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## **The IMF and Fragile States: Eight Selected Country Cases**

Shinji Takagi, Donal Donovan, Bessma Momani, Lorenzo L. Perez,  
Miguel de Las Casas, and Michael Pisa

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Prepared by  
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Abstract

The paper presents eight selected country cases to support the IEO evaluation “The IMF and Fragile States.” For each country, it provides brief historical background, discusses the nature of its fragility, and assesses the IMF’s relationship with that country. The countries covered are Afghanistan, Bosnia and Herzegovina, Cambodia, Haiti, Iraq, Kosovo, Myanmar, and Timor-Leste.

The views expressed in this Background Paper are those of the author(s) and do not necessarily represent those of the IEO, the IMF or IMF policy. Background Papers report analyses related to the work of the IEO and are published to elicit comments and to further debate.

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## Abbreviations

ADB	Asian Development Bank
AfDB	African Development Bank
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
APD	Asia-Pacific Department (APD)
ARTF	Afghanistan Reconstruction Trust Fund
BiH	Bosnia and Herzegovina
BOP	balance of payments
BPA	Banking and Payments Authority (Timor-Leste)
CARTAC	Caribbean Regional Technical Assistance Center (IMF)
CBK	Central Bank of Kosovo
CBM	Central Bank of Myanmar
CBTL	Central Bank of Timor-Leste
CIA	Central Intelligence Agency (U.S.)
CPA	Coalition Provisional Authority (Iraq)
CPIA	Country Policy and Institutional Assessment (World Bank)
CPK	Communist Party of Kampuchea
CPP	Cambodia People's Party
DAB	Da Afghanistan Bank
DSA	debt sustainability analysis (IMF)
EBRD	European Bank for Reconstruction and Development
EC	European Community
ECF	Extended Credit Facility (IMF)
EFF	Extended Fund Facility (IMF)
EPA	ex post assessment (IMF)
EPCA	Emergency Post-Conflict Assistance (IMF)
ESAF	Enhanced Structural Adjustment Facility (IMF)
EU	European Union
EUFOR	European Union Force
EUR	European Department (IMF)
FAD	Fiscal Affairs Department (IMF)
FDI	foreign direct investment
FRETILIN	Revolutionary Front for an Independent East Timor
FSAP	Financial Sector Assessment Program (IMF, World Bank)
FSSA	Financial System Stability Assessment (IMF)
GDP	gross domestic product
GRA	General Resources Account (IMF)
HIPC	Heavily Indebted Poor Country (IMF, World Bank)
HQ	headquarters
ICD	Institute for Capacity Development (IMF)
IEO	Independent Evaluation Office (IMF)



IFI	international financial institution
ILO	International Labor Organization
IMF	International Monetary Fund
IMFC	International Monetary and Financial Committee (IMF)
ISAF	International Security Assistance Force (Afghanistan)
ISIS	Islamic State of Iraq and Syria
KLA	Kosovo Liberation Army
LEG	Legal Department (IMF)
LIC	low-income country
LICUS	low-income country under stress (World Bank)
LTX	long-term expert
MCM	Monetary and Capital Markets Department (IMF)
MDG	Millennium Development Goal
MEFP	Memorandum of Economic and Financial Policies (IMF)
METAC	Middle East Technical Assistance Center (IMF)
MFD	Monetary and Financial Systems Department (IMF)
MOF	ministry of finance
NATO	North Atlantic Treaty Organization
NGO	non-governmental organization
NLD	National League for Democracy (Myanmar)
ODA	official development assistance
OHR	Office of the High Representative (BiH)
PCDR	Post-Catastrophe Debt Relief Trust Fund (IMF)
PFM	public financial management
PRGF	Poverty Reduction and Growth Facility (IMF)
PRGT	Poverty Reduction and Growth Trust (IMF)
PRSP	poverty reduction strategy paper (IMF, World Bank)
PRK	People's Republic of Kampuchea
PSI	policy support instrument (IMF)
RCF	Rapid Credit Facility (IMF)
RFI	Rapid Financing Instrument (IMF)
RMS	Revenue Mobilization Strategy (Cambodia)
ROSC	Report on the Observance of Standards and Codes (IMF, World Bank)
RS	Republika Srpska (BiH)
RTAC	regional technical assistance center (IMF)
SAA	Stabilization and Association Agreement (EU)
SBA	stand-by arrangement (IMF)
SCF	Stand-by Credit Facility (IMF)
SDP	Strategic Development Plan (Timor-Leste)
SDR	Special Drawing Right (IMF)
SIGAR	United States Special Inspector General for Afghanistan Reconstruction

SMP	staff-monitored program (IMF)
SOE	state-owned enterprise
SPR	Strategy, Policy, and Review Department (IMF)
STA	Statistics Department (IMF)
STF	Systemic Transformation Facility (IMF)
TA	technical assistance
TAOLAM	Technical Assistance Office in Thailand (IMF)
UN	United Nations
UNAMA	United Nations Assistance Mission to Afghanistan
UNDP	United Nations Development Program
UNESCO	United Nations Educational, Scientific, and Cultural Organization
UNMIC	United Nations Mission in Kosovo
UNODC	United Nations Office on Drugs and Crime
UNSC	United Nations Security Council
UNTAC	United Nations Transitional Authority of Cambodia
UNTAET	United Nations Transitional Administration in East Timor
U.S.	United States
USAID	United States Agency for International Development
USDOS	United States Department of State
USDP	Union Solidarity and Development Party (Myanmar)
VAT	value-added tax
WEO	<i>World Economic Outlook</i> (IMF)
WWII	World War II

## CHAPTER 1—AFGHANISTAN<sup>1</sup>

### SUMMARY

When the international community reengaged with Afghanistan in 2001, the country was in a perilous state after more than two decades of conflict. Early in the reconstruction process, the Afghan government took advantage of international support to make impressive strides in rebuilding institutions and implementing sound economic policies. The IMF played a crucial role by providing policy advice and technical assistance that promoted macroeconomic stability, laid the foundations for economic growth, and strengthened the government's capacity. By 2004, the government had introduced a new currency, made ambitious tax reforms, and largely achieved macroeconomic stability. The IMF's supportive role has been widely acknowledged.

Starting in the mid-2000s, however, the rate of progress slowed amid a worsening security situation. By 2012, when the Fund's ECF-supported program fell off track, longstanding vulnerabilities became more evident. Given the large role played by the United States in setting the overarching strategy for Afghanistan, the IMF's ability to influence the trajectory of economic policy has been constrained. Even so, in hindsight, the IMF could have done more to strengthen financial supervision and provided Afghan officials and donors with more candid and realistic assessments about the country's economic prospects and vulnerabilities. The IMF's chief medium-term goals in Afghanistan, including achieving fiscal sustainability, boosting economic growth, and maintaining financial stability, have been elusive.

### I. BACKGROUND

#### A. Brief History

1. Major powers have sought control over Afghanistan for centuries because of its strategic position: the passage through the Himalayas that lies within the country is the shortest route between central Asia and the Indian subcontinent and has served as the main thoroughfare for trade and military forces travelling between the two regions. The country's manmade borders have also contributed to its instability, and the Durand Line, which was negotiated with the U.K. in 1893, is still a source of tension between Afghanistan and Pakistan.

2. Afghanistan is a multi-ethnic, predominantly Muslim society. Pashtuns make up an estimated 42 percent of the population and reside mainly in the south and east of the country, while Tajiks (roughly 27 percent of the population), Hazaras (9 percent), and Uzbeks (8 percent) reside mainly in the north and west (Carberry, 2013; CIA Factbook, 2017). Afghanistan is also a country dominated by tribes, and tribal allegiances have undermined the ability of the central government to control the provinces. An additional fault line is the cultural split between rural

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<sup>1</sup> Contributor: Michael Pisa.

Afghanistan and the capital city of Kabul, which has widened or narrowed depending on the preferences of those in power.

3. Afghanistan's most recent period of political instability stretches back to the coup d'état of 1973 and the armed resistance that followed the Russian invasion in 1979, when the country became a battleground for the Cold War. After the Soviet Union withdrew in defeat in 1989, factions of former resistance fighters split largely on ethnic lines began to fight for control of the country. In 1994, a new fundamentalist group, the Taliban, took advantage of the chaos caused by the civil war to assert authority in the south. By 1996, the Taliban had achieved control of Kabul, although the Northern Alliance, a group of mostly Tajik and Uzbek fighters, would continue to resist (Saikal, 2006).

4. The rest of the world mostly ignored the rise of the Taliban and its militant form of fundamentalism until the attacks of September 11, 2001, which were carried out by Al-Qaeda, an extremist organization that the Taliban had given shelter to in Afghanistan. In response, the United States and its allies began a military campaign in October 2001 that quickly drove the Taliban from Kabul and killed Al Qaeda leaders or drove them out of the country.

5. At the Bonn Conference in December 2001, a group of mostly Tajik Afghan elites chose Hamid Karzai, a Pashtun, to head the Afghan Interim Administration. Karzai would go on to become the country's first democratically elected president in 2004. In the same month, the United Nations created an International Security Assistance Force (ISAF) aimed at helping the country maintain security. Foreign troop levels would grow significantly over time, from 18,000 U.S. and ISAF troops in 2003 to roughly 140,000 foreign troops at the height of the surge in 2011 (Brookings Institution, 2017).

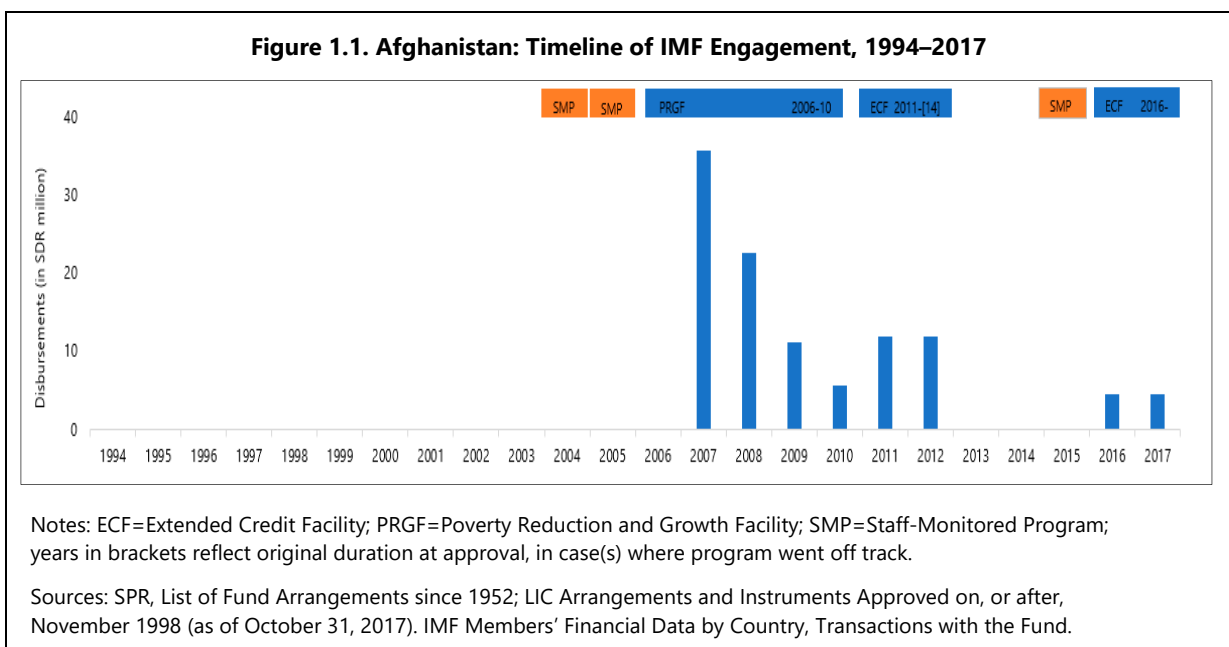
## **B. Sources of Fragility**

6. The challenge of stabilizing and reconstructing Afghanistan was extreme even compared to that in other fragile states. The country is arid, mountainous, and landlocked. Most Afghans are poor (even today, roughly 39 percent live below the national poverty line) and lack access to clean water, electricity, and medical care. Literacy rates remain among the lowest in the world (UNESCO, 2017). Youth unemployment is also a major problem in the country where roughly 63 percent of the population is under 25 years of age (World Bank, 2017).

7. Most importantly, except during a brief period of calm between 2002 and 2005, the security situation has remained fragile, as the Taliban has shown the ability to regroup and reassert control after losses. Today, the Taliban controls 11 percent of the districts and contests an additional 29 percent; it has also ramped up the number of attacks in major cities (SIGAR, 2017). As a result, civilian casualties in 2016 were the highest on record (3,498 deaths and 7,920 injuries) (UNAMA, 2017). The Taliban's resilience has been aided by the opium trade.

## II. THE IMF'S RELATIONSHIP WITH AFGHANISTAN

8. The recent history of IMF engagement in Afghanistan falls roughly into four phases (Figure 1.1). In the first phase (2002–05), the IMF staff worked with the Afghan authorities to restore the capacity necessary to conduct sound economic policy. In the second phase (2006–10), the IMF provided the country financial support through a PRGF-supported program and worked with the authorities to strengthen their medium-term economic strategy. The third phase (2011–14) marked a rupture in relations between the IMF and the authorities, as the latter dealt with the fallout of the Kabul Bank crisis, rising political uncertainty, and the drawdown of foreign troops. In the fourth phase (2015–17), the Afghan government worked to restore the credibility of its economic reform agenda, as the security situation once again worsened.

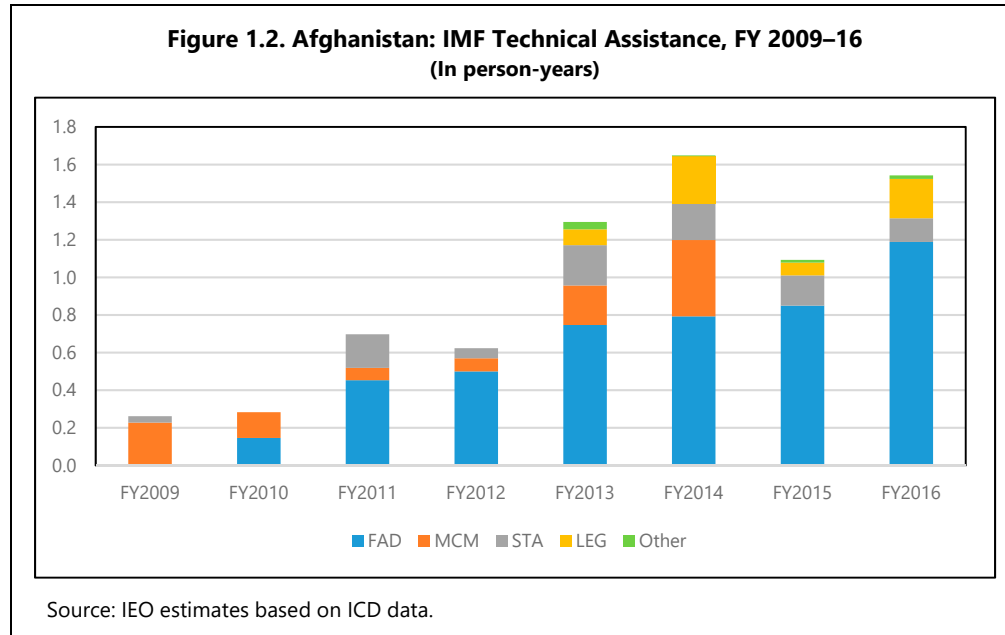


9. Throughout this period, the IMF played an important role in the international effort to rebuild Afghanistan by providing advice and technical assistance that promoted macroeconomic stability, laid the foundations for economic growth, and strengthened the government's capacity to implement policy (Figure 1.2). The IMF's formal program engagement in the country included two Staff-Monitored Programs (SMPs), a PRGF-supported program from 2006 to 2010, an Extended Credit Facility (ECF)-supported program from 2011 to 2014, which ultimately went off-track, and a follow-up ECF-supported program that began in July 2016 and remains on track.

### A. Phase 1 (2002–05): Building Capacity

10. The IMF staff began to work closely with the Afghan government in January 2002, one month after the Bonn Agreement was finalized, with the aim of helping the government build a foundation for economic management and macroeconomic stability. The short-term focus was on rehabilitating the Ministry of Finance (MOF) and the central bank, Da Afghanistan Bank (DAB),

and working with them to design an appropriate policy framework. At the time, both institutions were characterized by IMF staff as being “reduced to little more than empty shells in terms of the functions they perform.”



11. Given this limited institutional capacity, the IMF staff focused on providing advice and technical assistance on issues deemed crucial for restoring macroeconomic stability, including the formulation of fiscal policy, the choice of a currency arrangement, and the design and conduct of monetary policy. The IMF also worked with both institutions and the Central Statistics Office to improve the quality of recorded data to a level necessary for basic surveillance. At the outset, the government’s ability to carry out fiscal policy was severely limited. Because the fiscal reporting framework between the center and the provinces had completely broken down under Taliban rule, the central government could raise only minimal revenue outside of Kabul. More broadly, a general lack of tax compliance and weakness in tax and customs administration stymied revenue collection.

12. Throughout this early period, staff from the IMF and the World Bank assisted the authorities in preparing budgets that were realistic and consistent with macroeconomic goals, and the authorities remained committed to strong fiscal discipline. This included taking the IMF’s advice to avoid monetary financing of the deficit, which the authorities adhered to with one brief exception in 2003. The IMF staff also helped the MOF computerize its public financial management system, which increased donors’ willingness to provide on-budget financing.

13. Another economic challenge with implications for stability was the urgent need to help the government shift to a new currency, which was necessary due to the high level of counterfeit currency printed by warlords and circulating in the country. IMF staff initially believed that it would take two years to establish the preconditions for this transition but later decided, along

with the authorities, that the task was more urgent. The IMF provided several technical experts to help with the transition, which went remarkably well: when the DAB introduced the new Afghani in October 2002, the transition caused only a temporary increase in inflation.

14. The IMF staff had a strong working relationship with the Afghan authorities in this period, which was supported by the establishment of a resident representative's office in 2002. The resident representative (Res Rep) played an important role coordinating donors working on economic reform, including the U.S., the United Kingdom, the UN, the Asian Development Bank (ADB), and the World Bank. The IMF also provided technical assistance in several areas of expertise over this period, including assisting with expenditure management, taxation, central bank modernization, and the preparation of new financial sector legislation.

15. Afghanistan's first Article IV consultation since 1991 took place in 2003 and was heralded as an important signal of the country's normalization. Soon afterwards, the authorities lobbied hard for an IMF-supported program, noting that conditionality would help to incentivize reform. The IMF staff was reluctant to immediately establish a program, given concerns about the country's limited institutional and administrative capacity, severe data limitations, and a desire to wait until a new government was established (which would occur in December 2004, when President Hamid Karzai took office). Moreover, there was little need for IMF financing, given the large amount of donor funding already in the country. For these reasons, the IMF chose to pursue a two-year SMP to give the new government time to establish a track record of reform.

16. By the time the SMP ended in 2006, IMF staff judged that macroeconomic stability had been "largely achieved," as evidenced by rising growth, moderate core inflation, rising fiscal revenue, a stable exchange rate, and growing international reserves (Figure 1.3). This achievement reflected the impressive strides made by Afghan authorities in improving macroeconomic management, strengthening capacity, and creating conditions for sustainable growth. Based on successful completion of the SMP, the IMF agreed to a PRGF-supported program with Afghanistan that began in June 2006.

## **B. Phase 2 (2006–10): Progress Slows**

17. The gains made by the Afghan government between 2001 and 2005 were impressive. However, several worrisome trends became apparent towards the end of this period, including an increase of violence in the south, more frequent complaints about corruption, frustration with the government's perceived inability to deliver services, and a rebound in opium production. It was also clear by 2006 that capacity building at the MOF and the DAB was proceeding unevenly. While the MOF had made significant progress in strengthening budget, expenditure, and tax management, improvements at the DAB lagged. The persistent lack of capacity at the DAB, particularly in financial supervision, would manifest itself later during the crisis at Kabul Bank.

**Figure 1.3. Afghanistan: Key Macroeconomic Indicators, 2000–17**



Sources: October 2017 WEO database; OECD DAC statistics.



18. With these risks as background, the PRGF-supported program aimed to: (i) maintain fiscal discipline and achieve medium-term fiscal sustainability; (ii) implement structural reforms to boost economic growth; and (iii) address the large external debt through the Heavily Indebted Poor Countries (HIPC) Initiative. Of these objectives, enhancing fiscal sustainability was a key focus, and most of the program's structural benchmarks were related to fiscal management. The IMF provided technical assistance on tax policy and tax administration through multiple missions by Fiscal Affairs Department (FAD) staff and a resident expert who was assigned to the MOF. The IMF also played an important role in disciplining expenditures, advising the authorities to resist pressures to lower corporate tax rates and dramatically increase civil service salaries. The authorities followed the IMF's advice on both issues, including by implementing civil service reform consistent with the medium-term fiscal framework. This reform was particularly difficult given the wage pressure caused by donors, who paid Afghan employees salaries more than ten times higher than those paid by the government.

19. The character of international engagement changed dramatically over the course of the PRGF-supported program, as the United States and its NATO allies decided to take a more aggressive approach to fighting the Taliban, in response to continued instability in the south. This strategic shift led to a sizable increase in foreign troop numbers and aid. The increased aid helped to fund development and provided a boost to GDP growth, which reached an all-time high of 20.6 percent in 2009. However, it also created new problems for the government, by complicating efforts to manage the budget and achieve fiscal sustainability.

20. As the scale of foreign involvement and the number of civilian casualties increased, President Karzai became increasingly distrustful of the international community, particularly the United States (Partlow, 2016). At the same time, donors were becoming more impatient with the president, who appeared to be unwilling or unable to root out corruption. By the time Karzai was elected for a second term in 2009, in an election marred by widespread voter fraud, his relationship with donors had soured. Despite these challenges, and to the credit of MOF and DAB staff, the government's performance under the PRGF-supported program, which ended in late-2010, was deemed satisfactory by IMF staff and the program was fully disbursed. By that time, the government had also taken the necessary steps to reach the completion point under the enhanced HIPC Initiative, which resulted in a 96 percent reduction of Afghanistan's external debt.

### **C. Phase 3 (2011–14): The Kabul Bank Crisis Causes a Rift**

21. In late August 2010, roughly three weeks before the end of the PRGF-supported program and the beginning of a follow-on ECF-supported program, Kabul Bank, the largest bank in Afghanistan, experienced a deposit run triggered by rumors of gross mismanagement. The bank was both systemically and strategically important for Afghanistan, as the government used its branch network, the largest in the country, to pay civil servants and members of the national army. For that reason, NATO commanders feared that the bank's collapse could lead to desertions and increased insecurity. With advice from the IMF, Afghan authorities acted quickly

to contain the run and within several days a team of banking experts from the IMF, the U.S. Treasury, and the World Bank arrived in Kabul to provide guidance on how to preserve assets and protect depositors. The crisis exposed the central bank's inability to conduct robust financial supervision and the extent of corruption among Afghan elites (one of the shareholders was a brother of Karzai, while several others were considered political allies).<sup>2</sup>

22. In response to the crisis, the IMF delayed approval of the new program and reassessed its parameters. Already exasperated with Karzai, several donors, led by the U.S. and the U.K, argued that a new program should not go forward until the Afghan authorities made tangible progress on prior actions related to asset recovery and bringing the bank's shareholders to justice. Donors also decided to withhold funding from the Afghanistan Reconstruction Trust Fund (ARTF) for the recurrent budget until a program was in place (the ARTF ultimately withheld \$73 million from the government in 2011). During this time, there was debate within the IMF about the reputational risk of conducting a new program. However, donors were keen to have the IMF remain involved in the country, and IMF management came to believe that the authorities did enough to meet the prior actions to justify a program.

23. The redesigned ECF-supported program, which began in November 2011, kept the focus on macroeconomic and financial stability but also emphasized tackling corruption and strengthening the rule of law. It included benchmarks that required Parliament to approve both a recapitalization of the central bank and a comprehensive strategy to combat economic crime. The IMF staff warned management that the program carried large risks, and the authorities struggled to meet its conditions from the start.

24. Economic growth weakened considerably through this period due to rising uncertainty about the effects of major transitions scheduled for 2014, including the drawdown of NATO troops and the next presidential election, which Karzai was legally prohibited from running in. In the face of lagging growth, rising uncertainty, and a breakdown in trust between the international community and the Afghan authorities, the government failed to meet several structural benchmarks related to the financial sector and it missed targets for revenue collection by increasingly wide margins. At the same time, control over expenditures weakened and the government faced a cash crunch that forced spending cuts in 2013. By February 2014, the IMF staff deemed the program off-track. At that time, the staff informed the authorities of the IMF's desire to continue close engagement and its openness to negotiating a new arrangement once a new government was in place following the April election.

25. 2014 was a particularly difficult year for the IMF in Afghanistan. In January, the IMF's Resident Representative, Mr. Wabel Abdallah, was killed in a terrorist attack on a restaurant in Kabul, marking the first time that an IMF staff member had been lost to violence in the line of

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<sup>2</sup> The scale of corruption and fraud at Kabul Bank was extraordinary: the largest shareholders lost more than \$900 million of the bank's \$1.3 billion in deposits in a series of ill-fated investments in companies and real estate in Afghanistan and Dubai.

duty. The tragedy changed the nature of the IMF's engagement in Afghanistan, as the IMF closed its office in Kabul soon after the incident and no IMF staff members have travelled to the country since.

#### **D. Phase 4 (2015–17): Rebuilding Reform Momentum in a Difficult Environment**

26. Although the 2014 election of Ashraf Ghani was marred by allegations of vote tampering, it also marked Afghanistan's first democratic transfer of political power. Early in his presidency, Ghani, who had developed a good working relationship with the IMF a decade earlier when he served as Minister of Finance, urged the IMF to reestablish a program for Afghanistan. The IMF staff subsequently negotiated a nine-month SMP with the authorities that gave them an opportunity to build a record of reform in the run-up to a potential ECF-supported program. In addition, the SMP aimed to strengthen the framework for revenue mobilization, and address remaining vulnerabilities in the banking sector, while preserving macroeconomic stability.

27. The period after the 2014 election was marked by political tension, as the administration struggled to maintain support from key constituents and Parliament. At the same time, security conditions worsened, with the Taliban gaining ground in parts of the country as foreign troops withdrew. The resulting loss in confidence stifled domestic demand and foreign investment, and GDP growth fell from 14.2 percent in 2012 to just 1.3 percent in 2014 and 0.8 percent in 2015 (Figure 1.3). But despite the difficult circumstances the authorities implemented the SMP successfully, meeting most structural benchmarks on schedule, including obtaining parliamentary approval for a new banking law and revenue measures. When the SMP ended in May 2016, the IMF staff began negotiating a new ECF-supported program, which was approved in July 2016.

28. Afghanistan's current ECF-supported program rests on two pillars: (i) structural reforms that focus on institution building, fiscal and financial reforms, and measures to combat corruption for scaled-up private sector development; and (ii) prudent macro-financial policies to preserve macro-financial stability. Despite the challenging security situation, the current reform-minded administration has so far successfully implemented the ECF program. During this period, the IMF continued to provide technical assistance in the areas of its core competence to staff at the MOF and the DAB, including tax policy, public financial management, anti-money laundering and combating the financing of terrorism (AML/CFT), management of problem banks, and external statistics. The IMF-supported Middle East Technical Assistance Center (METAC) played an important role in delivering TA and training to Afghan officials. Since 2014, all training has been done outside Afghanistan, including in Amman and Singapore. Throughout the ECF, Fund staff has also sought close collaboration with other international partners, including the World Bank, whose staff has joined the IMF missions.

### III. RECURRENT ISSUES IN IMF–AFGHAN RELATIONS

29. The IMF staff has grappled with several important issues during its engagement in Afghanistan, including (i) fiscal sustainability; (ii) financial supervision; (iii) corruption; (iv) policy advice and program design; (v) collaboration with partners; and (vi) the security environment.

#### A. Fiscal Sustainability

30. From the beginning of the IMF's engagement in 2002, a key focus was helping the Afghan government to strengthen public financial management and attain fiscal sustainability. Early on, the IMF provided technical assistance that helped the government significantly improve its expenditure management in a short time, including by computerizing central payments processing and reporting to Treasury by 2003. The IMF also helped the authorities implement ambitious tax and customs reforms that improved revenue collection from an extremely low base: the country's tax-to-GDP ratio grew from 2 percent in 2002 to 9.1 percent in 2010. However, despite these early gains, revenue generation would remain a constant challenge. By 2013, the tax-to-GDP ratio had fallen to 6.7 percent, due to slowing growth and weakening compliance. By contrast, other fragile states had an average tax-to-GDP ratio of 14 percent in 2006–14 (OECD, 2014).

31. Revenue collection was hampered by the government's inability to exert control outside of Kabul and by the unstable security environment. Several IMF staff members reported that the Afghan authorities negotiated informal revenue-sharing deals with local warlords to preserve loyalty in the provinces. Graft at customs depots also eroded revenue. The U.S. Special Inspector General for Afghanistan Reconstruction stated that "approximately half of custom duties" collected in 2013 "were believed to have been stolen" (SIGAR, 2015). In addition, the country had relatively few tax instruments and depended heavily on trade-related taxes. IMF staff attempted to address this problem by initiating work on a value-added tax (VAT) framework with the authorities in 2011. The authorities' original plan to implement the VAT proved too ambitious, given administrative capacity constraints. IMF staff has provided assistance to put implementation on a realistic time frame and the government now aims to introduce the VAT in 2021.

32. The IMF staff consistently underestimated the degree to which weak tax compliance hindered the prospects for major revenue growth in Afghanistan. After the mid-2000s, the authorities failed to make progress on revenue-related reforms, and the government's failure to meet the revenue targets in the ECF-supported program (despite their being lowered on multiple occasions) was a key reason the program went off track. Some IMF staff members believed that the large inflows of on-budget aid reduced the Afghan authorities' motivation to take the politically difficult steps needed to increase revenue.

33. Adverse developments also took place on the expenditure side. Though for most of the period under review the government did a commendable job of controlling on-budget expenditures, three factors drove spending pressures: security, development, and the need to

take over the recurrent operations and maintenance costs associated with donor-financed projects. Donors' practice of channeling most security and development support outside of the core budget undermined the government's ability to manage its finances. The IMF urged donors to limit this practice whenever possible.

34. Throughout the IMF's engagement, staff estimates of when the Afghan government would attain fiscal sustainability in the absence of aid flows—defined as occurring when domestic revenues cover operating expenditures—were overly optimistic and thus had to be repeatedly pushed farther into the future. For example, in 2006, during negotiations for the PRGF-supported program, the staff estimated that sustainability would be reached by 2010, but by the end of the program the staff had pushed the date back until 2024, and in the 2014 Article IV the date was pushed back to "after 2030."

35. The repeated revisions in fiscal sustainability forecasts reflected overoptimistic forecasts for GDP growth, revenue, and expenditure. For example, for 2013–17 the Debt Sustainability Analysis (DSA) conducted in 2012 projected average GDP growth of 5.6 percent, compared to actual growth of 3.0 percent, and average revenue growth of 13.5 percent, compared to actual growth of 8.3 percent. Estimates of long-term expenditure growth had to be revised even more dramatically, based on higher-than-expected spending on security, for which the government is expected ultimately to take responsibility. The 2011 DSA projected that average primary expenditure would be 24.9 percent of GDP between 2016 and 2030, but a year later the projection was revised to 36.4 percent for roughly the same period (2017–32). The DSA conducted in 2016, estimates that Afghanistan's long-term average primary expenditure will be 30.5 percent of GDP.

36. Given that helping the government to achieve fiscal sustainability was a key objective of the IMF, it is fair to ask whether the IMF should have done anything differently to meet this goal. Three issues are worth consideration. First, the IMF could have been more aggressive in warning donors about how the massive surge in project investment would affect fiscal sustainability, as the international community often failed to consider how the government would maintain the development projects they funded. Given the decision by the United States and its NATO allies to move forward with a surge strategy aimed at achieving quick security and development wins, this warning likely would have fallen on deaf ears. However, the IMF could have stressed the issue.

37. Second, and relatedly, more realistic growth and fiscal estimates by the IMF would have provided donors with a more accurate assessment of the difficulty of achieving sustainability—and may have given them pause in rolling out new projects that the government would struggle to maintain. While the IMF staff was careful to warn that its estimates depended on an improving security environment, the estimates paid too little attention to more negative (and perhaps more realistic) scenarios in which security did not improve. Finally, the IMF could have put more pressure on the Afghan authorities to root out the corruption that undermined customs collection during the PRGF-supported program, before it became entrenched (see "corruption" below for further discussion).

## B. Financial Supervision

38. Afghanistan's banking system grew rapidly following the fall of the Taliban regime in 2001. By 2010, there were 17 licensed banks (compared with 6 in 2001), including two state-owned banks and five branches of foreign banks. The total assets of the banking system increased more than 16-fold between 2004 and 2010, from \$261 million (4.9 percent of GDP) to \$4.3 billion (21.0 percent of GDP) (DAB, 2010). The combination of rapid financial sector growth, a massive inflow of foreign money, and the continued lack of capacity at the DAB made Afghanistan vulnerable to a banking crisis. As early as 2007, the IMF staff warned that the growth of the banking system had strained supervisory capacity and underscored the need for strengthening supervision. At the same time, the staff reported hearing rumors of mismanagement at Kabul Bank, though these rumors did not hint at the scale of the problem.

39. An obvious question is whether the IMF could have done more to help the DAB strengthen supervision before the crisis occurred, through policy advice, program conditionality, or technical assistance. On several occasions the staff flagged its concerns to the DAB governor and donors about the need to improve supervisory capacity, but the PRGF-supported program included only two structural benchmarks related to strengthening prudential capacity.

40. Nor did the IMF provide direct technical assistance to the DAB on financial supervision between 2003 and 2010, when this role was carried out by a USAID-hired consulting firm. While resource constraints mean that the IMF must rely on development partners for implementation support, it is legitimate to ask, in this case, whether the staff took too much of a hands-off approach in an area so central to the Fund's core mandate. The implicit decision to allow the United States essentially to oversee technical assistance on financial supervision diminished the Fund staff's ability to monitor financial sector developments. Inevitably, there were occasional turf battles, which further restricted the Fund's access to the DAB's financial supervision department. Several IMF staff members who were interviewed stated that, in retrospect, the IMF should have insisted more forcefully on closer involvement in the capacity development process.

41. Regardless of whether it had placed advisors in the DAB, the IMF had a responsibility to help safeguard financial stability in Afghanistan. As noted above, the staff was aware of rumors of mismanagement at Kabul Bank and in hindsight it clearly could have done more to prioritize the issue (as could other official actors that engaged with the DAB on financial supervision). For example, whenever tension arose the IMF staff could have worked more closely with the U.S. Executive Director to help improve the working relationship with the USAID-hired consultants. The inability of the DAB's financial supervision department to uncover problems at Kabul Bank, despite the scale of fraud, demonstrates the failure of the donor community to do enough to build capacity at the central bank.

42. Following the crisis, the IMF took a much more focused approach to promoting strong financial supervision. The ECF-supported program included 18 structural benchmarks on supervision, many of which related to efforts to overhaul Kabul Bank (including putting the bank

into receivership and preparing it for sale or liquidation) and to managing risks at Afghanistan's second largest bank, Azizi Bank. The benchmarks also supported broader efforts to strengthen the country's anti-money laundering and anti-terrorism-financing laws.

### **C. Corruption**

43. Afghanistan is considered one of the most corrupt countries in the world and was ranked 169<sup>th</sup> out of 176 countries in Transparency International's 2016 Corruption Perceptions Index. The perception of rampant corruption has drained popular support from the government and provided an opportunity for the Taliban. Internal documents indicate that the IMF staff became increasingly concerned about the impact of corruption on revenue collection (and in other areas) early in the PRGF-supported program that began in 2006. Specifically, they noted the corrosive effect of patronage deals between the government and key power brokers in the provinces, as well as widespread graft at customs depots. However, the IMF did not explicitly engage on issues related to governance and rule of law until the Kabul Bank crisis brought the issue to the fore in 2010. By that time, these behaviors were arguably more difficult to change.

44. Most of the IMF staff members interviewed for this evaluation believed that the IMF could have done more under the PRGF arrangement to address corruption related to customs and tax administration. However, they also noted that most of the money lost to fraud in Afghanistan was in the areas of procurement and project management—areas in which the IMF had no expertise or direct involvement. Moreover, even if the IMF had diverted more resources towards addressing corruption during this period, it is unlikely that it could have changed behavior due to two forces outside of its control: the scale of off-budget aid flows and the pernicious influence of the opium trade.

### **D. Policy Advice and Program Design**

45. Except for a brief deterioration in relations following the Kabul Bank crisis, the Afghan authorities were generally responsive to the IMF's advice. Most of the IMF staff members involved in the PRGF-supported program believe that the program was well tailored to the Afghan context, and that its benchmarks served as useful guideposts for reform without being overly ambitious. In fact, during the negotiations the authorities asked the IMF to include more structural benchmarks, as they believed their inclusion would help generate reform momentum.

46. The character of the ECF-supported program (2011–14) was markedly different, with 31 structural benchmarks, many of which would be politically difficult to achieve. Several staff members commented that the number of benchmarks was excessive and that at donors' behest the program put too much emphasis on governance. The IMF demonstrated flexibility by deciding to go forward with the program even though the authorities failed to fully meet several prior actions.

47. Overall, the IMF's policy advice was pragmatic and well prioritized with two exceptions. First, as discussed above, the IMF could have given higher priority to strengthening financial supervision under the PRGF arrangement. Second, the IMF could have better anticipated the economic slowdown triggered by the inevitable drawdown in troops (which began in 2011), and worked with the government to prepare contingency plans. A more realistic assessment of the country's vulnerability to a slowdown would also have improved the accuracy of the IMF's fiscal sustainability estimates.<sup>3</sup> The IMF could have helped the authorities and donor community prepare for the economic downturn by considering the economic implications of the troop withdrawal, what steps the authorities could take to navigate the transition successfully, and how donors could best support the authorities.

### **E. Collaboration with Partners**

48. From the beginning of the reconstruction process, donors urged the IMF to play a major role in Afghanistan. The Fund responded by helping to coordinate donor efforts related to economic policy and by providing a macroeconomic framework that served as a guide for reform. It also worked closely with the World Bank and other agencies to rebuild capacity at the MOF and the DAB. In all these efforts, the Resident Representative office played a critical role.

49. Donors were keen to have the IMF establish a program with the government because they believed it would help generate reform momentum and instill fiscal discipline. In addition, having a program would accelerate the path towards easing the country's debt burden, by meeting the Paris Club requirement that an IMF-supported program be in place before relief could be granted. While some staff believed that the government did not have the capacity in 2004 to complete a meaningful reform program, the IMF was ultimately swayed by the strong demand of donors and the authorities.

50. Donors also put pressure on the IMF to have programs in place or on track with a timeline that coincided with key donor conferences. For example, donors strongly urged the IMF to have a program in place ahead of the Tokyo Conference in 2012, because the international community was withholding further budget support until the Fund signaled that the Afghan government was taking credible steps to respond to the Kabul Bank crisis. While some staff members lamented the tight timelines created by the donor conference schedule, one noted that the pressure was often constructive in forcing the authorities to commit to more rapid reforms. Also, although most staff members were aware of pressure from donors, they reported feeling

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<sup>3</sup> In hindsight, it is clear that the troop surge that began in 2009 massively inflated Afghan growth, which peaked at 20.6 percent that year. The IMF staff paid insufficient attention to how the build-up of foreign troops affected GDP growth and the potential effect of a drawdown, as well as to how a deteriorating security environment would affect fiscal sustainability. While modelling more pessimistic scenarios may have irked some donors who preferred to focus on a positive (and hopefully self-fulfilling) narrative, the lack of attention to more negative outcomes hindered preparation for the economic downturn that followed.



protected by management, and did not believe that outside pressure led the IMF to make unnecessary compromises.

## **F. Security**

51. The precarious security environment in Afghanistan often limited the IMF's ability to carry out its role, and the tragic death of the IMF's Resident Representative in 2014 underscored the risks of working in Kabul. The IMF took a more risk-averse posture than other development actors working in Afghanistan, including the World Bank and the United Nations. Even before 2014, while most IMF missions visited Kabul their ability to move through the city was limited, and thus they were often unable to engage with a wider set of stakeholders, including civil society groups and parliamentarians. Since 2014, all missions, including for technical assistance, have been conducted in third countries, usually Jordan, the UAE, or Azerbaijan

52. The Afghan authorities have noted that the IMF's absence on the ground has significantly hampered its ability to understand local realities, liaise with senior officials, and provide policy advice. They have stated that requiring the government to send senior officials from the MOF and the DAB abroad three to four times a year, even for a limited number of days each, to meet with IMF missions is highly disruptive. As part of the current ECF, Fund staff has tried to compensate for the lack of in-country engagement by (1) holding more frequent phone and videoconference contact with the authorities; (2) hiring a local economist based in Kabul to better understand the local political context and enable closer engagement with the authorities and donors; and (3) using METAC to deliver substantial TA, despite the constraints of this taking place at off-site locations.

53. Most of the IMF staff members interviewed also believed that having an in-country resident representative and conducting missions in Kabul was essential to the Fund's effectiveness in Afghanistan. They expressed doubt that the IMF could have been a major player during the rebuilding phase without the Res Rep's office and noted that the Res Rep's ability to continuously engage with the authorities helped them to develop a deep understanding of political dynamics in the country. They also agreed that technical assistance was much more effective when conducted in-country.

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## CHAPTER 2—BOSNIA AND HERZEGOVINA<sup>1</sup>

### SUMMARY

The end of a 44-month-long war in 1995 left Bosnia and Herzegovina (BiH) with a devastated economy, a highly fragmented society, and a highly complex government structure (as agreed under the Dayton Accords) consisting of the state, two autonomous entities, and a local self-governing area. The IMF immediately provided timely technical assistance for the creation of a central bank and other policy institutions essential for a functioning economy, even though initial attempts to engage in a program relationship were repeatedly frustrated by a lack of cooperation between the two autonomous entities.

Over the subsequent 22 years, the Fund supported the country with policy advice, financing, and technical assistance. Under a succession of IMF-supported programs, BiH achieved a degree of macroeconomic stability, recorded several years of strong growth, and weathered bouts of economic difficulty; above all, it has been able to establish a functioning market economy. Even so, given the fragmentation of national decision making, program implementation was often problematic and the pace of any reform was slow. The IMF staff persevered and remained engaged with the country despite the obstacles. Most observers agree that, under BiH's difficult circumstances, the IMF performed well as a lever for reform, as an anchor for policy making (for example, in counterbalancing populist tendencies), and even as coordinator and mediator between different government levels or entities in the face of centrifugal forces.

### I. BACKGROUND

1. After centuries of foreign rule, first by the Ottoman Empire and then by Austria-Hungary, and following the tumultuous years of WWII, Bosnia and Herzegovina (BiH) in 1946 formally became one of the constituent republics of the Socialist Federal Republic of Yugoslavia. Events associated with the disintegration of Yugoslavia, including a 44-month-long war from 1992 to 1995, saw about 100,000 dead and more than two million displaced, with immeasurable damage to infrastructure and institutions. With the Dayton Accords signed in December 1995, which brought an end to the war, a tripartite national presidency and a legislature emerged from an election held in September 1996. In an attempt to establish a roadmap for reform implementation and towards European Union membership, BiH signed a Stabilization and Association Agreement (SAA) with the EU in 2008, although the Agreement was put on hold and did not enter into force until June 2015. An application for EU membership was submitted in 2016.

2. Unlike many fragile states, Bosnia and Herzegovina has rebuilt its institutional capacity to provide basic services to the population and it is no longer classified as fragile by the World Bank. Even so, continuing tensions weaken institutions and policy making, hampering economic development and social cohesion. These features have social, religious, and political dimensions,

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<sup>1</sup> Contributor: Miguel de Las Casas.

compounded by pervasive corruption (Transparency International ranks the country 83<sup>rd</sup> out of 176 in its Corruption Perceptions Index) and a massive bureaucracy.

3. The country's government structure remains complex, with the Dayton Accords stipulating a federalized BiH in which 51 percent of the land would be a Croat-Bosniak Federation (Federation of Bosnia and Herzegovina, "the Federation") and 49 percent a Serb Republic (Republika Srpska, RS). The country was organized in multiple layers: (i) the state, whose powers were limited mostly to foreign affairs; (ii) two entities (the Federation and the RS) with extensive powers and a high degree of autonomy; (iii) ten cantons in the Federation; and (iv) municipalities in both entities. The internationally appointed Office of the High Representative (OHR) was tasked with monitoring the implementation of the peace agreement and possessed the authority to impose legislation and even to remove officials, turning BiH into a protectorate. The Dayton setup makes effective coordination difficult between different government levels or between the two entities.<sup>2</sup>

## **II. THE IMF'S RELATIONSHIP WITH BOSNIA AND HERZEGOVINA**

### **A. Phase 1 (1995–2004): Stabilization and Reconstruction**

4. BiH became a member of the IMF in December 1995.<sup>3</sup> Early missions found a country devastated by war. Per capita income was estimated at \$600 and unemployment reached 65 percent in some regions. The economy was virtually inoperative, with most of the industrial capacity destroyed, a crippling lack of infrastructure for transport, telecommunications, and power, and an almost total absence of economic data. The basic legal and institutional frameworks necessary for transition to a market economy were missing. On the socio-political front, despite progress in demilitarization, there continued to be widespread abuses of human rights and great animosity among different factions.

5. Under these circumstances, the IMF staff used the range of alternatives available for IMF engagement (Figure 2.1). Financial support under Emergency Post-Conflict Assistance (EPCA) was approved in December 1995 (in the same decision that approved BiH's membership), in the amount of SDR 30.3 million, and the staff mounted "an intensive campaign of missions" to help development and reconstruction efforts. The IMF's work was part of an intensive international cooperation program in which the main players were the United States, the World Bank, and the European Union. Cooperation was so close that, for example, the IMF participated in joint missions with the World Bank and the USAID. The IMF took the lead in the fiscal, central banking, and

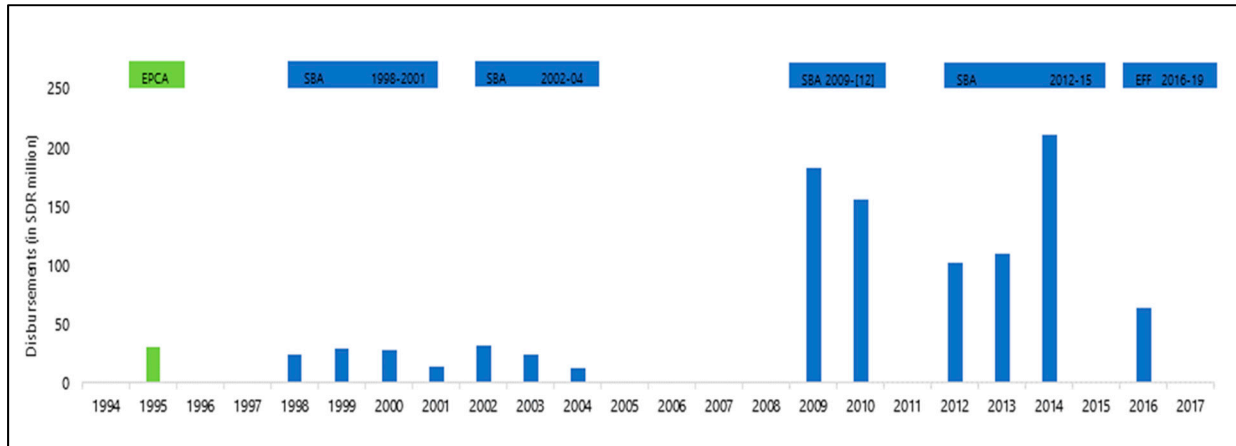
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<sup>2</sup> The role of the OHR has been dramatically reduced, and, in 2004, NATO forces were largely replaced by EUFOR Althea, a EU operation. Originally thought as a temporary arrangement that would pave the transition towards greater integration of the entities, the Dayton system has perpetuated itself.

<sup>3</sup> BiH's process towards IMF membership began before the end of the war and was complicated by outstanding obligations to the IMF of SDR 27.2 million, most of them overdue. The situation was resolved through two bridge loans, granted by The Netherlands and the U.S.

economic statistics areas. A particular focus was the creation of a central bank, given the responsibilities assigned to the IMF in this realm by the Dayton Accords.

**Figure 2.1. Bosnia and Herzegovina: Timeline of IMF Engagement, 1994–2017**



Notes: EFF=Extended Financing Facility; EPCA=Emergency Post-Conflict Assistance; SBA=Stand-by Arrangement; years in brackets reflect original duration at approval, in case(s) where program went off track.

Sources: SPR, List of Fund Arrangements since 1952; LIC Arrangements and Instruments Approved on, or after, November 1998 (as of October 31, 2017). IMF Members' Financial Data by Country, Transactions with the Fund.

6. During the stabilization and reconstruction phase, the IMF supported BiH with two arrangements. Immediately after the conclusion of the war, the Fund's strategy was to move quickly to a program relationship, supported by a Stand-by Arrangement (SBA) or an arrangement under the Enhanced Structural Adjustment Facility (ESAF). However, despite continued efforts by the IMF staff and the support of other donors (whose aid was conditional on an IMF arrangement being in place), progress was hampered by the lack of policy-making integration between the Federation and the RS, whose authorities were less than cooperative in implementing the Dayton Accords. It took almost three years of intensive negotiations and several prior actions before the Executive Board could approve the first SBA for BiH in May 1998. Four years later, in August 2002, the approval of the second SBA would face similar problems.

7. The first two SBAs had three main pillars: (i) use of a fixed exchange rate as a nominal anchor, under a currency board arrangement; (ii) tight fiscal policy, designed to prevent domestic borrowing by all levels of government while supporting reconstruction and social needs; and (iii) large-scale external financial assistance on concessional terms (and debt forgiveness), facilitated by the IMF's catalytic role. In parallel, the programs contemplated a series of structural reforms aimed at helping reconstruction efforts, reactivating the economy, and transitioning to a market-based economy.

8. Program implementation was problematic from the start. Internal documents show the complexity of the governance problems. Political and ethnic divisions, coupled with the constitutional structure established by Dayton, left policy making hostage to multiple vetoes and

the absence of state-wide instruments. Among other problems, this resulted in weak fiscal discipline where ownership was absent at the political level. Governance was complicated further by the large number of loss-making state-owned enterprises (SOEs), corruption, red tape, and fiscal noncompliance. On top of the governance issues, implementation was hampered by stressed relations with the international community over allegations of misuse of international aid, the ongoing conflict in Kosovo, the lack of data, and external political pressure. The completion of the first SBA, for example, took many missions,<sup>4</sup> four waivers (including a non-complying purchase), two augmentations, and three extensions, stretching the original twelve-month program to three years, the maximum allowable for an SBA. Similarly, negotiations under the second SBA were tense in a highly populist political environment. Completion could only be achieved with the active involvement of the High Representative to prevent actions that could have jeopardized the SBA.

9. Not surprisingly, progress on the institutional and structural fronts was slow. Thus, BiH continued to suffer from the lack of a well-functioning banking sector, a tax system that was fragmented between the different entities, an unfulfilled program of privatization, and widespread corruption. Nevertheless, the authorities managed to achieve some results under the 1998 and 2002 SBAs (Figure 2.2). With inflation stabilized, the BiH (convertible) mark was consolidated as the country's currency and the fiscal deficit narrowed significantly. The banking system was largely privatized, recapitalized, and subjected to better regulations.

### **B. Phase 2 (2005–14): Reform Attempts**

10. By 2004, the IMF's assessments had become more optimistic. The authorities were planning to launch an ambitious set of reforms aimed at deepening economic transition and at positioning the country to start negotiations for EU accession. Despite all the problems during the previous ten years, the IMF staff showed great determination to remain engaged in BiH, continuing to stress the need to focus on the country's most salient challenges: unemployment and poverty, dominance of the public sector, corruption, and a growing external deficit. To address these problems, the staff's advice focused primarily on the restructuring of the corporate sector, including the need to push through the privatization agenda and to strengthen control over SOEs. In parallel, it recommended that fiscal and labor market institutions be revamped, the necessary measures be adopted to improve data quality, and the strong fiscal balance and the currency board be maintained.

11. At the operational level, the staff proposed to support the structural reform agenda with an SBA or an extended arrangement. During 2005–06, negotiations on a program were launched at least eight times, but political fragmentation repeatedly got in the way. Political maneuvering prevented agreement on key issues such as the settlement of war claims, the creation of a fiscal council, and the unification of statistical offices. Disagreements grew between BiH and the

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<sup>4</sup> It is worth remembering that each mission to BiH requires a complicated series of interactions with at least three sets of authorities and their respective institutions.

international community. Among the international players, views differed about how best to interact with a country widely considered “ungovernable” and about how best to address its challenges.<sup>5</sup> The international community considered that a higher degree of intervention would be counterproductive and that disengagement would be dangerous. Lack of coordination among representatives of the international community, especially between the OHR and the EC, also posed a problem. The IMF continued to cooperate with other institutions, and most intensively with the OHR and the World Bank.

12. Meanwhile, the IMF continued to tackle what the 2005 Article IV report called “extreme fragility” with technical support, policy advice, and monitoring. The IMF’s Financial System Stability Assessment (FSSA) presented in 2006 centered on the need to strengthen supervision and regulation (not least by unifying supervisors at the state level). The 2008 Report on the Observance of Standards and Codes (ROSC) found the statistical system to be dysfunctional, producing data with significant weaknesses that limited their usefulness for effective policy making and surveillance, as well as undercutting the capacity to absorb TA. Also, the staff warned about a mismatch between the country’s statistical needs and the ongoing statistical capacity-development activities, which aimed more at compliance with external donor requirements.

13. Little was achieved on the reform front. The 2007 Article IV team, for example, saw little hope for institutional and political reforms and dim prospects for an IMF-supported program, as they found “policy-making more fragmented than ever,” coupled with a “dysfunctional governance structure” that perpetuated ethnic divisions.

14. All these problems did not prevent BiH from achieving several years of macroeconomic stability, relatively strong growth, and low inflation. In June 2008, in a burst of optimism a Stabilization and Association Agreement (SAA) was signed with the EU. The associated measures were not implemented, however, given the long-standing distortions coupled with a deteriorating macroeconomic situation; widening current account deficits, accelerating inflation, procyclical fiscal policy, and growing uncertainty regarding the government’s contingent liabilities. It was in these circumstances that the global economic and financial crisis of 2008 hit BiH, forcing the entities to coordinate with each other and to reach agreement on an IMF-supported program.

15. The 2009 SBA was the largest in the country’s history. Although the World Bank and the EU were initially expected to shoulder part of the financing, they were only able to commit €130 million and €50 million, respectively, leaving the IMF to cover the bulk of the €1.3 billion financing gap. The stated program objectives were to safeguard the currency board, address fiscal imbalances, strengthen the financial sector, and cushion the effects of the growing external deficit.

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<sup>5</sup> At the time, the EU and the U.S. were more focused on political developments, such as the possibility of securing an SAA and negotiations for NATO partnership.



**Figure 2.2. Bosnia and Herzegovina: Key Macroeconomic Indicators, 2000–17**



Sources: October 2017 WEO database; OECD DAC statistics.

16. Though at first the authorities' performance was adequate and the SBA succeeded in stabilizing the economy and weathering the effects of the crisis, BiH politics got in the way once again. A deep political crisis erupted and policy cooperation among the entities broke down, preventing the implementation of economic reforms and the completion of reviews beyond the third one. Though the Fund staff made intensive efforts in the following months (involving five missions in the following year), the SBA was allowed to expire. Only one-third of the approved amount was disbursed, reforms were clogged, and policy implementation was severely hampered. The fourth SBA, approved in 2012, fared little better. The IMF's technical mission, fielded in 2014 under the Financial Sector Assessment Program (FSAP), concluded that, while some improvements had been made since 2006, most problems within the financial sector remained unsolved.

### **C. Phase 3 (2015–17): A Change in Approach**

17. 2015 brought new optimism, as economic recovery was assessed to be taking a firmer hold, and a new government pledged to move forward with the required measures towards EU accession. The new momentum materialized in a comprehensive Reform Agenda that was put together by the EU and the IMF and closely coordinated with the World Bank and other international financial institutions (IFIs). Anchored in an IMF-supported program, the Reform Agenda's main pillars were (i) supporting the private sector and the business environment; (ii) adopting sound fiscal policies; and (iii) strengthening the financial sector. The commitment shown by the authorities regarding EU membership led the EU Foreign Affairs Council to let the 2008 SAA enter into force in June 2015. In February 2016, BiH submitted an EU membership application, which was accepted in September. The next step would be accession to "candidate status."

18. After nearly two years of continuous missions and negotiations with the authorities, and close coordination with the EU, the World Bank, and other IFIs, the IMF staff put together a new program. The Executive Board approved an arrangement under the Extended Fund Facility (EFF) in September 2016, which adopted a new strategy. The program's goals were to: (i) intensify structural reforms that would raise the economy's growth potential, improve the business climate, and attract investment; (ii) improve the quality and composition of public spending; (iii) revive bank lending while safeguarding financial sector stability; and (iv) strengthen cooperation and coordination among domestic institutions. Alongside the IMF, the EU and the World Bank affirmed their intention to provide financial support. Nevertheless, political gridlock yet again prevented the fulfillment of prior actions and the first review of the EFF was delayed for over a year, until February 2018.

### III. STAKEHOLDER VIEWS

#### A. The IMF's Roles and Objectives

19. Those interviewed in the field, including current and former officials, representatives of think tanks, and representatives of international organizations, were unanimous in stating that the IMF's involvement had made a positive contribution to the stability and development of the country. Among the IMF's most highlighted achievements were the setting up of the central bank, the establishment of the VAT system and the fiscal council, the launch of the convertible mark, the adoption and maintenance of the currency board, and serving as the "glue that holds together the country." More specifically:

- First, the IMF was the main catalyst for reform, facilitating a triple transition of the country from war to peace, from communism to market economy, and from disintegration to integration. It has been identified as the main ally of local reformers faced with the pressure from anti-reform and anti-integration politicians, unions, and a part of the press, who defended vested interests and looked back to the communist era with nostalgia. The IMF proved to be the only institution with sufficient leverage to push ahead politically contentious reforms such as privatizations and the excise tax on fuels.
- Second, the IMF provided a counterbalance to populist measures that aimed at gaining political wins but were damaging to the country's development and stability. Interviewees highlighted the importance of the IMF's support to state-level institutions such as the central bank and the tax authority that provided a framework for economic stability but were under constant threat from politicians at the entity level. Moreover, the IMF provided an anchor not only for policy making by the authorities but also for members of the international community.
- Third, the IMF acted as coordinator and mediator by bringing together officials from the entities and the state who, on many occasions, would not have sat at the same table. The IMF also supported the activities of state institutions that were attempting to play a coordinating and integrating role.
- Fourth, some interviewees underlined the IMF's catalytic role in unlocking financing from other institutions and generating a "credit rating" effect. Others noted that its financing role has given the IMF the required leverage to push for implementing reforms.
- Fifth, the IMF helped to fill a capacity gap in two ways: (i) by transferring the expertise and advice necessary to build BiH's technical capacity to formulate and implement the reforms that modernization entails; and (ii) by acting with other members of the international community to provide leverage that compensated for BiH's lack of political will. This was, in the interviewees' opinion, key to achieving results.

20. On the other hand, a few interviewees criticized the IMF for putting undue pressure on parliamentarians to pass pieces of legislation, rather than patiently explaining and convincing them and the public. In their view, the IMF, as part of the international community, shared the responsibility for impeding the development of democracy by being intrusive and by removing locals' incentives to take the reins of their own country.

### **B. Manner of Engagement**

21. Interviewees overwhelmingly gave high marks to the IMF's policy advice and conditionality, which they considered to have been well tailored, realistic, and implementable. The advice improved over time, thanks to a two-way learning process that allowed the IMF's focus to evolve from macroeconomic stability to structural reforms.

22. Nearly all stakeholders who were in a position to assess IMF-supported programs or IMF policy recommendations considered them to have been well put together, with inputs from the authorities. There was also agreement that the IMF's structural conditionality had been instrumental, a *sine qua non* to make reforms a reality, though it was often described to the public as an imposition. Some interviewees pointed to a "protectorate mentality" among the authorities that made them expect someone else to solve their problems.

23. As regards implementation, views were nearly unanimous that the delays and failures of programs could not be ascribed to program design. Despite ownership and strong commitment at the technical level, implementation was often paralyzed by volatile and populist politicians, especially on such sensitive issues as the compensation of war veterans.

24. An interesting issue was whether the IMF managed to strike the right balance between toughness and flexibility in the design and monitoring of conditionality. The majority view was that the IMF's stance had evolved from being rigid in the first few years of engagement, becoming more flexible and nuanced, and that the Fund had managed to adequately calibrate its posture as the complexities of the BiH case became apparent. A significant minority of interviewees believed, however, that the IMF erred on the side of softness, sometimes influenced by the stance of other international institutions, in order to buy social peace.

25. All stakeholders, including the staff members interviewed, agreed that the IMF's toolkit was adequate; there seemed to be no lack of facilities or instruments to address the needs of BiH. While the EFF was widely considered more appropriate, given its longer-term structural focus, the SBAs had proved sufficiently flexible to address BiH's problems.

26. While recognizing the IMF's overall positive performance, a few interviewees criticized several aspects of its manner of engagement:

- For some time, the IMF leaned towards the use of SBAs over EFF-supported programs. Given BiH's lack of capacity and need for structural reforms, an earlier shift to an extended arrangement would have been warranted.

- The IMF was excessively biased towards the revenue side, when the problem in BiH was on the expenditure side. The IMF kept demanding revenue measures when there were enough funds and public spending was on the rise, though capital investment had grown very little. The IMF spoke of the need to build infrastructure but did not analyze the quality of expenditure.
- The IMF focused too much on headline macroeconomic numbers without considering their deeper implications, such as for the quality of growth.
- The IMF was sometimes too reactive to legislative issues, instead of actively lobbying and convincing politicians of its point of view.

### **C. Staff Effectiveness**

27. The vast majority of officials interviewed described their relationship with the IMF staff as excellent, stressing staff members' trustworthiness, frequent availability, and responsiveness, and considering them as knowledgeable and hard-working. They also noted that the staff had been accommodative of the country's complexity, patient, and thorough in their analysis. The turnover within the staff assigned to BiH was not considered too high, although a proposal was made to synchronize the terms of the mission chiefs and resident representatives with that of the government.

28. Even though the staff was well prepared and able to learn quickly the political economy peculiarities of BiH,<sup>6</sup> the IMF often became entangled in domestic politics in two ways. First, according to those interviewed in the field, the IMF was too reluctant to blame politicians for implementation problems and taken the blame upon itself, giving the politicians cover for their responsibility. Second, the IMF was caught in the cross-fire between the different branches of government, with some interviewees complaining that the IMF staff listened too much to one branch over another. By all accounts, including by staff members, these dynamics reduced the effectiveness of the IMF's work and hampered the implementation of reforms.

29. Some believed that the IMF had been too rigid in its approach, though less so in more recent years than formerly. They attributed the problem to the centralized nature of decision-making at the IMF or to the IMF's mandate, which focuses the Fund's interactions almost exclusively on finance ministry and central bank officials.

### **D. Collaboration with Partners**

30. Partner institutions were generally satisfied with their relationship with the IMF. Coordination among different institutions was by and large considered good, a critical element given the highly fragmented administrative structure. Institutions often shared expertise and lent

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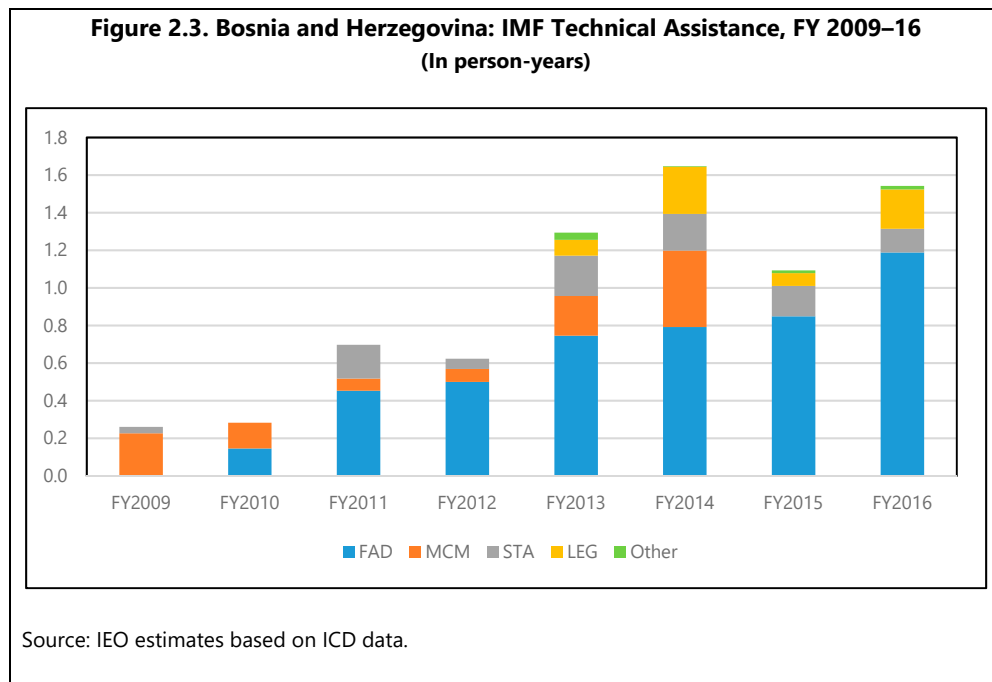
<sup>6</sup> In other institutions working in BiH, such as the EBRD, local representatives had the support of a political affairs department on the political economy front.

each other leverage. Some interviewees stated that the IMF played a coordinating role in the areas of its expertise. They agreed that the IMF's analysis had contributed to their decision making.

31. The Reform Agenda, the vehicle through which most international coordination now takes place in BiH, is led by the EU and supported by the IMF and other international partners. The agenda provides operating principles and a well-functioning organizing framework; it focuses on the most urgent, basic, and pragmatic reforms first, leaving big political reforms for later. It is organized around a clearly defined, but mutually supportive, distribution of responsibilities, allowing the IMF, for example, to include more structural reforms in its EFF-supported program by relying on inputs from the World Bank.

### E. Technical Assistance

32. The provision of TA and training, including through the Joint Vienna Institute, has been a major part of the IMF's work in BiH (Figure 2.3). Recipients gave very high marks to its quality, the knowledge demonstrated by experts, their professionalism, and the usefulness of the advice. In particular, three aspects were highlighted: continuity in the composition of TA missions, the fact that authorities were presented with alternative options for implementation, and a nondoctrinaire attitude.



33. Interviewees also agreed that the Fund's recommendations were well targeted, realistic, and implementable, reflecting a good level of understanding of the specificities in each case (though political interference often derailed implementation). A good alignment of TA with program objectives was considered very important in this respect. In a few cases, however, it

took TA providers a while to understand the political implications of their technical recommendations.

34. Most officials who were interviewed felt that the amount of TA received was satisfactory. Of the staff members interviewed, a few thought that the country could have benefited from more, but the majority thought that the amount of TA provided to BiH (by the IMF and others) had already strained the country's absorptive capacity. TA was mostly demand-driven, attending to the needs and requests of the authorities (though immediately after the war capacity was so low that TA was planned by development partners). Sometimes the IMF proposed certain actions, but it did so in response to well-identified needs and in coordination with the authorities.

35. Interviewees made suggestions aimed at improving TA provision. They supported greater use of long-term experts and TA advisors with regional experience. The authorities stated that they would also appreciate the establishment of a mechanism through which they could communicate their assessment of TA back to the IMF. Finally, while officials considered that TA was well coordinated and allocated among various providers, they mentioned a few instances of duplication with other institutions (mainly the World Bank).

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## CHAPTER 3—CAMBODIA<sup>1</sup>

### SUMMARY

Cambodia emerged in the early 1990s from decades of political instability that included a genocide and successive civil conflicts. The IMF has been actively engaged in Cambodia since 1993, initially with financial arrangements. Since 2003, persistent external arrears to official creditors have prevented the country from accessing Fund resources (this situation will likely remain unless political differences with the creditors are resolved), but the Fund has continued to engage through surveillance and technical assistance.

The IMF has played an important role in Cambodia in helping the authorities with appropriate macroeconomic policies and in building key economic institutions. The country has enjoyed strong economic performance during the last 20 years while reducing poverty significantly. Though poverty remains high and there are pervasive governance shortcomings, it has overcome the legacy of the conflict years and is now no longer considered a fragile state.

### I. BACKGROUND

#### A. Brief History<sup>2</sup>

1. Following independence from French colonial rule in 1953, Cambodia enjoyed a period of relative prosperity under the benign dictatorship of Prince Sihanouk. By the mid-1960s, as the Vietnam War intensified and as Sihanouk's political control weakened, new forces came into play, including the Communist Party of Kampuchea (CPK) led by a former school teacher, Saloth Sar, who later took the name of Pol Pot. Sihanouk was ousted by a military coup in 1970, and the country was renamed the Khmer Republic. This was done in the context of a Vietnamese communist invasion and a burgeoning civil war inside Cambodia between government forces and forces allegedly loyal to Sihanouk. The civil war ended with a victory by the communists, known by then as the Khmer Rouge, and the creation of Democratic Kampuchea.

2. Over the next three years, many of Cambodia's institutions were destroyed, and the urban population, forcibly exiled from towns and cities, was put to work as agricultural laborers. The new regime abolished money, markets, formal schooling, Buddhist practices, and private property. In the rush toward a socialist Utopia, one of the worst genocides of the 20<sup>th</sup> century was committed under the Pol Pot regime. Nearly two million Cambodians, or one in every four, died of overwork, malnutrition, and misdiagnosed diseases, or were executed. Subsequently, Democratic Kampuchea's relations with Vietnam worsened, while strong relations were established with the People's Republic of China.

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<sup>1</sup> Contributor: Lorenzo L. Perez.

<sup>2</sup> Sources: Brinkley (2011) and Chandler (2007).

3. Democratic Kampuchea effectively destroyed itself when its leaders decided in 1977, with Chinese encouragement, to wage war on the Socialist Republic of Vietnam. In 1979, the Vietnamese army and a Cambodian rebel group invaded the country and overthrew the Khmer Rouge,<sup>3</sup> whose forces retreated into the jungle. A new People's Republic of Kampuchea (PRK)—later renamed the State of Cambodia—was established. For several years, the regime submitted to Vietnamese guidance and control while combating Khmer Rouge forces, with some 600,000 Cambodians displaced to refugee camps along the Thai border and tens of thousands murdered. With the withdrawal of the Vietnamese troops, peace talks began and a comprehensive peace settlement was reached in October 1991. The United Nations Transitional Authority in Cambodia (UNTAC) arrived in February 1992, tasked to ensure the conduct of free and fair elections for a constituent assembly in May 1993.<sup>4</sup>

4. The elections resulted in a coalition government headed by two co-prime ministers, Prince Norodon Ranariddh (son of Prince Sihanouk) of the royalist party and Hun Sen of the Cambodia People's Party (CPP). A new constitution established a multi-party democracy in the framework of a constitutional monarchy, with Sihanouk elevated to king; the Khmer Rouge was outlawed in 1994. In 1997, Hun Sen used his personal troops to launch a coup against Ranariddh and cemented his power by becoming the country's sole prime minister. Cambodian politics has remained divisive, with controversial and disputed elections in 2003 and 2013, but Hun Sen has successfully held on to power. A government crackdown on the main opposition since late 2015 (including a recent arrest of its leader) means that there is de facto one-party rule.

## **B. Sources of Fragility**

5. While Cambodia is no longer classified as fragile by the IMF, it retains important elements of fragility. The government of Prime Minister Hun Sen has been accused of a number of corrupt practices over the years including illegal sales of real estate to foreigners and of rights to exploit offshore oil deposits. Over a period of some 12 years up to 2010, foreign donors had demanded an end to corruption in their aid meetings with the government. Every year the government promised the passage of an anti-corruption law but delayed its approval until 2010. Cambodia's average scores on the World Bank's Country Policy and Institutional Assessment are relatively high in economic management (3.6), structural policies (3.7), and policies for social inclusion/equity (3.4), but low in public sector management and institutions (2.8).

6. Notwithstanding the shortcomings in governance, Cambodia has enjoyed strong economic performance during the last two decades. Cambodia's economic growth has been one of the fastest among Asian developing countries, driven by vibrant garment exports, and the fast-growing real estate, construction, and tourism sectors. After years of sustained growth,

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<sup>3</sup> Hun Sen was part of this Cambodia rebel group. He had been a battalion commander in the Eastern Region of Democratic Kampuchea and had fled with his troops to Vietnam during the internal purges of the Khmer Rouge.

<sup>4</sup> By the time the UNTAC mission ended in September 1993, it had spent more than \$2 billion, making it the UN's costliest operation up to that time.

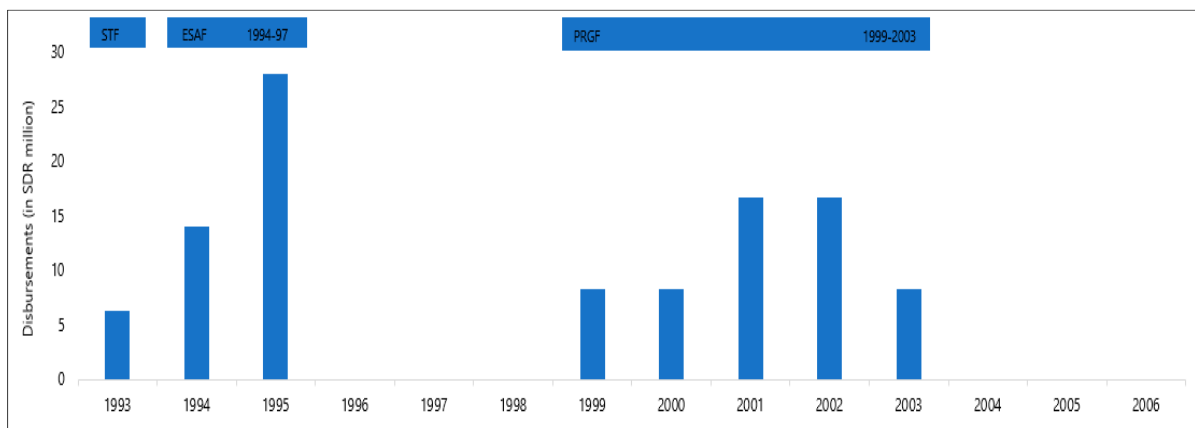
Cambodia has achieved lower middle-income status. The strong economic performance has resulted in a substantial reduction in poverty (from about 50 percent of the population to 18 percent), and noteworthy progress in achieving the Millennium Development Goals. The near-term outlook remains broadly favorable and growth is projected to remain robust, boosted by the same factors that contributed to past growth and lower oil prices.

7. Even so, Cambodia's economic performance is susceptible to external shocks, given the narrow export base and a large external current account deficit. Garment exports can be affected by a slowdown in Europe or the United States, and weaker-than-expected growth in China can have negative spillovers through foreign direct investment, banking, and tourism. While many other developing countries that are not considered fragile are susceptible to similar external shocks, Cambodia's political situation is a factor that introduces greater fragility. Hu Sen has effectively been ruling the country for some 25 years and there are no indications that his administration is preparing a transition of power. Quite the contrary, the recent steps taken in preparation for the 2018 elections seem to suggest he intends to remain in power.

## II. THE IMF'S RELATIONSHIP WITH CAMBODIA

8. Cambodia became a member of the IMF in December 1969. Following the 1973 Article IV consultation held in October, Article IV consultations did not take place for 20 years. During this period, Cambodia suffered from the devastation created by the genocide, which seriously damaged key economic institutions and sharply reduced the country's human capital. The country also faced waves of rapid inflation and exchange rate depreciation, reflecting the government's recurrent resort to money creation to finance the fiscal deficit.

**Figure 3.1. Cambodia: Timeline of IMF Engagement, 1993–2006**



Notes: ESAF=Enhanced Structural Adjustment Facility; PRGF=Poverty Reduction and Growth Facility; STF=Systemic Transformation Facility.

Sources: SPR, List of Fund Arrangements since 1952; LIC Arrangements and Instruments Approved on, or after, November 1998 (as of October 31, 2017). IMF Members' Financial Data by Country, Transactions with the Fund.

9. After the general elections of May 1993 sponsored by UNTAC, the IMF started to provide financial assistance to Cambodia (Figure 3.1). But since 2003 the country's persistent arrears to official creditors have prevented it from accessing Fund resources. Thus, the relationship revolved around policy advice and capacity development support over the next 15 years.

### A. IMF-Supported Programs

10. The IMF-supported programs during 1993–99 were geared to problems typical of a country in post-conflict-cum-transition to market economy (Table 3.1). An arrangement under the Systemic Transformation Facility (STF) was approved in 1993 in support of a program covering 1993–94. The STF-supported program built upon an earlier stabilization program supported by an informal monitoring arrangement adopted in October 1992, which provided a framework for the clearance of arrears to the IMF. Cambodia drew only the first two tranches under the STF and then formulated a medium-term adjustment program that was supported by a three-year arrangement under the Enhanced Structural Adjustment Facility (ESAF-I) in early 1994. But the mid-term review of the second annual program could not be completed, due to governance problems in forestry management and revenue collection. Despite efforts to bring the program back on track in the midst of a deteriorating political situation, the ESAF-I expired without further reviews.

**Table 3.1. IMF-Supported Programs in Cambodia, 1993–2003**

Facility: Timing and Amounts	Objectives, Measures, and Outcomes
<b>Systemic Transformation Facility (STF), 1993–94</b>	
The STF was approved in October 1993, following the clearance of SDR 37 million in arrears to the Fund. It had a single purchase of SDR 6.25 million (10 percent of quota) which was made at the time of approval.	Restoration of macroeconomic stability was attained through a tightening of fiscal and monetary policies, renewed access to donor support, and a successful political transition. Some institutional reforms were implemented (e.g., budget law). All quantitative and structural benchmarks were observed.
<b>Enhanced Structural Adjustment Facility (ESAF-I), 1994–97</b>	
The three-year arrangement under the ESAF was approved in May 1994, in an amount of SDR 84 million (129 percent of quota). Only the purchases of the first-year program were made and performance under the program deteriorated after the approval of the second annual arrangement in September 1995.	Consolidation of macroeconomic stability and reconstruction, supported by tight financial policies, aid-financed investment, institution building, and structural reforms. During the program period, Cambodia experienced robust growth, low inflation, and strong export growth. There were, however, persistent fiscal pressures resulting from low revenues and large military outlays.
<b>Poverty Reduction and Growth Facility (PRGF), 1999–2003</b>	
The three-year arrangement under the PRGF (initially ESAF) was approved in October 1999, with total access of SDR 58.8 million (67 percent of quota). All resources were drawn because all quantitative performance criteria were met, as were all but one of the structural adjustment criteria. All six reviews were completed with only minor delays.	The program's main focus was on fiscal reform (in particular efforts to increase revenues), reduce military spending, reform public administration, and provide additional funds for social services and public investment. The authorities also aimed at improving forestry management and advancing structural reforms to support private growth and poverty reduction. Macroeconomic performance under the program was generally positive but the targeted increase in fiscal revenues was not achieved, forestry management remained problematic, and poverty remained pervasive.

11. In 1999, with the greater political stability that followed the 1998 general elections and a renewed impetus for reform, Cambodia entered into a three-year arrangement under the ESAF/Poverty Reduction and Growth Facility (PRGF). The ESAF/PRGF-supported program aimed at consolidating macroeconomic stability and developing a basis for high and sustained growth to address poverty, within the Poverty Reduction Strategy Paper (PRSP) framework. A comprehensive poverty reduction strategy was not developed until the last part of the PRGF-supported program, but all six program reviews were completed.

12. Macroeconomic performance during the programs supported by the STF, ESAF-I, and PRGF arrangements (1993–2002) was characterized by a quick return to price stability, while growth averaged above 4 percent (Figure 3.2). The exchange rate was unified under a market-based regime and remained relatively stable thereafter, while official reserves grew steadily. Progress was made in building up the Central Bank and the Ministry of Finance and in restructuring the financial sector. To meet fiscal targets, expenditures were compressed below target, and payment arrears arose. Some progress was made in privatizing state enterprises but the divestitures of seven major rubber plantations were delayed. Limited progress was achieved in improving governance, implementing civil service reform, and demobilizing military groups.

13. While implementation capacity improved under the 1999 PRGF-supported program, the Fund staff's 2004 ex post assessment (EPA) noted that Cambodia would need significant efforts and political determination to achieve fiscal sustainability, enhance governance, and ensure a successful implementation of the remaining poverty reduction strategy (IMF, 2004). Under these circumstances, the EPA did not consider Cambodia to be a candidate for early graduation from use of Fund resources.

## **B. Policy Advice in the Context of Article IV Consultations**

14. In 2005, at the request of the authorities, agreement was reached on a new program that could be supported by the PRGF, but the proposed program was not presented to the IMF Board because understandings were not reached on the rescheduling of the debt Cambodia owed to the U.S. and the Russian Federation.<sup>5</sup> Prior to 2005, the IMF-supported programs had been approved notwithstanding these arrears because negotiations were ongoing to resolve the issues, but by 2005 the negotiations were deadlocked. While the authorities desired a close collaboration with IMF staff, a program under the Policy Support Instrument (PSI) could not be considered, given the existence of arrears to official creditors. Because Cambodia already had a good track record with the IMF, a Staff-Monitored Program was considered inappropriate.

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<sup>5</sup> The debt owed to the U.S. arose from American commodity exports to Cambodia. The debt owed to Russia was inherited from the previous Vietnamese-sponsored government's obligations to the former Soviet Union. According to the authorities' published data, arrears amounted to around \$630 million in September 2017.

**Figure 3.2. Cambodia: Key Macroeconomic Indicators, 2000–17**



Sources: October 2017 WEO database; OECD DAC statistics.

15. Even so, the government has since maintained a close policy dialogue with the IMF through Article IV consultations and technical assistance. The IMF staff has continued to actively participate in donors' forums held every year and visited Cambodia twice a year while maintaining a resident representative office in the country except for a short period of time.

16. Favorable macroeconomic developments during the second half of the 1990s masked policy and structural weaknesses. The policy discussions during the Article IV consultations that began in 2004 have addressed these weaknesses, with the focus changing over time in response to evolving circumstances. Three areas received particular attention: (i) governance-related problems and steps needed to address them; (ii) increasing revenue mobilization to strengthen public finances; and (iii) improving the operational framework of the Central Bank and bank supervision in the context of rapid credit expansion.

17. First, the IMF staff expressed concern in 2004 that Cambodia's competitiveness had weakened, pointing out that poor governance (in part due to lack of progress in legal and judiciary reform) exacerbated uncertainty in the business environment while rudimentary infrastructure and high wages kept operating costs high. Government capacity remained constrained by lack of human capital and entrenched governance problems. In subsequent consultation discussions, poor governance was treated only indirectly (e.g., in the context of "improving competitiveness"). Poor governance and corruption continue to be an issue. Passage of an anti-corruption law was delayed for more than 10 years. A recent IMF mission chief observed that corruption was embedded in the bureaucracy.

18. Second, over the years the staff argued for strengthening Cambodia's fiscal position on a permanent basis through additional revenue mobilization, in order to strengthen fiscal capacity to respond to shocks and to create greater space for growth-enhancing and priority public spending. In this context, the staff stressed the need to reduce domestic financing of the budget and to develop a plan of fiscal consolidation. Policy recommendations included enhancing revenue administration and reforming public financial management. The adoption of a Revenue Mobilization Strategy in October 2014 and efforts to strengthen revenue and customs administration yielded a sharp increase in revenue.

19. Third, in the monetary and financial sector, the staff first addressed the question of how to reconcile the need for the exchange rate to reflect fundamentals with the need to accommodate a rise in money demand. Subsequently, the underdeveloped financial sector's vulnerability became an issue of concern when monetary aggregates were growing rapidly. In 2008, concerns arose when a sharp deceleration of external inflows caused a liquidity shortage for banks. Measures to manage the risks faced by banks were recommended and the lack of a real operational framework for the Central Bank received attention. The weakness of banks (arising from lagging property values and shrinking collateral values) and the need to improve bank supervision and regulation continued to be a focus of the discussions in 2009.

20. In 2010, Cambodia received a financial system stability assessment under the Financial Sector Assessment Program (FSAP). The 2010 FSAP recommended several high-priority actions, such as improving the quality of data for risk assessment purposes and a moratorium on new bank licenses, pending improvement in supervisory capacity. Other issues that received attention over the ensuing years included the high degree of dollarization, which limited room for domestic monetary policy; the need to promote financial deepening; and ways of strengthening the functioning of the foreign exchange market to safeguard the stability of a rapidly changing financial system.

21. In 2015 and 2016, IMF surveillance highlighted the risks inherent in continued rapid credit growth, while exploring additional ways to safeguard macroeconomic and financial stability. The staff proposed raising reserve requirements, introducing macro-prudential policies, and strengthening bank supervision and regulation where needed. The 2016 Article IV consultation emphasized the need to achieve a “soft landing” of the credit cycle and to mitigate associated risks. For this, the staff proposed using a well-sequenced set of micro- and macro-prudential tools, developing a crisis management framework, and continuing to upgrade the regulation and supervision of the financial sector.

22. Since 2003 the IMF has maintained a close policy dialogue with the Cambodian authorities despite the absence of a financial arrangement. The authorities were by and large receptive to IMF advice even though they did not always implement proposed measures in a timely manner. The dialogue matured over time. It focused initially on the establishment of core policy institutions and measures to address the immediate consequences of the conflict period, and subsequently evolved into a discussion of more complex policy challenges. The staff applied its knowledge of global and regional experience while taking into account Cambodia’s specific circumstances. Officials held a high regard for the quality of IMF staff, especially those staff members who had provided technical assistance.

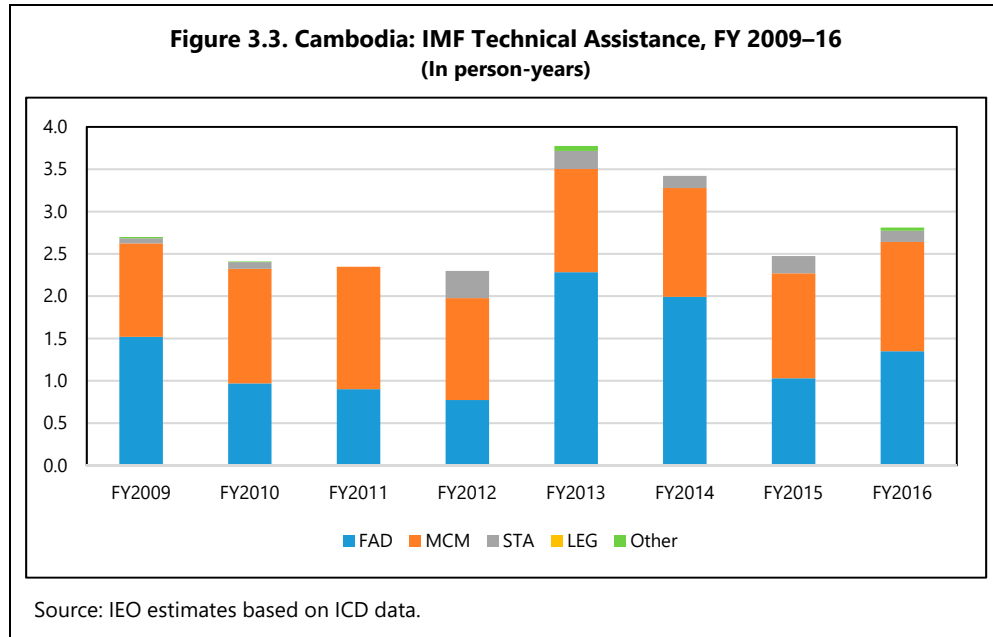
23. Continuity in the country’s leadership, from the head of state down to key economic officials, facilitated this dialogue (even though the turnover in IMF staff was high, as officials often complained). The Fund might have influenced Cambodia’s policies more strongly had it been able to continue to provide financial assistance; if some of the proposed measures had been made part of the performance criteria, the chances of their timely implementation might have been greater. IMF staff members who were interviewed highlighted the need to understand the political economy in a fragile country like Cambodia and to be realistic about the country’s capacity to deliver reforms. There was unanimity on the important role that resident representatives played in this context. Officials welcomed the outreach some of the Res Reps had conducted involving universities and other places.

### **C. Capacity Development Work**

24. Capacity development, including technical assistance and training, has been a key area of IMF engagement in Cambodia, given the limited implementation capacity especially at the outset



and the absence of a financing arrangement subsequently. Cambodia has been a large recipient of IMF TA in recent years, with the volume averaging about 2.5 person-years of field delivery (person-years) per year during FY 2009–16 (Figure 3.3).



25. The technical assistance program for 1994–97 related to the areas of tax policy and administration, monetary policy and central bank operations, statistics, and the legal framework. Success was achieved in preparing the 1997 tax law, setting up a legislative framework for the banking system, and improving economic statistics. A comprehensive review of this TA program, conducted in 1997, concluded that the well-defined and limited goals, and strong commitment by the authorities at the highest levels, had contributed to its success. Where the program had failed to meet its original objectives, the review noted, the shortfalls largely stemmed from overly ambitious objectives and less-than full collaboration between local officials and TA advisors. The Cambodian government concurred with these assessments.

26. Another technical assistance action plan was prepared for the 2001–03 period, aimed at strengthening the government’s capacity to formulate, implement, and monitor sound fiscal and monetary policies supportive of Cambodia’s poverty reduction strategy. This plan incorporated concerted efforts by the IMF, the Asian Development Bank, the United Nations Development Program, and several bilateral donors. No assessment of the 2001–03 technical assistance plan was conducted.

27. FAD staff noted that Cambodia had been slow to implement tax policy recommendations and that the multiple TA missions had yielded limited results. While FAD TA missions typically receive back-stopping support, one staff member expressed the view that the limited results from TA missions had partly resulted from lack of strong follow-up support. FAD and the area department usually coordinated well in the preparation of the terms of reference, but FAD

experts did not have enough time or resources to remain in contact with the authorities after their visit; in his view, the area department was better placed to do the follow-up work. MCM staff noted the importance of on-site training as part of the technical assistance provided to the Central Bank. This was highly appreciated by the authorities.<sup>6</sup>

#### **D. Collaboration with Partners**

28. Representatives of development partners found that the work of the IMF in Cambodia had been well focused, providing a valuable input to the government and the international community. The briefings of development partners by visiting IMF missions had provided key information for their decision making. The IMF was considered to have worked closely with other international financial institutions in the coordination of TA, in such areas as bank supervision and financial sector reform, including through the Public Financial Management Reform Program.

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<sup>6</sup> An MCM evaluation of technical assistance on bank supervision by long-term experts (LTX) in Asia in 2009 noted that LTX had become increasingly important in delivering technical assistance in the financial sector and overall had substantially help to improve bank supervision. This assessment emphasized that the effectiveness of LTX depended on the existence of a coherent strategy of authorities, a clear vision of the role of TA in implementing reforms, and buy-in from middle management in the host institution. To be effective, LTX required not only technical competence but also strong interpersonal and communications skills and a willingness to adjust to local conditions and culture.

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## CHAPTER 4—HAITI<sup>1</sup>

### SUMMARY

Haiti is the Western Hemisphere's poorest country. Since its beginning as an independent nation in the early 19<sup>th</sup> century, a multitude of factors including historical and social elements, vulnerability to natural disasters, and political instability have made the country one of the world's most fragile states. Starting in the mid-2000s, the prospects under reform-minded governments seemed more positive, but a massive earthquake in 2010 caused enormous loss of life and reduced much of the capital city and surrounding areas to rubble.

Helping to address Haiti's persistent problems has proved a difficult challenge for the international community, including the IMF, which has played a prominent role in external assistance efforts. Apart from some brief interruptions, Haiti has been in a semi-continuous program or "near program" relationship with the IMF over the last six decades and has also received extensive technical assistance. Despite many reversals, the IMF's involvement has been associated with some success overall in macroeconomic stabilization, but implementing sustained structural reforms has proved more elusive, and more on-the-ground support would be helpful. Most observers consider that without IMF support, Haiti's situation would have turned out even more unfavorably. The record to date and the prospects suggest that Haiti will need to continue to rely heavily on the IMF for many years to come.

### I. BACKGROUND

#### A. Brief History<sup>2</sup>

1. For most of its two hundred years since independence, Haiti has been wracked by political and financial instability, domestic repression, and natural calamities. Foreign intervention of various kinds—including colonization, two invasions by the United States, and the intermittent presence of international peacekeeping forces—has been a long-standing feature of Haiti's history. Despite receiving large amounts of external economic assistance, it has remained by far the poorest and most socially deprived country in the Western Hemisphere. Haiti's persistent and deep-rooted fragility has provoked much soul searching by the domestic and international community.

2. Haiti gained independence from France in 1804. In the century that followed, presidents were often ousted after a short time in office, civil violence was commonplace, and economic

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<sup>1</sup> Contributor: Donal Donovan.

<sup>2</sup> Sources: Dubois (2012); Farmer (2012); Deibert (2017).

instability reigned. In 1915, U.S. President Woodrow Wilson, invoking the Monroe Doctrine, sent troops to occupy Haiti and U.S. personnel remained until 1934.<sup>3</sup>

3. In the ensuing two decades, the economy began to pick up somewhat, despite continued political instability. But in 1957, Francois Duvalier was elected president. During the Duvalier regime, which became politically repressive, the U.S. suspended most aid. Following his death in 1971, his son, Jean Claude Duvalier ruled for 15 years. The U.S. lifted its aid suspension and the economy improved initially, but poverty and worsening social conditions contributed to a growing exodus of Haitians. Under these circumstances, in 1986, President Duvalier, under international pressure, went into exile.

4. Following further political instability, Jean-Bertrand Aristide, was elected president in 1990, but beset by civil resistance, he was deposed in an army coup in about a year. From 1992, the U.S., later joined by the U.N., imposed an economic embargo against the military regime. In late 1994, facing a massive surge in Haitian refugees, the U.S. invaded Haiti to help restore Aristide to power from exile. 1996 saw the first peaceful transition from one democratically elected president to another; Aristide was reelected for a second term in 2001 but an armed revolt forced him to again depart into exile in 2004.

5. The prospects under subsequent reform-minded governments seemed more positive, with an upsurge in aid inflows, foreign investment, and tourism. However, in January 2010, a massive earthquake reduced much of the capital, Port au Prince, and surrounding areas to rubble. Hundreds of thousands of people died; a million or more became homeless; and much of the physical and institutional capacity of the government was destroyed. Although the unprecedented pledge of official and private aid revealed the international willingness to help ease Haiti's dire predicament, the scale also highlighted the extreme weaknesses of domestic capacity, especially as regards the provision of basic social services. While the overall security situation has improved in recent years, crime remains a serious concern and political instability has persisted.

## **B. Sources of Fragility**

6. Two centuries after being widely viewed as the "Pearl of the Caribbean," Haiti has become the poorest country in the Western Hemisphere. Although the symptoms of Haiti's fragility (political instability and violence, dysfunctional institutions, inadequate economic policies, widespread poverty, and weak social indicators) are well recognized, there is more debate—much of it controversial—as to its sources. There are several aspects, including:

- Although Haiti's geographical situation renders it highly vulnerable to major natural disasters, including Hurricane Matthew in 2016, other countries in the region are also

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<sup>3</sup> The U.S. administration feared that Haiti had become easy prey for a takeover by any European power (including Germany) to use as a base hostile to the United States.

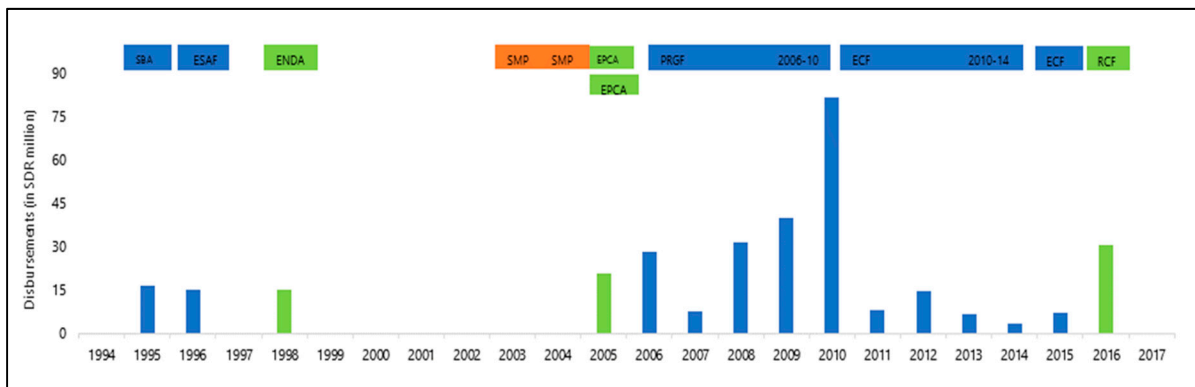
vulnerable. The damage suffered by Haiti has been exacerbated by the state's inability to provide basic economic, social, and environmental protection to cushion their impact.

- Some have even claimed that the harmful legacy of predatory colonial rule and the impact of more recent foreign interventions has been used at times by leaders as a distraction from addressing domestic problems successfully.
- Haitian political struggles have also been interpreted (more conventionally) as the exploitation by elites of the limited available resources for personal enrichment and the perpetuation of power.
- Some have argued that Haiti's extreme dependence on (often volatile) external assistance, inhibits development of an effective public sector and a properly functioning Haitian state.

## II. THE IMF'S RELATIONSHIP WITH HAITI

7. The IMF has played a prominent role in external efforts to assist the Haitian economy. Apart from some brief interruptions, Haiti has been in a semi-continuous program or "near program" relationship with the IMF for most of the period since it became a member in 1959. The protracted nature and intensity of the IMF's engagement with Haiti is particularly striking. Since membership, Haiti has adopted 32 IMF-supported programs covering 48 of the last 64 years, supported by extensive technical assistance and training. Until the mid-1990s, these typically took the form of one-year Stand-by Arrangements. Between 1996 and 2003, repeated efforts were made to deepen the IMF's engagement (Figure 4.1), but an arrangement under the Enhanced Structural Adjustment Facility, as well as several subsequent Staff-Monitored Programs, quickly went off track. Throughout, attempts at reforms were seriously undermined by ongoing political instability and violence.

**Figure 4.1. Haiti: Timeline of IMF Engagement, 1994–2017**



Notes: ECF=Extended Credit Facility; ENDA=Emergency Natural Disaster Assistance; EPCA=Emergency Post-Conflict Assistance; ESAF=Enhanced Structural Adjustment Facility; PRGF=Poverty Reduction and Growth Facility; SBA=Stand-by Arrangement; SMP=Staff-Monitored Program.

Sources: SPR, List of Fund Arrangements since 1952; LIC Arrangements and Instruments Approved on, or after, November 1998 (as of October 31, 2017). IMF Members' Financial Data by Country, Transactions with the Fund.

8. After the enforced departure of President Aristide in 2004, the renewed engagement by the IMF met with somewhat more success. SMPs were followed by two drawings under Emergency Post-Conflict Assistance. Despite slippages (partly due to aid delays, floods, and security-related expenditures), program performance was generally regarded as satisfactory. The IMF staff throughout emphasized the deep-rooted political, social, and administrative difficulties facing Haiti.

9. In 2006, the IMF intensified its engagement through a three-year arrangement under the Poverty Reduction and Growth Facility; interim PRSP and HIPC decision-point documents were also issued. Despite continuing political and security concerns, external shocks, and natural disasters, the program remained broadly on track. Quantitative performance criteria were almost always observed although there were often significant delays in structural reforms.<sup>4</sup> After the fifth program review in January 2010, the devastating earthquake struck. The IMF reacted quickly by approving a drawing under EPCA, further augmenting (and extending) the PRGF arrangement, and cancelling all of the debt that Haiti owed under the Post-Catastrophe Debt Relief Trust Fund.

10. A successor three-year arrangement under the Extended Credit Facility was approved in late 2010. The staff noted that despite some progress, growth remained disappointing, due to structural and institutional barriers, a lack of investment, and continuing political and security tensions. Earlier concerns (including weak basic social services and issues of aid disbursement and coordination) were reiterated, although they subsequently received less explicit attention. Performance under this program was generally considered satisfactory (all reviews were completed), especially as regards macroeconomic stabilization; structural reforms (especially relating to governance and transparency) were more halting.

11. Drawing on an ex post assessment of Haiti's longer-term engagement with the Fund, the staff concluded in early 2015 that although the political situation remained "challenging" the authorities had "made progress." A new ECF arrangement was approved subsequently. While the staff discussed the broad reform agenda in general terms, the authorities' program (including structural benchmarks) generally stayed within the IMF's traditional core areas of macroeconomic expertise. No program reviews were completed under the arrangement. In late 2016, in the wake of Hurricane Matthew, the IMF approved a drawing by Haiti under the Rapid Credit Facility. After a prolonged period of political instability, following elections and the appointment of a new government, in June 2017 a staff level agreement was reached on an SMP (which received management approval in February 2018).

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<sup>4</sup> The PRFG arrangement was augmented twice, and program design did not contain as a performance criterion a limit on the size of the budget deficit, so as not to constrain expected external financing.

### III. STAKEHOLDER VIEWS

#### A. The IMF's Overall Impact

12. As in many other fragile states, the IMF's approach has emphasized macroeconomic stability and structural reforms to spur growth and improve social conditions. Despite many reversals, the IMF's involvement has been associated with some success overall on the macroeconomic stabilization front. Haiti has avoided hyperinflation or a plunging exchange rate (Figure 4.2).

13. Haiti made progress in structural areas, notably public financial management and strengthening the fiscal revenue base, but sustaining structural reforms generally proved difficult, and economic growth was slower in Haiti than in many other fragile states.<sup>5</sup> Average per capita income remains below the level of 25 years ago and a significant improvement in poverty levels and in the public provision of social services has yet to occur. As several current officials pointed out, the benefits from macroeconomic "austerity measures" have yet to be translated into a tangible improvement in most living standards.

14. That said, stakeholders interviewed all agreed on the need for prudent financial policies as part of the wider agenda and that, without IMF-supported programs, Haiti's situation would likely have turned out even more unfavorably. They also noted that natural disasters, as well as recurrent bouts of political and social instability, had often derailed growth-promoting reform initiatives. Nevertheless, many observers noted a popular perception that the close involvement of the IMF in Haiti over many decades had not contributed to very positive economic outcomes overall. In the words of one former senior official, rightly or wrongly the IMF was generally viewed as the "policeman" rather than "the doctor." This has posed a particular challenge for the ability of programs to garner sufficiently wide ownership and political acceptability.

#### B. The IMF's Policy Advice

15. Despite general support for the IMF's efforts to promote prudent fiscal, monetary, and exchange rate policies, some of the Haitian officials who were interviewed for this evaluation felt that programs had at times been too inflexible. They suggested, that *inter alia*: (i) budgetary deficit targets had been unduly constrained at times and did not allow sufficiently for suitable infrastructural investment to spur growth; (ii) on occasion unrealistically high international reserve targets had been specified; and (iii) external borrowing limits should have been more flexible to permit non-concessional borrowing to finance worthwhile projects. Some remarked that program targets could have taken more account of some of the pressures associated with the electoral cycle, especially given Haiti's often volatile political environment. Some said that

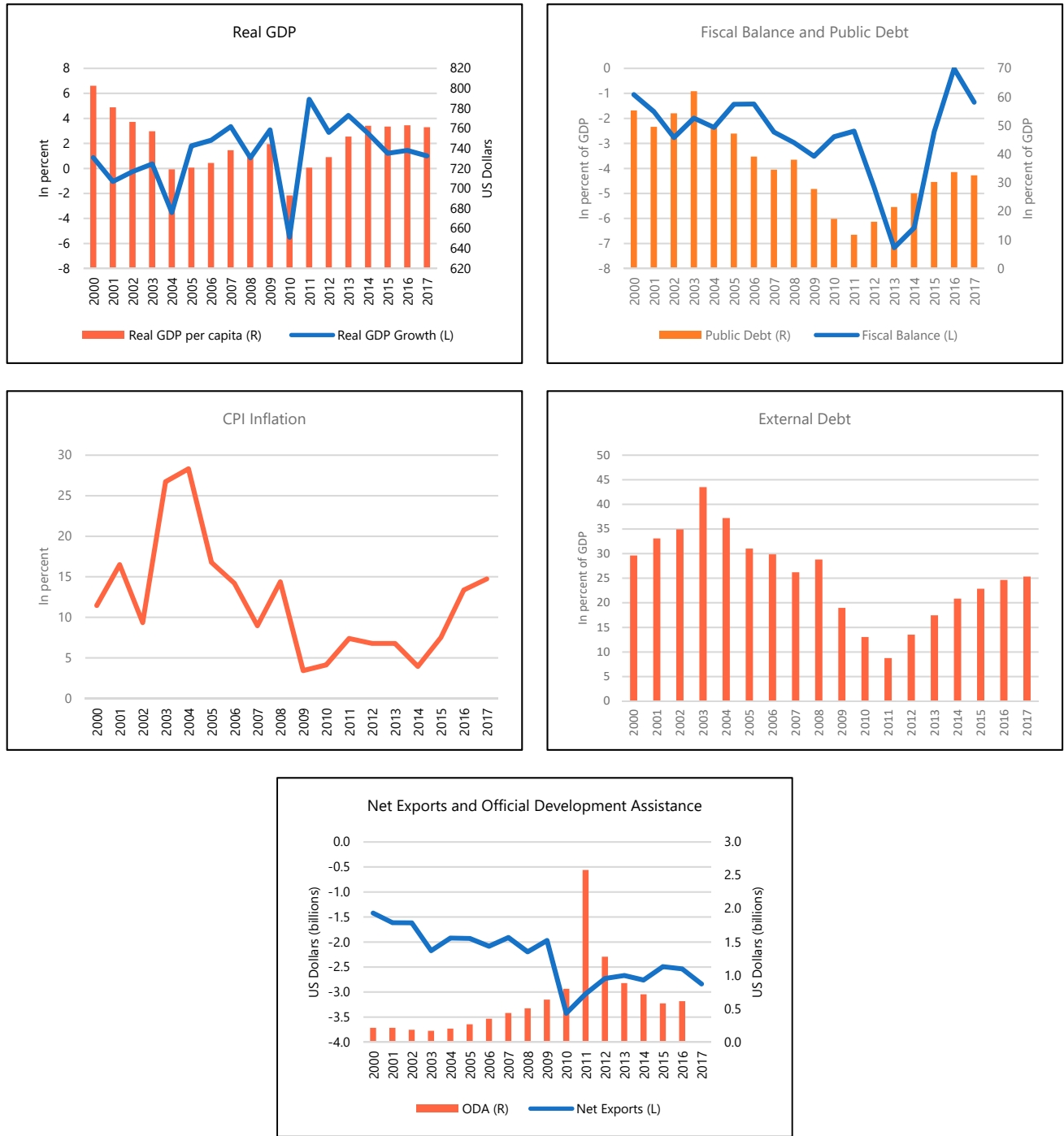
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<sup>5</sup> Haiti's growth during the first two PRGF/ECF arrangements consistently fell well short of projections. Some observers pointed out that given the major weaknesses in Haiti's statistical base not too much emphasis should be placed on real sector and national accounts data.



though improvements had been made in recent years, the IMF should devote more attention to the social impact of sensitive policy measures.

**Figure 4.2. Haiti: Key Macroeconomic Indicators, 2000–17**



Sources: October 2017 WEO database; OECD DAC statistics.

16. Interviewees also stressed the need for realism as to the feasibility of planned measures, including their technical, institutional, and resource aspects. There were no “quick fixes” or “low hanging fruit” and difficult reform measures often took longer than anticipated to implement. Several former officials remarked that too often in the past—in order to conclude negotiations successfully—commitments had been given that lacked the necessary supporting elements, and that such commitments undermined credibility, including that of the IMF. It is difficult to assess systematically this concern since staff reports typically did not outline *ex ante* the key ingredients of success nor discuss *ex post* the reasons for slippages (e.g., the absence of decisions by the executive or the legislature or insufficient human or technical resources, including from partners).

17. Several interlocutors raised the issue of whether the IMF should have been more involved in Haiti’s spending decisions. They recognized the limitations of the IMF’s traditional mandate and spheres of expertise, and current officials were reluctant to see any expansion in programs’ structural conditionality. However, some stakeholders including Haitian former officials and donor representatives believed that there was greater scope for the IMF, in conjunction with others, to engage more forcefully on some issues, especially given the IMF’s considerable influence and leverage.

### **C. The IMF’s Financial Facilities**

18. While recognizing the IMF’s mainly catalytic role, officials felt that given the large needs, access by Haiti to IMF financing should have been somewhat greater. They complained that the combination of a small quota and constrained access limits meant that the resources the country received under the recent Rapid Credit Facility (RCF) had been very modest (Figure 4.1).

19. Although the authorities viewed the RCF very positively, its use (limited to twice within a period not extending beyond a twelve-month period) was overly constrained. Use of the RCF was intended to help pave the way for a subsequent arrangement under the ECF. However, a range of stakeholders (including some officials, IMF staff members, and donor representatives) thought that the standard of upper-credit-tranche conditionality required for an ECF-supported program was challenging for a fragile country such as Haiti to meet.

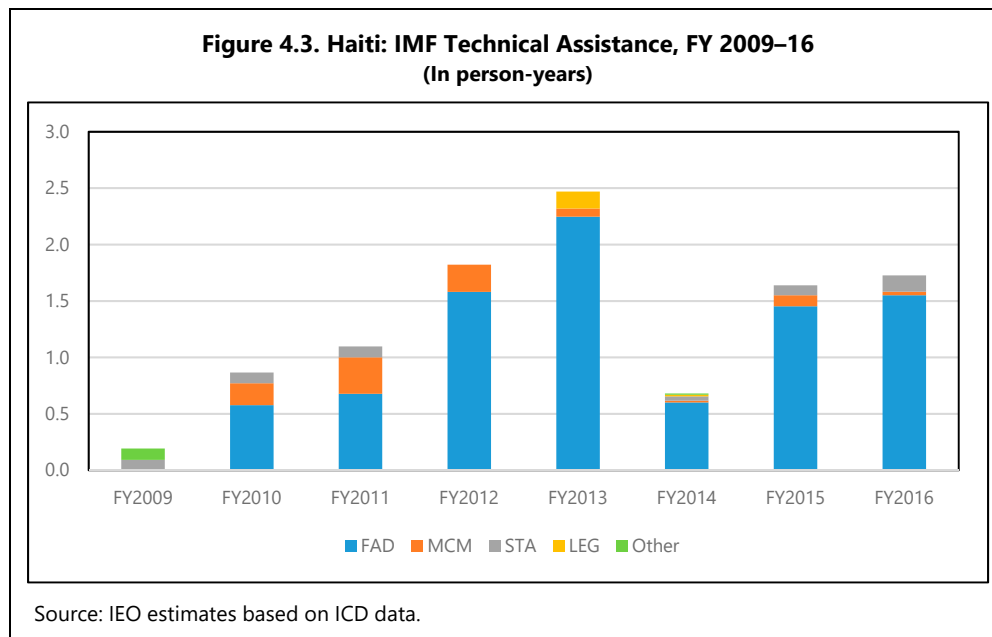
20. The use of a Staff-Monitored Program to help bridge the transition from an RCF-supported program elicited mixed reactions. While recognizing that an SMP helped “test” the capacity to implement a more ambitious ECF-supported program, partners expressed concerns that such a program would not provide adequate assurances for donors, nor give the authorities sufficient incentives to take strong measures quickly enough, given the often-short political time horizons and uncertainty about the timing of a possible subsequent ECF-supported program.

21. From this perspective, some interlocutors thought that in the case of a particularly fragile state such as Haiti, it was worth exploring alternative approaches such as a more flexible timing for use of the RCF, or allowing less demanding conditionality under the ECF. Access under the ECF could be such as to reduce the potential financial risk to the IMF. The aim would be to try to

maintain a continuum of (suitable graduated) financing that, together with donor support, would maximize the incentive for well-paced, steady reform and help avoid “stop-go” situations.

#### D. Capacity Development Work

22. Over the decades, to help address Haiti’s deep-rooted institutional weaknesses, the IMF, often in partnership with other development partners, has provided considerable assistance, encompassing TA missions, the placement of resident advisers, and both “on the ground” and external training. For the period FY 2009–16, the IMF on average provided roughly 1.3 person-years of technical assistance, of which the majority was in the area of public finances (Figure 4.3).



23. Officials valued these capacity-building activities highly, considering them an essential feature of the IMF’s engagement. They welcomed the IMF’s recent tendency to emphasize more intensive, on-the-ground practical help in implementation rather than the compilation of comprehensive reports. Although staff reports at times referred to ongoing TA activities, the absence of published impact analysis renders it difficult to assess systematically what areas of TA proved most effective and to what extent cancellation or reallocation of TA resources had occurred or was considered.

24. While acknowledging the Fund’s budgetary constraints and problems in recruiting suitable experts to work under difficult conditions, both staff members and country officials urged the IMF to accord high priority to the placement of resident advisers (an adviser was placed earlier in the Treasury Directorate and later in the Ministry of Finance). They felt that relying on sequential short-term visits by staff from headquarters or the Caribbean Regional

Technical Assistance Center (CARTAC) was unlikely to match the extent of the challenges.<sup>6</sup> They further noted the need to strengthen Haitian officials' macroeconomic programming skills, to allow them to come to the negotiating table with their own well-thought-through projections and plans, thereby increasing Haiti's sense of program "ownership."

25. Stakeholders who had been directly involved in capacity building stressed the need for an appropriate balance between the implementation role of external experts and the training of officials to undertake this work themselves. Although ideally both elements should proceed simultaneously and at a measured pace, where reforms were urgent external experts might need to be heavily involved in implementation, at least in the short run. The recruitment of trained Haitian officials by outside entities (including international agencies) had on occasion complicated matters.<sup>7</sup>

### **E. Collaboration with Partners**

26. Given Haiti's immense needs, the assessments and actions by the donor community have continued to be vital. Donors viewed positively the IMF staff's role in helping prepare and disseminate key macroeconomic data and projections. Overall coordination among donors was generally felt to have worked reasonably well in the areas of budget support and some aspects of public financial management. Some donors felt that the picture was less clear in other areas, given the different approaches used by donors in their particular spheres of interest and the absence of a sufficiently robust coordinating structure among the authorities themselves. As an example, it was noted that a large amount of uncoordinated TA had raised significant challenges in the revenue administration area and had proved to be counterproductive.

27. Donor representatives noted the helpful briefings that IMF missions had regularly provided at the end of their stay. However, some of them urged the Fund to consult more deeply to ascertain donor views and plans regarding structural measures before it commenced program negotiations. Such advance consultation would help avoid inconsistencies between the finalized Memorandum of Economic Policies and the authorities' ongoing understandings vis-à-vis other partners.

28. Officials who were interviewed voiced concern that the very sizeable aid flows associated with NGO activity typically bypassed the Haitian budget; they thought that the IMF should raise this issue in broader international fora. According to the IMF staff, about 10,000 NGOs were operating in Haiti in 2012, accounting for about two-thirds of all expenditure on economic and

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<sup>6</sup> In this connection, they mentioned the language barriers to the scale of CARTAC-based assistance because Haiti is the only French-speaking member.

<sup>7</sup> Suggestions to help address the problem of turnover included targeting a well-defined group of officials to benefit from training and focusing on "training the trainers." The possibility of special donor-financed arrangements to retain well-qualified local staff was also mentioned.

social development and 50 percent of all foreign exchange earnings.<sup>8</sup> Officials complained that this situation often involved a lack of coordination and caused direct competition with the government while complicating macroeconomic management and impeding the process of state building. At the time, staff noted that the authorities were exploring ways to address some of the NGO concerns.<sup>9</sup>

## F. Outreach

29. Stakeholders generally were of the view that, outside a relatively small circle of officials involved in economic and financial matters, the IMF's role in Haiti was far from well understood. Misunderstandings were widespread as regards the nature of the Fund's mandate, the rationale for its policy advice, and the extent of its ongoing assistance to help develop capacity.<sup>10</sup>

30. Most stakeholders felt that, provided that the authorities were supportive, the IMF staff should engage more in outreach to help "demystify" its own activities.<sup>11</sup> Suggestions included: (i) the holding of regular press conferences at the conclusion of missions (i.e., not only during Article IV consultation missions but also whenever a program was agreed upon); (ii) structured contacts with parliamentary institutions or political groupings; and (iii) regular interaction with the media (as already undertaken by some donors).

31. Increased outreach by the IMF would require care and due regard to possible sensitivities of the authorities. Some observers emphasized that it should not substitute for the authorities themselves outlining their plans; ideally, perhaps, the authorities might wish to participate jointly with IMF staff in some activities. However, it was felt that over time increased outreach could help dispel misconceptions about the IMF and increase ownership by domestic stakeholders, including the executive and legislative branches and civil society.

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<sup>8</sup> However, fewer than 5 percent of the NGOs in Haiti were registered or provided reports on their activities.

<sup>9</sup> Defenders of the *modus operandi* of the NGOs have argued that the imperative of meeting major pressing concerns (as former U.S. President Clinton put it in the Haitian context, "to get stuff done") does not allow the luxury of waiting until effective public institutions are in place.

<sup>10</sup> Other areas mentioned included the IMF's relationship with donors and basic institutional elements such as the relative roles of the resident representative, visiting missions, and the Executive Board.

<sup>11</sup> The staff's ex post assessment for Haiti also recommended greater outreach by the IMF (IMF, 2014).

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## CHAPTER 5—IRAQ<sup>1</sup>

### SUMMARY

Following the 2003 U.S. invasion, the IMF intensified its long-dormant relationship with Iraq. Although it has not provided Iraq with large amounts of financing, the Fund has since engaged with the country through a series of financial arrangements to promote macroeconomic stability and growth-enhancing structural reforms, as well as through technical assistance to build capacity and key institutions. Over the years, the IMF has provided internal discipline to government agencies and facilitated coordination among donors, despite the country's limited institutional capacity and human capital to digest its advice and analysis.

Iraqi officials who were interviewed for this evaluation expressed appreciation for the IMF's engagement and expertise. Nevertheless, they expressed a desire for more policy-focused advice that was applicable to the situation on the ground and for greater understanding of Iraq's political fragility. While valued by authorities, IMF technical assistance has recently been significantly hampered by the staff's inability to travel to Iraq, which has diminished its ability to learn about local conditions and limited its influence and impact. Iraq is a unique case of a fragile state bestowed with large oil wealth. The IMF is expected to continue its engagement with Iraq for the medium term in policy advice and capacity building.

### I. BACKGROUND<sup>2</sup>

#### A. Brief History

1. Located in the Middle East, Iraq has a rich history of ancient civilizations. Today it has a relatively young population of nearly 40 million. Iraq is multi-ethnic and multi-lingual and has a great deal of religious diversity. Social harmony has been strained by years of autocratic rule, forced Arabization of minorities, external wars, civil war, and the rise of domestic terror groups.
2. Much of the population is Arab (75 percent) located primarily in the center and south of the country. Arab Shiite Muslims (60 percent of the total population) live predominantly in the south (Basra). Shiites are a smaller sect of Islam, comprising approximately 10 percent of the global Muslim community, who exhibit a spiritual affinity with Iran. Iraq also has a sizeable Arab Sunni Muslim minority (20 percent) that lives mainly in the center of the country (Anbar, Fallujah, and Mosul) and was once a favored community under the Baathist control of Saddam Hussein. Kurds account for 17 percent of the Iraqi population. Forming a separate linguistic community with deep cross-border affinities with Kurdish communities in Turkey, Iran, and Syria, they live mainly in the north of the country and are primarily of a Sunni Muslim background though

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<sup>1</sup> Contributor: Bessma Momani.

<sup>2</sup> Sources: Horowitz (2000); Wimmer (2003); Brancati (2004); Simon (2004); Dodge (2005); and Dobbins and others (2009).

generally less conservative than their Arab Sunni counterparts. Kurds have a long-standing separatist tendency in Iraq and other Middle East states, particularly in Turkey where most Kurds live. In addition to these three main groups, there are many small ethnic and religious groups, such as Assyrians, Arab Christians, Chaldeans, Turkmen, and Yazidis, who live primarily throughout the northern Iraqi province of Nineveh.

3. Constructing the Iraqi state in 1932, the British manufactured a political myth designed to ensure internal coherence among a decentralized and fractured people. Iraqi nationalists, allied to elite networks of political officials, the military, urban notables, and industrialists, played an important role in defining and perpetuating the narrative of the Iraqi state as an Arab nation that would protect its citizens from the undue influence and intervention of foreign powers. This Iraqi brand of Arab nationalism was championed by the short-lived installation of King Faysal through to the authoritarian rule of Saddam Hussein and his Baathist Party.

4. In March 2003, the United States invaded and occupied Iraq. At the time, the U.S. administration blamed Saddam Hussein for assisting in the 9/11 terrorist attacks and for having weapons of mass destruction, although both of these charges have proven false. The provisional authority that the U.S. installed proved unable to cope with the multiple simultaneous demands that it faced, including the pro-Baathist insurgency, and the situation eventually spiraled out of control. Without either a broad civil society movement or ideological cohesiveness that could aggregate the Iraqi peoples' interests, it was not surprising that the people divided along ethno-sectarian lines. The spread of radical elements within Iraq and throughout the region were evidenced by the rise of Al-Qaeda of Iraq and the Islamic State of Iraq and Syria (ISIS). Continuing violence and social disorder produced an exodus of Iraq's professional and educated class. The loss of this middle class has further hampered Iraq's political development, in addition to challenging its socioeconomic development.

5. The governments headed by Prime Minister Nouri al-Maliki (2006–14) of the Islamic Dawa Party did little to bring the country together and to address Iraq's tumultuous relationships with its neighbors. Some efforts to bring Sunni groups into the political process were relatively successful in 2007. The use of Sunni national-guard-like troops to stamp out insurgents in their own communities helped the Iraqi government reassert control over many Sunni towns and villages. In 2010, as U.S. and foreign troops left Iraq and as power coalesced around a more inclusive Iraqi Parliament, Iraq had a reprieve from insurgent attacks. But this reprieve was short-lived. The alienation of Sunni communities resurfaced by 2013, and al-Qaeda strengthened its foothold in Iraq by claiming to speak for disaffected Sunnis. Iraq suffered from a full-blown insurgency that metastasized into the ISIS terrorist organization laying claim to 40 percent of Iraqi territory in mostly Sunni cities and towns at its height in 2015.

6. After a broad international coalition to fight ISIS was formed, both Iraqi federal troops and Kurdish militias fought to liberate towns and cities from ISIS while the international coalition assisted with aerial support, tactical expertise, and training of ground forces. By late 2017, nearly all of Iraqi territory had been liberated. Infrastructure damage and destruction was high and



thousands became internally displaced refugees. People living under ISIS rule suffered social and psychological damage, adding healthcare burdens on the Iraqi state. Moreover, while ISIS imposed radical teachings on students, years of education were lost in many subjects, similarly adding to the fiscal pressures on the state.

## **B. Sources of Fragility**

7. Iraq's fragility has been compounded by multiple wars under Saddam Hussein, chronic debt incurred to service war efforts, brain drain of human capital, and political infighting. The U.S. invasion and occupation of Iraq in 2003 contributed not only to the breakdown of social order, but also to the loss of Iraq's manufactured state identity.

8. The process of organizing people into ethnic political parties, it has been shown, can often lead to a radicalization of interests, further cementing perceptions of "otherness" and the permeation of ethnic considerations into all aspects of governance, from education policies to tax policies. When ethnic divisions are further fomented by social disorder, there is an added risk of a breakdown in "civility" that can lead to violence, the dehumanization of outgroups, and the escape of people into familiar ethnic neighborhoods. The rise of Baghdad's walled-in city, including the Green Zone, and the ethnic cleansing within these Bantustan-like communities reflect this radicalization of ethnic identity in its ugliest form.

9. The U.S. had hoped that through the power-sharing mechanisms of federalist arrangements and strong regional governments the Iraqi state could meet the needs of ethnic groups without reverting to ethnic politics. The rush to implant democracy in Iraq by the Bush administration proved premature, as time did not permit the rise of broad-based, non-ethnic based political parties. Moreover, the international and U.S. domestic pressure to bring about a quick transfer of power to Iraqis and to restore Iraqi sovereignty further cemented ethno-political dynamics into Iraq's newly democratic institutions.

10. De-Baathification policies in 2003 contributed to the hollowing out of the Iraqi state's administrative capacity and removed key technocrats who could have helped rebuild state capacity. After 2003, sectarianism, corruption, civil war, and the rise of terrorist organizations such as Al-Qaeda Iraq and its successor ISIS all contributed to the deteriorating socio-political and socioeconomic situation. Iraqi people's trust in government is low, as is transparency, and sectarian identities are high. The Iraqi state finds it difficult to provide security and justice to its people, further compounding already weak state-society relations.

11. After a decade of political turmoil, institutional weakness continues to plague contemporary Iraq. The sheer lack of Iraqi capacity and poor accounting systems were apparent to the IMF staff at the onset of the Fund's engagement with Iraq in 2003. This weakness continued to complicate IMF work, which is highly dependent on accurate economic data and a country's keeping of sound financial records. The situation eventually improved somewhat, but

the lack of transparency, poor governance, and inadequate accountability of finances grew to be another problem that the IMF staff had to contend with.

12. Iraq is an oil-rich country and is considered middle-income, but oil dependence contributes to its fragility. Iraq has the fifth-largest proven oil reserves in the world. Oil is the state's primary export (99 percent), the almost-sole source of government revenue (90 percent), and the most important source of economic wealth (58 percent of GDP). Iraq is a classic rentier state that is highly dependent on oil wealth with low productivity in other sectors leading to high unemployment, an undiversified economy, a bloated public sector rampant with patronage and nepotism, state-owned enterprises crowding out private enterprises, and few linkages into other economic forms of production.

13. Oil resources are located in ethnic enclaves or in disputed territory, adding another layer of complexity in Iraq's already sectarian society. The Iraqi central government has legal authority over all oil revenues but the distribution of oil wealth has been inefficient, compounded by weak governance. Iraq generally has poor public investment management of its oil wealth with few long-term plans to diversify the economy away from this resource. The drop in international oil prices since 2014 has further complicated Iraqi economic decision making.

## **II. THE IMF'S RELATIONSHIP WITH IRAQ**

14. As early as January 2003, before the U.S. invasion in March, the U.S. Executive Director's office requested meetings to be held between IMF staff and U.S. Treasury Department officials, to ask about staff views on when to replace the Iraqi currency, whether to pay Iraqi civil servants in U.S. dollars, and how long it would take to reissue new bank notes, among other matters. The IMF staff noted that it had little information on Iraq and, even though Iraq had been a member of the IMF since the Bretton Woods Conference, IMF engagement with Iraq had been dormant, without Article IV consultations or technical assistance, since the Iraq-Iran war began in the early 1980s. Nevertheless, IMF staff noted that a currency reform could take six months and that political stability was key to economic success.

15. Iraq's uncertain legal status immediately after the 2003 invasion, as a state under an occupying power, put the IMF in a difficult position. The staff tried to take a pragmatic approach to Iraq; while technical assistance could be offered despite Iraq's murky status, lending arrangements were not legally possible until a new government was internationally recognized. The IMF wanted to help Iraq improve its economic affairs, while taking care not to get entangled in international politics. Area department staff and the Legal Department (LEG) were the most cautious, wanting to see the establishment of a permanent Iraqi government and therefore hesitant about engaging in a program, while management was at times more willing to reengage with Iraq despite the country's uncertain international legal status.

16. The International Monetary and Financial Committee (IMFC) encouraged the IMF to reengage with Iraq at the IMF spring meetings in April 2003. The IMF accepted an Iraqi

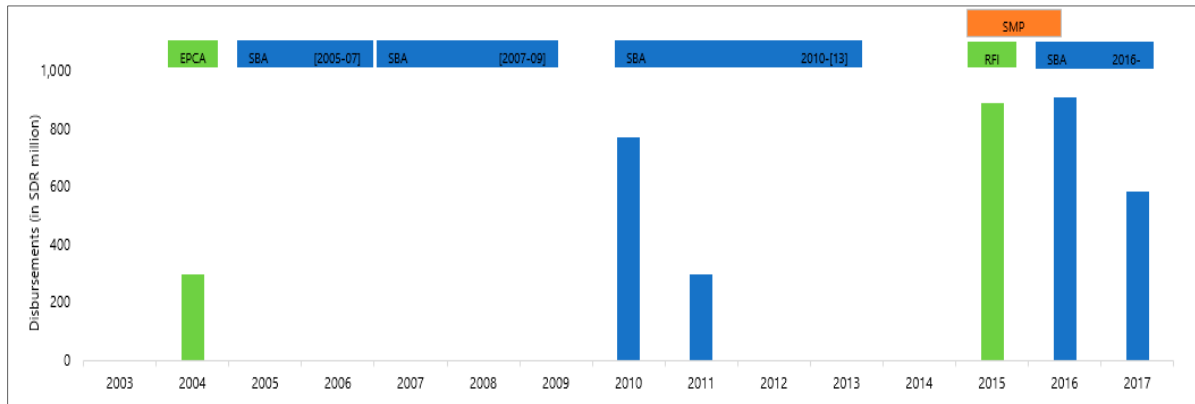
25-person council to attend the meetings as “special invitees,” although this council did not represent a sovereign state. In the early stage of IMF involvement in Iraq, there was some staff concern that IMF involvement was either premature or served a political agenda that they did not want to partake in. One significant and early example of IMF staff hesitation came in July 2003 when the staff was involved in conversations about the Iraqi procurement decisions taking place at the U.S.-operated Program Review Board while at the same time playing an advisory role in preparing Iraq’s budget.

17. Despite pressures from the U.S. administration, the IMF staff avoided entering any financing arrangements with Iraq until the interim government received international legal recognition. LEG noted, in July 2003, that according to UN Security Council Resolution 2483, the Coalition Provisional Authority was an “occupying power” and not the internationally-recognized government of Iraq and, therefore, could not exercise the rights of membership with respect to use of Fund resources. At the time, the U.S. administration wanted the IMF to approve a disbursement of 100 percent of Iraq’s quota and a Stand-by Arrangement (SBA). The IMF suggested that no more than 25 percent of quota was normally available under Emergency Post-Conflict Assistance (EPCA) and that having an internationally recognized government remained a mandatory precondition for access to Fund resources.

18. In June 2004, UNSC Resolution 1546 determined Iraq to be a sovereign state. The IMF provided financing under EPCA in September 2004. However, the security situation deteriorated rapidly. Pro-Baathist insurgents targeted symbols of the new state, from police stations to army posts. This developed into a full-blown insurgency against the new government with thousands of innocent civilians killed in the crossfire.

19. Since its re-engagement, the IMF and Iraq have signed five financial arrangements (Figure 5.1). Both the 2005 and 2007 arrangements were precautionary but Iraq needed them in order to receive debt relief at the Paris Club. The 2004 EPCA drawing was used to unlock a first tranche of debt reduction at the Paris Club, despite concerns that this would set an undesirable precedent, because usually a Stand-by Arrangement is required as a precondition for debt relief. The 2010 SBA collapsed after oil prices dramatically increased and provided Iraq with a revenue windfall, reducing its need for external funding. Iraq returned to the IMF in 2015 after it experienced shocks due to the decline in oil prices and the rising domestic costs of its war effort against ISIS. An arrangement under the Rapid Financing Instrument (RFI) was approved in July 2015, followed by an SBA in 2017.

20. Iraq’s economic performance since 2003 has been decidedly mixed. The country experienced robust economic growth after the fall of Saddam Hussein, bolstered by the lifting of economic sanctions and rising oil prices, but economic growth has remained dependent on the fortunes of the oil sector (Figure 5.2). CPI inflation stabilized after the mid-2000s, but recurring fiscal deficits contributed to rising public debt levels even though external debt relief reduced the debt burden.

**Figure 5.1. Iraq: Timeline of IMF Engagement, 2003–17**

Notes: EPCA=Emergency Post-Conflict Assistance; RFI=Rapid Financing Instrument; SBA=Stand-by Arrangement; SMP=Staff-Monitored Program; years in brackets reflect original duration at approval, in case(s) where program went off track.

Sources: SPR, List of Fund Arrangements since 1952; LIC Arrangements and Instruments Approved on, or after, November 1998 (as of October 31, 2017). IMF Members' Financial Data by Country, Transactions with the Fund.

### III. MAIN ISSUES

#### A. The IMF's Role and Objectives

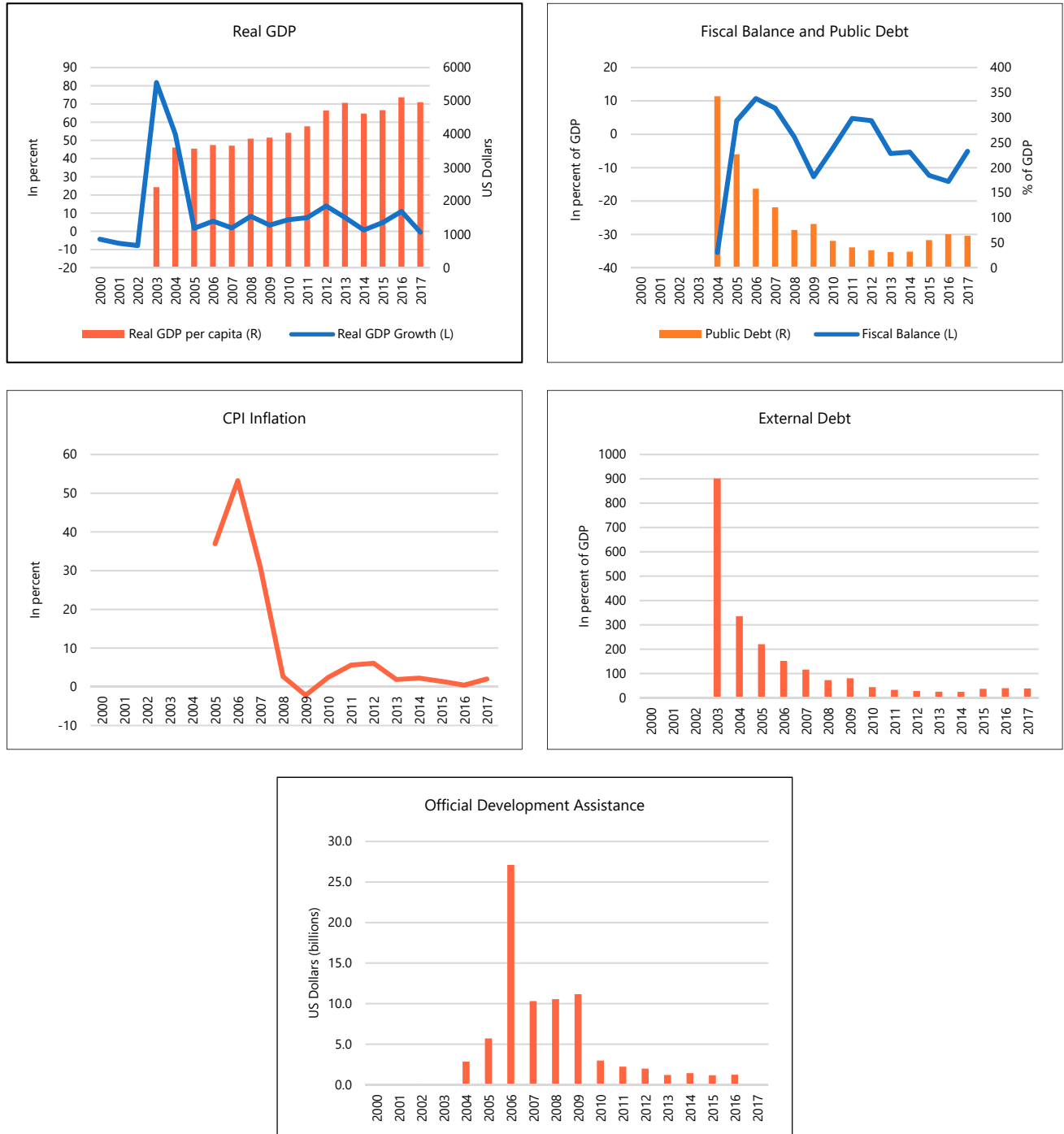
21. Unlike many fragile states, Iraq had a relatively strong balance of payments position in the early years of its IMF engagement and again after the oil boom of 2008. Most IMF arrangements with Iraq were therefore precautionary, aimed at catalyzing bilateral support and at unlocking debt relief. Some staff members observed that since the IMF was typically not providing large amounts of financing, it had limited carrots and sticks to motivate needed reforms by the Iraqi government. They argued that the IMF should have done more to leverage its catalytic role as Iraq sought to raise additional financing from other sources as well as to obtain debt relief.

22. A related issue was the flexibility in applying program conditionality. According to the IMF staff, Iraqi officials often sought to justify slippages in meeting program conditions by arguing that the country's fragility required larger fiscal outlays on social payments or war efforts (like the current fight against ISIS and al-Qaeda before it). The IMF staff acknowledged that fragile states have more difficulty than other states in meeting budget targets, but believed that at times Iraqi officials used the fragility argument as an excuse for lack of commitment. For their part, some officials noted that the IMF could have permitted more flexibility in program design to respond to very difficult local conditions.

23. The IMF also played an important role at the initial stages in rebuilding critical institutions such as the Central Bank to stabilize the economy. However, staff members who were interviewed reiterated that Iraq's hollowed-out institutions and weak administrative capacity had continued to hamper the effectiveness of IMF-supported programs and that not enough early

attention was paid to building Iraq’s institutional capacity. Several staff members who had worked on Iraq in more recent years noted that the tools and training to support institution and capacity building remained far short of what was needed.

**Figure 5.2. Iraq: Key Macroeconomic Indicators, 2000–17**



Sources: October 2017 WEO database; OECD DAC statistics.

24. Iraqi officials believed that the IMF's role as a coordinator of donors and a catalyst for increased investment was far more valuable than its financing role. In interviews with the IEO, they emphasized that the IMF had played a key part in unlocking official bilateral donor financing, particularly in the early years of its engagement. Iraqi officials noted that IMF involvement in Iraq carried a lot of weight with official creditors, providing "discipline" among the stakeholders. They thought that the IMF's role had been particularly relevant in the preparation of a Debt Sustainability Analysis (DSA) for the 2004–05 Paris Club meetings, and crucial in the technical and laborious work of collecting information on Iraq's debt profile. When Iraq attracted renewed external interest during the fight against ISIS and al-Qaeda, the IMF again played an important coordinating role. Creditors and donors targeted their technical assistance in line with the goals of IMF-supported programs.

25. Interviews show that the IMF was valued as an *internal* coordinator of statistics and data harmonization by both Iraqi officials and the donor community. For example, in Iraq it has consistently been difficult to obtain accurate information about government spending levels; as in other fragile states, discussions among government agencies can be political battles and often the IMF performs a brokering role to get agencies to speak to each other and coordinate information. Both Iraqi officials and IMF staff members observed that the IMF was highly valued in this capacity. An IMF arrangement motivated the government to collect and share data across agencies. Officials noted the benefits of having the IMF, a respected outsider, play the role of intermediary. Staff members believed that this helped to promote long-term transparency and improved Iraqi governance.

## **B. Creditor Coordination**

26. The IMF played a crucial role in coordinating Iraq's official external creditors to provide debt relief. Following decades of Iraqi isolation, IMF staff had little knowledge of Iraq at the time of the invasion, but U.S. officials were persistent in pressing the IMF to provide technical advice on debt issues. The U.S. administration felt that the international community needed to share the burden of Iraqi reconstruction after 2003, and it therefore pressed IMF management to move quickly to provide a debt sustainability assessment that would show Iraq needed relief from its international creditors. At the time, the U.S. believed that to stabilize Iraq would take less than a year and felt that some urgency was needed in resolving the country's debt. Moreover, having an IMF financing arrangement in place was a precondition for the release of debt relief by the Paris Club.

27. The IMF's debt sustainability assessment became contentious and highly politicized. The issue was whether Iraq's debt was "odious" and therefore could be written down under international law. Wanting Iraq to have a clean start, U.S. administration officials called for a finding that the Iraqi debt was odious. This view met sharp opposition from other Iraqi creditors, primarily Russia, France, Arab Gulf countries, and private creditors, who believed that the U.S. was attempting to slash Iraq's debt burden at their expense.

28. The DSA exercise was complicated by sharp increases in oil prices after 2004. The IMF staff used more modest oil price projections based on the 2004 *World Economic Outlook (WEO)* to argue that Iraq needed significant debt relief. The staff took care to prepare realistic projections of the recovery of oil production in Iraq, including having meetings with Iraqi and Coalition Provisional Authority officials on oil production prospects and on the investment required to achieve the recovery. The Iraqi government, with U.S. technical and political support, challenged the assessment while other Paris Club creditors wanted revenue projections that were more optimistic. The DSAs kept being revised, as oil prices started rising above the future market prices used in the *WEO*.

29. In designing and negotiating an IMF financing arrangement at this time, the IMF area departments tended to sympathize with the Iraqi authorities' desire for flexibility on the terms of the program, while other IMF departments were more skeptical. LEG pointed out that Fund policy required assurances of debt relief (although not necessarily a final Paris Club minute) before the Fund could offer financial support. Moreover, as Iraq continued to show an improved balance of payments, there was staff skepticism about whether Iraq needed IMF financial support at all.

30. Considering the IMF's more recent collaboration with Iraq's other external partners, the Iraqi authorities found the IMF's role to have been most valuable. For example, they saw the Fund as having played a constructive role when in mid-2016, Canada, Germany, Japan, Kuwait, The Netherlands, and the United States, all pledged to assist Iraq with more than \$2 billion in humanitarian assistance and to assist in stabilization of areas liberated from ISIS. As one official noted, "only the IMF has the prestige and authority to coordinate donors."

### **C. Policy Advice and Program Design**

31. The fact that an IMF arrangement was not needed for financing purposes, but needed for Paris Club rescheduling, was seen by IMF staff as often putting the IMF at a disadvantage in negotiations. IMF arrangements were seen as valuable keys to unlocking more valuable debt relief, which often placed pressure on IMF staff to provide waivers and to accept lower levels of country ownership.

32. The lack of adequate data has been a major challenge for the IMF throughout its engagement with Iraq. The situation improved over the years but remained fraught with inconsistencies. Even after many years of IMF engagement with Iraq, the staff was concerned that there remained serious gaps in economic data, including balance of payments, fiscal, real sector, inflation, and currency data. In addition, overall inefficiencies and transparency concerns persisted with respect to central banking and payments systems, budget execution, social safety net disbursements, and management of public enterprises.

33. Some IMF staff members raised concerns about Iraq's weak institutional capacity to implement, monitor, or even prepare data for the analysis required for an SBA, and wanted greater reliance on prior actions to provide greater assurances of program performance. Other

staff members wanted the SBA to be treated as precautionary, to ensure safeguarding of Fund resources. However, as LEG pointed out, there was no legal basis to prevent the Iraqis from drawing on precautionary arrangements.

34. Considering the decade and a half of IMF engagement, staff members who were interviewed believed that they had made a major contribution in assisting the central bank to build its policy-making and implementation capacity, and that important progress was made in containing inflation, currency stabilization, building central bank independence, improving legislation, enhancing international reserves, and in the overall design of monetary policy.

35. Staff members felt that they had been less successful on budgetary and fiscal issues. They were highly concerned that Iraqi spending had continued to increase despite the government's commitments to fiscal consolidation under repeated arrangements. Some of the funds being spent appeared to come from the international community, weakening IMF leverage. Actions to remove costly oil subsidies and lower the public wage bill, for example, were repeatedly delayed. Some staff members suggested that at the Ministry of Finance, which was more susceptible to political change and capture, there was less room for success than at the Central Bank. A number of staff members expressed the opinion that the authorities knew that the IMF would not be so strict on structural conditionality as long as monetary and fiscal targets were met. However, in recent years, cash management procedures were improved as the result of IMF engagement.

36. Political factors, like elections or the need to keep the support of vested interests, were often taken into account in designing fiscal targets or the pace of disbursements under IMF-supported programs. Similar reasons were given for providing repeated waivers. Many Executive Board members, with significant U.S. support and appeals to management, also were prepared to take these political factors into consideration when Iraq requested that programs continue despite the lack of security and domestic political instability.

37. Iraqi officials who were interviewed observed that the high level of international interest in Iraq meant that the IMF staff generally had a relatively good understanding of the country's regional political and security challenges, although it also put the IMF's work under close scrutiny. At times, they said, the Fund took a suitably pragmatic approach to policy advice and program design, but its conditionality could also be unrealistic on occasions, failing to take due account of difficult political circumstances. According to officials, the area department was more sympathetic to Iraq's situation than were the functional departments, which tended to be more rigid and to take an abstract view of what was achievable in Iraq with less understanding of local political context. Officials also suggested that staff turnover was high and that new staff members often had to be "re-taught" about the local political context that the authorities faced.

38. A number of IMF staff members who had worked on Iraq believed that a greater emphasis on state building should have been included in program design and IMF support for Iraq. The IMF had focused on strengthening the central bank, advising on public expenditures and the tax system, and strengthening statistical agencies, and much of this assistance was quite

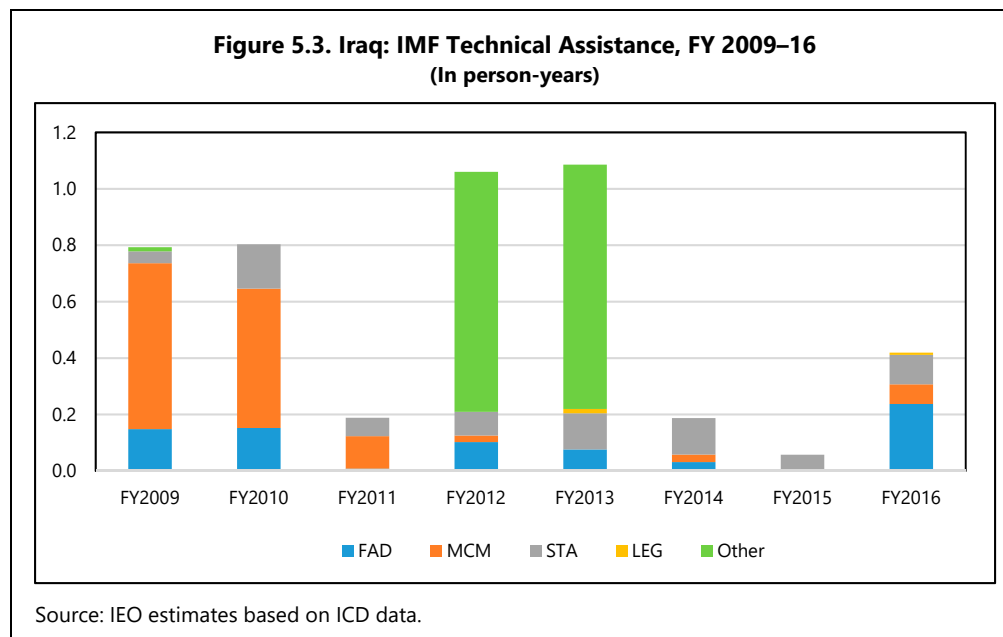


effective, in the view of staff and officials. But the staff members stressed that they lacked the expertise or mandate needed to advise on building Iraqi institutions that could ensure the governance essential for a well-functioning economy. These institutions included property rights, the rule of law, transparency, a robust security sector, labor market laws, investment regimes, and government effectiveness.

#### D. Capacity Development

39. The IMF provided technical assistance to Iraq from the outset of its engagement, even though the amount (hardly ever exceeding one person-year annually) (Figure 5.3) was modest relative to the needs and to the TA Iraq received from other sources.

40. Some staff interviewees noted that the technical assistance to Iraq was at times pitched too high in its technical sophistication and should have been more practical. Iraqi officials, too, believed that the training had been too technical and not sufficiently policy-focused. Iraqi authorities had often found that technical assistance was not adequately tailored to their unique needs. They mentioned that they had often had questions about the legal reforms needed to comply with international best practice, for which the IMF did not have helpful advice. They also found the training courses to have been too short in duration. IMF staff noted that technical assistance to the Iraqi Central Bank was seen as more effective than training to the Finance Ministry, perhaps owing to the political capture of the latter, as discussed above.



41. Security concerns hampered the effective delivery of technical assistance, particularly after the Fund introduced restrictions on travel to Iraq in 2014. Seminars and training were sometimes held in Amman, Beirut, or Dubai, but having them outside Iraq limited their duration and depth. Since the travel restrictions were introduced, bilateral donors have picked up some of

the in-country training and coordination needs, and the IMF has played a useful role in helping identify topics for the training seminars based on IMF program objectives. Nevertheless, Iraqi officials believed that because the staff of the World Bank, aid agencies, and the United Nations were able to come to Iraq (particularly within Baghdad's Green Zone or Irbil) to carry out their work, the IMF staff should have been readier to continue to provide technical assistance inside the country. In this context, resident technical advisors were seen as particularly valuable by Iraqi officials.

42. Iraqi officials noted that due to internal corruption and nepotism, those sent on regional courses had not always been the most appropriate professional choices. An Iraqi official suggested that the IMF could have done more to assess those nominated to take training courses outside the country to ensure the person attending was qualified. Iraqi officials also noted that there had been no follow-up on training seminars. They recommended that after the training sessions, the IMF visit Iraqi agencies or otherwise investigate how the lessons from training were applied.

#### **E. Staff and Country-Specific Knowledge**

43. Because Iraq was a high-profile case, particularly in the early years of IMF reengagement, it was not difficult to find staff willing to work on the country. But as the security situation worsened, it became more difficult to find staff members to work there, particularly as a resident representative.

44. IMF staff members who had worked on Iraq expressed that they would have benefited from a better understanding of Iraqi history, politics, culture, religion, and society. However, they noted that they were often pressed for time to finish their work and there were few incentives in promotion and career advancement to better understand the country's socio-political context. Moreover, in the early years of re-engagement, area department capacity to work in the Arabic language was weak, which hampered engagement at the working level.

45. Iraqi officials expressed their desire to have more Arabic-speaking IMF staff assigned to work on their country. They noted that when they were able to communicate with the IMF in their mother tongue, engagement was more fruitful. IMF staff members with Arabic language skills were also likely to have a better understanding of Iraqi culture, society, and domestic context—an understanding that Iraqi officials believed was of great value. Iraqi officials did not find the staff in Washington to have sufficient country-specific knowledge, although they found its technical skills to be excellent.

46. Staff interviewees recommended that their colleagues working on Iraq should obtain a solid understanding of the social and political dynamics in the country beyond the technical issues. While some degree of learning-by-doing often occurred, more institutional resources needed to be devoted to help the staff attain the necessary knowledge of Iraq's political context.

47. Staff members noted that they did not do outreach with parliamentarians, civil society, or academics, partly because they were not able to visit Iraq, but also because they felt there were few incentives or rewards for doing so.

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## CHAPTER 6—KOSOVO<sup>1</sup>

### SUMMARY

Kosovo, once an autonomous province of the Socialist Republic of Serbia within Yugoslavia, became a victim of rising conflict between Serbian and Kosovar nationalism in the context of Yugoslavia's disintegration. During the conflict that ensued from 1996 to 1999, thousands of its Albanian population were killed, and hundreds of thousands were displaced. At the war's end, Kosovo was left in shambles, devoid of institutions or capital and plagued by corruption and social tensions.

The IMF was quick to engage in Kosovo long before it unilaterally declared independence in 2008 or had its independence recognized by the International Court of Justice in 2010. Barred from providing assistance to a non-sovereign nation, the Fund made its contributions to the international reconstruction efforts in the form of technical assistance to the United Nations Mission. IMF TA helped establish preconditions for a functioning market economy, including by building the foundation of a central bank and other core macroeconomic institutions. Once Kosovo became an IMF member, the IMF began to provide financial assistance as well.

The IMF's early contributions to the building of core institutions in Kosovo are widely acknowledged to have been significant and effective. Faced with changing and complex circumstances, the IMF staff displayed a high degree of flexibility and adaptability in procedures and operations. Although Kosovo largely achieved macroeconomic stability, its program implementation was mixed in an environment of political impasse, capacity constraints, and governance problems. Kosovo's experience suggests the need to avoid overly ambitious objectives when capacity is severely limited and to collaborate with development partners to achieve progress. Given Kosovo's political uncertainty and acute lack of data, the IMF may have done too much micromanaging and been excessively conservative at times, thereby limiting the room for more growth-friendly policies.

### I. BACKGROUND

#### A. Brief History

1. The troubled history of Kosovo traces its origin to the centuries-long territorial competition between the Serbian and Albanian populations of the Western Balkans. In the early 20<sup>th</sup> century, Serbia took control of the territory, forced thousands of Albanians to flee, and favored the migration of Serb colonists. With a rising share of Albanians following the end of World War II, however, they constituted three-fourths of the population by 1981 and four-fifths by 1991.

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<sup>1</sup> Contributor: Miguel de Las Casas.

2. As part of Yugoslavia, Kosovo had enjoyed a high degree of self-government, but the situation changed in 1989 when Slobodan Milosevic was elected president and revoked Kosovo's autonomy amid growing Serbian nationalism. After passive non-violent resistance failed, Kosovar nationalists created the Kosovo Liberation Army (KLA) in 1996 to launch a guerrilla war against Yugoslavia (Serbia). In the conflict that ensued, thousands of Albanians were killed and hundreds of thousands displaced. NATO began aerial bombing of strategic locations in March 1999 and Serb forces responded with a campaign of ethnic cleansing against the Albanian population. In June 1999, a peace agreement called for the withdrawal of Serb forces and the deployment of 50,000 NATO peacekeeping troops. A UN Security Council resolution empowered the UN Mission in Kosovo (UNMIK) to govern the province of Kosovo and, in 2005, international talks began on the future of Kosovo. The proposal for "supervised independence" by the UN special envoy gained much support from the international community, but failed in the face of Serbian and Russian opposition.

3. Kosovo unilaterally declared independence in February 2008. Despite mixed international reaction, the first elections were held in November 2009 and in July 2010 the International Court of Justice issued an advisory opinion affirming the legality of Kosovo's declaration of independence. In the meantime, Kosovo's relationship with Serbia and the internal Serb minority remained tense, with occasional episodes of violence in 2011. In late 2012, Kosovo started negotiations with the European Union for a Stabilization and Association Agreement (SAA), a first step towards EU accession. In April 2013, Kosovo and Serbia signed the First Agreement of Principles Governing the Normalization of Relations, by which Kosovo's authority in the region was recognized and some autonomy was granted to the Serbs in the north. In August 2015, Serbia and Kosovo took further steps to normalize their relations and clear their respective paths towards EU membership. In October 2015 Kosovo's SAA was signed, and it entered into force in April 2016.

## **B. Sources of Fragility**

4. Ethnic and religious cleavages have hampered social harmony in Kosovo for centuries. While the overall security situation is now stable, the political landscape remains tense and divisive, and human rights abuses persist.<sup>2</sup> While UNMIK no longer administers the territory, it is mandated to promote security, stability, and respect for human rights in Kosovo and in the region, engaging with the governments in Pristina and Belgrade.<sup>3</sup> At the same time, NATO forces, though downsized, remain on the ground with a mandate to deter hostility and threats against Kosovo, ensure public safety and order, demilitarize the KLA, support humanitarian efforts, and coordinate with and support the international civil presence.

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<sup>2</sup> <https://www.un.org/press/en/2016/sc12365.doc.htm> and <https://www.hrw.org/world-report/2017/country-chapters/serbia/kosovo>.

<sup>3</sup> <http://www.un.org/en/peacekeeping/missions/unmik/background.shtml>.

5. Development challenges continue to encourage emigration of the population.<sup>4</sup> According to UNDP, Kosovo remains the poorest country in the region, with 30 percent of the population living in poverty and a low Human Development Index (0.739). The unemployment rate is over 30 percent, a figure that rises to just below 60 percent for women and those younger than 24. Corruption remains pervasive, with Transparency International (2016) placing Kosovo in 95<sup>th</sup> place out of 176 countries in its Corruption Perceptions Index. Institutional capacities are in many cases underdeveloped, as indicated by Kosovo's low Country Policy and Institutional Assessment score produced by the World Bank.

## II. THE IMF'S RELATIONSHIP WITH KOSOVO

### A. The Immediate Post-Conflict Phase

6. The IMF engaged with Kosovo even before the end of the conflict, helping with an assessment of the domestic and regional impact of the conflict. Later the IMF moved quickly to set up an office in Pristina within six months of the 1999 peace agreement, even though Kosovo was a non-sovereign state within the Federal Republic of Yugoslavia (later Serbia and Montenegro). Given the absence of a recognized local government, the IMF's work in Kosovo was formally considered as technical assistance provided to the reconstruction and economic policy arm (known as Pillar IV) of UNMIK. The IMF's early engagement was closely coordinated with the World Bank, the EU, and the USAID.

7. The IMF staff found that Kosovo's economy, already in bad shape before the war, was devastated. Human and productive capital was severely damaged, and what little information was available indicated that about 50 percent of the population lived below the poverty line. The IMF's primary role was to provide TA, with the aim of establishing the preconditions for the country's successful transition to a market-based economy. In particular, IMF TA during this period focused on setting up payment and tax systems, adopting the legal use of the deutsche mark, developing core macroeconomic institutions (including the foundations of the central bank), and rebuilding capacity and infrastructure. From the start, staff identified widespread organized crime, weak governance, ethnic tensions, and political uncertainties as the main challenges.

8. Despite these challenges, quick progress was made in economic recovery and rebuilding institutions; economic growth picked up and inflation stabilized (Figure 6.1). Over the next three years (2001–03), the IMF provided TA through the Fiscal Affairs Department, the Monetary and Capital Markets Department,<sup>5</sup> and the Statistics Department. Even so, at the end of 2004, IMF staff still believed that Kosovo remained vulnerable to a destructive spiral of political instability and economic underdevelopment. The economy remained heavily dependent on foreign

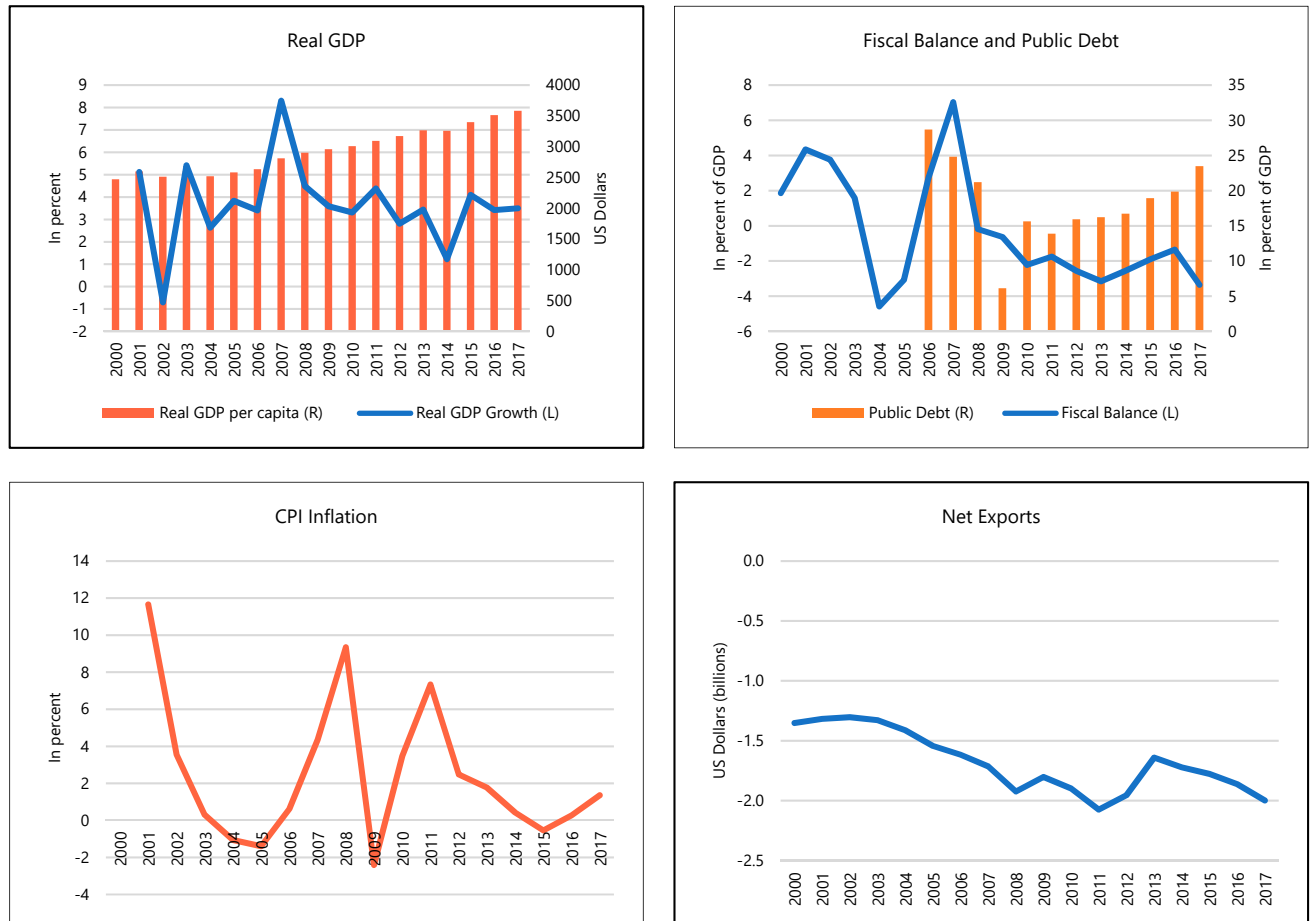
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<sup>4</sup> <http://www.dw.com/en/poverty-forces-a-mass-exodus-from-kosovo/av-18268811>.

<sup>5</sup> As well as its predecessor, the Monetary and Financial Systems Department (MFD).

assistance and remittances, and needed to generate sufficient growth to reduce unemployment and foster national reconciliation, though uncertainty remained regarding Kosovo's final political status.

**Figure 6.1 Kosovo: Key Macroeconomic Indicators, 2000–17**



Sources: October 2017 WEO database; OECD DAC statistics.

9. In 2005, the IMF staff judged the Kosovar economy to be entering a new phase in its transition to a market-based economy. In November, the authorities adopted a Memorandum of Economic and Financial Policies, which allowed the Fund to make regular assessments of economic developments in a policy framework that resembled a Staff-Monitored Program (SMP). The shadow program's focus was on improving competitiveness by investing in human and physical capital and by rationalizing costs. A year later, however, reforms were paralyzed by political stalemate.

10. The IMF staff attempted several times to reach agreement on another SMP-like arrangement but failed to agree with the authorities on fiscal issues (e.g. war veterans'

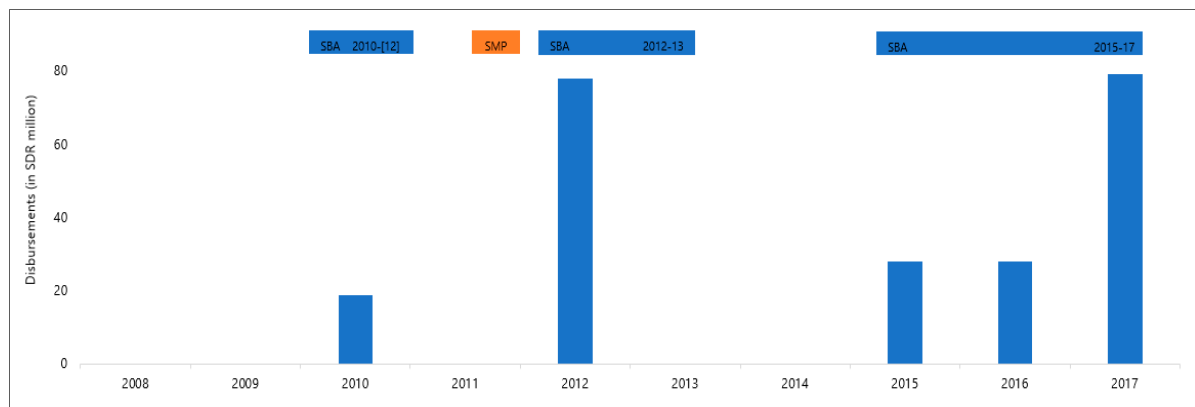


compensation) amid growing uncertainty over the final status of Kosovo. TA absorption and implementation was also affected. After Kosovo's unilateral declaration of independence in February 2008, policy implementation became more fragmented and any agreement even more elusive. As a consequence, the Fund staff began to prepare a series of aide-memoires (which were published by UNMIK) that, in the absence of a more formal arrangement, aimed at assuring the authorities and the donor community of the IMF's intention to remain engaged with the country.

## B. Membership and IMF Lending

11. Kosovo applied for IMF membership in July 2008, perceiving that gaining membership would give it access to IMF and World Bank resources and prompt the acknowledgement of its sovereignty by the international community (the IMF would become the first international organization to accept Kosovo's membership). The IMF's first formal membership mission to Kosovo took place in August 2008, though membership was formally granted only a year later. In the meantime, the IMF remained engaged through frequent surveillance missions, which aimed mainly at anchoring fiscal policy and promoting necessary reforms and supporting capacity building, and included preliminary discussions on a post-membership program to be supported under the General Resources Account (Figure 6.2).

**Figure 6.2. Kosovo: Timeline of IMF Engagement, 2008–17**



Notes: SBA=Stand-by Arrangement; SMP=Staff-Monitored Program; years in brackets reflect original duration at approval, in case(s) where program went off track.

Sources: SPR, List of Fund Arrangements since 1952; LIC Arrangements and Instruments Approved on, or after, November 1998 (as of October 31, 2017). IMF Members' Financial Data by Country, Transactions with the Fund.

12. On July 21, 2010, against the background of political pressure from the international community, especially the United States, the Executive Board approved the first Stand-By Arrangement with the Republic of Kosovo. The SBA-supported program's main objective was fiscal and financial sector stabilization. Structural reforms were also included but were predominantly the focus of parallel programs supported by the World Bank and the EU. At the time of IMF Board approval, the staff identified institutional weaknesses and political instability as

the main risks to program success. Subsequent events proved this right. President Sejdiu resigned, Prime Minister Thaci was accused of crimes against humanity, and the governor of the Central Bank of Kosovo was arrested and dismissed, leading the coalition government to collapse. With the government reversing the previous conservative fiscal policy to expand spending, the first program review was never completed.

13. Before attempting another SBA, staff and the authorities agreed on a six-month SMP in July 2011, supported by a coordinated surge in technical assistance.<sup>6</sup> The Kosovar authorities managed to complete the measures stipulated under the SMP, especially those related to fiscal policy and budget execution, and qualified themselves to receive additional support under an SBA that was approved in April 2012. Given that the country's balance of payments needs were modest, and in anticipation of implementation risks, the program was conservatively designed, with disbursements stretched out over its 20-month life. This second SBA-supported program included as its objectives: (i) restoring fiscal sustainability and anchoring fiscal policy; (ii) structural reforms in the fiscal, financial, and (with World Bank lead) competitiveness areas; and (iii) generating a strong catalytic effect.

14. A Financial System Stability Assessment (FSSA) under the Financial Sector Assessment Program (FSAP) was conducted in connection with the SBA-supported program. The FSSA report identified the areas in which substantial progress had been made and the priority areas for attention going forward. Performance under the SBA-supported program was generally good, despite the constant political tension created by "normalization" talks with Serbia, the alleged corruption during privatization, elections, and coalition government dynamics. All five program reviews were completed on schedule (the arrangement was treated as precautionary, and no drawing was made, after the third review in 2012). Despite achievements in economic growth, fiscal sustainability, and competitiveness, the staff continued to emphasize the fragility of the situation and the challenges ahead.

15. Although the authorities asked to begin negotiations on a successor program immediately after the completion of the 2012 SBA, political turmoil and fiscal excesses delayed the approval of a new SBA until the summer of 2015. This time, the staff focused on bringing underlying deficits down, reducing unproductive current spending, resolving bottlenecks in credit provision, and tackling corruption. The program carefully tried to strike a balance between preserving fiscal sustainability and creating space for structural reforms, while catalyzing additional support from bilateral and multilateral donors. Program implementation started off strongly, based on close interaction with staff, a high level of ownership, and continued strong provision of TA. However, political paralysis over the process of normalizing relations with Serbia, and the fiscal stress associated with the surge in the number of war veterans qualified to receive

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<sup>6</sup> The IMF provided technical assistance in a wide range of areas, including tax collection and public financial management, financial sector development, and improvement of the business environment, in cooperation with the World Bank and the USAID.

a pension, forced a delay in the approval of the second review. Finally, the second and third reviews were combined and approved in March 2017, together with an extension of the program till August 2017.

### **III. STAKEHOLDER VIEWS**

#### **A. The IMF's Roles and Objectives**

16. Stakeholders in Kosovo—including current and former officials, development partners, donors, and international institutions—stated in interviews with the IEO that they highly valued the work of the IMF, from which Kosovo had benefited “immensely.” Former officials, in office during the early years of IMF engagement, stated that, given the capacity limitation, the institutions needed for economic development could not have taken shape without the IMF’s help. Some observed that policy makers still looked for the IMF’s approval before acting, as the Fund was considered an impartial assessor and advisor.

17. The IMF’s roles most highlighted by local stakeholders were the promotion of macroeconomic stability and sustainability, the containment of the populist tendencies of local politicians eager to overspend, and, more generally, the provision of an anchor for policy making and a roadmap for development. Examples of concrete measures achieved under IMF support were the adoption of the deutsche mark as legal tender, the creation of the central bank, the preparation of reliable statistics, and the overhaul of the fiscal system.

18. The IMF has earned a solid reputation for its work among national officials and other stakeholders, and even in the eyes of the public, though some who were interviewed identified areas where the IMF could improve. First, representatives of non-governmental organizations stated that the IMF needed to be more transparent, engaging more with the media and civil society. A more open explanation of the IMF’s views, before political decisions were made, could promote better decisions and broader support. Second, it was said that the IMF should become more involved in fighting corruption, as it is in a privileged situation to detect wrongdoing or misuse of funds.

#### **B. Manner of Engagement**

19. Current and former officials displayed a high degree of satisfaction with the substance of the IMF’s work in the contexts of policy advice, program relationship, and capacity building. Several staff members emphasized the importance of providing an overall framework around which to articulate surveillance, program work, and TA activities, while highlighting the need to focus efforts on a few key objectives, given capacity constraints. However, they stated that such a focused approach often did not receive the support of HQ reviewers, who tended to push for a more demanding approach.

20. IMF advice was generally judged to have been appropriate and well tailored to the specifics of Kosovo. Examples include the establishment of a fiscal rule and the design of an emergency liquidity assistance framework. The quality of the work also improved over time as better data became available. Most officials and IMF staff judged the IMF's toolkit to be appropriate to address Kosovo's needs. They considered that flexibility in its use was critically important, and that the framework allowed for sufficient room. The 2010 SBA's failure should be attributed to a domestic political problem that staff could not have foreseen or prevented.

21. The criticism most often repeated by officials was that during the early years the IMF underestimated the growth potential of the economy and had been too rigid and conservative. In their view, policy recommendations and conditionality could have been more growth-friendly. A few observed, as areas of concern, a lack of consistency in IMF advice across country teams, excessive focus on the headline macroeconomic numbers (to the exclusion of underlying factors), and a relative lack of focus on private sector development.

### **C. Staff Effectiveness**

22. Stakeholders held in high regard the professionalism of the IMF staff. They valued its knowledge not only of technical issues but also of the socio-political context of Kosovo and the region. Some officials even considered that the staff had a better perception of the Kosovar reality than the policy makers, as it took a technical approach unvarnished by political considerations. They felt that having an IMF resident representative was key to the Fund's understanding of the realities on the ground.

23. Some interviewees highlighted the quality of IMF staff communication—open, clear, and honest—both with government officials and with a broad range of third parties. Transparency, integrity, and availability were also mentioned, which led to a highly-valued relationship. At the same time, the IMF was able to speak truth to power and exert pressure when necessary.

24. Several officials complained that the IMF had in the past tended to micromanage the affairs of the country. In their view, staff went into excessive level of detail during negotiations, and in the process interfered with highly political decisions. This became less of an issue as the IMF's relationship with the authorities matured over time.

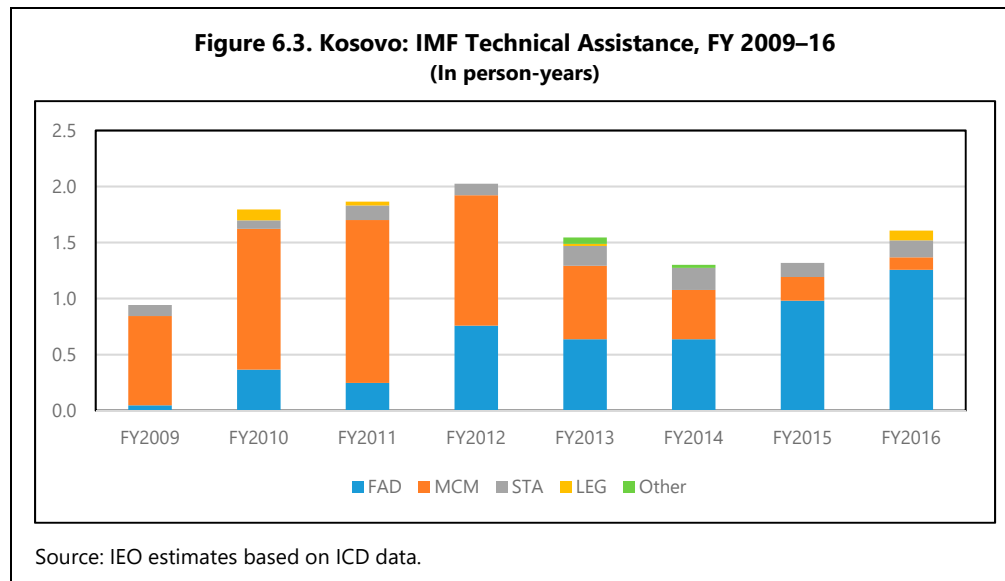
### **D. Collaboration with Partners**

25. Stakeholders, including staff members, agreed that the IMF's cooperation with development partners had been good. A fluid and meaningful cooperation was necessary in a country like Kosovo, where partners must present a coherent front to gain traction. Cooperation has been achieved without compromising the IMF's independence, and the Fund's policy prescriptions often served as the framework for other institutions. Nevertheless, some former officials suspected that nothing in Kosovo escaped the influence of the U.S. and that, albeit indirectly, IMF operations must have been affected.

26. There was consensus that cooperation among agencies had been based on a clear and symbiotic division of labor. The USAID was immersed in the day-to-day work, with a very hands-on approach, while the IMF's support was more strategic. Thematically, the IMF was the recognized leader in the macroeconomic, fiscal, and financial areas, whereas the World Bank and the EU took the lead on the structural front. The IMF provided a macroeconomic anchor for the donor community.

### E. Technical Assistance

27. Recipients of IMF TA who were interviewed gave it high marks; the IMF had helped the country on many issues and at all stages, from the drafting of laws and regulations to the monitoring of implementation, from central banking to the preparation of statistics (Figure 6.3). Staff members who were interviewed highlighted the importance of the TA dimension of the IMF's work in Kosovo: when capacity is very low, surveillance and program work assumes the character of TA. Recipients believed that the IMF had provided as much as Kosovo could absorb, sometimes stretching their absorption capacity. Supply-driven during the early years, TA subsequently became mainly demand-driven.



28. Recipients were pleased with the substance and delivery of TA. Most considered that the recommendations were high in quality and realistic, reflecting the Fund's combination of solid technical knowledge and awareness of the specifics of Kosovo. Delivery was also satisfactory. The recipients highlighted the responsiveness of IMF experts, who were proactive in diagnosing the problems and open and candid in presenting possible solutions.<sup>7</sup> In those areas in which the IMF

<sup>7</sup> An official provided an example of "perfect execution" in the area of tax compliance: "they came up with a strategy for a period of two years, then they developed a risk response plan, and followed up with an assessment of implementation. Over 20 officials were trained under that project."

had little expertise, the authorities sought the help of other agencies, but the IMF was generally the preferred provider. Coordination on TA with other institutions was good but not perfect, since there were occasional timing and scheduling problems that affected absorption, largely owing to local organizational and political challenges.

29. Recipients observed areas for improvement: (i) sometimes the experts the Fund provided were retirees, whose expertise they perceived as somewhat outdated; (ii) greater use of long-term advisors was the preferred choice; (iii) more emphasis should be placed on follow-up and assessment; and (iv) it would be useful to exploit more the regional dimension of TA, including through regular discussions among regional recipients in the Balkans.

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## CHAPTER 7—MYANMAR<sup>1</sup>

### SUMMARY

Sixty years of dictatorship, conflict, mismanagement, and isolation left Myanmar with a legacy of profound economic and social underdevelopment. Since the start of economic opening in the late 2000s, the IMF has supported Myanmar's transition to a functioning market economy by providing not only policy advice but also technical assistance, which became the centerpiece of its work. Myanmar has since achieved macroeconomic stability, with robust growth and stable inflation, though enormous development challenges remain to raise the economic wellbeing of its population.

A one-year Staff-Monitored Program agreed in 2013 provided a framework for reform and policy implementation. Even though progress under the SMP was strong—boosted among other things by solid national ownership and an improved relationship with the international community—the authorities afterwards refrained from engaging with the IMF in a program relationship, with or without financing. Even so, the IMF's support to Myanmar remained intense. In fact, Myanmar for some time has become the largest recipient of IMF TA. The IMF has shown flexibility and realism in adapting its mode of engagement and tailoring its advice to Myanmar's evolving circumstances.

### I. BACKGROUND

#### A. Brief History

1. Located on the trade routes between South and East Asia, Myanmar (previously known as Burma) has a long history of local kingdoms but was invaded several times by foreign powers and fell under British domination in 1885. The British turned Burma into a province of India, eradicated the monarchy, and destroyed the country's traditional social and economic structures. In 1937, the nationalist movement headed by U Nu and Aung San forced the British rulers to separate Burma from India and to grant the country its own constitution. Interrupted by a brief period of Japanese occupation during World War II, in 1948 Burma became an independent republic configured as a parliamentary democracy. In 1962, a military coup brought to power General Ne Win, who abolished the federal system and inaugurated the "Burmese Way to Socialism," a nationalized economy with tight societal controls. During Ne Win's 26-year reign, the country's economic conditions deteriorated sharply, corruption was perceived to be pervasive, and food shortages intensified.

2. Mass protests of 1988, in which at least three thousand people were killed and thousands more were arrested, caused Ne Win to resign. A military junta took power, declared martial law,

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<sup>1</sup> Contributor: Miguel de Las Casas.



changed the country's name to Myanmar, renamed the capital city from Rangoon to Yangon,<sup>2</sup> and put under house arrest Aung San Suu Kyi, the daughter of Aung San and leader of the National League for Democracy (NLD). Although the junta in 1990 held the first elections in 30 years, it refused to acknowledge the results in which the NLD won the clear majority. Throughout the 1990s and early 2000s the junta governed the country with harsh repression, inviting condemnation from the international community and economic sanctions by the United States and the European Union. In 2007, the so-called Saffron Revolution—an anti-government protest triggered by the sudden removal of fuel subsidies and backed by Buddhist monks—was brutally suppressed.

3. Following another election in November 2010, boycotted by the NLD and considered fraudulent by the UN and western countries, the military-backed party Union Solidarity and Development (USDP) took over 75 percent of the seats in parliament. Thein Sein was selected as president and the junta was dissolved. A series of reforms and opening measures led to a significant improvement in the country's external relations,<sup>3</sup> with the U.S., the EU, Australia, and Japan lifting some of their economic sanctions. In 2015, the government and eight out of the fifteen armed groups provisionally agreed on a ceasefire, and the NLD won the elections. In March 2016, the newly elected president ended the 50 years of military rule. Aung San Suu Kyi, who is constitutionally banned from becoming president, became Chief of the President's Office and Minister of Foreign Affairs before assuming the newly created position of State Counsellor.

## **B. Sources of Fragility**

4. Myanmar's fragility emanates from four main sources. First, almost 60 years of dictatorship, mismanagement, and isolation left the country profoundly underdeveloped. One of Asia's poorest nations, Myanmar has around 26 percent of its population living under the national poverty line (poverty is twice as high in rural areas, where 70 percent of the population lives). Its infant mortality rate is 40, second only to Lao's 51 in Asia, while just 26 percent of the population has access to electricity. Politically, despite the restoration of democracy, the military still holds a firm grip over the civilian government and the economy.

5. Second, Myanmar has a legacy of continuous civil conflict, characterized as the world's longest-running civil war,<sup>4</sup> with long-standing and complex ethnic, political, and religious roots. Many armed groups still active today are mainly politically motivated, but they also present

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<sup>2</sup> The capital was later moved to the newly constructed city of Nay Pyi Taw.

<sup>3</sup> For example, Aung San Suu Kyi, along with hundreds of other political prisoners, was released and allowed to contest parliamentary by-elections in April 2012, and preliminary peace agreements were reached with major armed ethnic groups.

<sup>4</sup> <http://www.post-gazette.com/world/2012/05/13/Myanmar-ending-the-world-s-longest-running-civil-war/stories/201205130149>.

themselves as defending the people against the military's human rights violations.<sup>5</sup> Despite some recent ceasefire efforts (e.g., the 2015 Nationwide Ceasefire Accord; the 2016 Twenty-First Century Panglong Conference), lasting peace remains elusive. In September 2017, an attack on police posts carried out by Rohingya (Muslim) militants sparked a military crackdown that caused at least 500,000 refugees to flee Rakhine State into Bangladesh.

6. Corruption is a third source of fragility. Transparency International ranks Myanmar 136<sup>th</sup> out of 176 nations in its 2015 Corruption Perceptions Index. Although anti-corruption efforts are underway, corruption still affects a large proportion of individuals, businesses, and institutions, with the independence of the judiciary being of particular concern.<sup>6</sup> Myanmar's massive bureaucracy, concentration of political and economic power in the hands of the military, lack of transparency, opium production, and large illegal trade all weigh against eradicating corruption.

7. Fourth, Myanmar is vulnerable to extreme weather events. According to the 2016 Global Climate Risk Index, it was the world's second most weather-affected country in the last 20 years. The best example is Cyclone Nargis, which killed around 140,000 people and left almost 2.5 million homeless in 2008. Myanmar has suffered two major earthquakes, three severe cyclones, and floods over the past ten years.<sup>7</sup> These natural disasters impact not only human lives but also the country's economy dependent on natural resources and agriculture.

## II. THE IMF'S RELATIONSHIP WITH MYANMAR

### A. Re-engaging with the IMF

8. The beginning of the 21<sup>st</sup> century saw Myanmar's economy shattered. Adding to the effects of social and economic underdevelopment was the military junta's track record of human rights violations and pervasive drug-related activity, which led to the imposition of sanctions by the international community, including the U.S. and the EU as well as international organizations such as the International Labor Organization. Although the IMF remained engaged with Myanmar through annual Article IV consultations, staff worked without the aid of any reliable data or political commitment on the part of the authorities. IMF policy recommendations—repeatedly focused on the elimination of deficit-financing money creation, revenue mobilization, liberalization of exchange controls, and the pressing need for reforms—had little impact.

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<sup>5</sup> Some of these violations have been well documented for decades. See for example: <http://khrgh.org> and <https://www.amnesty.org/en/countries/asia-and-the-pacific/myanmar/report-myanmar/>. Some of the insurgent groups have themselves been accused of human rights violations.

<sup>6</sup> <https://www.unodc.org/southeastasiaandpacific/en/what-we-do/anti-corruption/topics/01-work-myanmar.html>.

<sup>7</sup> <http://reliefweb.int/map/myanmar/myanmar-natural-disaster-risks-and-past-events-31-may-2016>  
<https://germanwatch.org/en/download/13503.pdf>.

9. In 2007, when IMF staff reports began to note timid progress on the economic policy front, the IMF Board approved a TA strategy for Myanmar. This move proved controversial at the time: some countries, including the U.S., reacted negatively, seeing it as giving support to the military regime, while other parties, including the EU and most non-governmental organizations, considered small-scale and well-focused TA as a form of humanitarian assistance. The IMF moved cautiously, making its TA provision conditional on Myanmar's implementation of past IMF recommendations.

10. The November 2010 elections were an important inflexion point. Despite the victory of the military-backed USDP and the resurgence of ethnic divisions, the government adopted a more positive attitude towards economic liberalization and launched a series of political and reconciliation measures. Relations with the U.S., Japan, and Australia improved, although the U.S. kept its sanctions in place. The staff recognized that Myanmar was on the brink of a "controlled transformation," and prepared for an intensive surveillance and TA agenda in support of policy making and reform implementation. However, Myanmar's severe lack of technical capacity and "grossly inadequate" data were identified as impediments to progress.

11. In the following months, the reform momentum remained strong. Aung San Suu Kyi's NLD won the April 2012 by-elections, putting pressure on the government to advance reforms and prompting a relaxation of sanctions by the U.S. and other western countries.<sup>8</sup> Actions were taken towards the unification of the exchange rate,<sup>9</sup> the reduction of monetization, and the resolution of external arrears.<sup>10</sup> At the same time, Myanmar strengthened its relationship with the IMF.<sup>11</sup> The authorities allowed regular visits by an IMF regional resident representative and made substantial progress towards eliminating multiple currency practices and other exchange restrictions, with the aim of accepting the obligations under Article VIII of the IMF Articles of Agreement. In parallel, the IMF's provision of capacity building support grew exponentially, boosted by Deputy Managing Director Shinohara's visit in June 2012.

### **B. Engagement Under a Staff-Monitored Program**

12. To support policy and reform implementation and the process of clearing the arrears owed to external creditors, the authorities adopted a one-year Staff-Monitored Program (SMP) in January 2013. The starting point was difficult, as the economy was plagued by persistent fiscal

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<sup>8</sup> In February 2012, the U.S. had waived the sanction that required U.S. Executive Directors at international financial institutions to oppose any use of their funds for Myanmar, including TA.

<sup>9</sup> As a first step, the kyat was successfully floated on April 2, 2012, with technical support from the IMF.

<sup>10</sup> On April 24, 2012, Myanmar and Japan reached agreement to reschedule Myanmar's debt, paving the way to resume Japan's development assistance to the country. At the same time, Myanmar announced its intention to collaborate with the Paris Club and the Asian Development Bank on resolving the arrears it owed to other creditors.

<sup>11</sup> Helped by the opening of TAOLAM, the IMF's regional technical assistance center located in Bangkok.

deficits financed by the central bank, high and volatile inflation, limited financial intermediation, and a lack of economic management tools.

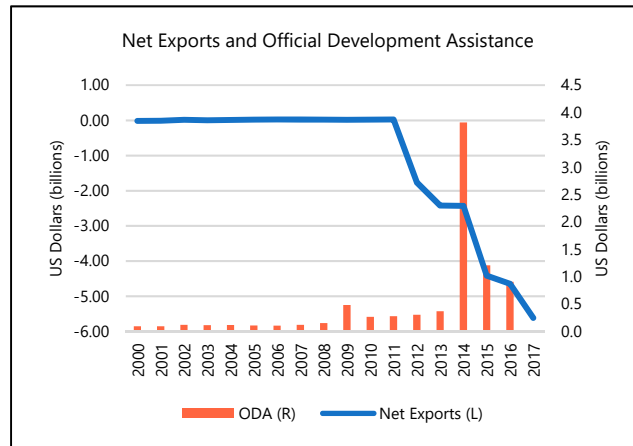
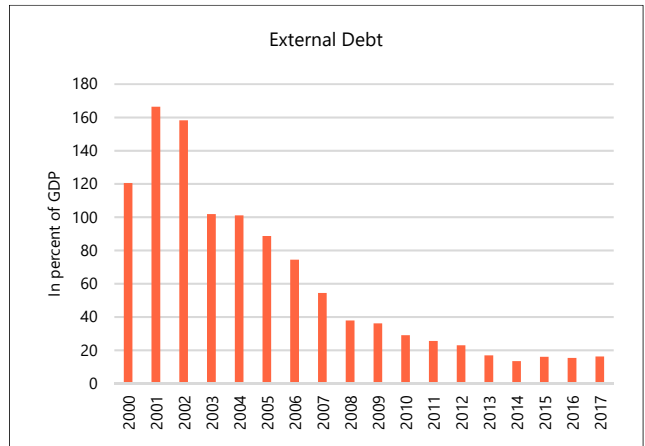
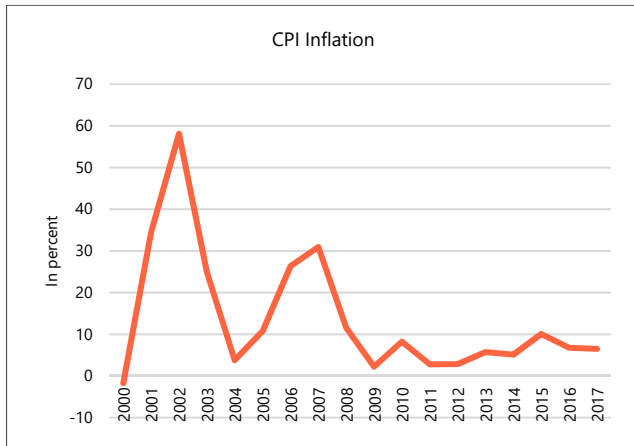
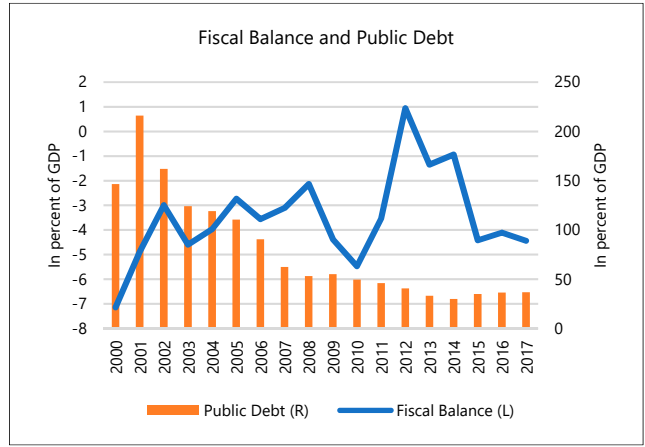
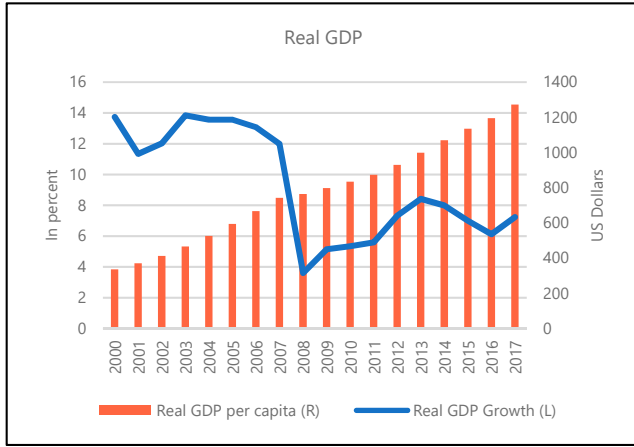
13. The SMP was embedded in the government's medium-term strategy to raise sustainable growth, open the economy, and reduce poverty and inequality. It sought to: (i) unify the exchange rate; (ii) establish a monetary policy framework; (iii) develop the financial sector; (iv) overhaul the system of public finances; (v) clear the arrears; and (vi) implement key structural reforms. The SMP also foresaw close coordination with key development partners, mainly the World Bank and the Asian Development Bank.

14. Progress under the SMP was strong, boosted by the solid national ownership of program goals, a continued process of political reconciliation and liberalization, a favorable economic outlook, and an improved relationship with the international community (which included the suspension of most sanctions, the repayment of arrears to the World Bank and the ADB, and an agreement with the Paris Club). Implementation was underpinned by the provision of TA, as the government's already limited capacity was stretched further by the process of economic transition. At the time of the last review, in January 2014, Myanmar had managed to meet all quantitative and structural benchmarks, albeit with a delay in foreign exchange market and monetary policy reforms. Strong implementation allowed for the maintenance of macroeconomic stability, including a resumption of growth, low inflation, accumulation of international reserves, and the development of institutions for macroeconomic management (Figure 7.1).

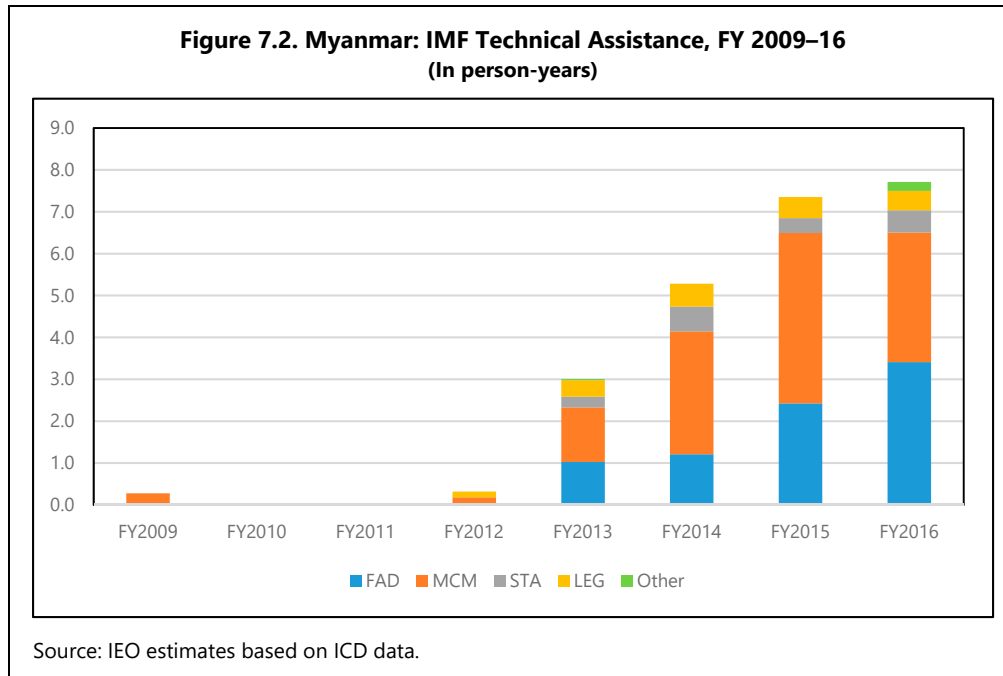
15. Despite the success of the SMP, the authorities resisted a successor program, with or without financial support. They did initially seek IMF assistance in 2015 to address the urgent external financing need that followed Cyclone Komen, which produced massive floods that affected 1.6 million people and caused damage valued at more than 3 percent of GDP. The government and the IMF negotiated a blended arrangement under the Rapid Credit Facility and the Rapid Financing Instrument, for the amounts of SDR 64.6 million (25 percent of quota) and SDR 129.2 million (50 percent of quota), respectively. The idea was to use the Fund arrangement to unlock additional resources from international donors. The request documents were prepared but were never presented to the Executive Board, as the authorities decided not to follow through with the request.

16. Nevertheless, the IMF–Myanmar relationship continued to intensify and capacity development work became its center of gravity. Indeed, Myanmar became the largest recipient of IMF TA, receiving more than seven person-years of TA in FY 2015 and FY 2016 (Figure 7.2). IMF provided capacity-building support, often in coordination with development partners, in such areas as establishing monetary policy tools, strengthening the regulatory and supervisory frameworks for the banking sector (in preparation for the entrance of foreign banks), and upgrading tax policy and administration, including through the introduction of a value-added tax.

**Figure 7.1. Myanmar: Key Macroeconomic Indicators, 2000–17**



Sources: October 2017 WEO database; OECD DAC statistics.



17. Surveillance work also deepened, given the authorities' concerns about developments in the foreign exchange market. Frequent surveillance missions, well articulated with TA efforts, focused on helping the Central Bank of Myanmar to accelerate the deployment of monetary policy tools to reduce excess liquidity in the system and allow greater exchange rate flexibility. Myanmar's economy entered a phase of strong growth, supported by the continuous implementation of reforms and inflows of foreign direct investment, although economic imbalances remained significant.

18. Following the victory of Aung San Suu Kyi's NLD in the November 2015 elections, a new government was formed in April 2016 amid great expectations, both political and economic. The IMF staff immediately touched base with the new administration, to encourage the authorities to address continued macroeconomic imbalances—most importantly inflation and the current account deficit—and to push ahead with needed reforms, mainly in the monetary and financial areas. The latest Article IV staff report highlighted the country's historic opportunity against a set of "formidable challenges." The government launched a high-level economic vision aimed at unlocking the country's potential, supported by a wave of domestic and external optimism, which included the removal of all remaining U.S. sanctions in October 2016. Nevertheless, IMF reports continued to emphasize the fragile nature of the hoped-for economic success, which would be contingent on the progress made in other areas, including a final settlement with the armed ethnic groups.

### **III. STAKEHOLDER VIEWS**

#### **A. The IMF's Roles and Objectives**

19. Stakeholders, including country officials, who were interviewed for the evaluation were consistently appreciative of the roles the IMF had played in Myanmar. The IMF's work as policy advisor was widely praised, as it helped the country navigate the first steps of a difficult transition from planned to market economy and, more generally, from dictatorship to democracy, helping develop mechanisms for transparency and accountability. In particular, the IMF was instrumental in helping the country clear the arrears owed to official creditors. The IMF also provided a macroeconomic framework, became an anchor for policy making, and helped offset the lack of local capacity.

20. Officials' appreciation focused on the IMF's efforts in capacity and institution building. Staff and representatives of other international financial institutions concurred that TA was the most important aspect of the IMF's role in Myanmar. One interviewee emphasized the flexibility and realism the Fund had displayed, having moved away from simply setting targets and monitoring performance to becoming more of a development partner. Given the enormous demand for support, most stakeholders considered that the IMF should increase its presence in Myanmar.

#### **B. Manner of Engagement**

21. The Staff-Monitored Program (2013–14) was considered to have been a success. Officials who were in office during that period considered the program to have been effective, especially in clearing the arrears owed to external creditors. In their view, the SMP was also helpful in creating the appropriate discipline for policy making within the public sector. While the IMF was demanding and significant efforts were needed to comply with Fund conditionality, officials did not consider the Fund to have been excessively rigid. Staff members emphasized that the SMP was useful as a roadmap for reforms and as a framework in which to integrate surveillance and technical assistance coherently.

22. Despite the success of the SMP, the authorities decided to refrain from further program engagement—with or without financing. Several explanations were offered for this reluctance. Officials emphasized the authorities' prudent attitude towards external debt and their preference not to be constrained by conditionality. They also suggested that IMF financing was expensive and could not compete with concessional financing and aid offered by the World Bank, the ADB, or China. Staff members added that lingering "IMF stigma" (as elsewhere in Asia) might have played a role, because committing the country to IMF conditionality would have left the new government exposed to political criticism. Finally, some staff members considered that there was a gap in the IMF's toolkit for countries moving from a Staff-Monitored Program to upper-credit-tranche conditionality arrangements.

### **C. Staff Effectiveness**

23. Officials highly valued their relationship with the IMF and the professionalism of its staff. They considered the staff knowledgeable and well aware of the specificities of the country, both economic and political. They highlighted the complementarity between the IMF's technical and strategic approach and the more hands-on and lending-focused approach of other institutions such as the World Bank. Interviewees appreciated the staff's broad outreach to universities and members of Parliament as useful. The Managing Director's December 2013 visit was recalled as a strong sign of IMF support for the government's reform efforts.

24. Other stakeholders, while endorsing the overall quality of IMF-Myanmar relations, noted that the authorities were still in the process of fully understanding the IMF. They cautioned that one factor that could hinder the success of the relationship is the gap between the technical and political levels of the administration; while the technical side is eager to learn from outside experts and apply the best possible solutions, the political decision makers are much more cautious, overwhelmed by the transition to democracy and lacking the necessary knowledge. Hesitancy on their part affects policy and reform implementation.

25. Former officials expressed concerns over the high turnover of IMF teams, which raised the cost of bringing mission members up to speed and re-establishing relationships. Third parties also mentioned that (i) the IMF could usefully have been more frank and candid in the public presentation of its views, rather than softening its message to avoid offending the authorities; and (ii) in some cases, the IMF's "textbook" recommendations could have been better tailored to Myanmar's realities.

### **D. Technical Assistance**

26. IMF technical assistance was appreciated as responsive and effective, with recommendations well tailored to the specific needs of Myanmar. Officials stressed implementation difficulties and the need for the IMF to: (i) be patient; (ii) work with politicians and high-ranking officials to bring them onboard; and (iii) provide follow-up support. Staff members interviewed acknowledged the need for patience and longer-term engagement, but noted that such an approach often created a tension with HQ reviewers.

27. TA has been both demand- and supply-driven. The country has become the largest recipient of IMF TA, given the enormous capacity gaps and the abundance of donor support. While the authorities request assistance in those areas in which they identify gaps, the IMF also proposes suggestions in areas where improvement is needed. To the extent that most of the TA provided to Myanmar is externally financed, donors may also have a say in how the funds are spent. As to quantity, officials would like to receive more, but they also recognized that absorption capacity was strained. Staff on its part highlighted the importance of carefully assessing absorptive capacity when planning future TA support. Stakeholders agree that the IMF struck a reasonable balance between the country's needs and its absorptive capacity.



28. Among the different modalities for TA delivery, officials expressed a clear preference for long-term resident advisors. They viewed one-off missions and training of all types (on-site, online, or TAOLAM) as useful but limited in effectiveness. They also expressed a desire to see the IMF convey the knowledge of latest developments in international forums, such as the Basle Committee, of which Myanmar is not a member, and share the experiences of other countries.

29. Within the IMF, Myanmar is considered to be a successful case of TA delivery, due in part to the integration of surveillance with TA, a strong relationship with counterparts, and a sufficient presence on the ground.

### **E. Collaboration with Partners**

30. The authorities and development partners considered that the IMF's collaboration with other international institutions (mainly the World Bank but also the ADB) and with bilateral donors (Japan, the U.S., the EU, China, India, and Thailand) had been satisfactory. Informal coordination took place frequently and was carried out both by the Myanmar team and by TA experts. Formal channels included the Development Assistance Coordination Unit, hosted by the government, and the Committee for the Coordination of Financial Sector Technical Assistance to Myanmar, hosted by the Central Bank. While the IMF's presence in Myanmar was small, compared with that of other institutions, the impact of its work was at least as great. The IMF tended to take the lead within its areas of competence, and the division of labor among partners worked well.

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## CHAPTER 8—TIMOR-LESTE<sup>1</sup>

### SUMMARY

Timor-Leste gained independence from Indonesia in 2002 following two-and-a-half years of United Nations transitional administration. As part of concerted international efforts, the IMF's initial role was to help build state capacity from scratch, especially in treasury and central bank operations, even before the country became a member. After the key institutions of a functioning economy had been built, the IMF continued to provide technical assistance, which, for a time, made Timor-Leste one of the largest recipients of IMF TA.

The IMF has never had a lending arrangement with Timor-Leste. The initial availability of generous donor support was followed, starting from 2004, by a build-up of substantial oil and gas revenues. The country has not had a budgetary shortfall or a balance of payments problem that called for IMF financial support. The 2009 withdrawal of the Fund's resident representative further diminished the IMF's interaction with the authorities. The government's understandable desire to scale up public investment has been a continuous source of tension with the Fund's equally understandable advice to slow down the pace of withdrawal from the petroleum fund, given capacity limits and the need to extend the benefits of offshore wealth to future generations.

### I. BACKGROUND<sup>2</sup>

#### A. Brief History

1. Timor-Leste, also known as East Timor, is a multi-ethnic, multi-lingual country of just over one million people that occupies the eastern half of the island of Timor in the Pacific Ocean. The main economy is based on the cultivation of rice, along with coffee, maize, tobacco, copra, and yams. The country has been producing oil and gas in the Timor Sea (with full production starting in 2004), but production peaked in 2012 and the reserves are expected to be depleted by the early 2020s (though there remain reserves yet to be explored).

2. Timor-Leste is one of the world's newest nations, having secured its independence from Indonesia in 2002 following two-and-a-half years of UN transitional administration. The country had been under Portuguese colonial rule from the mid-16<sup>th</sup> century to late 1975, when the Revolutionary Front for an Independent East Timor (FRETILIN) declared independence. Just days later, the Indonesian military, viewing the prospects of a free East Timor as a security threat, invaded and then occupied the territory. Six months later it was incorporated by Indonesia as its 27<sup>th</sup> province.

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<sup>1</sup> Contributor: Shinji Takagi.

<sup>2</sup> Source: Molnar (2010).

3. FRETILIN and other separatist groups became united over time to wage what would become a 24-year-long guerrilla war against the reign of terror.<sup>3</sup> The Dili Massacre of 1991, in which some 250 pro-independence demonstrators were killed, became a turning point for the independence cause. Under growing international pressure, the transition of power in Indonesia in the aftermath of the 1997 financial crisis created a window of opportunity. In January 1999, new Indonesian president B. J. Habibie announced that the East Timorese people would be allowed to decide their own fate in a national referendum. With a worsening security situation, however, the ballot date was postponed twice. The result of the voting, announced on September 4, showed 21.5 percent for special autonomy within Indonesia and 78.5 percent for independence. After the announcement, the pro-Indonesian militias carried out a widespread rampage in the capital city of Dili and elsewhere.

4. Under the auspices of the United Nations Transitional Administration in East Timor (UNTAET), the Constituent Assembly was installed in September 2001. In October, the assembly chose May 20, 2002 as the date by which the constitution would be in place and the presidential elections finalized. The constitution was written by the first Constituent Assembly, and was modeled after that of Portugal with certain adaptations from Mozambique. It took effect with the official independence of the nation on May 20, 2002. The Constituent Assembly was transformed into the first National Parliament.

5. Following the post-referendum destruction of much of the productive capacity of the country, Timor-Leste's real GDP began to recover and the country has since experienced periods of robust growth, though subject to sometimes high and volatile inflation (Figure 8.1). Despite the impressive gains, the country still suffers from the legacy of the past, including an acute shortage of human capital coupled with a high incidence of illiteracy, along with a lack of institutional capacity and physical infrastructure.<sup>4</sup> In 2006, the history of resolving political differences through violence brought the country to the verge of civil war. Early 2008 saw rebel attacks on the president and the prime minister. Fractional politics continued, as revealed by the outcome of the July 2017 parliamentary elections.<sup>5</sup>

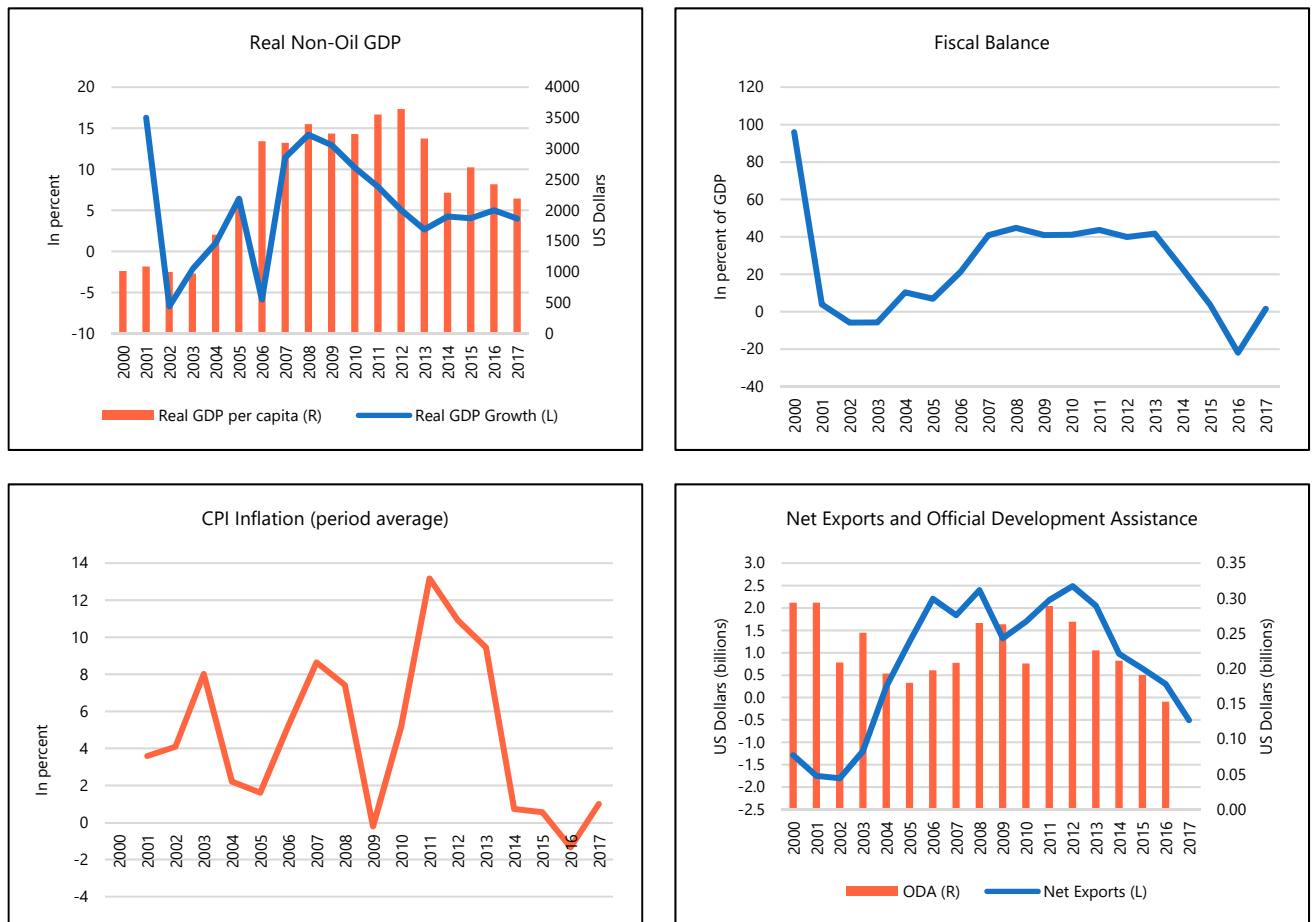
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<sup>3</sup> It is estimated that over 200,000 East Timorese were killed during the occupation, including an estimated 60,000–100,000 in the first year after the 1975 invasion.

<sup>4</sup> In 2001, the World Bank estimated that 41 percent of the people lived in poverty; about 50 percent were illiterate; three-quarters lived without electricity; and more than half relied on unsafe sources for drinking water; and that many households had lost dwellings and livestock during the violence of 1999 (World Bank, 2002).

<sup>5</sup> The two major parties, together accounting for 60 percent of the total votes cast and virtually tied at 30 percent each, failed to form a coalition government. In the event, FRETILIN chose the Democratic Party to form a minority government nearly two months later.

**Figure 8.1. Timor-Leste: Key Macroeconomic Indicators, 2000–17**



Note: Data are estimates for 2016 and projections for 2017.

Sources: October 2017 WEO database; OECD DAC statistics.

## B. Sources of Fragility

6. Several factors contribute to fragility in Timor-Leste, including:

- **Tribal diversity and heritage.** Portuguese colonial rule failed to create a national identity. The generally identified components of nationalism or nationhood—shared history, shared experiences, common culture, common language, and common religion—are only present to a limited degree. The people of Timor-Leste identify more with their own cultural relations; the traditional political organizations based on chiefdoms and alliances still hold salience.
- **A culture of violence.** Timor-Leste's history has been one of conflict and violence over many centuries.

- **Weak governance.** Portugal made little investment in Timorese institutions, physical capital, or education. Lack of experience with nationhood has been exacerbated by weak institutions.

## II. THE IMF'S RELATIONSHIP WITH TIMOR-LESTE

### A. Key Institution Building

7. The IMF's most important role in Timor-Leste has been helping to build the institutions of a functioning economy. The basic state institutions were built from scratch during the period of UN administration, when foreign professionals almost entirely managed the essential functions of the state. The IMF became part of these international efforts even before Timor-Leste became the IMF's newest member in July 2002. The first donors' meeting, held in Tokyo in December 1999, in which an IMF representative made a presentation, set up two trust funds, one to be managed by the United Nations (to support typical government functions) and the other to be managed by the World Bank and the Asian Development Bank (to finance reconstruction and development projects). In some areas of technical assistance, the IMF worked under a cost-sharing arrangement with the UNDP.

8. The IMF provided technical assistance to help establish core economic institutions for macroeconomic management, primarily in the fiscal and monetary areas. Working with experts engaged by the World Bank and other donors, it provided support for setting up a new revenue administration, drafting the budget law, and designing a capacity building plan for the Ministry of Planning and Finance, and in 2002 an IMF resident advisor assisted in budget preparation. These efforts encountered some issues of donor coordination. For example, there were reportedly issues in public expenditure management, where systems and traditions differed across donor countries; some trials and errors were required in implementing new tax measures (Gupta and others, 2005).<sup>6</sup> IMF staff members who had been involved noted that there was a duplication of efforts including by bilateral donors. Following the adoption of the U.S. dollar as legal tender in January 2000, the IMF assisted the UN in setting up the Banking and Payments Authority (BPA) in 2002.<sup>7</sup> From mid-2001 to March 2002, IMF experts helped prepare a scheme to promote the use of the U.S. dollar by educating the public (Jacome and Lonnberg, 2010). Later, the IMF provided technical support to the conversion of the BPA to a full-fledged central bank, the Central Bank of Timor-Leste (CBTL), in 2011.

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<sup>6</sup> For example, the presumptive tax on coffee exports had a depressing effect on the sector and was therefore abolished (Gupta and others, 2005).

<sup>7</sup> Previously, basic central banking functions had been performed by the BPA's predecessor, the Central Payments Office (CPO).

## **B. Attempted Program Engagement**

9. Timor-Leste has not received financial assistance from the IMF. In fact, from the beginning of independence to the early 2010s, the Timorese authorities followed a conservative policy of avoiding external borrowing even on concessional terms. What made this possible was the initial availability of generous donor support and the build-up, starting in 2004, of substantial oil and gas revenues. The country has not had a budgetary shortfall or a balance of payments problem that called for IMF financial support (Figure 8.1).<sup>8</sup> Even so, internal documents show that from 2006 to 2007, the IMF explored with the authorities the possibility of engaging in a Staff-Monitored Program, which involved no financing, as “a precursor to the Policy Support Instrument.” But if there was any chance of engaging with the authorities through one of these formal structures, it was certainly gone by the end of 2008, when the political crisis accelerated the shift of government priorities from stabilization and reform towards development spending to produce quick, visible results.

## **C. Technical Assistance**

10. Once the initial state-building phase was over, the role of the IMF was to provide technical assistance in areas of its core competency as well as policy advice through Article IV consultations. Some of the IMF staff members interviewed expressed their view that the IMF’s most notable contribution had been the technical support provided to the establishment of a petroleum fund which, incorporating the features of a Norwegian model, became operational in 2005. With IMF TA, the Banking and Payments Authority put in place the institutional structure, operational guidelines, and basic safeguard arrangements for investing petroleum resources; the MOF’s Petroleum Fund Administration Unit received IMF TA on developing a methodology to estimate a sustainable income stream from petroleum on an annual basis.

11. Officials interviewed were more equivocal about the role of the IMF in the establishment of the petroleum fund, stating that the idea had come from the Timorese authorities themselves, who took the initiative to contact the Norwegians for assistance. In fact, the need for a strategy to smooth out government spending of expected gas and oil revenue from the Timor Sea had been long recognized, not only to extend the benefits of offshore wealth beyond the windfall revenue period but also to prevent the windfall revenue from undermining the competitiveness of the non-oil traded goods sector (World Bank, 2002).

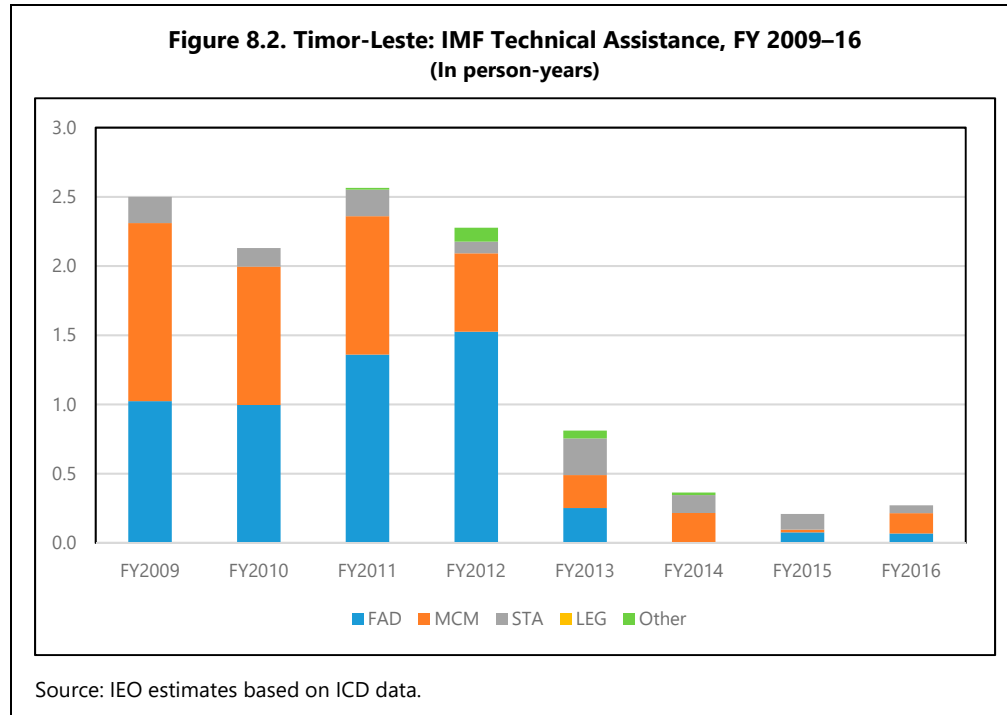
12. The Ministry of Finance (with its General Directorate of Statistics) and the Central Bank, including its predecessor the Banking and Payments Authority, have been the primary recipients of IMF TA. From the beginning to the early 2010s, long-term resident advisors were assigned to Timor-Leste, including in statistics, budget execution, and drafting of a Central Bank law. Internal

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<sup>8</sup> Timor-Leste has more recently borrowed from the World Bank and the Asian Development Bank.

documents show, however, that the implementation of TA recommendations was not always consistent, even when the authorities expressed full understanding and support.

13. For a time, Timor-Leste was one of the largest recipients of IMF TA, but the volume of TA saw a sharp decline in recent years, largely reflecting the withdrawal of long-term resident advisors. For example, the volume fell from around 2.5 person-years of field delivery in FY 2009 to less than 0.3 person-years in FY 2015–16 (Figure 8.2). Technical support to develop capacity in statistics (including on consumer prices, national, fiscal, and monetary accounts, and balance of payments) is ongoing, but there are currently no long-term resident advisors. Any TA that takes place in various areas today, including by advisors based at the IMF’s Pacific Financial Technical Assistance Center, is provided through short-term, often one-off, visits. The absence of resident technical advisors is a striking feature of IMF TA in a country where the government still relies on a large, though declining, number of donor-funded advisors across the national administration.



#### D. Relationship Management

14. The IMF’s relationship with Timor-Leste became less intensive after the core economic institutions had been built and petroleum revenues started pouring in. In technical assistance, even in the fiscal and monetary areas, the IMF has been a relatively small player, as the World Bank and bilateral donors, especially Australia, have also been heavily involved. The IMF closed its resident representative’s office in Dili in mid-2009, ostensibly against the



background of an IMF-wide downsizing of staff.<sup>9</sup> Up to that time, the Fund's Res Reps had often developed close personal relationships with senior policymakers and served as their de facto resident advisor; they were also proactively engaged in identifying TA needs and conveying their assessments to headquarters. At the time, the authorities expressed "deep regrets" about the closing of the resident representative's office and repeatedly expressed, for a time, their desire to see the office reopened.<sup>10</sup>

15. It was under these circumstances that, in December 2010, a major disagreement between the 2010 Article IV team and the authorities broke out over the content of the staff report, particularly over the growth projections. In a letter addressed to the Executive Director representing the country, the authorities complained about a large number of inaccuracies and misrepresentations of their views. They called the staff's growth forecasts "a mediocre unqualified underestimation with no transparent methodology." Earlier in April 2010, the government had published an outline of the Strategic Development Plan for 2011–30, assuming that the non-oil economy would grow at 12 percent per year during 2010–20. The IMF mission's forecasts of 6–8 percent, based on a conservative budget execution assumption, were thought to undermine the government's public announcement.<sup>11</sup> Board approval of the Article IV consultation, which was to take place on a lapse-of-time basis, was placed on the formal agenda, with the Executive Director issuing a statement representing the authorities' profound disagreement.

16. Again in 2014, disagreements arose over the IMF staff's assessment of Timor-Leste's economy. The authorities did not consent to the publication of the staff report for the Article IV consultation. Although they considered the staff's overall assessment to be balanced, they perceived the "Key Issues" section to be too critical. Publication was resumed for the staff report for the 2016 Article IV consultation.

17. These open confrontations are symptomatic of a difficult ongoing relationship between the IMF and the Timorese authorities. With petroleum revenues that far exceed the annual budget, Timor-Leste is in a position to take what the IMF (and the broader donor community) can offer on its own terms. Experience with centuries of foreign domination has created the kind of sensitivity to perceive any unwanted advice, not to mention disagreement, as a foreign attempt to challenge their hard-won independence. The authorities are also eager to project a strong image of their economy to help attract foreign private investment. IMF staff interviewees

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<sup>9</sup> A long-term FAD advisor continued to remain in Dili until 2013.

<sup>10</sup> The Jakarta-based Senior Resident Representative visited Dili every few months during 2011–12.

<sup>11</sup> The staff's preliminary estimate of non-oil GDP growth in 2010 was 6 percent, against the government estimate of 9.5 percent. Staff then forecast growth to recover to 7.3 percent in 2011 and to peak at 9.75 percent in 2013–14 before stabilizing at 6 percent thereafter, whereas the government assumed that growth would remain at double-digit levels throughout. In the event, the government assumption of double-digit growth in the 2010s never materialized (Figure 8.1).

indicated to the IEO that the absence of a resident representative made it difficult to maintain meaningful policy dialogue with the authorities. Representatives of the donor community expressed the view that managing the relationship with the government of Timor-Leste would be difficult for any development partner, with or without a resident representative.

18. In this context, in November 2012, Timor-Leste moved to the Brazilian constituency at the IMF Executive Board (where its interests are looked after by the Executive Director himself) from the Italian constituency (where the country's interests had been assigned to Portugal, a junior member).<sup>12</sup> Now, considering that the country's interests are being more actively represented at the Board, the authorities told the IEO that they feel a greater sense of ownership in the institution. This shows the important role an Executive Director's office can play in managing the IMF's relationship with a member country, especially where no resident representative is assigned.

### **III. THE IMF'S POLICY ADVICE**

19. Timor-Leste has been on a 12-month cycle for Article IV consultations and, until 2017, had been under "intensive" surveillance (meaning that the country received two staff visits a year, including an Article IV consultation mission). The IMF completed 12 Article IV consultations with the country between 2003 and 2017. Almost all consultation missions repeated similar themes, namely, the need to strengthen the economic institutions and local capacity, to manage the country's petroleum wealth, and to create an environment conducive to private sector development. IMF staff and the Timorese authorities typically agreed that the use of the U.S. dollar as legal tender had served the country well although there was an occasional reference to exploring an alternative arrangement in the future. The staff also raised social safety net issues.

#### **A. The Period of Early Engagement, 2002–05**

20. Initially, the large fiscal deficits were financed by cash grants from donors, given the lack of access to domestic borrowing and the authorities' policy of not borrowing externally, even on concessional terms. Once oil production began in earnest, staff called on the authorities to develop sources of fiscal revenue not dependent on the oil sector. The 2004 Article IV mission suggested that government expenditure should be kept to around 20 percent of GDP over the long term, thus allowing about 85 percent of oil/gas wealth to be preserved in financial assets for future generations. The onset of oil production led to the emergence of a large fiscal surplus, an increase in the external current account surplus, and accumulation of international reserves. The 2005 Article IV mission encouraged cautious management of petroleum fund resources in line with FAD/MFD advice.

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<sup>12</sup> At the IMF, Portugal holds an Advisor position in the Italian Executive Director's office, whereas at the World Bank it has an Alternate Executive Director position. This explains why the Timorese authorities felt that at the World Bank it was not necessary to switch from the Italian to the Brazilian constituency.

## **B. The Period of Scaled-Up Public Investment, 2006–17**

21. Following the civil unrest of 2006, the government came under heavy pressure to use the petroleum wealth to accelerate non-oil growth and to reduce poverty in a more visible way; the pressure intensified after the political crisis of 2008. With a step-up in government spending, economic growth accelerated and inflation emerged in 2007 (Figure 8.1). The IMF staff called for a more moderate speed of fiscal expansion, given capacity constraints, and argued that transfers and subsidies should be reduced and diverted toward more efficient and welfare-enhancing uses, such as the expansion of the cash-for-work program and pensions for the elderly. IMF advice was largely disregarded. Instead, the government started frontloading the spending from the petroleum fund from around 2009, a process that was accelerated by the 2011 strategic development plan.

22. From 2006, the authorities began to think of concessional borrowing as a way of financing priority infrastructure while preserving the integrity of the petroleum fund. The 2008 Article IV consultation argued that it could be more cost-effective to use concessional loans than to withdraw from the petroleum fund under certain conditions.<sup>13</sup> In 2009, for the first time, the fiscal deficit was financed by withdrawals from the petroleum fund that exceeded the estimated sustainable income, calculated as 3 percent of estimated oil wealth, given the front-loaded scaling up of public investment. While supportive of government investment in public infrastructure, health, and education, the IMF staff considered that that level of spending was stretching administrative capacities. And, with persistent double-digit inflation (which reached 15.4 percent in 2011), the staff argued for slowing down the planned increase in capital spending.

23. A slowdown in the pace of expenditure growth from 2012 led to a slowdown in the non-oil sector and inflation. A 40 percent decline in petroleum revenue in 2015 led to a substantial drawdown of the petroleum fund, and the balance of the fund declined for the first time in 2015. Even so, the 2016 budget outlined a significant scaling up of public investment for 2017–19. In the 2016 Article IV consultation, the staff warned that fiscal trends under existing capital expenditure plans were unsustainable as the existing rate of withdrawals would deplete the petroleum fund over the long term. The staff called for bold fiscal consolidation measures to safeguard long-term fiscal and debt sustainability; it also called for new domestic non-oil revenue sources as well as for strengthened withdrawal rules to reduce the exercise of discretion. To support the authorities, in 2016, the IMF staff provided technical assistance on public investment strategies under the Infrastructure Support Initiatives, in the form of Debt, Investment and Growth Analysis and Public Investment Management Assessment.

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<sup>13</sup> In 2012, Parliament approved for the first time concessional borrowing of \$43 million from the World Bank, the Asian Development Bank, and the Japan International Cooperation Agency to finance infrastructure projects.

### **C. Traction of IMF Advice**

24. The Timorese government generally reacted negatively to repeated IMF advice to slow down the pace of withdrawal from the petroleum fund. Such advice may well have been sound on objective grounds, but the authorities viewed it as lacking understanding of the political and social realities of Timor-Leste. Some officials who were interviewed for the evaluation considered the visiting missions to be inflexible, “elitist,” and even arrogant. IMF missions were perceived to have their minds already made up before they arrived, with the purpose of their visit just to confirm what had already been drafted in Washington. This mode of engagement, they argued, did not allow the authorities’ views to be fully taken into account and diminished the scope for open and frank discussion. Almost all interviewees in Dili questioned how the IMF could possibly give them tailored advice when the staff visited the country briefly at most twice a year. They also complained about the high turnover of mission members.

## **IV. CONTINUING ISSUES IN IMF–TIMOR-LESTE RELATIONS**

### **A. The Role of the IMF**

25. The authorities who were interviewed for the evaluation stated two important reasons to remain engaged with the IMF. First, the IMF’s assessments affect how the country is perceived by private investors from whom the government is trying to attract foreign direct investment. Some officials were resentful of the chilling effect that IMF staff reports could have on investor sentiment, which they said was disproportionate to their value added and the amounts of time that IMF missions spent in the country. Second, officials recognized that the country’s oil reserves would be depleted sooner or later and viewed a good relationship with the Fund as a safeguard against any future economic contingency.

### **B. Resident Representative**

26. Officials and development partners stated that, without a resident representative, it would be difficult for the Fund to get to know the intricacies of policy making in Timor-Leste. Staff agreed that once the Res Rep’s office was closed the IMF lost traction with the authorities. The officials in charge of IMF mission logistics noted that the quality of the staff report that a mission produced depended critically on the ability to arrange meetings with a wide variety of stakeholders—a task that would normally fall to the Res Rep. Asked about capacity development work, the authorities complained that, without a Res Rep, the process of requesting technical assistance slowed down; some said that the Fund became much less responsive to their TA needs.

### **C. IMF Training Courses**

27. There is a lot of demand in Timor-Leste for training courses offered by the IMF, but people who had taken them stated that their level was too high for officials from their country and that more tailoring was needed to meet its specific circumstances.

#### **D. Resident Advisors**

28. TA recipients stated that without a resident expert little follow-up took place, and the impact of IMF TA was diminished in a country with limited capacity. Staff members noted that IMF-provided resident experts typically had become almost like advisors to the government, taking on a policy-making role that posed accountability issues. As the IMF's resident experts were treated like government workers (as were donor-provided experts), the authorities would often object to the IMF pulling them out when the projects were completed. In this context, staff stressed that there should be a clear understanding with the government that IMF-provided experts remain accountable to the IMF and leave their assignments when the terms of reference for a particular project are completed.

#### **E. IMF Human Resources**

29. The seniority of IMF mission chiefs (and Res Reps up to 2009) was downgraded progressively as the Fund's engagement with the country became less intensive. Currently, the mission chief position is staffed at the A14 level. The IMF's Asia-Pacific Department (APD) has used the mission chief position for Timor-Leste (as well as similar positions for small states) to provide promising economists with managerial experience for the first time. These A14 economists concurrently work as second desks for larger economies, devoting approximately half of their time to their mission chief assignments. This arrangement appears to have worked well in attracting a group of ambitious economists to work on these otherwise professionally less attractive assignments, but does mean that the relationship with the country has little continuity and that acquisition of country-specific knowledge can become constrained.

#### **F. IMF Manner of Engagement**

30. The intensive surveillance phase has ended for Timor-Leste, meaning that the IMF no longer provides central resources to support a semi-annual staff visit (though such a visit can continue to take place with departmental resources). Staff members recognized that, for Timor-Leste as well as other fragile small states where the Fund has no Res Reps, visiting the country once a year as part of the Article IV consultation would not be sufficient for the Fund to maintain traction with the authorities and to keep pace with ongoing developments. APD assigns a regional Res Rep to a group of small Pacific island economies. A similar arrangement, whereby Timor-Leste shares a Res Rep with a neighboring country (as was tried in the past when the Jakarta-based senior Res Rep visited Dili every few months) could be tried as a way of intensifying dialogue while keeping the costs down.

#### **G. Collaboration with Partners**

31. As state capacity developed, Timor-Leste assumed a greater role in coordinating donor support. In 2011, the country and its development partners agreed to use the Strategic Development Plan for 2011–30 as the overarching framework for the planning and alignment of

all future external assistance. Annual and quarterly development partners' meetings are currently scheduled, at the political and operational levels, respectively (Republic of Timor-Leste, 2017), although donor representatives stated to the IEO that the meetings had not always been held consistently. In the absence of a Res Rep, in any case, the IMF cannot regularly participate in these meetings, with its vehicle of coordination being largely limited to periodic dialogue with World Bank staff in Washington and Dili.

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