INTERNATIONAL MONETARY FUND

IMF POLICY PAPER

IMF STRATEGY FOR FRAGILE AND CONFLICT-AFFECTED STATES (FCS)

March 2022

IMF staff regularly produces papers proposing new IMF policies, exploring options for reform, or reviewing existing IMF policies and operations. The following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its March 9, 2022 consideration of the staff report.
- The **Staff Report**, prepared by IMF staff and completed on February 14, 2022, for the Executive Board's consideration on March 9, 2022.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

Electronic copies of IMF Policy Papers
are available to the public from
http://www.imf.org/external/pp/ppindex.aspx

International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR22/75

IMF Executive Board Supports New Strategy for Fragile and Conflict-Affected States

FOR IMMEDIATE RELEASE

Washington, DC—March 14, 2022: On March 9, the Executive Board of the International Monetary Fund (IMF) discussed a proposed strategy paper for strengthening IMF support to fragile and conflict affected states (FCS). This paper is a response to the needs of members states and the Board-endorsed recommendations of the 2018 Independent Evaluation Office (IEO) Report on *The IMF and Fragile States*.

FCS are home to nearly 1 billion people facing a variety of protracted challenges: from reduced institutional capacity and limited public service delivery, to forced displacement and war. Fragility and conflict are also exacerbated by climate change, food insecurity, gender inequalities, and more recently by the economic repercussions of COVID-19. The pandemic has disproportionately affected FCS in terms of the impact on per capita incomes, inflation, and public debt. Today, FCS are at a significant risk of falling behind in their post-pandemic recovery, but also in achieving the Sustainable Development Goals.

The Strategy paper makes the case that the implications of fragility and conflict are macro-critical: they destabilize balance of payments (BOP) positions, disrupt trade and financial flows, and hinder the development of productive resources. Moreover, crises originating in FCS can also affect economic outcomes in neighboring countries and regions. Addressing these challenges requires a well-tailored approach which factors in the drivers of fragility, political economy dynamics, and specific constraints to reform in each country, in coordination with other partners.

Executive Board Assessment[1]

Executive Directors welcomed the opportunity to discuss the Fund's strategy for fragile and conflict-affected states (FCS). They concurred that addressing fragility and conflict is an important policy priority for the international community, especially given the disproportionate economic impact of the pandemic in FCS, and the interlinkages with climate change, food insecurity, and persistent gender disparities. Directors agreed that the implications of fragility and conflict are macro-critical and relevant to the Fund's mandate—both in terms of the long-run economic impact on members, but also because spillovers originating in FCS can undermine macroeconomic stability and growth prospects in neighboring countries and regions.

[1] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

700 19th Street NW
Washington, DC 20431
USA

Directors noted that about one fifth of Fund members are classified as FCS. They agreed that the Fund has an important role to play, within its mandate, to help these countries exit from fragility and support them to achieve macroeconomic stability, enhance resilience, strengthen governance, and promote inclusive growth. Directors expressed strong support for the proposed FCS strategy and its measures, which responds to the Board-endorsed recommendations of the 2018 Independent Evaluation Office Report on The IMF and Fragile States and builds on actions under the related Management Implementation Plan. They welcomed the inclusive process through which the FCS strategy was developed, with extensive consultations with the World Bank, the UN system, and other partners and stakeholders.

Directors endorsed the proposed principles of engagement to ensure that the Fund's mandate and comparative advantage will be effectively leveraged to help country authorities in FCS achieve better macroeconomic outcomes. They emphasized the importance of focusing engagement on areas within the Fund's core competencies; promoting greater tailoring of instruments to the country-specific manifestations of fragility and conflict; as well as strategically enhancing partnerships with humanitarian, development, peace, and security actors. Directors noted that country ownership and effective communication with the public are key to advancing reforms in FCS.

Directors strongly supported the proposal to roll out Country Engagement Strategies (CES) across FCS. They concurred that the CES is an important vehicle to identify the key drivers of fragility and conflict to better tailor Fund engagement; support the integration of surveillance, capacity development (CD), and lending programs; inform program design and conditionality; and support a stronger dialogue with country authorities and partners. Directors emphasized the importance of consultations with country authorities throughout the CES process, as well as leveraging other institutions' analyses and expertise. Many Directors suggested considering a faster rollout of CES than proposed, if feasible. These Directors also suggested keeping the option of preparing CES for countries not formally defined as FCS but that are at high risk.

Directors generally agreed with the proposed measures to further calibrate the Fund's instruments and modalities of engagement to FCS conditions. They supported an expanded field presence to ensure that stepped-up CD provision in FCS is better tailored to local absorptive capacity and coordinated with other development partners. Directors emphasized the critical role that Fund CD can play in supporting FCS to progressively build institutions that effectively perform macroeconomic policy functions, noting the alignment between the FCS strategy and the FY23-25 CD priorities.

With regard to the lending toolkit, Directors supported the view that FCS that can implement UCT-quality programs should be encouraged to do so. They supported making full use of existing flexibility in the lending toolkit and enhancing program design through realistic macroeconomic frameworks and parsimonious and tailored conditionality aligned with institutional capacity and informed by the CES. Many Directors underlined that floating tranches should not be attached to core aspects of the program so as not to disincentivize reforms.

Directors noted that the recognition of post-program financing gaps should be accompanied with the appropriate safeguards. A few Directors suggested considering post program assessments for defunct arrangements. To address situations where there is an urgent balance-of-payment need and UCT-quality programs are not possible, most Directors expressed openness to using the flexibility of having concurrent staff-monitored programs and RCF/RFI, as this should support the transition to a UCT-quality arrangement, and looked forward to proposals for targeted adjustments to the RCF framework. Many Directors also suggested exploring in the future options for a new ECF window enabling shorter-duration arrangements to transition to longer-term UCT-quality programs. Lastly, Directors noted that the proposed Resilience and Sustainability Trust (RST) could help FCS address their long-term structural challenges, but many Directors expressed concerns that many FCS may not qualify for the RST if a UCT-quality program is required. Directors requested that more information and a clear justification on the approach adopted in a country be included in staff reports for Board discussion.

Directors supported enhancing partnerships to amplify the impact of Fund engagement in FCS by leveraging complementarities while avoiding duplication of efforts and leveraging the Fund's engagement to catalyze increased donor support. Collaboration with the World Bank is especially critical and the adoption of its methodology for FCS classification as proposed in the FCS strategy is an important step to ensure greater consistency of approaches between the two institutions. A few Directors underlined the importance of robust Country Policy and Institutional Assessments. Directors emphasized the need to ensure a smooth transition to the new FCS classification methodology, which should not result in diminished support to countries that will be dropped from the current internal IMF FCS list.

Directors agreed with the resource allocation proposal, consistent with the FY23-25 Medium-Term Budget, as per the budget augmentation framework. They agreed with the proposed FCS engagement model focused on closer support and follow-up with country authorities and partners. Directors supported the initiatives to enhance the expertise, recognition, and accountability of staff working on FCS, along with appropriate incentives. Directors acknowledged the inherent risks in FCS engagement and the importance of risk mitigation. Many Directors stressed that the Fund should be prepared to accept residual risks when sufficiently assessed and justified to fulfill its unique mandate and be able to best serve its membership.

Directors looked forward to the planned operational guidance to help staff effectively implement the FCS strategy, as well as to annual updates on progress made. A number of Directors suggested having a timeframe for reviewing implementation of the FCS Strategy.

February 14, 2022

THE IMF STRATEGY FOR FRAGILE AND CONFLICT-AFFECTED STATES

EXECUTIVE SUMMARY

Supporting fragile and conflict-affected states (FCS) is an important priority on the international policy agenda. FCS are home to nearly 1 billion people facing a variety of protracted challenges: from reduced institutional capacity and limited public service delivery, to forced displacement and war. Fragility and conflict are also exacerbated by climate change, food insecurity, and gender disparities. The economic impact of the COVID-19 pandemic has been most severe in FCS, as per capita incomes are estimated to recover to 2019 levels only after 2024. Debt and inflationary pressures have also mounted. *FCS are at a significant risk of falling behind in their post-pandemic recovery, but also in achieving the Sustainable Development Goals.*

About a fifth of IMF members are classified as FCS. In these countries, fragility and/or conflict destabilize balance of payments (BOP) positions, disrupt trade and financial flows, and hinder the development of productive resources. The effects are persistent over time: exit from fragility can take decades, as the policy space for reforms is constrained and trade-offs between short and long-run policy objectives are difficult to make. Progress is prone to high risks and recurrent setbacks. Moreover, social, economic, political, and security crises in FCS can also threaten macroeconomic stability and growth prospects in neighboring countries and regions. *The implications of fragility and conflict are thus macro-critical and directly relevant to the IMF's mandate. Addressing them requires a tailored approach that factors in the drivers of fragility, political economy dynamics, and specific constraints to reform in each country.*

This paper proposes a comprehensive Strategy to strengthen IMF support to FCS in accordance with the Fund's mandate and comparative advantage. Through long-term engagement and working with partners, the Fund will enhance its effectiveness in supporting FCS to achieve macroeconomic stability, strengthen their resilience, and promote inclusive growth to help them exit from fragility. Given the inherent complexity of FCS contexts, reforms are influenced by many factors outside the Fund's control. Nevertheless, within the scope of its mandate and comparative advantage, the Fund is committed to doing its part. *As such, the Strategy proposes concrete measures to tailor IMF engagement, instruments, and policy advice to the specific manifestations of fragility and conflict.*

The Strategy is a response to the Board-endorsed recommendations of the 2018 Independent Evaluation Office (IEO) Report on *The IMF and Fragile States*. The Report recognized the Fund's long-standing role in helping FCS promote sustainable economic growth, achieve macroeconomic stability, and progressively build stronger and more accountable institutions. Yet, the IEO also noted that important challenges remain in tailoring program design and conditionality to FCS circumstances; the realism and country specificity of policy advice; the provision of capacity development amid limited absorptive capacity; and the flexibility of the lending toolkit. There is also scope for improving strategic partnerships—especially with international and regional organizations that have a wider field presence—and strengthening support to IMF staff, including attracting talent.

The FCS Strategy draws on these insights and lessons learned. It proposes a framework and a set of measures that will allow the Fund to address these challenges and be better positioned to support the most vulnerable members. These include:

- Adopting **principles of engagement** to ensure that the IMF's **mandate and comparative advantage** will be effectively leveraged to help country authorities in FCS achieve better macroeconomic outcomes. Greater tailoring to the fragility and conflict context is one such key principle, underscoring the importance of focusing on the distributional aspects of macroeconomic adjustments and calibrating the pace and timing of structural reforms to political economy dynamics and institutional capacities.

- Rolling out **Country Engagement Strategies (CES)** across FCS. CES will identify key drivers of fragility and conflict to better tailor Fund engagement, support the integration of surveillance, capacity development, and lending programs, inform program design and conditionality, as well as the dialogue with country authorities and partners.

- Calibrating **IMF modalities of engagement** to better serve the needs of FCS. **Surveillance and analytics** will address more systematically the macro-critical implications of fragility and conflict drivers such as governance and corruption, food insecurity, climate change, or regional spillovers from conflict. An expanded IMF field presence will ensure that **capacity development (CD)** intensifies support for institution-building efforts, is better tailored to local absorptive capacity, and better coordinated with other development partners. To help country authorities in FCS successfully implement medium-term upper-credit tranche (UCT)-quality programs, the Fund will make full use of the existing **flexibility of its lending toolkit to improve program design and streamline conditionality, tailored to the specific situation of each FCS** and informed by the analysis in the CES. For FCS facing an urgent BOP need but where a UCT-quality program is not feasible, emergency financing instruments can be used provided that all requirements are met. In such cases, the combination of Staff Monitored Programs (SMPs) with emergency financing represents a useful component of the Fund's existing policy toolkit to support country authorities building a track-record of policy reform implementation ahead of a medium-term program.

- **Enhancing partnerships to amplify the Fund's comparative advantage.** The Strategy spells out how the IMF will work with development, humanitarian, as well as peace and security actors, based on respective mandates. **Collaboration with the World Bank will also be strengthened**. The Fund will adopt the **methodology, thresholds, and criteria of the Bank's FCS list**, which will help achieve greater consistency between institutions with the same shareholders and complementary mandates. The Fund and Bank will also share diagnostics more systematically—including fragility and conflict assessments—and deepen cooperation on macro-structural reforms based on best practices.

To achieve these goals, the Strategy will benefit from additional resources reflected in the FY23-25 Medium-Term Budget, as per the budget augmentation framework discussed by the Board in December 2021. The new resources will allow the Fund to significantly expand its footprint in FCS. An additional 40 local economists will be recruited to strengthen country offices. The coverage of FCS by Resident Representatives will also grow, thus enabling closer support and follow-up with country authorities and local partners. With expected donor contributions, the Fund's ability to provide CD regionally and in-country will increase by 70 percent to enhance its assistance to FCS governments undertaking policy reforms. Resources will also allow the Fund to stabilize the financial position of Regional Capacity Development Centers (RCDCs).

The Strategy also provides measures to better support staff working on FCS. These include the implementation of a career development framework featuring stronger incentives for experienced staff to work on FCS and a new learning curriculum to expand staff skillsets. Moreover, a Fund-wide recognition scheme for institutional priorities, including for FCS work, will be considered to acknowledge exceptional staff contributions. Staff will also benefit from the activation of a dedicated community of practice focusing on FCS.

Given the inherent risks in FCS engagement, the Strategy will be phased in starting in FY22, with implementation gradually accelerating between FY23-FY25. This will allow for course corrections and effective risk management, recognizing the intrinsic volatility of the fragility and conflict landscape. Progress will be carefully monitored through a set of indicators, starting with a new *Staff Guidance Note on the Implementation of the FCS Strategy* that will address operational implications of the proposed measures.

Approved By
Ceyla Pazarbasioglu

Prepared by a team led by Franck Bousquet (ICD) and comprised of: Cathy Pattillo, Aliona Cebotari, Jose Gijon, Gabriel Leost, Boileau Loko, Monique Newiak (AFR); Anne-Marie Gulde-Wolf, Jarkko Turunen, Todd Schneider (APD); Nisreen Farhan, Angham Al-Shami, Nagwa Riad, Noha El-Gebaly (COM); Katherine Baer, Abdelhak Senhadji, Raphael Espinoza, Keyra Primus, Isabell Adenauer, Racheeda Boukezia (FAD); Christian Mumssen, Craig Beaumont, Linda Kaltani, Joseph Thornton, Marta Spinella, Beata Jajko, Tetsuya Konuki (FIN); Mala Narain, Marc Klein, Roberto Guimaraes-Filho (HRD); Roger Nord, Michaela Erbenova, Matt Davies, Mark Lewis, Oussama Kanaan, Oana Croitoru, Neri Gomez (ICD); Yan Liu, Bernhard Steinki, Gabriela Rosenberg, Gomiluk Otokwala, Chady El Khoury, Kyung Kwak, Jonathan Pampolina, Joel Turkewitz (LEG); Taline Koranchelian, Laura Jaramillo Mayor, Azim Sadikov, Carol Baker, Yevgeniya Korniyenko (MCD); Udaibir Das, Gerard Almekinders, Veronica Bacalu, Maria Oliva (MCM); Axel Schimmelpfennig, Andrea Salerno (OBP); Jonathan Manning (ORM); Antonio Spilimbergo, Chris Papageorgiou, Malhar Nabar, Futoshi Narita (RES); Guillaume Chabert, Gavin Gray, Bjoern Rother, Daehaeng Kim, Rima Turk, Jiangyan Yu, Francisco Parodi, Tomohide Mineyama, Chiara Castrovillari, Roland Kpodar, Paul Bisca, Madita Weise (SPR); Christine Dieterich, Stephanie Medina Cas (STA); Nicole Laframboise and Joyce Wong (WHD).

CONTENTS

FIGURES

TABLES

ANNEX

Abbreviations and Acronyms

AML/CFT	Anti-Money Laundering / Countering the Finance of Terrorism
BOP	Balance of Payments
CCRT	Catastrophe Containment and Relief Trust
CD	Capacity development
CES	Country Engagement Strategy
CPI	Consumer Price Index
CPIA	Country Policy and Institutional Assessment
CSO	Civil society organization
CtR	Capacity to repay
DSA	Debt Sustainability Analysis
DSSI	Debt Service Suspension Initiative
ECF	Extended Credit Facility
EMDEs	Emerging Markets and Developing Economies
FCS	Fragile and Conflict-affected States
FDI	Foreign direct investment
FM	Fiscal Monitor
FTE	Full-time equivalent
GDP	Gross Domestic Product
FY	Fiscal Year
GFSR	Global Financial Stability Report
HDP	Humanitarian-Development-Peace nexus
HIPC	Heavily Indebted Poor Countries
HR	Human resources
HQ	Headquarters
ICD	Institute for Capacity Development
IDPs	Internally Displaced Persons
IEO	Independent Evaluation Office
LICs	Low-Income Countries
LTX	Long-term experts
MICs	Middle-Income Countries
MDBs	Multilateral development banks
ODA	Official Development Aid
OECD	Organization for Economic Cooperation and Development
PER	Public expenditure review
PFM	Public Financial Management
PPFG	Post Program Financing Gap
PRGT	Poverty Reduction and Growth Trust
RCF	Rapid Credit Facility
RCDC	Regional Capacity Development Center
RFI	Rapid Financing Instrument
RRA	Risk and Resilience Assessment of the World Bank
RTAC	Regional Technical Assistance Center
RST	Resilience and Sustainability Trust
SDGs	Sustainable Development Goals
SDR	Special Drawing Rights
SMP	Staff Monitored Program
UCT	Upper-Credit Tranche
UN	United Nations
UNHCR	United Nations High Commissioner for Refugees
WEO	World Economic Outlook
WFP	World Food Program