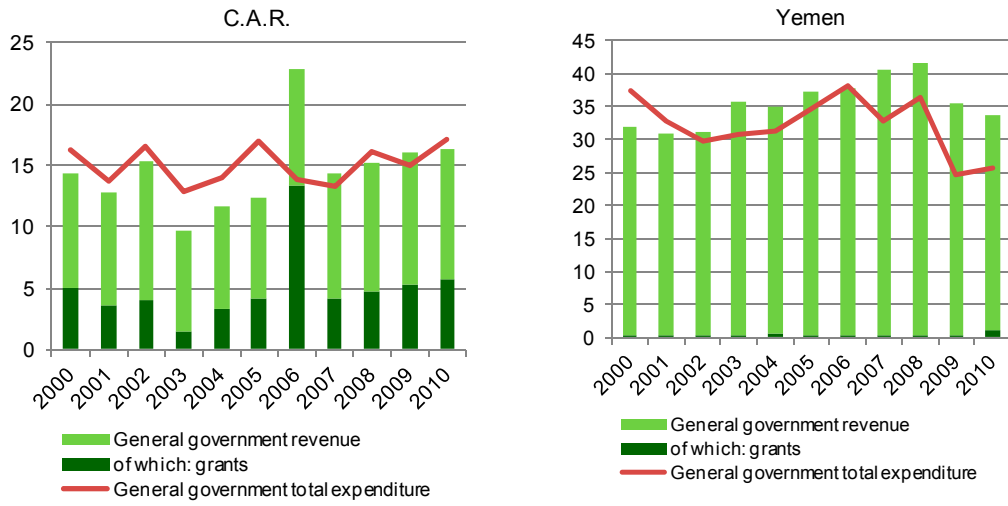
### **Programs with Constrained Resources—Central African Republic and Yemen**

137. **Sparse and volatile donor assistance has had a significant impact on the development strategies of many LICs in fragile situations.** Donors, with their ultimate responsibility to their electorates, seek to meet a number of different objectives with their aid allocations to LICs. Such objectives typically include the need to achieve economic development and political reform in the recipient country. Failure to meet established benchmarks in these areas can lead to a reduction in aid to the country. Major developments in other recipient countries, or a change in the economic conditions in donor countries, can also influence the volume of aid provided. For such reasons, a number of countries have to meet their spending needs out of volatile and often meager resource envelopes. This hinders their ability to meet the requirements of their populations, including the Millennium Development Goals (MDGs), and gain legitimacy, thus impeding statebuilding.

138. **The two countries considered in this section are all facing such problems (Figure 14).**

- In the Central African Republic, faced with very limited budgetary assistance, total government spending has been constrained to about 15 percent of GDP. In a situation where per capita GDP is very low, wages and salaries amount to just 5 percent of GDP and capital spending is of a similar magnitude, the task of achieving meaningful transition is very difficult. For this reason, IMF Country Report No. 10/332 notes the need for additional donor assistance in 2010 to support budget implementation, and that still more is needed for crucial development spending such as the rehabilitation of the critical provision of utility services.
- In Yemen, the exhaustion of oil reserves in the medium term necessitates a sharp adjustment of expenditures. Such an adjustment would be aided by external assistance, but political factors impede its ability to attract donor assistance. IMF Country Report No. 10/300 indicates that low identified external financing of 0.7 of GDP in 2010 resulted in the programming of higher domestic financing (an increase in central bank budgetary support), lower public investment, and lower priority spending.

Figure 14. Aid and Government Expenditures





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