

**Does Foreign Aid Make Least Developed Countries
More Dependent on Aid Rather Than Independent? A
study of IMF conditionality in Mongolia**

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Abstract

The aid dependency undermines the quality of public service delivery, as well as the incentive to improve the budget management and sustain the fiscal deficit without resorting to the external financial aid. The paper reviews the aid effectiveness debate and focuses on the presence of policy as precondition for improving the performance of aid disbursement. Specifically, it focuses on the IMF macroeconomic policies and structural adjustment programs on the country case study and whether the externally imposed policies in form of conditionality reduce the national ownership of programs. The paper concludes that the IMF conditionality does indeed reduce the government ownership of IMF-supported programs. Nevertheless, there is a trend in increasing the program ownership after the IMF reformed the delivery of concessional loans through streamlined and flexible conditionality. However, in the absence of political will to “own” the programs and move forward to improving the quality of economic governance, the underdeveloped countries will remain dependent on the foreign aid.

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Abbreviations

ESAF	Enhanced Structural Adjustment Facility
FDI	Foreign Direct Investment
FRL	Fiscal Responsibility Law
GDP	Gross Domestic Product
GNI	Gross National Income
IMF	International Monetary Fund
LDCs	Least Developed Countries
LME	London Metal Exchange
MDGs	Millennium Development Goals
ODA	Official Development Assistance
PPP	Purchasing Power Parity
PRGF	Poverty Reduction and Growth Facility
SBA	Stand-By Arrangement
SDR	Special Drawing Right
SOEs	State Owned Enterprises
SSA	Sub-Saharan Africa
WB	World Bank

Chapter 1: Introduction

The aid hype has been brought to the attention of the world with the enthusiasm of Millennium Development Goals (MDGs) set to be accomplished by 2015. However, the closer the date for accomplishing the MDGs is approaching fast, the more questions are raised about the effectiveness of aid in achieving the objectives set forward. The global consensus reached by 189 nations to reduce extreme poverty by half at the Millennium Summit on September 2000 (Hulme, 2010:2) seems not even close to the quantitative numbers it set to reach. Further, the consensus has not outlined how to best achieve the MDGs. The calls for tackling the global poverty by increasing the amount of aid have been challenged on the ground that it might actually be the cause of poverty rather than its solution. In 2006 alone \$103.6 billion dollars of financial aid has been provided to developing countries (Williamson 2010:17). Over the quarter of a century the total of \$2.3 trillion has been dispersed in the form of foreign aid (Easterly, 2006:4).

The role of foreign aid in facilitating growth in the aid receiving countries has been debated extensively since the late 1960s. Nevertheless, the consensus has been reached on the effect of aid on growth, albeit with disappointing results compared to the amount of aid disbursed. The new emphasis of aid debate has shifted the focus from growth to the necessary conditions for increasing the effectiveness of aid. The paper is built on two key points. First, that the “micro-macro paradox is dead and buried” (McGillivray, 2003:24), namely establishing the macroeconomic impact of foreign aid. Secondly, the ultimate objective of aid effectiveness is the financial independence of the recipient-country free from external debt and the ability to sustain its economy from its own revenue without resorting to foreign assistance.

In this regard, the purpose of the research paper is to investigate the hypothesis that the conditionality imposed by the International Monetary Fund (IMF) does reduce the government ownership of the IMF-supported macroeconomic policies and structural adjustment programs. The paper is structured as follows. Chapter 2 provides the literature review on three current perspectives of aid effectiveness debate, followed by new shift in the debate focusing on the conditions necessary for the better performance of aid. Chapter 3 takes a closer look on the conditionality of aid and the shortcomings associated with it. Chapter 4 examines the IMF conditionality on the specific country

case study and seeks to establish whether the foreign aid in the form of IMF concessional lending reduces the ability of the country to lead macroeconomic policies that will to its financial independence.

Chapter 2: Literature Review

The role of aid in poverty reduction and fostering of growth and development in recipient countries has become one of the most controversial topics. Since around 1.5 and 2.5 billion people are living under the poverty line, depending on the poverty threshold of \$1.25 and \$2-a-day respectively (Hulme, 2010:115), live in the less developed countries (LDCs), the effectiveness of aid is viewed in terms of its impact on the economic growth of these countries. In order to determine whether aid is effective in reducing poverty, which is the main criteria for its assessment or whether it creates the dependency of developing countries on the aid flows, it is necessary to examine the literature on aid effectiveness.

2.1 Three Perspectives on Aid Effectiveness Debate

There are three perspectives on the aid effectiveness debate. On the one hand, there are proponents of aid, referred to as the leftists in the political term, since the aid effectiveness has become a highly politicized issue. The main concern of the believers in aid is the inequality within societies (Collier and Dercon, 2006:223) and the dismissal of the notion that economic process in name of globalization will help to lift out the “bottom billion” (Collier, 2007:4) from the poverty. The core argument of the supporters of aid is based on the public interest theory that insists on the necessity of the foreign aid to fill in the financial and investment gaps (Williamson, 2010:17) through the development interventions. The optimistic view of aid effectiveness is championed by Jeffrey Sachs in his book “The end of poverty” (2005) which calls for action in the form of the “big push” development model that requires increasing the amount of aid to developing countries (Sachs, 2005). Sachs argues that for aid to be effective and reach the MDGs, the donor countries need to increase their share of aid disbursement which is targeted at the ratio of 0.7 percent of their gross national income (GNI). In 2004, the target number stood on average at 0.25 percent of the GNI (Shirley, 2008:48).

On the other hand, there are opponents of aid or the rightists in the political term, who claim that less aid is the better. Clemens and Moss (2005) argued that the target of 0.7 percent is miscalculated and instead, the right amount of aid disbursement is 0.01 percent of the gross domestic product (GDP) of donor countries (Shirley, 2008:50). In other words, the effectiveness of aid has been increasingly doubted and criticized in terms of the amount spent and the development progress it achieved. In contrast to the public interest theory, the critiques of aid effectiveness base their argument on the public choice theory (Williamson, 2010:17) that rejects the development interventions as being socially inefficient. They argue that too much aid creates dependency by impeding with savings, crowding out the investment and thus, slowing down the economy. In short, they believe that aid has a negative impact on growth. This view of aid effectiveness is led by Bill Easterly in his much-cited book “White man’s burden” (2006) (Easterly, 2006). The radical anti-aid view is expressed by Dambisa Moyo in her book titled “Dead aid” (2009), where she argues that aid is detrimental to the growth of the recipient country because the benefits of aid are subject to being captured by the incumbent government and thus, rendering it dependent on aid (Moyo, 2009). She proposes the solution to poverty reduction by terminating the aid inflows altogether.

The third perspective on aid effectiveness falls between the leftists’ and rightists’ political views. In his book “The bottom billion” (2007), Paul Collier combines the views of both perspectives and emphasizes the importance of combining aid with other instruments of development (Collier, 2007). Since the financial aid can be given for various purposes and takes various forms, the one-size-fits-all model of development has failed to work in the fight against poverty (Collier, 2007: X). The issue is not about how much aid should be provided but rather how effectively to provide it. The aid is not the only solution to the world poverty since it has limitations on its own. The aid is only one of the instruments to fix the problems faced by the bottom billion and requires the combination of other instruments to improve the effectiveness of aid.

2.2 Aid-Growth Debate

The issue of aid effectiveness is a controversial issue since there is conflicting statistical evidence on the effect of aid on growth. The aid-growth debate can be traced back to the late 1960s studies. Hansen and Tarp (2001) provide an overview of aid effectiveness literature over three generations. They included in their survey 131 cross-country

regressions running from late 1960s to 1998 (Hansen and Tarp, 2001:380) examining the impact of aid on economic performance. In addition, Doucouliagos and Paldam (2006) identified 24 studies of aid-savings relation during the period of 1968-2004 and 29 studies of aid-investment relation during the period of 1975-2004 respectively. According to Levin and Renelt (1992), Easterly (2001) and Barro and Sala-i-Martin (2004), the robust measurement of economic growth is the capital accumulation either through savings or investment (Doucouliagos and Paldam, 2006:2).

2.2.1 Aid – Savings/Investment – Growth

The first generation of studies used the Harrod-Domar model of growth to establish a causal chain of aid-savings-growth. The second generation of studies replaced the Harrod-Domar model for the simple Solow growth model to analyze aid effectiveness directly from aid to growth or through the investment (Hansen and Tarp, 2001:377-381). The increase in savings and/or investment was seen as a key to development. The first two generations of studies were based on neo-classical growth models that perceived aid as exogenous to growth. The two separate studies conducted by Hansen and Tarp (2001) and Doucouliagos and Paldam (2006) on the effect of aid on capital accumulation through both savings and investment sides came to the contradictory conclusions. Nevertheless, there is a consensus on the unclear effect of aid on growth. Neither study denies or confirms the strong correlation between aid-savings/investment-growth links. Since various studies yield different results on the aid-savings/investment-growth relation, the authors assume that in the aggregate there is a positive but insignificant link between aid and growth (Hansen and Tarp, 2001:7; Doucouliagos and Paldam, 2006:21).

2.2.2 Aid – Policy – Growth

The third generation of studies on impact of aid on growth through the policy variable rendered the debate of aid effectiveness through savings-investment obsolete. The third generation of studies on aid effectiveness deviates from the previous two generations of studies on four novel grounds (Hansen and Tarp, 2001:385-6). Firstly, the aid-policy-growth studies include more years and countries. Secondly, the policy environment measure is included directly as an explanatory variable. Thirdly, the aid is taken as endogenous compared to the previous generations of studies that perceived the aid as

exogenous. Fourthly, the aid-growth link is viewed as non-linear and the aid fungibility is addressed.

The aid effectiveness studies by Hadjimichael et al. (1995), Durberry et al. (1998), Hansen and Tarp (1999) and Burnside and Dollar (1997) represent the main studies of the generation between 1990 and 2000. The latter study is one of the most cited papers in aid effectiveness literature and is the cause of heated debate among scholars and practitioners in the development field. All four papers employed the annual rate of increase in real per capita GDP as a measurement of economic growth (Hansen and Tarp, 2001:386). The studies by Hadjimichael et al. (1995) and Durberry et al. (1998) are consistent in their results in establishing a positive relationship between aid and growth. The study by Burnside and Dollar (1997) found that aid has a positive effect on growth conditional on good policy (Burnside and Dollar, 1997:33). In other words, in the absence of good policy environment, aid has a little impact on growth since the effectiveness of aid is directly dependent on the qualities of economic policies. In contrast, Hansen and Tarp (1999) replicated the study of Burnside and Dollar (1997) and established the positive link between aid and growth independent of policy variable (Hansen and Tarp, 2001:389).

Hansen and Tarp (2001:393) emphasized that the results of Burnside and Dollar (1997) study are highly dependent on the choice of explanatory variables. Their reservation is consistent with the observations of Lensink and White (2000:3) who also pointed out to the possibility of omitted variables that may bias towards the predetermined outcome, whether it is negative or positive. In other words, depending on the choice of explanatory variables the results vary and thus, they do not stand the independent replication, which creates the unreliability of findings. According to Levine and Renelt (1992) and King and Levine (1993), only few explanatory variables significantly affect economic growth. These variables include the “investment share, the secondary school enrollment rate, the initial level of income” and other financial indicators that have not been taken into account by Burnside and Dollar (1997) (Lensink and White, 2000:3).

2.2.3 “Micro-Macro Paradox” is Dead and Buried

The main studies of aid effectiveness literature between 1990 and 2000 established a positive relationship between aid and growth, albeit no consensus was reached on the

conditions necessary for growth. In fact, McGillivray et al. (2006:1033) and Collier (2007:100) do agree that aid contributes to growth even though the amount of aid disbursed does not match to the pace of development. Further, Riddell (1999:326) dismissed the aid dependency argument brought up by the critiques of aid effectiveness by stipulating that reducing the aid flows without corresponding to the aid needs will exacerbate rather than solve the problem of poverty in the LDCs. However, the debate over impact of aid on growth has not died down yet. Easterly et al. (2003:4) reproduced the methodology of Burnside and Dollar (1997) by adding more countries and years and found no statistically significant correlation between aid and growth. Whereas, Ovaska (2003:184) found a negative relationship between aid and growth: 1 percent increase in aid decreases annual growth rate of real per capita GDP by 3.65 percent.

The third generation of studies on aid effectiveness dissolved Mosley's (1987) "micro-macro paradox" (McGillivray et al. 2006:1033) that is the positive results of specific projects on micro level are inconsistent with the macroeconomic impact of aid on growth. The controversy over aid-growth debate has been settled on the consensus that without aid flows the rate of economic growth of recipient-country is much lower than with it. However, the aid-growth debate has been elevated to the new level of aid-policy-growth debate or more precisely, whether aid is conditional on policy or not.

2.3 Does Policy Matter?

The novelty introduced by Burnside and Dollar (1997) sparked a new round of aid effectiveness debate centered on the necessary conditions for growth in the LCDs. Here, the novelty is the aid-policy link that includes the interaction between the economic variables (budget deficit, inflation, trade openness) with non-economic variables (policy). Their findings established a statistically significant relationship between aid and policy and thus, concluded that the impact of aid on growth depends on the quality of economic policies. Did it create a new dilemma of chicken-and-egg? In other words, what comes first in aid-policy-growth causal chain: aid or policy? What is the necessary condition for aid efficiency: is it aid or policy that is a precondition for growth?

The findings of Burnside and Dollar (1997) paper were challenged by other authors. Hansen and Tarp (2001) paper argues the other side of the aid-policy-growth debate by establishing correlation between aid and growth without the presence of policy

qualification. Contrary to Burnside and Dollar (1997), Ovaska (2003:184) concluded that the quality of institutional environment plays an insignificant role to impact the effectiveness of aid in terms of results and outcomes. Furthermore, there is a line of thinkers who argue that the countries with the sound institutional environment do not need the foreign aid since they can adopt right combination of policies in order to achieve the economic growth. Whereas, the poverty-stricken countries that are most in need of aid do not have the capacity to spend aid money efficiently due to the lack of good governance and policy and thus, render the disbursement of aid ineffective. For example, according to Leeson (2008) the presence of good policy environment makes the need for aid unnecessary, while the absence of it renders the aid ineffective (Williamson, 2010:18).

The aid-policy-growth causal chain can be attributed to the third perspective of aid effectiveness debate literature which argues that the question of aid effectiveness is not about the quantity of aid to be disbursed but rather about the instruments to employ for improving the disbursement of aid. The parallel can be drawn between the chicken-and-egg dilemma and aid objective dilemma. This will allow us to pose the question differently. Instead of asking, “Does aid or policy come first?” we can ask ourselves “What is the objective of aid: follow the needs or effectiveness?” Ideally, it should be the both. The ultimate goal of aid should be addressing the needs of poor and facilitating the growth process. The perfect mechanism is making aid work even in the environment with poor governance and policies.

The growth itself is a slow process and it takes time to reach long-term objectives of aid allocation. According to Collier (2007:71), it takes 59 years on average for the country with bad governance and policy to come out of stagnation. The lack of sound institutional environment including the government accountability and rule of law is seen at the core of the growth failure (Collier and Dercon, 2006:235) because bad policies are persistent to change. Collier (2007:64) emphasizes on the inequality in opportunities rather than the requirement for good policy that determines the success or failure of the country in the development process. On the one hand, the condition for good institutional environment creates the condition for the realization of opportunities when they arise. On the other hand, when there are no opportunities, the presence of good governance and policy will not help to generate the opportunities.

Nevertheless, there is a consensus in the development debate over the importance of having a good policy environment (Burnside and Dollar 2000, Shirley 2008, Ovaska 2003, Riddell 1999) in order to better address the poverty problems and thus, facilitate the growth. This movement can be said to have come in the light of the results associated with the third generation (1999-2000) of studies linking the quality of policy with the aid-policy-growth relation albeit the lack of empirical evidence that the good governance in terms of sound economic policies and strong institutions determines the effectiveness of aid. The importance of having sound institutions becomes more relevant in the light of the criticism that donors lack coordination. The disagreement on the mechanism of aid transfers makes the coordination of the efforts more difficult. The donor coordination problem reduces the effectiveness of aid and further, threatens to undermine the efforts of each other. The information asymmetry is also noted as one of the reasons for the aid failure due to the divergent interests and incentives of donors and recipient-countries (Williamson, 2009:20-26).

Chapter 3: Conditionality of Aid

Collier (2007:108) emphasized that the bad governance trap is the one which needs most the increased injection of aid. On the one hand, the conditionality of aid in the framework of the neo-classical growth theory is consistent with the “Washington Consensus” that has been advocated by the international donor organizations such as the IMF and the World Bank. The conditionality is referred to the policy conditionality that requires the recipient-country to adopt certain economic policy reform in return for the fund disbursements. The findings of Burnside and Dollar (1997, 2000) study are consistent with the “Washington Consensus” that aid should be given to the countries with the sound institutional environment.

On the other hand, conditionality of aid is viewed as an obstacle limiting the inflow of aid to the countries that need it the most. Ironically, the current allocation of aid decreases the better the attained level of policy environment becomes and thus, there is inconsistency between the actual allocation and poverty-efficient allocation of aid (Burnside and Dollar, 2000:864). The poverty-efficient allocation of aid requires the allocation of aid to maximize the poverty reduction. According to Collier and Dollar’s (2002:1497) calculation, the efficient allocation of aid could double the number of people

being lifted out of poverty from 10 million to around 19.1 million per year. The United Nations (UN) Millennium Project (2005b:110) along with Sachs's line of argument made the proposition that the more aid would mean better institutions and thus, the MDGs would be achieved through the good governance. However, Shirley (2008:53) points out to South-East Asian countries such as China, Taiwan and South Korea as an example of countries that achieved the desired economic growth without foreign financial assistance. In contrast, Sub-Saharan African countries that received the bulk of financial aid have little economic progress.

Burnside and Dollar subsequent paper shifts the focus from policies to institutions and from conditionality to selectivity of aid. They defend their earlier findings that the difference in institutions is the main indicator in the rate of economic growth (McGillivray et al., 2006:1043). The UN Conference on Financing for Development held in Monterrey, Mexico in 2002 generated the "Monterrey Consensus" that acknowledged the aid selectivity approach in allocating aid on the basis of sound policies and good governance that will ensure the effectiveness of the Official Development Assistance (ODA) to the developing countries (Dollar and Levin, 2006:2034). For the purpose of the paper, the term foreign aid refers to the ODA that comprises of grants and concessional loans that have at least 25 percent grant component (WB, 1998:6).

3.1 Shortcomings of Structural Adjustment Programs

Since 1980s, the World Bank and the International Monetary Fund (IMF) adopted the standard practice for the allocation of ODA through the conditionality (Morrissey, 2002:154) that is, by disbursing aid in exchange for the recipient-country's promise to implement macroeconomic policy reforms. The policy conditionality or conditional lending had proved to be ineffective for the number of shortcomings.

3.1.1 *Principal-Agent Problem*

First of all, the conditionality imposes the preferences of the donor on the recipient-country by dictating the policies the former views fit for the economic growth of the latter. The preferences of the donor do not necessarily coincide with the preferences of the aid receiving government which creates the classical principal-agent problem. The divergence of preferences may lead to simple non-compliance. The disbursement of aid

before the policy reform is undertaken provided an opportunity for some recipient-countries to go back on their promises due to lack of commitment on the donor side to monitor the policy implementation. For example, it was the case with Zaire. Despite the inflows of foreign aid the country maintained its poor economic performance and was ridden by corruption for decades (Shirley, 2008:57). Alternatively, the recipient-country may comply with the conditional aid in order satisfy the donor preferences rather than reflect on its public spending preferences (Moss et al., 2006:7). The compliance is usually triggered by the fear that if the recipient-country does not agree with the donor preferences, the latter would reduce the amount of aid to be allocated.

However, as Morrissey (2002:167) argues, in practice both parties have an interest in the disbursement of aid and come to the agreement in the direction of policy reform. On the one hand, aid forms the alternative source of revenue for the government consumption which relieves it from the pressure to raise domestic revenue through tax collections and create the favorable policy environment for attracting private investment (Knack, 2001:312). By depending less on its population for raising the revenue necessary for the public spending, the government becomes less accountable to its citizenry. In turn, less accountability provides the government with the opportunity to pursue policies with short-term political benefits rather than long-run economic gains without the fear of jeopardizing the outcome of next elections.

On the other hand, the donors employ the result-based approach to the allocation of aid. The results-based rather than needs-based approach of aid disbursement leads the donor agencies to provide the funds despite the risk of non-compliance with the conditionality or reversing the undertaking later by the change of the rules, regulations or even constitution. The staff of aid agencies have their own incentives in approving the project and disbursing the funds since they are rewarded for “moving the money” (Shirley, 2008:61) by promoting their careers. According to Collier (2007:122) the current system of aid allocation is based on incrementalism – project- by project-based aid disbursement - rather than on the structural change. This fragmentation of project-based aid allocation more often than not lacks the coordination of policies; sometimes leading the agency departments compete for the aid funds. It is clear that the asymmetry of information stems from the principal-agent problem where the information possessed by the

recipient-country is not available for the donor and thus, the divergent incentives and information stand as a stepping-stone to the better performance of aid.

3.1.2 Aid is Fungible

Secondly, the aid is fungible or in other words, aid funds can substitute government spending. Although, the conditionality means the use of aid is earmarked for specific policy areas and thus, restricts its usage, the fungibility of aid makes the monitoring of policy implementation difficult to trace. For example, the government of Argentina used the aid money to compensate the employees of the state-owned enterprises (SOEs) who became unemployed in the process of the privatization of public enterprises (Shirley, 2008:57).

3.1.3 Number of Conditionality

Thirdly, in order to strengthen the monitoring and limit the fungibility of aid, the donors increase the number of conditions (Leandro et al. 1999:286) attached to aid which puts a further strain on the capacity of the institutions to carry out the adjustment programs. Between 1952 and 1995 the IMF binding conditions rose from 4 to 12, whereas the conditions imposed by the World Bank rose from 35 to 56 between 1983 and 1990 (Dreher, 2004:445-6).

3.1.4 Lack of Program Ownership

Fourthly, the imposition of the donor preferences through conditionality interferes with the sovereignty of the recipient-country by reducing the policy ownership (Moss et al., 2006:7) and providing the donors with a room for maneuvering in the domestic affairs. The one-size-fits-all-model of aid allocation disregards the economic, geopolitical, demographic, religious and historical characteristics of each recipient-country. It is true that all the developing countries and in particular LDCs have a common problem to resolve – the bottom billion living in poverty. However, common problem does not imply the common solution. What is good conditionality for one country does not necessarily is a solution for another. For example, Collier (2007:65-66) refers to Chad and Bangladesh that both rated low in 2005 Transparency International rating list. However, this does not imply that the same model of adjustment reforms apply to both countries since they differ by the poverty traps associated to each of them. The

characteristics of Chad as landlocked and natural resource country (oil) require the government to adopt more proactive reforms such as the institutional change, cooperation with private sector in order to improve the public service delivery. Whereas, Bangladesh as coastal and resource-scarce country needs to adopt the “single shot” (Leandro et al., 1999:287) policies such as tariffs and exchange rate to keep the economy stable in order to attract foreign direct investment (FDI). The policies that required structural reform had a lower rate of compliance, while policies that required little follow-up had higher rate of compliance (Leandro et al., 1999:287). As mentioned above, the aid system based on incrementalism produces the “piecemeal conditionality” (Leandro et al., 1999:287) that may be inconsistent due to inappropriate sequencing of policy reforms and further, undermine the impact of each other.

3.2 “Poverty-Maintaining” Conditionality

By 1990, it became apparent that the adjustment programs did not bring the desired results of growth in the recipient-countries; in particular the poor growth performance was evident in Sub-Saharan Africa (SSA). Few success stories in SSA such as South Africa, Uganda and Botswana had seen their economies grow at high rate but followed with downfalls in other sectors of economy, i.e. high unemployment rate (Riddell, 1999:319). Although, the overall picture gave the impression that the macroeconomic adjustment programs worked in those countries, the closer look reveals the devastating impact on the larger population, namely the bottom billion. One of the reasons for the adjustment or conditionality to fail in SSA is down to the fact that population growth rate exceeded the growth rate of economy (Riddell, 1999:318). In order to prevent more people falling into poverty the growth rate of economy must at least match the growth rate of population. Once more, this proves that the one-size-fits-all-model of development is not an appropriate tool in fight against poverty.

The adjustment or conditionality can be referred as “poverty-maintaining” growth (Riddell, 1999:319) as long as the macroeconomic reforms are seen as a precondition for growth. Instead, macroeconomic policies must be viewed as an outcome of institutional change. The specific projects such as increasing the number of people obtaining a primary education and basic health information provide the opportunity for poor people to increase their income and improve their livelihoods. The economic growth alone is not enough to reduce poverty; it needs to be coupled with investment in human capital.

The sustainable growth can be achieved by impacting the maximum number of people in the growth process through the creation of employment. Therefore, the allocation of aid must also not leave out the development of infrastructure that generates job opportunities. However, the roads and schools built need to be maintained in order to enjoy their long-term benefits. This can only be done through the existence of institutional system that fosters continuous ownership. Unless the change occurs in the system that produces the policies any attempt to change policies will be doomed to failure (Shirley, 2008:15).

The effectiveness of conditionality has been increasingly doubted since the publishing of the World Bank report *Assessing Aid* (1998) which based its claims on the studies by Burnside and Dollar (1997) and Collier and Dollar (2002). Burnside and Dollar (1997) study revealed that aid is beneficial in the presence of good macroeconomic variables such as fiscal, monetary and trade policies, while Collier and Dollar (2002) determined the formula for an optimal aid allocation which is the countries with high level of poverty but with good economic policies. Although, the poor institutional development of the recipient-country is blamed as one of the reasons for the poor economic performance, the pattern of aid allocation is also blamed for the ineffectiveness of aid in promoting growth and reducing poverty. According to Alesina and Dollar (2000:55-56), the direction of aid flows is determined by political, strategic, economic and policy performance, among these considerations colonial past and political alliances play a significant role in allocation of aid. In addition, there is no evidence that aid causes the adoption of good macroeconomic policies despite the revelation that multilateral donors allocate aid in favor of good policy, whereas there is no such a significant correlation between bilateral donors and preference for good policy (Burnside and Dollar 1997:864).

3.3 IMF Conditionality

The conditionality can be viewed as one of the most controversial policies adhered by the IMF. The conditionality in a broad sense covers the design and monitoring of macroeconomic and structural policies that are incorporated in the IMF-supported programs¹. Traditionally, the conditionality covered macroeconomic policies to ensure the repayment of the concessional loan and macroeconomic stability of the recipient-

¹ IMF Factsheet, available at http://www.imf.org/external/np/exr/facts/howlend.htm#_Focused_program_to [03.05.2011]

country. The major criticisms of adjustment programs stem from the failure to bring the desired growth through the macroeconomic policy reforms, neglects the impact of programs on social spending and income distribution (Buiru, 2003:56). By mid-1990s in the wake of Asian crisis as well as the debate over what constitutes a “good” economic policy, the focus shifted from the macroeconomic to structural aspects of adjustment programs (Dreher, 2004:450). The economic growth has become attributed to structural and institutional factors in addition to macroeconomic variables. The IMF conditions that included structural measures constituted less than 20 percent between 1985-1986, whereas by mid-1990s they were included in almost all IMF-supported adjustment programs (Dreher, 2004:451).

The IMF “structural policies include, *inter alia*, financial-sector policies; liberalization of trade, capital markets, and the exchange rate system; privatization of public enterprise policies; tax and expenditure policies (apart from overall fiscal stance); labor-market policies; pricing and marketing policies; transparency and disclosure policies; poverty reduction and social safety-net policies; pension policies; corporate governance policies (including anti-corruption measures); and environmental policies” (Goldstein, 2003:366). Since the concessional loans are provided with the interest below the market, the conditionality ensures the repayment back to the Fund with the interest. Agreeing on the conditionality the member state is assured to make purchases or receive disbursements for a specified amount during the specified period from the Fund.

The parallel can be drawn between the conditionality and the collateral. In the case of the IMF structural adjustment programs, the conditionality serves as a collateral for the IMF to safeguard the repayment of loan and as a constraint on the recipient-government to take high risks with the policy reforms. In other words, the imposition of conditionality serves two purposes: *ex ante*, it ensures the government does not default on its obligation and *ex post*, it achieves the macroeconomic stability in order to solve the balance payments problem (Khan and Sharma, 2001:5), which was, in a first place, the reason for the government to turn to the IMF seeking the financial assistance. Since in return for the provision of concessional loan to the government the IMF cannot receive the collateral in the strict term of commercial bank lending, the enforcement mechanism amounts to the “combination of moral suasion, maintenance of the borrower’s reputation, peer pressure and the threat of being shut out of international capital

markets” (Khan and Sharma, 2001:8). However, as mentioned earlier, the penalties are unlikely to be enforced due to the political or strategic interests. In particular, when the study by Mussa and Savastano (1999) found that the rate of compliance with the IMF policy conditionality was observed in less than half (45.5 percent) of all IMF-supported programs (Buiru, 2003:65).

By 1990s the conditionality was not enough to safeguard the revolving character of the IMF resources, namely the repayment of loan to be available for the other members of the IMF (Morrissey, 2002:155). Meltzer Commission pointed out to six reasons why there is a poor record of the international financial institutions in poverty reduction and institutional (Meltzer, 2002:31). They include the following: 1) missing the target, namely the large portion of aid is allocated to the middle-income developing countries that have access to private capital; 2) the share of allocation by the international financial institutions is smaller than the share of private capital accessible; 3) the guarantee in the form of conditionality induced from the government severs the link between the program failure and the donor’s risk of loss; 4) fungibility of money that makes it difficult to trace; 5) the conditionality served as an ineffective mechanism for reform from unwilling borrower; 6) the lack of government ownership reduces the effectiveness of conditionality.

3.4 Government Ownership of Program

The ownership is crucial to the success of program implementation since returns to an investment are dependent on the policy environment created by the government (Khan and Sharma, 2001:14). The national ownership of programs is viewed as a solution to the principal-agent problems since the agent (the recipient-country) will perform better if its incentives and objectives are aligned with those of the principal (the donor). In other words, the ownership of programs means the policy choices the government will make in the absence of conditionality imposed by the IMF. Morrissey (2002:167) emphasizes that the donors by providing information and advice to the governments will assist them to make informed choices instead of imposing standard policy prescriptions. Although, the Article of Agreement of IMF does not mention the concept of ownership and thus, there is no exact definition of it. Nevertheless, the revised guidelines on conditionality include in its principles the ownership aspect of conditionality. It explicitly refers to the government’s primary responsibility to select, design and implement its economic and

financial policies. After much internal debate on what constitutes a national ownership, the agreement was settled on the following definition:

“Ownership is a willing assumption of responsibility for an agreed program of policies by officials in a borrowing country who have the responsibility to formulate and carry out those policies, based on understanding that the program is achievable and is in the country’s own interest” (IMF, 2001:6).

Since the World Bank report *Assessing Aid*, the Meltzer Commission (2000) urged the IMF and other international financial institutions to lend to the country with good policy environments (Khan and Sharma, 2001:9). Under the pressure to reform and increase the effectiveness of its lending the IMF streamlined its conditionality by focusing on few objectives and prioritizing the core areas.

Chapter 4: Country Case Study

4.1 Methodology

Today, both the World Bank and the IMF provide financial assistance for structural adjustment support. The IMF concessional lending arrangement with the member state is usually a precondition for the World Bank adjustment lending (Dreher, 2004:446). The aim of lending and support of both financial institutions is directed towards increased growth and reduced poverty. However, the IMF-supported structural adjustment programs would not achieve its aim if there were a lack of political will. Therefore, the research question will focus on the following: “Does the IMF conditionality reduce the government ownership of program?” Is the government less likely to “own” the IMF program because it is financed conditionally? In this regard, it is useful to analysis the case study of the effect of aid on growth and poverty reduction.

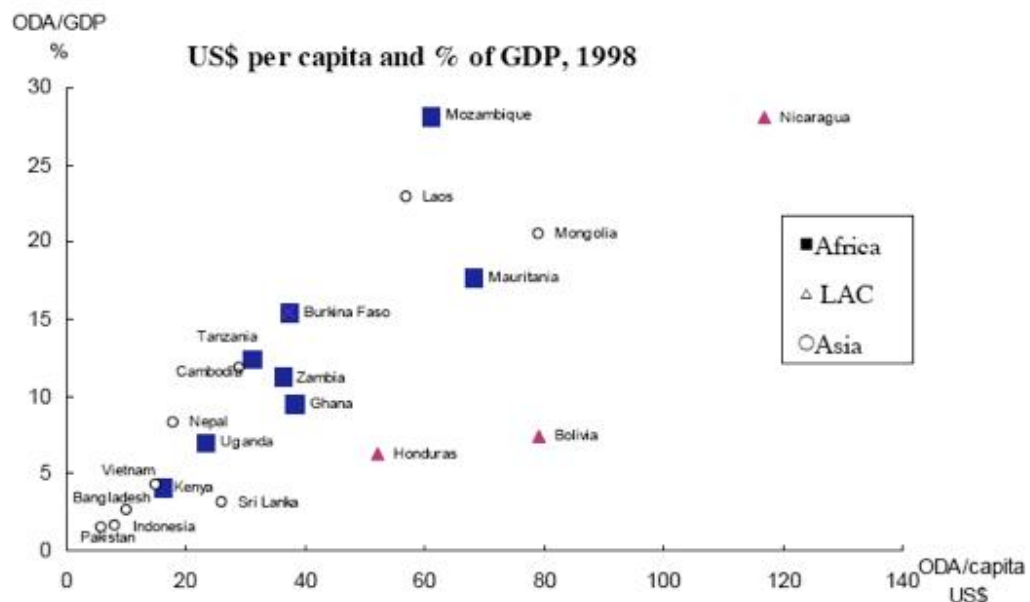
The methodology used in the research combines the qualitative and quantitative methods. Several regressions are run to establish a correlation between the price of copper and the share of fiscal overall balance in GDP, the share of mining and quarrying industries in GDP and the economic growth, and ODA per capita and net ODA received as share of GNI. The indicators are taken from the primary source such as the government primary indicators from the Ministry of Finance, secondary sources such as

statistical yearbook from the National Statistical Office and the indicators from the World Bank website. The secondary quantitative data necessary for the research have been collected from the IMF and the World Bank.

4.2 Case Selection

Mongolia illustrates a good example of aid effectiveness study, based on the development traps identified by Collier (2007). Mongolia is caught, except the conflict trap, in all other three traps, such as the natural resources trap, the trap of being landlocked and the trap of bad governance in a small country. Relevant to the purpose of the research, the country is highly dependent on foreign aid (Figure 1) combined with a lack of geopolitical interests on the part of main donors. The main multilateral donors are the IMF, the World Bank and the Asian Development Bank, while the bilateral donors are Japan, the USA and Germany (Fritz, 2002:90). Therefore, based on following criteria Mongolia is an exemplary case for aid dependency study: 1) high dependency on foreign aid; 2) landlocked; 3) abundant with natural resources; 4) presence of weak institutional capacity.

Figure 1: Aid Dependency



Source: World Bank. World Development Report 2000/2001, pp. 314-315.

Since Mongolia embarked into transition economy and became the member of the IMF in 1991, it had five financial arrangements (Table 1) with the IMF during the period of 1991-2010.

Table 1: Financial arrangements of the government of Mongolia with the IMF

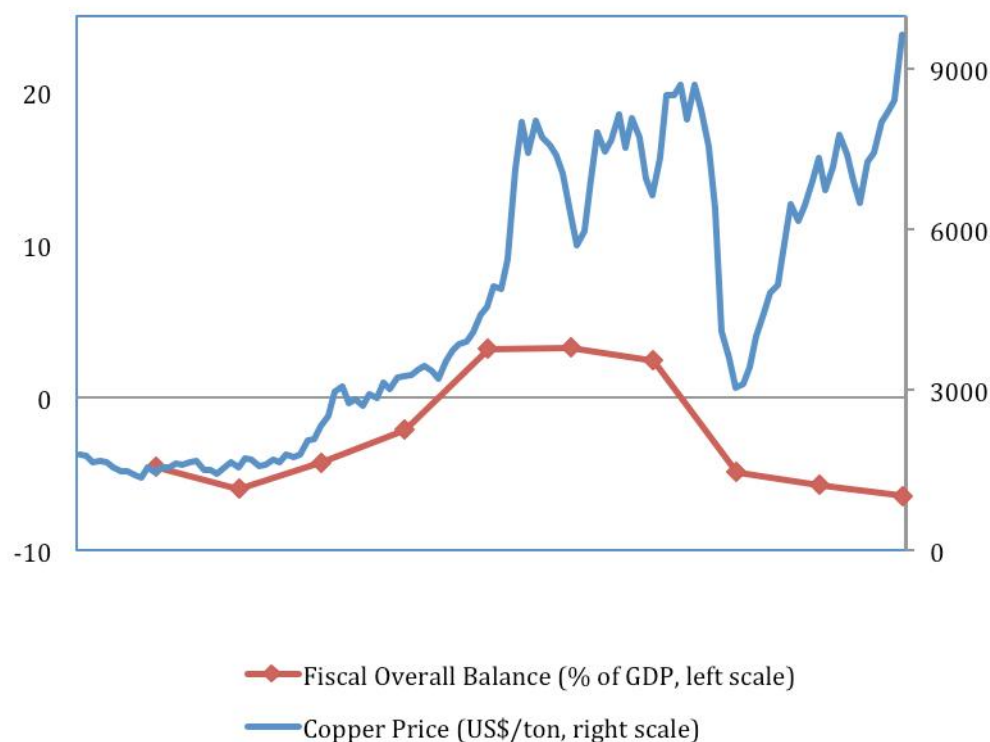
	Financial arrangement	Period	Amount approved (millions of SDR ²)
1	Stand-By Arrangement (SBA)	1991-1992	22.5
2	Enhanced Structural Adjustment Facility (ESAF) I	1993-1996	40.8
3	ESAF II	1997-2000	64.9
4	Poverty Reduction and Growth Facility (PRGF ³)	2001-2005	28.5
5	SBA	2009-2010	153.3

The latter Stand-By Arrangement took effect in April 2009, after the Letter of Intent from the government of Mongolia requesting the financial assistance in stabilizing the economy and keeping the inflation down hit hard by the global financial crisis of 2008. The request comes after more than three years since the last financial arrangement with the IMF was completed in 2005. The long interval between the last two arrangements with the IMF can be explained by the fact that the sudden surge in the price of commodity exports, copper in particular, generated the significant share of the government revenue from the export and kept the fiscal balance on the plus side and thus, made the government less dependent on the external funding (Figure 2). However, the collapse in the world price of copper in 2008-2009, coupled with the recent global financial crisis, made the economy vulnerable and thus, forced the government to turn to the IMF for financial help.

² Special Drawing Right

³ The ESAF renamed to the PRGF since 1999.

Figure 2: Fiscal Balances and Copper Price



Source: Government Budget Indicators of Mongolia, 1991-2010, Ministry of Finance, Mongolia.

Before the implementation of the latter SBA, none of the previous four IMF-supported programs were successfully completed in full. Under the initial SBA, Mongolia was not yet eligible to use concessional loan and thus, conditionality was not applicable in this case. The objective of the initial SBA was to stabilize the economy. The next three arrangements contained extensive conditionality.

4.3 Four Financial Arrangements: 1991-2005

The first formal financial arrangement with the IMF started with the ESAF I, which was acknowledged as ambitious at the outset (IMF, 2005:4). It included multiple objectives. The completion of the ESAF I resulted with mixed performance. There was an indication of strong government commitment in the earlier phase of the program, but it weathered away when the boom of commodity prices in 1995 eased the financial constraint (IMF, 2005:11) and caused delays in implementation.

The ESAF II concentrated on the banking sector reform, but contained numerous structural conditions. By 1996, the fall in copper prices on London Metal Exchange (LME) slowed down the economic growth and caused fiscal deficit. The increased number of conditionality intended to minimize the risk of lending in the aftermath of Mongolian banking crises of 1994, 1996 and 1998/9, and the weak program implementation under the ESAF I. However, the number of conditionality did not improve the policy track record. Under the ESAF II only two annual arrangements were completed (IMF, 2005:11). Here again, the government ownership faltered away by the internal political crises.

Although, the PRGF arrangement focused initially on fiscal sustainability, the main macroeconomic goals, such as reducing the fiscal deficit, were achieved due to the boom in commodity price. Following the IMF guidelines to streamline conditionality, the PRGF was accompanied by fewer conditions, but nevertheless the compliance rate remained poor (IMF, 2005:23). The favorable external environment, rather than the IMF-supported policy reform, eased the financial constraint faced by the government, which led to the disagreement between the IMF and the government over the latter's fiscal expenditure (IMF, 2005:12). The disagreement over the spending of the windfall revenue indicates the divergent preferences of the parties.

4.4 Pattern of Government Spending

“The importance of public revenue to the underdeveloped countries can hardly be exaggerated if they are to achieve their hopes of accelerated progress.”

- Nicolas Kaldor, Foreign Affairs, January 1963⁴

There is a pattern of the government of Mongolia to stray off from the program track whenever the windfall revenue caused by the increase of copper and other minerals prices loosens the fiscal constraint. On the one hand, the availability of other sources for budget revenue eased the financial constraint of the government making it less abiding to the IMF conditionality. On the other hand, when the program has too many objectives

⁴ Source: Moss, Todd, Gunilla Pettersson and Nicolas van de Walle. 2006. ‘An Aid-Institutions Paradox?’. Center for Global Development.

the government loses the focus on critical issues and this creates a problem of ownership by lack of commitment to the spirit of the policy reform.

The IMF and the World Bank criticized the expansionary fiscal policy of the government as one of the main causes of the budget deficit that further exacerbated the economic situation during the recent global financial crisis. Since the central government of Mongolia is the main tax collector, it executes 91 percent of public expenditure and provides public service delivery (WB, 2009:viii). The rapid increase in prices of commodity export generated the windfall revenue for the government between 2005 until the global financial crisis in 2008 (Figure 2). The mining boom increased the government spending on wages and salaries which accounted to 17 percent, on universal social transfers which accounted to 29 percent of total expenditure by the end of 2007, and infrastructure (WB, 2009:viii). Whereas, the same cannot be said about education and health spending, which comprised 11 and 6 percent of expenditure respectively (WB, 2009:viii). The insufficient spending on education and health sectors were noted by the IMF, as well. General education is an important aspect of human capital in a poor country, since the disparity of access to education between urban and rural population will contribute to rising inequality. The IMF pointed out to repeated failure on the part of the government to eliminate structural inefficiencies (IMF, 2005:19). The geographical location of Mongolia explains the increased spending in the infrastructure rather than in education and health sectors. The investment in infrastructure for the landlocked country is improving transportation links for its commodity exports and creating job opportunities to reduce unemployment.

4.5 Public Spending versus Quality of Public Services

However, the amount of spending does not match with the quality of public services provided. Why the government has a difficulty in translating the public spending into effective services? The effectiveness can be attributed to the number of factors.

First of all, the macroeconomic policies and structural adjustment programs were implanted in the country lacking the basic fundamental institutions necessary for transition to a market economy (Anderson et al, 2000:527). Since Mongolia qualifies as one of the poorest countries in terms of growth performance and Purchasing Power

Parity (PPP)-based per capita income⁵ (IMF, 2003:22), it has low administrative and institutional capacity to carry out policy reforms, which is recognized as a major constraint for program implementation.

Second, development outcomes depend on the design of fiscal policy and budget management. The pattern of public spending falls into the trap of resource-rich countries prone to Dutch disease. In other words, when there is an increase in prices of commodity exports that make up the large share of the government revenue, the government exercises incremental public expenditure leaving little to spend during the downturn of the economy. For example, government spending on poorly designed social transfers inflates the price and reduces the budget savings that in turn adversely affects the economy during external shocks and increases its future vulnerability. The pro-cyclicality of budget creates the fiscal un-sustainability, which in turn renders the government dependent on the external financial assistance rather than being dependent on its budget surplus.

Third, the political incentive biased towards the interest groups and reluctance on the part of the government to proceed with the certain reforms in order not to disadvantage those rent-seeking groups. The “boom-and-bust” fiscal approach of the government creates less incentive to reform or improve the tax administration and collection mechanism. The heavy reliance of the government of Mongolia on the mining boom renders it less reliant on the taxation of its citizens, which in turn makes the government less accountable. The government of Mongolia failed to fulfill its commitment under the structural adjustment programs to reform civil service and the pension system (IMF, 2005:18-19). Inadequate reforms have been carried out in education and health sector, and poorly designed social assistance missed the target beneficiaries.

4.6 Fifth Financial Arrangement: 2009-2010

Following the criticism of the government’s expansionary fiscal policy, the IMF and other donors pushed for adopting multi-year fiscal framework that will improve the budget management in terms of cost efficiency and setting the spending priorities into a single document. The pro-cyclical economic policy can be remedied by passing

⁵ Ranking in the last place (26th) among the other countries in the transition economy with ratio of PPP per capita to GDP on average at 1448 between period of 1990-2000. See Appendix 6, IMF, 2003.

legislation on Fiscal Responsibility (FRL) that includes the adoption of a multi-year fiscal framework. This ensures saving during the “boom” years. The macroeconomic policy reforms implemented by the government of Mongolia under the IMF-supported structural adjustment programs proved weak to withstand the external shocks, which was evident during 2008-2009 financial crisis. Therefore, under the latter SBA, the IMF included the parliamentary passage of the FRL as one of its structural conditionality, which was completed on 24 June 2010, albeit with some delay in its implementation (IMF, 2011:19).

The fifth financial arrangement with the IMF – the SBA, proved more successful in terms of government compliance with structural conditionality. The success of the SBA was attributed to streamlining the conditionality as part of wide-ranging reform of IMF lending. In comparison with previous financial arrangements with the IMF, the amount under the latter SBA is of an exceptional size, equaling 153.3 SDR, while the number of conditionality is fewer. The IMF acknowledged that it took high risk in lending this amount to a country with poor track record and previous lack of government ownership of the IMF-supported programs (IMF, 2011:8). None of the previous four programs were successfully completed in full. Nevertheless, taking prior policy measures, such as fiscal adjustment in 2009 budget and non-discriminatory foreign exchange auctions, facilitated the success of the latter program (IMF, 2011:8). The successful implementation was also contributed by fewer structural conditionality and more focused scope of structural benchmarks.

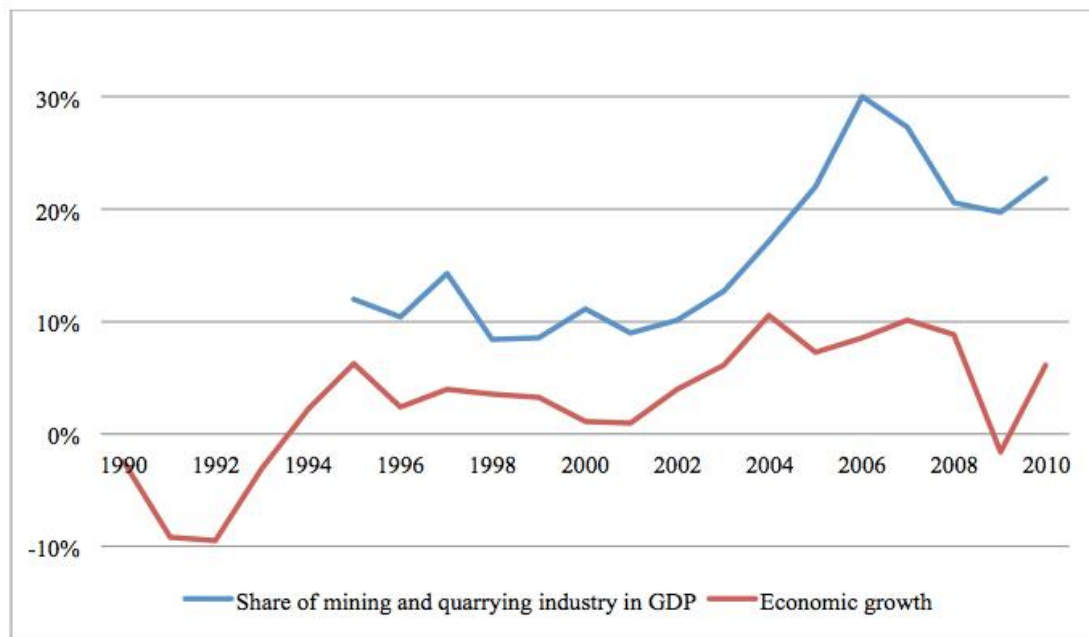
4.7 Role of Conditional Aid in the Development of Mongolia

The IMF accounts for playing a crucial role in Mongolia’s smooth transition to market economy with earlier interference with macroeconomic reforms (IMF, 2003:15). The IMF classified Mongolia as “mature stabilizer”⁶ with restored economic growth: the inflation is mainly under the control, many of the SOEs are privatized and there is the least restrictive trade regime in comparison with other countries from the Commonwealth of Independent States⁷. Nevertheless, despite the IMF-supported adjustment programs, the economy remains vulnerable to external shocks.

⁶ Mature stabilizers are low-income countries that have achieved per capita growth greater than 1 percent and inflation less than 10 percent. Source: *Monetary and Fiscal Policy Design Issues in Low Income countries*. (www.imf.org)

⁷ See Appendix 8 “Trade Restrictiveness Ratings, 1997-2001”, IMF, 2003.

Figure 3: Share of Mining and Quarrying Industry in GDP and Economic Growth

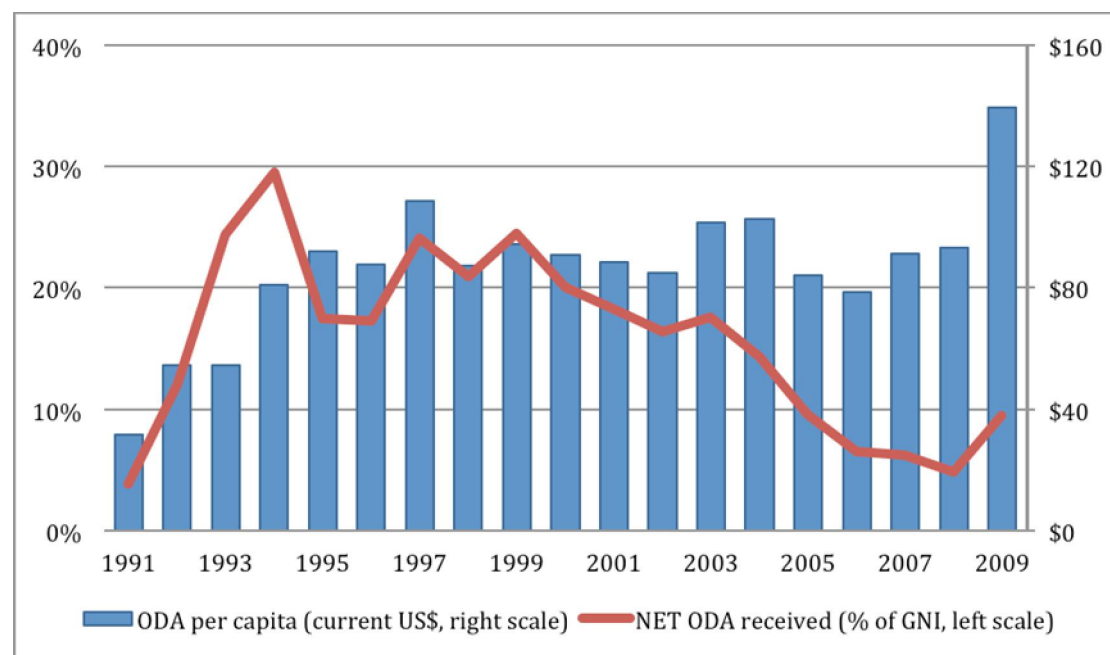


Source: Statistical Yearbooks: 1997-2010, National Statistical Office of Mongolia

Figure 3 shows the positive correlation between the share of mining and quarrying industry in the GDP and economic growth. With the increase in share of mining and quarrying industry in the GDP, there is an increase in economic growth and vice versa. At the beginning of transition to market economy, the share of mining and quarrying industries in the GDP declined, followed by the decline of economy; since 2003 it started to grow reversing the economic performance. The rise of copper and other minerals prices on the international market, as well as the FDI flowing into the mining and quarrying industries, are attributed to the increase in the share of the sector in the GDP. The share of mining and quarrying industries in the GDP reached its peak of 30 percent in 2006. The rapid economic growth was observed between the periods of 2003-2008 with the average growth rate of 8.6 percent per year. This positive performance continued until the economy was hit by the global financial crisis in 2008, when the prices of copper and other minerals fell, which was followed by the economic downturn. From 2008 the economy plummeted reaching its lowest point and negative growth rate in 2009. However, it was not as bad as in 1992, when the economic growth reached 9.5%.

The unavoidable consequence of transition economies is the accumulation of external debt. Mongolia's external debt is above the 40 percent threshold, which makes it vulnerable to running into debt distress or bankruptcy (IMF, 2005:28). Figure 4 below shows the net ODA received as a share of the GNI and ODA per capita in US\$ during the period of 1991-2009.

Figure 4: Official Development Assistance in Mongolia



Source: <http://data.worldbank.org/indicators>

Since the country embarked into transition economy, the government faced severe financial constraint and in order to smooth the transition process, the government needed external financial assistance. With the progress in implementing its transition into market economy and the rapid economic growth between 2003 and 2008, the share of net ODA received gradually declined reaching 4.8 percent of the GNI. The declining trend was reversed in 2008 in the wake of global financial crisis that increased the share of net ODA to 9.4 percent of the GNI in 2009. However, the share of net ODA received reached its peak in 1994 when it amount to 29.5 percent of the GNI. In terms of the ODA per capita, it equaled around US\$ 90 on average and was constant until the financial crisis hit in 2008, which increased the allocation of ODA to US\$140 per capita. Although, from the graph it gives the impression that the ODA received as the share of GNI (see red line) did not increase substantially, while the ODA per capita increased

substantially (see blue line). In fact, the foreign aid received by the government was constant because the share of financial assistance shrinks in comparison with the scope of economic activities. When we look at per capita aid allocation, the aid was constant because the population is relatively small and has not increased rapidly since the transition period.

The question is: Should the fiscal policy be used to reduce external debt or increase public spending? By looking at the strategy taken by the government of Mongolia it is going towards Dutch disease attributed to natural resources abundant countries, since too much reliance is given to the commodity price boom, mining revenue in particular. This generates the pro-cyclical economy. The IMF conditionality seeks to reduce future vulnerability to the external shocks through structural reform measures that would reduce pro-cyclicality of budget. The measures require the government to strengthen the institutional framework by focusing on the policy reform that emphasizes the improvement of the tax system that would generate revenue independent of commodity export as well as improving the social transfer programs without inflating the economy.

4.8 Conclusion on Case Study

IMF conditionality does tend to reduce the government ownership of IMF-supported adjustment programs. The low rate of compliance is observed in four out of five financial arrangements with the IMF. There is no assurance of post-program implementation albeit the compliance with the conditions of lending in the latter SBA (IMF, 2011:6). The structural reform measures to improve the social transfer programs were slow to achieve its objective due to the cultural and political reluctance to identify and treat the poor differently (IMF, 2011:14). This cultural and political divergence of preferences is a stepping-stone towards the successful implementation of the structural reforms. The rate of non-compliance indicates to the government reluctance to commit itself to conditionality and “own” the program initiated by the IMF. However, the fact that the last financial arrangement was a success points to the improvement made in the conditionality arrangement, namely reducing the number of conditionality, focusing the objectives on core areas of reform rather than incorporating multiple objectives, prioritizing the objectives, strengthening the ownership of the programs through negotiations with the staff of the government.

Chapter 5: Conclusion

Neither optimistic nor pessimistic view on the aid effectiveness is applicable here. Neither how much nor how little in terms of amount of foreign aid is relevant here. The only relevance in improving the performance of aid is the efficiency of aid disbursement. The foreign aid in form of IMF concessional loan is only one of the instruments to fix the problem of poverty in the LDCs. The analysis of the IMF-supported structural adjustment programs and the compliance with its conditionality on the case study of Mongolia proves the hypothesis that the IMF conditionality does reduce the government ownership of programs. The one-size-fits-all model of development proved unsuitable when the countries face development traps specific to their circumstances.

The economic governance is at the centerpiece of generating an environment for growth and poverty reduction as well as for aid effectiveness (Dollar and Levin, 2006:2044). It is a driving force for the effective implementation of structural reform and its sustainability. The newly emerged tendency toward selectivity in terms of economic governance is already seen in the latter IMF-supported structural adjustment program. However, in order to increase the national ownership of the programs, it is very unlikely for the IMF to waive on the conditionality in its entirety. The conditionality is here to stay. It will remain a rule rather than an exception. Taking into account the scale and duration of the structural reforms to reduce the future vulnerability of the economy to external shocks, Mongolia is long way from sustaining its economy without the donor's financial assistance. Unless the government takes steps to manage its fiscal deficit during economic downturns, it will remain dependent on the foreign aid. The same reasoning applies to other LDCs when the lack of political will undermines the efforts of donors.

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