

INTERNATIONAL MONETARY FUND

**Aid Inflows—The Role of the Fund and Operational Issues for Program Design**

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## EXECUTIVE SUMMARY

**The Fund has worked to ensure an enabling macroeconomic environment for aid use through its advice, technical assistance, and financial support, including debt relief.** The Medium-Term Strategy (MTS) calls for a deeper involvement of the Fund in assessing the relationship between aid inflows, Millennium Development Goal (MDG)-related resource needs, and macroeconomic stability. This paper considers one of the mandates outlined in the MTS: advising low-income countries on appropriate macroeconomic policies in the face of increased and volatile aid inflows.

**The paper focuses on the operational implications of high and volatile aid for the design of Fund-supported programs.** It provides a conceptual framework that should guide country teams in giving advice to low-income countries on a case-by-case basis, without specific quantitative performance thresholds for the spending and absorption of additional aid. In doing so, it responds to some of the concerns raised by the Independent Evaluation Office (IEO) in its recent evaluation of the Fund and aid to sub-Saharan Africa.

**In order to address the key questions on the macroeconomic management of aid, the paper assesses recent experience with program design.** The evaluation focuses on experience since the establishment of the Poverty Reduction and Growth Facility (PRGF) in September 1999 and through the first programs monitored under the Policy Support Instrument (PSI). The assessment comprises two elements: a broad examination of quantitative program conditionality and adjusters, and case studies.

**A key focus is the extent to which program design has accommodated the full use of aid by allowing both spending and absorption.** While the case studies focus on total fiscal aid, the report recognizes that in recent years a rising share of aid has consisted of program support, the spending of which is under the government's control. This shift has supported budget flexibility and reduced transaction costs.

**The paper confirms that Fund-supported programs have become more accommodating of the use of aid, and more supportive of pro-poor spending.** Since 1999, program design has changed to accommodate the spending of (more) aid in program baselines; and there has been a partial move toward accommodating the spending of unanticipated aid and offsetting unanticipated shortfalls. Nevertheless, aid volatility has often complicated fiscal policy design.

**It also underscores the importance of the coordination of fiscal, monetary, and exchange rate policies to managing aid inflows.** Actual aid absorption was substantially smaller than projected and permitted under most Fund-supported programs. Generally, a reluctance by the monetary authorities to allow their currencies to appreciate led to larger-than-programmed international reserves, creating inflationary pressures. Real appreciation has often been a concern, but rarely a problem.

**The following best practices for future program design and policy advice can be drawn from this study:**

- *Aid projections:* Fund aid projections, both in the immediate forecast and in subsequent years, should represent staff’s best estimate of the amount of aid that will materialize, based on all available information. While programs should have one baseline, Fund staff should assist authorities in preparing alternative scenarios of scaling up.
- *Spending aid:* Fund-supported programs should generally support the full spending and absorption of aid, provided macroeconomic stability is maintained, and taking into account specific country circumstances and development needs. Fund-supported programs should rarely constrain aid-based spending on the grounds of risks to competitiveness. Micro-absorptive capacity constraints can, however, argue for a gradual approach to raising public spending. Specific conditionality (such as spending floors) can be incorporated to support the expansion of poverty-alleviating programs.
- *Absorbing aid:* Monetary programs should seek to combine absorption of aid with price stability and reserve adequacy. It is essential to have a clear and common understanding of the exchange rate regime and monetary policy objectives. In general, scaling up strengthens the case for exchange rate flexibility, while managed floating can raise difficult challenges for program design. Scaling up ties in with the “Net Foreign Asset/Net Domestic Asset” conditionality framework for monetary policy.
- *Aid volatility:* While aid disbursements are often volatile, Fund-supported programs should promote a smooth path of fiscal spending. Once reserve adequacy has been achieved, program adjusters should allow temporary deviations from programmed foreign financing to be absorbed through domestic borrowing, financed through reserve drawdowns.
- *Allocating expenditures, resource use, and meeting the MDGs:* Fund staff should collaborate closely with the World Bank, and rely on the Bank and other development partners for sectoral assessments. Staff will continue to assist the authorities in monitoring the use of scaled-up resources using Poverty Reduction Strategy (PRS)-based definitions of priority spending.
- Program documents should provide better explanations of program design. This applies, in particular, in the case of deviations from the identified standard best practices.

## I. INTRODUCTION

1. **The Fund has actively supported implementation of the March 2002 Monterrey Consensus, which called for both increased and more effective international support to low-income countries (LICs) and the pursuit of sound policies and good governance by these countries.** Progress on both fronts is necessary for achieving the MDGs. To this end, and recognizing LICs' urgent spending needs, the Fund has worked to ensure an enabling macroeconomic environment for aid use through its advice, technical assistance, and financial support, including debt relief. In particular, as noted in the Managing Director's Report on Implementing the Fund's MTS, the Fund's aim is to help LICs design macroeconomic policy frameworks that support sustained growth and poverty reduction while maintaining macroeconomic stability and debt sustainability.<sup>1</sup>

2. **The MTS calls for a deeper involvement of the Fund in assessing the relationship between aid inflows, MDG-related resource needs, and macroeconomic stability.** In particular, it states that Fund staff should: (i) assess and report whether projected aid inflows are consistent with macroeconomic stability and with the estimated costs of achieving countries' development goals, including the MDGs; (ii) advise countries on appropriate macroeconomic policies; and (iii) inform donors when more aid can be absorbed effectively without endangering macroeconomic stability or debt sustainability.

3. **This paper considers the second of these three mandates under the MTS—appropriate macroeconomic policies in the face of increased and volatile aid inflows for program design.**<sup>2</sup> While earlier work looked at the theoretical underpinnings of such advice, here the focus will be on the operational implications, in particular in Fund-supported program design. Seven questions that arise in the context of scaling up frame the discussion:<sup>3</sup>

- *How cautious or optimistic should the baseline projections of aid inflows be in a Fund-supported program?*
- *To what extent, at what pace, and in what combination, should increased aid be used—to raise public spending, to finance higher net imports, and/or to help build higher foreign exchange reserves?*

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<sup>1</sup> See IMF (2006a).

<sup>2</sup> Other aspects of the MTS related to LICs will be discussed in a forthcoming paper on the role of the Fund in the PRS process.

<sup>3</sup> The reasoning behind the answers to these questions is equally relevant for policy advice to countries that do not have a Fund-supported program.

- *How can fiscal, monetary, and exchange rate policies be coordinated to help avoid problems of excessive inflation, crowding out of private investment, or exchange rate volatility related to scaling up?*
- *How should countries manage their macroeconomic policies in the face of high volatility of aid?*
- *How can competitiveness be safeguarded in the face of higher aid-based spending?*
- *How can debt sustainability be maintained in determining how much debt-financed spending can be undertaken?<sup>4</sup>*
- *How might programs manage limits to micro-absorptive capacity and issues surrounding expenditure allocation and monitoring resource use—in large part drawing on input from development partners, in particular, the World Bank, as these issues are mostly outside the Fund’s core areas of expertise.<sup>5</sup>*

4. **This report draws on previous staff work on the macroeconomic challenges for low-income countries created by aid inflows.** It builds on the 2005 review of program design supported by the Fund under the PRGF—in particular, the “spend-and-absorb” framework for examining the policy responses to aid.<sup>6</sup> It also draws from the assessment of policies in low-income countries that have successfully addressed the most apparent macroeconomic imbalances, as well as other recent Fund studies concerning the implications of higher aid and the appropriate policy response.<sup>7</sup> This report confirms that PRGF-supported programs have become more accommodating of pro-poor spending,<sup>8</sup> and underlines the importance of the coordination of fiscal, monetary, and exchange rate policies to managing aid inflows.

5. **It also responds to some of the concerns raised by the IEO in its recent evaluation of the Fund and aid to sub-Saharan Africa.<sup>9</sup>** The IEO found scope for further clarification of Fund policies, including concerning aid projections, the accommodation of

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<sup>4</sup> Debt sustainability issues have recently been addressed in IMF (2006b) and IMF (2006c), and this paper mainly summarizes the best practices for program design. See Section III.F for details.

<sup>5</sup> Collaboration between the World Bank and the Fund are discussed further in the context of the February 2007 “*Report of the External Review Committee on Bank-Fund Collaboration.*”

<sup>6</sup> See IMF (2005a) and Berg et al. (2007).

<sup>7</sup> See IMF (2005b), Isard et al. (2006), and Gupta et al. (2006).

<sup>8</sup> See IMF (2002), IEO (2004), IMF (2005b), and IEO (2007).

<sup>9</sup> See IEO (2007).

additional aid, and the use of alternative scenarios. Each of these is addressed in this paper. It provides a conceptual framework that should guide country teams in giving advice to low-income countries on a case-by-case basis, with no specific quantitative performance thresholds for the spending and absorption of additional aid. Other issues raised by the IEO, in particular on the mobilization of aid, will be addressed in a forthcoming paper on the role of the Fund in the PRS process.

6. The remainder of the paper is organized as follows: Section II presents a brief review of the methodology used to assess past program design. Section III considers each of the seven questions raised, looking at an assessment of experience in PRGF-supported programs and considering what principles should guide Fund work with low-income countries. The last section presents some conclusions and issues for discussion for Directors.

## II. METHODOLOGY USED TO ASSESS PROGRAM DESIGN

7. **In order to address the key questions on the macroeconomic management of aid, this paper assesses recent experience with program design.** This section introduces the methodology and the framework for this exercise.<sup>10</sup> The evaluation focuses on experience since the establishment of the PRGF in September 1999 and through the first PSIs. The assessment—presented by subtopic in the next section—comprises two elements: a broad examination of quantitative program conditionality and adjusters; and case studies. The examination of quantitative fiscal and monetary conditionality covers the first annual programs of 26 arrangements immediately following the establishment of the PRGF (“first generation programs”) and all 34 of the current or most recent PRGF- or PSI-supported programs (“second generation programs”), including all successors to first generation programs.<sup>11</sup> The case studies cover the subset of LICs that have witnessed large or strongly increasing aid inflows so that aid management was a program design issue. The sample also includes most countries that saw a significant scaling up of aid between 2000 and 2005—defined as an increase in aid by 5 percent of GDP or more.

8. **A key focus is the extent to which program design has accommodated the full use of aid by allowing both spending and absorption.** The basic purpose of aid is to allow recipient countries to increase their consumption and investment (i.e., *spend the aid*) using the transfer of external resources from the donor (i.e., *absorb the aid*; Box 1). A spend-and-absorb strategy is instrumental in ensuring that aid helps raise the rate of economic growth and reduces poverty by financing new public investments and social spending.

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<sup>10</sup> Further information is presented in the background paper to this report.

<sup>11</sup> The data on the recent programs are taken from the latest published staff report on the use of Fund resources (UFR). The data on the predecessors reflect the program design at the time of the request or the first UFR staff report following the establishment of the PRGF. See the background paper, Annex II.

### Box 1. Spending and Absorbing Aid

**The macroeconomic policy response to aid may be characterized by the fiscal and monetary authorities' decisions on *spending* and *absorbing* the aid.** *Absorption* is defined as the widening of the current account deficit (net of aid) due to incremental aid (IMF, 2005; Aiyar, Berg, and Hussain, 2005; Foster and Killick, 2006, and Berg et al. 2007). It measures the extent to which aid engenders a real transfer of resources through higher imports, or through a reduction in the domestic resources devoted to producing exports. The central bank determines absorption through its sales of foreign exchange, and through monetary policy which influences aggregate demand, and hence the demand for imports. *Spending* is defined as the widening of the fiscal deficit (net of aid) accompanying an increment in aid.

**To absorb and spend is the textbook response to aid.** Absorption ensures that there is a real transfer of resources to the recipient country, while government spending allocates these resources to priority investment and consumption. Other responses to aid may be justified under particular circumstances for short periods. Neither to absorb nor spend the aid may help build up international reserves or smooth volatile aid flows (in the long run, however, this response is equivalent to forgoing aid altogether). To absorb but not spend substitutes aid for domestic financing of the government deficit (net of aid). Where the initial level of domestically financed deficit spending is too high, this can help stabilize the economy or crowd in private investment. To spend and not absorb is a common but problematic response (IMF, 2005). This response is similar to a fiscal stimulus in the *absence* of aid. The aid dollars stay in reserves, so the increase in government spending must be financed by government borrowing from the domestic private sector or by printing money. There is no real resource transfer given the absence of an increase in net imports. There is either a rise in interest rates or an increase in the money supply, depending on whether the government expenditure is sterilized or not.

The matrix below summarizes the four basic short-run policy combinations available to a recipient of scaled-up aid and their economic effects.

	<b>Absorbed</b>	<b>Not Absorbed</b>
<b>Spent</b>	<p>Textbook case where central bank sells aid dollars and fiscal deficit rises as aid is spent.</p> <p>Aid is used for public investment and consumption.</p> <p>No change in money supply. Risks Dutch disease.</p>	<p>Central bank accumulates foreign exchange as reserves; fiscal deficit rises as aid is spent.</p> <p>No real resource transfer.</p> <p>Unsterilized: Money supply rises. Risks inflation.</p> <p>Sterilized: Crowding out of private sector. Domestic debt accumulates.</p>
<b>Not Spent</b>	<p>Central bank sells foreign exchange but fiscal deficit remains unchanged.</p> <p>Helps achieve stabilization, provides resources for private investment.</p>	<p>Central bank accumulates foreign exchange as reserves; fiscal deficit net of aid unchanged.</p> <p>No real resource transfer.</p> <p>No Dutch disease.</p> <p>Equivalent to rejecting aid (in long run).</p>



9. **The degree to which programs accommodate higher aid can be assessed most effectively through multi-year case studies of program design (Box 2).** The advantages are twofold. First, aid need not be used in the same year it is received and its effective use may require prior macroeconomic stabilization. Second, case studies allow an examination of the interplay in a Fund-supported program among the baseline aid projection, the design of conditionality in the program, and the ultimate aid inflow.<sup>12</sup>

10. **Finally, Section III recognizes that alternative types of aid have different macroeconomic effects.** While the case studies focus on total fiscal aid,<sup>13</sup> this report recognizes that in recent years, a rising share of aid has consisted of program support, the spending of which is under the government's control. This shift has supported budget flexibility and reduced transaction costs. By contrast, the spending of project aid is largely controlled by donors, and is often not channeled through the budget. As a consequence, deviations from projected levels tend to be offset automatically through lower spending. The distinction between grants and loans is crucial for assessing debt sustainability. Furthermore, the distinction between budget support and project aid is no longer an adequate description of the reality of aid. More and more aid is being channeled through vertical funds to specific sectors and even to specific functions. Finally, while debt relief is a vital part of the broader aid strategy, and often crucial to restoring debt sustainability, its direct impact on "fiscal space" and foreign exchange markets is limited (other than through a subsequent reduction in debt service), and its use is not a separate focus in this paper.<sup>14</sup>

### III. AID-RELATED ISSUES IN PROGRAM DESIGN

11. **This section assesses how program design has evolved in response to the policy challenges posed by high and changing aid inflows and proposes best practices for future program design.**

#### A. Projecting Aid

12. **The use of aid in a Fund-supported program hinges on the baseline projection of aid inflows, as it guides policy making, including budget preparation.** The key policy question is how the staff and authorities should go about making this baseline projection.

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<sup>12</sup> An important element of program conditionality is the design of the program adjusters, which specify to what extent deviations from the anticipated level of aid can be spent and absorbed. However, the relevance of these adjusters hinges on the underlying projection of aid inflows. With optimistic (pessimistic) aid projections, only the downside (upside) adjusters are relevant.

<sup>13</sup> The term fiscal aid is used to denote budget support and project aid (to the extent it is channeled through the budget). It excludes balance of payments assistance and debt relief.

<sup>14</sup> While this paper does not focus on inflows other than aid, such as remittances or private flows, these can raise similar policy challenges, in particular for monetary and exchange rate management.

## Box 2. Overview of the Case Studies of Program Design<sup>1/</sup>

The case study countries have been receiving large or increasing amounts of foreign aid while their economic policies have been supported under the PRGF or PSI. Inflows rose from an average of 15 percent of GDP in 2000 to 20 percent in 2004 (including debt relief).

Two Fund-supported programs with **Burundi** allowed for the full spending of anticipated aid and accommodated aid volatility through target adjusters. The PRGF-supported program (2004–07) envisaged foreign exchange sales to control liquidity in light of sizeable aid inflows and thus provided the financing for a rapidly widening current account deficit. Competitiveness concerns did not materialize.

The management of aid varied over time under **Ethiopia's** 2001–04 PRGF arrangement. External assistance was initially not spent but used to reduce the fiscal deficit and stabilize the economy. Later, spending followed the availability of aid. However, Ethiopia did not make full use of flexibility under the PRGF-supported programs and consistently “overperformed” on fiscal and international reserves targets.

**Ghana** has had two PRGF arrangements since 1999. The emphasis on fiscal consolidation, anchored in domestic debt reduction in the later programs as well as the need to increase reserves coverage limited the spending and absorbing of aid inflows. This cautious approach was in part a response to aid volatility during 1999–2003. The 2006 program was the first one to encourage actively a spend-and-absorb approach.

Two PRGF arrangements for **Madagascar** since 1999 emphasized lowering very high initial levels of debt and restraining borrowing, following substantial debt relief. Fiscal and current account developments largely tracked changes in aid, with a somewhat greater share of aid spent than absorbed. Program design was not accommodative of using additional aid, but for the most part this was not a concern since aid forecasts were consistently optimistic. Although the 2001 arrangement emphasized priority outlays, the 2006 arrangement shows greater evolution through its treatment of scaling-up possibilities.

**Mozambique** has had two PRGF arrangements since 1999. Under the first arrangement and in the most recent program, monetary and fiscal targets have been designed to spend and absorb an expected surge of aid. In the same vein, the request for the second arrangement targeted a fiscal consolidation in the face of a projected (and realized) decline in aid inflows.

**Nicaragua** has had two PRGF arrangements since 1999. Both programs focused on improving medium-term fiscal sustainability and external viability. In this context, program design resulted in little spending and partial absorption of aid inflows. Most aid was used to substitute for domestic financing. However, more recent programs shifted toward a spend-and-absorb approach. As a result, monetary management of aid inflows has become even more challenging under Nicaragua's crawling peg regime.

**Rwanda** also had two PRGF arrangements since 1999. Debt sustainability was the main objective of all programs leading up to the April 2005 HIPC completion point. Program design reflected this in stringent limits on external borrowing and—until 2004—efforts to reduce domestic debt. Programs initially limited aid-based fiscal spending. The shift to a spend and absorb approach occurred in 2004. Since then, rapid aid increases have created challenges for the authorities in coordinating fiscal and monetary policies.

The two successive PRGF arrangements with **Tanzania** since 1999 put considerable emphasis on effectively managing aid inflows and generally supported a spend and absorb approach. Program design accommodated larger budget deficits to be financed by aid and included widening current account deficits to encourage aid absorption. Aid was fully spent; however, aid absorption lagged behind. Initially, the authorities were reluctant to use the foreign exchange resources to sterilize the impact of increased capital inflows. More recently, programmed and actual aid absorption increased.

## Box 2. Overview of the Case Studies of Program Design (concluded)

Poverty-related spending was protected under both PRGF arrangements with **Uganda** since before 1999. Aid has largely been spent. However, most of it was not absorbed as the authorities sterilized the liquidity impact of growing aid inflows. Program design shifted to a reserve money target and repeatedly relaxed international reserves conditionality to provide sufficient room for these policies in the monetary programs while maintaining low inflation.

**Zambia** had two PRGF arrangements. Aid shortfalls repeatedly prompted above-program domestic financing and inflation under the first arrangement. While both arrangements have focused on controlling inflation, aid could nevertheless be spent. Aid has also been absorbed as the nonaid current account has broadly tracked changes in aid.

1/ For a detailed discussion of each country, see the background paper, Annex I.

Should they use their best estimate of what is likely to be available over the program period or a projection based on some notion of need—for example, the estimated costs of meeting the MDGs, to help mobilize more aid.

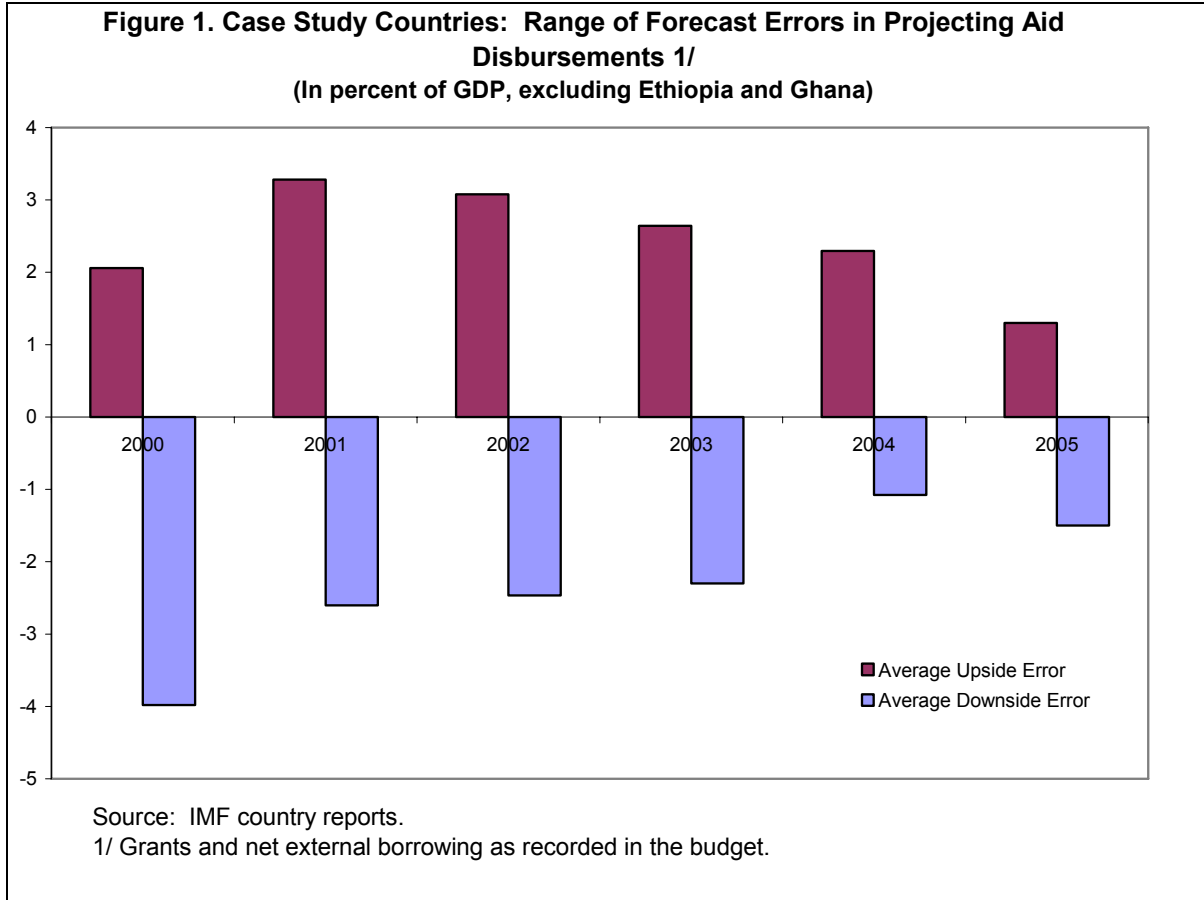
### Assessment of Current Practice in Fund-Supported Programs

13. **The case studies show that projections of *next-year aid inflows* have become more accurate—in particular, less cautious—over recent years** (Figure 1). Considerable aid uncertainty during the Enhanced Structural Adjustment Facility (ESAF) period had led to cautious aid projections in the early PRGF-supported programs. Repeated underestimation, however, prompted more accurate forecasts in recent years. Underestimation on a small scale continued in the Nicaragua and Uganda programs during recent years, where broader macroeconomic concerns called into question the future support of donors. Projection errors remained sizeable even in the past few years in Ethiopia and Ghana because aid was exceptionally volatile. These results largely confirm the findings of the IEO report.<sup>15</sup>

14. **For the medium term, aid was often under projected, although projections have become more accurate since 2005.**<sup>16</sup> The IEO report noted that Fund forecasts for medium-term aid often proved pessimistic in the past, but had recently caught up as rising overall aid levels were taken into account. However, there is substantial variation in scaling up across countries, that authorities and Fund staff must take into account when doing country-level

<sup>15</sup> See also Bulir and Hamann (2006) and Celasun and Walliser (2005).

<sup>16</sup> See IEO (2007).



projections. Targeted donor aid policies led to sizeable increases in aid flows in selected countries where economic performance improved, including those discussed in the case studies. But a scaling up of aid has in fact not been widely observed across low-income countries (Box 3 and background paper, Annex III). Relative to GDP, a large majority of PRGF-eligible countries did not see aid flows from the OECD's Development Assistance Committee (DAC) members rise substantially in 2000–05.

### Guiding Principles for Program Design

15. **In the face of promises for a substantial scaling up of aid that have yet to materialize across a large number of countries, how should low-income country authorities and Fund staff project aid—and thus frame the authorities' development financing.** There are three key considerations for a Fund-supported program that promotes the spending of aid.

### Box 3. Recent Developments and Initiatives for Scaling Up<sup>1/</sup>

**Overall aid inflows have doubled in U.S. dollar terms since 2000.** However, aid seems to be falling behind the commitment by the G-8 countries, at the 2005 Gleneagles summit, to double aid to Africa by 2010. Annual growth in aid continues to slow (excluding one-off disbursements for Tsunami relief and debt forgiveness for Afghanistan and Nigeria). Furthermore, no scaling up is evident when measuring movements relative to GDP. Net ODA flows have remained broadly unchanged as a share of PRGF-country GDP since 2002 (although this may partly reflect the depreciation of the U.S. dollar). Aid volatility has been significant with standard deviations of several percentage points of GDP, not uncommon.

#### Net ODA Disbursements to PRGF-Eligible Countries, 2000–05

	2000	2001	2002	2003	2004	2005
In U.S.\$ billions	23	26	31	36	39	48
excluding Afghanistan, Nigeria, and Tsunami relief	22	25	29	34	36	36
In percent of GDP 1/	24	27	31	32	30	31

Sources: OECD-DAC; and WEO.

1/ Excluding Afghanistan, Liberia, Somalia, and Timor Leste.

**Aid movements vary significantly across countries.** Relative to GDP, less than 20 percent of PRGF-eligible countries saw a scaling up of aid over the five-year period since 2000. About half the PRGF countries actually received less aid-to-GDP in 2005, than in 2000.

**Most of the aid took the form of grants.** Excluding debt forgiveness, grants accounted for about 70 percent of DAC member and multilateral assistance to PRGF-eligible countries in 2005, up from less than 60 percent in 2000.

**The prospects for aid to low-income countries in the coming years will depend on the implementation of the HIPC and MDRI Initiatives and on commitments to help low-income countries achieve the MDGs.** Estimates by the World Bank and the UN suggest that extra ODA on the order of \$40–60 billion a year could be needed to meet the MDGs. The OECD has estimated that ODA from the OECD-DAC countries should rise by \$50 billion in real terms between 2004 and 2010 to meet the Gleneagles commitment.

<sup>1</sup> Based on OECD-DAC data for PRGF-eligible countries, which excludes significantly rising aid from non-DAC donors. A more extensive discussion is presented in Annex III of the background paper.

16. **First, aid projections should represent staff’s best estimate of the amount of aid that will materialize, based on all available information.** The latter includes formal and informal donor indications, historical patterns, and information from the authorities. An important implication is that aid projections should *not* be restricted to firm donor commitments. Many country teams already use this approach.

17. **Second, deliberate over or underprojection of aid would require explicit justification.** In the context of a forward-looking budget strategy that takes into account the level and pattern of expected future revenues, including aid, there are different opportunity costs and risks associated with over or underprojection. A downward bias in aid projections would systematically drag down current-year outlays, ultimately resulting in less than full spending of aid. Furthermore, in the short term, if the authorities consider that more optimistic aid projections could start a virtuous cycle of results and funding, staff should

weigh the merits of an optimistic approach. On the other hand, an upward bias could result in a mismatch between revenues and financing, force future expenditure cuts, and disrupt needed expenditure continuity. This might not be sustainable over the medium term. Moreover, the absence of budgetary safeguards (see below) could argue for prudent projections, especially if aid is highly uncertain—for example, in post-conflict cases, where prudence may call for a projection based on donor commitments. Finally, estimates of budget support deserve careful scrutiny, as forecast errors may force difficult decisions, such as spending cuts or increased domestic borrowing, and could have a broader macroeconomic impact since they are not self-correcting. Staff reports and Memoranda of Economic and Financial Policies (MEFPs) should state clearly the basis for the aid projections being used both for the next year and the medium term. Projections that contain a significant element of staff judgment—in either direction—should be justified in program documents.<sup>17</sup>

18. **Third, aid forecasts in a program context need to reflect debt sustainability concerns**—through a two-stage approach. The first stage involves an assessment of aid availability as discussed above. In the second stage, for cases where risks of debt distress argue for restricting the use of available concessional loans, Fund staff should reiterate the need for donors to take into account the results of the joint Bank-Fund Debt Sustainability Analysis (DSA) and increase the concessionality of aid. However, if the overall grant element of the entire aid envelope is not raised sufficiently, the projected level of foreign borrowing and the related program targets should be set below the potential amount available.<sup>18</sup>

19. **In some cases, aid projections may not close the fiscal or balance of payments financing gap.** Realistic projections of aid combined with a fiscal program consistent with resource availability should generally reduce the need for a financing gap—which signals spending plans that have not been covered by adequate prospective financing. However, medium-term budget planning may not be synchronized fully with revisions of aid projections. On this basis, financing gaps could emerge, in particular, if: (i) sufficient aid has not yet been identified to cover recurrent costs in outer years—to signal the need to address these recurrent expenses; and (ii) domestic and external resources for the outer years are insufficient to cover essential or “ring-fenced” expenditure needs (see below).<sup>19</sup>

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<sup>17</sup> The IEO (2007) emphasized the need for better explanations of Fund-aid projections.

<sup>18</sup> See the discussion of debt sustainability issues in Section III.F.

<sup>19</sup> In addition, programs may need to include a “technical” financing gap, which reflects anticipated Fund disbursements or drawings, associated Paris Club treatments, and budget support from the World Bank that is affected by the status of a Fund-supported program—all of which should be shown as “below-the-line” and closing a technical financing gap to avoid pre-judging decisions by the Fund’s Executive Board and others. However, under a Fund-supported program, the current program year may not show an unfilled financing gap, as programs need to be fully financed.

20. **Fund staff should assist country authorities in preparing alternative macroeconomic scenarios based on higher aid, which would be presented in PRS and Article IV reports.** Alternative scenarios can show how additional aid would be used consistent with macroeconomic stability and debt sustainability, and possibly start a virtuous cycle of results and funding. Scenarios that indicate room for the effective use of higher aid consistent with macroeconomic stability can be used by the authorities in their efforts toward aid mobilization. The most useful scenarios would focus on an ambitious but controlled acceleration in aid inflows, rather than on MDG- or needs-based scaling up, which may entail financing gaps that could not realistically be filled. Alternative scenarios can inform changes in program design over time, especially when aid projections are revised. At the same time, PRGF-supported programs should be based on a single, realistic baseline with an aid projection that incorporates the best available information, given that: (i) the costs of meeting the MDGs are hard to assess;<sup>20</sup> and (ii) deliberately optimistic projections might give rise to recurrent shortfalls in donor assistance, disrupting fiscal management and giving insufficient guidance on how to prioritize the spending of the lower level of aid actually received.

### **B. Designing Macroeconomic Programs to Support the Use of Aid**

21. **The extent to which Fund-supported programs should accommodate the full use of aid, through a spend-and-absorb approach, has been controversial.** For example, questions have been raised regarding whether programs should ever limit the use of available aid, and if so, under what circumstances. The 2007 IEO report observed that inflation in excess of 5–7 percent and reserves below three months of imports, in particular, seemed to be associated with a less accommodative stance on the use of aid in Fund-supported programs.

#### **Assessment of Current Practice in Fund-Supported Programs**

22. **Fund policy advice and program design have shifted toward a spend-and-absorb approach to accommodate aid increases in countries where macroeconomic stability has been established and fiscal vulnerabilities have been addressed.** This shift was noted in the recent IEO report, and is confirmed by the case studies.

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<sup>20</sup> Estimating the costs of meeting the MDGs is a complicated technical exercise that entails detailed sectoral knowledge and microeconomic analysis, which are outside the Fund's role and expertise. In light of the call under the MTS for the Fund to focus on macroeconomically critical issues, Fund staff will need to rely heavily on development partners such as multilateral development banks to determine the aggregate envelope of aid required. Moreover, different reasonable assumptions can produce vastly different cost estimates. Staff would not be expected to assess the reliability of MDG cost estimates apart from commenting on whether an assessment is out of line with other available evidence.

23. **In terms of program design, a spend approach to increased aid would be reflected in higher overall deficits before grants.**<sup>21</sup> An absorb approach would be visible in an increase in projected net imports that matches the higher aid, and a corresponding programmed change of international reserves that reflects the extent of aid absorption. The higher net imports result not only from the imported component of the aid-based spending, but also from the second round-effect as spending on domestic goods reduces the available resources for producing tradables.<sup>22</sup> It follows that while the authorities control the spending of aid, aid absorption is also conditioned by private sector behavior.

24. **Since the launch of the PRGF, programs have increasingly accommodated the spending of aid in the case study countries.** Targeted fiscal deficits were adjusted in line with the availability of additional donor support in Mozambique (following debt and disaster relief), Tanzania (following debt relief), Uganda, and Zambia (Figure 2). Upward revisions of expected aid flows during fiscal years were largely incorporated into updated projections during program reviews. In other countries, the degree of spending was limited in earlier years: aid projections were uncertain (Rwanda) or domestic debt was too high or reserves too low (Ghana, Nicaragua, and Rwanda). Subsequently, the Rwanda program adopted a spend approach in 2004, followed more recently by Nicaragua (2005) and Ghana (2006).

25. **From a program standpoint, the absorption of aid is monitored through the monetary program.** Most monetary programs target price stability and the build-up of international reserves. A high Net International Reserves (NIR) floor can block aid absorption, but a moderate floor cannot ensure absorption. Thus, by construction, NIR floors allow above-target reserve accumulation, which implies that aid absorption can fall short of its baseline projection, without jeopardizing program targets. Three-quarters of first generation programs adopted a NIR/Net Domestic Asset (NDA) framework that limited central bank domestic credit while setting a floor on the accumulation of international reserves. Two-thirds of second generation programs continued to do so.<sup>23</sup>

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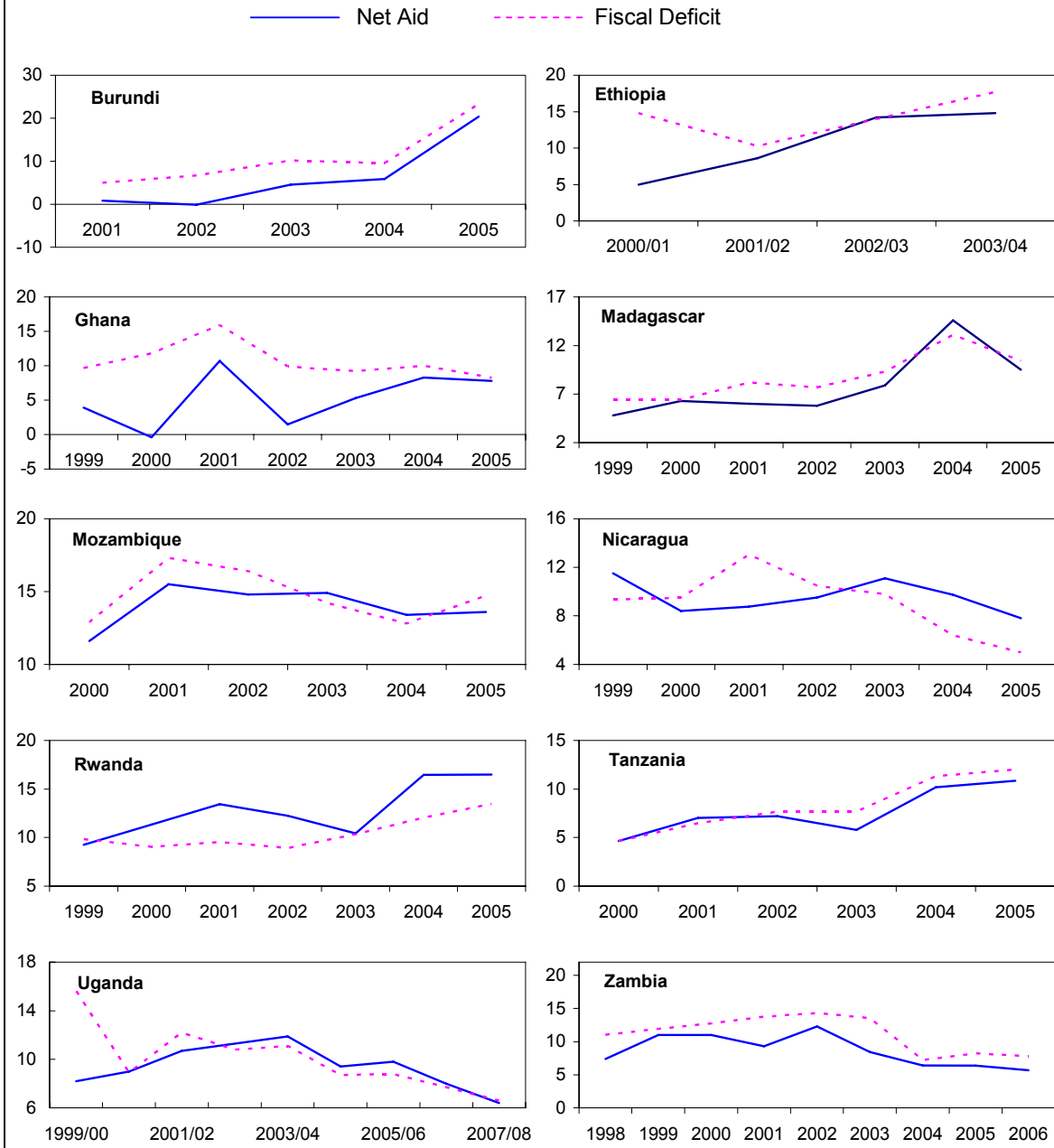
<sup>21</sup> As discussed in IMF (2007a, paragraph 25), a comprehensive assessment of the fiscal stance should consider a range of fiscal indicators, including the fiscal deficit after grants, which could also be the appropriate fiscal target in Fund-supported programs.

<sup>22</sup> A larger share of project aid—rather than of program aid—tends to be spent directly on imports, raising the first-round effect on imports, and limiting its macroeconomic impact. For a general analysis of the implications of aid for the structure of production, see Arrellano et al. (2005).

<sup>23</sup> Nine second-generation programs lack monetary conditionality altogether because the countries are members of a currency union. Seven first-generation and twelve second-generation PRGF-supported programs targeted reserve money.



**Figure 2. Case Study Countries: Net Aid Inflows and Fiscal Deficit (Before Grants), 1998–2006**  
(In percent of GDP)



Source: IMF country reports.

26. **Almost all country cases show that NIR floors were exceeded and thus actual aid absorption was substantially smaller than projected and permitted under the program.** As a result, absorption lagged behind spending. Of the country case studies, only in Zambia did aid absorption generally move in line with spending. In the other cases, a reluctance by the monetary authorities to allow their currencies to appreciate in nominal and/or real terms led to higher-than-programmed international reserves (see below). It is hard to assess, however, to what extent NIR targets were motivated by considerations related to aid absorption. While program documents explicitly assess the need for raising reserve coverage, reserve build-up reflects several sources, and program documents have not always explained on the degree to which the absorption of aid inflows should be accommodated.<sup>24</sup>

### **Guiding Principles for Program Design**

27. **The Fund aims to bring all low-income members to the point where all aid can be fully and effectively spent and absorbed.** Fund-supported programs should support the full use of aid whenever this approach does not jeopardize macroeconomic stability. Furthermore, if limits to microeconomic capacity to use the aid become evident, in particular in macroeconomic outcomes, staff should advise the authorities on ways to address these problems.<sup>25</sup> If these concerns are not remedied, a spend-and-absorb strategy may not be conducive to sustained growth and poverty reduction, but might instead allow unproductive spending and entail risks that would likely undermine progress down the road. Helping countries address macroeconomic vulnerabilities that might not allow the full use of aid in the short term is at the core of the Fund's mandate.

28. **Staff should assess carefully whether the preconditions for the effective and prudent full use of aid are met based on a range of country-specific considerations.** Given the variety of arguments, country circumstances, and development strategies, the appropriate policy mix can only be determined on a case-by-case basis.<sup>26</sup> Program documents should explain the strategy for spending and absorbing aid. In particular, deviations from an

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<sup>24</sup> The spend-and-absorb framework was introduced in IMF (2005a).

<sup>25</sup> The term “absorptive capacity” is often used to refer to microeconomic absorptive capacity—that is the extent to which the authorities can spend money on productive projects—and should thus be distinguished from the term “aid absorption,” which refers to the use of aid to accommodate higher net imports. As noted elsewhere in the paper, the Fund will need to rely heavily on development partners such as the multilateral development banks for assessments of microeconomic absorptive capacity.

<sup>26</sup> Similarly, no comprehensive quantitative definition of macroeconomic stability can be provided to guide policies across countries.

approach of full spending and absorption would warrant explicit justification in program documents:

- *A policy of partial spending and absorption is appropriate for countries with low reserves and/or high external debt.* For countries emerging from instability and with low initial reserves, a prudent approach includes saving part of the aid inflows—through the build-up of a prudent reserve buffer and/or the early repayment of relatively expensive external debt. The appropriate measure of reserve adequacy should be assessed in the context of aid volatility and other shocks (see below).
- *The authorities may also choose to smooth the use of aid over time.* Aid that is not spent and absorbed immediately is still available for later use, when the need may be greater or the use more beneficial. For example, if time is needed to prepare for scaled-up spending, spending effectiveness could call for delaying the use of higher aid. Moreover, there is a strong case for expenditure smoothing (see below). It follows that a spend-and-absorb approach should not imply the simple matching of annual aid flows and their use, but should be implemented in a medium-term fiscal framework.
- *An absorb but do not spend approach can be used to lower domestic public debt and/or reduce inflation.* In this scenario, the public sector does not spend all the aid, thereby reducing reliance on domestic government financing. This approach also involves the purchase (or reduced emission) of outstanding domestic public debt or base money in exchange for the foreign currency counterpart of aid received by the central bank. This approach was used effectively in Rwanda before 2004 and in Ghana until 2006, preparing the ground for the subsequent switch to a spend-and-absorb approach. In evaluating inflation, available evidence broadly supports the use of single-digit inflation objectives. Higher inflation can undermine growth and also hurt the poor directly.<sup>27</sup> However, there is no simple rule: headline inflation above the single-digit level would be more worrisome in the absence of a strong central bank or as a reflection of high domestic government financing, but could be benign in the wake of supply shocks or with scaling up under an exchange rate peg (see below).<sup>28</sup>
- *By contrast, a policy of sustained spending but not absorbing would be harder to justify.* This approach is essentially equivalent to one of higher domestically-financed fiscal spending, combined with increased (aid-based) foreign exchange reserves. Nonetheless, this expansionary policy could help exploit possible spare domestic

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<sup>27</sup> See IMF (2005a).

<sup>28</sup> Accordingly, there are many cases in which aid was programmed to be spent and absorbed even though inflation was close to or above 10 percent—such as, in Burundi since 2001, Mozambique in 2000–02, Rwanda in 2004 and 2005, or Ghana in 2006.

production capacity, with the reserves providing the option of absorbing the spending pressure through higher imports rather than inflation in case the expected supply response does not materialize. Furthermore, other considerations may play a role when deciding on the application of the spend-and-absorb principle on a country-by-country basis.<sup>29</sup>

29. **Attempts to smooth spending of project support is challenging, as projects are “lumpy,” and donors and countries have often agreed on a fixed schedule for disbursements and implementation.** Thus, country authorities are likely to find it hard to delay donor-funded projects or to advance them with domestic funds. Should the authorities find benefit to such an adjustment, it would require direct negotiation with the donor involved.

30. **Strengthening revenue mobilization remains critical in the wake of scaled-up aid.** Foreign aid could undermine efforts to mobilize domestic resources, which could lead to long-term aid dependency and aggravate resource volatility. Accordingly, in most cases, domestic revenue mobilization should not be weakened, especially if domestic revenues are below, about 15 percent of GDP.<sup>30</sup> However, in case of relatively distortive taxation, there can be a case for using part of the aid to lower tax rates.

### C. Coordinating Fiscal, Exchange Rate, and Monetary Policies

31. **Absorbing large aid inflows can raise challenges for managing the appropriate mix of nominal appreciation of the exchange rate and inflation.** The use of aid affects monetary and exchange rate developments in two ways. First, the spending of the aid can lead to a real appreciation—i.e., higher inflation and/or a nominal appreciation.<sup>31</sup> Second, if the aid is absorbed, that is the foreign exchange reaches the market rather than being accumulated by the central bank, it can lead to nominal (as well as real) appreciation pressures, at least in the short run. The interplay of these forces depends on the exchange-rate regime.<sup>32</sup>

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<sup>29</sup> In some cases, implementing the spend-and-absorb recommendation is more difficult. For instance, a number of shocks may hit an economy at the same time; sometimes, fiscal policy must be taken as given by the monetary authorities (or vice versa), or monetary policy decisions have to consider the overall objectives of monetary and exchange rate policies.

<sup>30</sup> See Gupta et al. (2006) and IMF (2007a and 2007b).

<sup>31</sup> See Section III.E. It should be noted that these effects of aid may be offset by other shocks, which should be taken into account in policy evaluations.

<sup>32</sup> See Chapter 7 in Berg et al. (2007) for an in-depth discussion.

- In a floating exchange rate regime, real appreciation pressures are channeled through a nominal appreciation. Monetary and inflation objectives need not be affected, as the monetary authorities sell the foreign exchange received in the context of foreign aid, and thus do not build up higher reserves that would fuel money supply growth and inflation.
- For exchange rate pegs/currency unions, however, temporarily higher inflation would be expected. The inflation would result as higher spending leads to higher nontradables prices, to which the central bank's foreign exchange reserves and the money supply are allowed to respond endogenously.
- With managed floats, pressures for a nominal appreciation could be dampened if part of the aid-related foreign exchange is not sold by the central bank, which would imply an increase in reserves and the money supply and, as a result, higher inflation. However, in the absence of an actual resource transfer from abroad (reflected in rising net imports), higher public spending is necessarily offset by reduced private spending.<sup>33</sup> Real resources for private sector spending are squeezed by the inflation tax or, in case of sterilization using domestic instruments, by the reduced availability of credit.<sup>34</sup>

### **Assessment of Current Practice in Fund-Supported Programs**

32. **Attempts by the monetary authorities to stabilize the nominal exchange rate by accumulating foreign exchange have often led to foreign aid not being fully absorbed.** In almost all country cases, the monetary authorities at times resisted nominal appreciation pressures resulting from aid inflows.<sup>35</sup> In Ethiopia, Ghana, and Rwanda, the exchange rate was kept stable relative to the U.S. dollar, and in mid-2006, their exchange rate regimes were reclassified by the Fund from managed floating with no predetermined path to a conventional fixed peg.<sup>36</sup> The resulting inflation pressures were offset through sterilization using domestic instruments in Mozambique (2000–03), Tanzania (2000), and Uganda (1999–2004).<sup>37</sup> In

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<sup>33</sup> Unless the higher spending is met by expanding domestic production owing to pre-existing excess capacity.

<sup>34</sup> All the problems encountered by managed floating due to sterilization costs, here and in paragraph 38 below, are also found in a full exchange rate peg.

<sup>35</sup> This finding is in line with IMF (2005b).

<sup>36</sup> These examples illustrate the challenges in preparing correct assessments: in all three cases, no peg had been announced by the authorities, and the proper identification of these regimes remains under discussion.

<sup>37</sup> IMF (2005b) shows that even countries labeled as independently floating in practice often intervene to limit exchange rate variability, and that since 1999 for a sample of mature stabilizers, more than three-quarters of overruns relative to program projections for central bank NIR were sterilized through lower NDA.

some cases, including in Rwanda (2005), the monetary authorities refrained from sterilizing excess liquidity using domestic instruments despite rising inflation, because of the high sterilization costs. Incomplete absorption of foreign aid may be the result of diverging priorities between monetary and fiscal authorities, when the fiscal authorities decide on rapid increases in aid-based expenditures while the monetary authorities seek to maintain exchange rate stability, or build up a reserve buffer.

33. **In several cases, the design of the monetary program was modified to allow or promote the sale of foreign exchange by the central bank.** The Nicaragua and Ghana programs lowered international reserves targets during subsequent program reviews—even when aid flows were revised upward. Program design was revised in two countries (Tanzania and Uganda) when limited aid absorption as a result of exchange-rate targeting, led to significantly higher inflation. For both countries, the PRGF-supported programs switched to reserve money targets (to curtail NIR-driven money growth) and lowered their international reserves targets repeatedly. In both cases, inflation was finally reined in, although at the cost of higher and more volatile domestic interest rates and some crowding out of private investment.

### **Guiding Principles for Program Design**

34. **A prerequisite for managing these challenges is a clear understanding of the exchange rate regime and the objectives of monetary policy.** Effective program design requires that the authorities and the staff share an understanding of the regime, and actual monetary management to be in line with it. Scaling up heightens the importance of avoiding ambiguities in this matter. De facto exchange-rate regimes are identified in staff reports and in the Fund’s annual and quarterly reports on exchange arrangements.<sup>38</sup>

35. **In principle, a strategy of spending and absorbing aid can be implemented in the context of each of the standard exchange rate regimes.** At the same time, each regime poses different challenges for reconciling the full absorption of aid with the need to avoid high inflation or excessive exchange rate volatility.

36. **A floating exchange rate regime implies full absorption of aid and supports price stability; but there can be a case for mitigating short-term exchange rate volatility.** In the context of a spend-and-absorb approach, a floating exchange rate regime allows for combining real (and nominal) appreciation with price stability. By insulating the monetary program from the impact of real appreciation pressures, the regime supports the central bank’s focus on maintaining price stability (and ensuring an adequate level of reserves). Accordingly, for countries with large and increasing aid inflows, staff has generally

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<sup>38</sup> The forthcoming, “*Report on Exchange Arrangements, Restrictions, and Markets*,” will reassess the classification criteria and discuss how to best ensure consistency with staff reports in all cases.

advocated continued adherence to prudent monetary objectives and a market-based exchange rate.<sup>39</sup> However, with lumpy and volatile aid, the result could be sharp exchange rate movements. This could give reason for stabilizing interventions, without altering real exchange rate trends. In particular, the authorities could adapt the timing of foreign exchange sales, but without relaxing trend monetary growth or resorting to domestic sterilization.<sup>40</sup>

**37. The opposite strategy, of fixing the nominal exchange rate also provides a viable framework for scaling up; but aid absorption would lead temporarily to higher inflation.** With reserves responding endogenously to higher (spending-induced) import demand, aid absorption is built in, but the monetary expansion would lead to an increase in the inflation rate, and efforts should then focus on minimizing the associated costs. This applies to both a simple peg, as in the franc zone in Africa, or to a crawling peg as in Nicaragua. However, the likely higher inflation under a peg in the presence of large aid inflows should be a criterion in the choice of exchange rate regime.

**38. Experience indicates that scaling up in the context of managed floating is relatively hard to manage well.** First, this regime tends to be less transparent, which complicates program design. Second, in the absence of a clear rule for ensuring absorption, monetary authorities have frequently refrained from selling aid-based foreign exchange, with the aim of stabilizing the nominal exchange rate. This in turn, resulted in higher (reserve) money growth, thus undermining efforts to reduce inflation to single-digit levels or endanger hard-won price stability.<sup>41</sup> By itself, this impact on (reserve) money can be offset through domestic sterilization. However, such sterilization can not undo the underlying problem of increased (fiscal) spending without an actual resource transfer. Furthermore: (i) sterilization entails significant quasi-fiscal costs—especially in case of thin financial markets, leading to sharply rising interest rates; and (ii) crowding out private investment has adverse growth effects.<sup>42</sup> Finally, the scope for discretionary exchange rate and monetary policies raises the

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<sup>39</sup> An effective response to scaled-up aid may also include improvements in monetary and foreign exchange operations; the foreign exchange market needs to be sufficiently resilient to intermediate large flows without excess volatility.

<sup>40</sup> As discussed in Adam, O’Connell, Buffie, and Patillo (2006), the appropriate policy rule could be for the central bank to retain the aid-based foreign exchange until it is actually spent, in order to avoid initial *overabsorption*.

<sup>41</sup> In this case, inflation would be associated with a policy that restricts the absorption of aid. By contrast, inflation due to scaling up under a fixed exchange rate would reflect the relative price adjustment that results from absorbing aid.

<sup>42</sup> This should not be understood as a general dismissal of sterilization, as a key element of liquidity management. Also, sterilized interventions could be a legitimate part of the response to private inflows. But in the case of aid, the additional resources are generally intended to boost investment and consumption rather than reserves.

importance of monetary-fiscal policy coordination in order to match spending and absorption.

39. **Therefore, program design in the context of managed floating requires special attention.** Targeting a certain exchange rate path or band need not be problematic provided that the regime, including subordination of inflation objectives to exchange rate stability, is clearly spelled out. This case would be akin to a formal peg, in which case no specific conditionality should be set to control money creation. However, if the intervention strategy is not clear, the monetary program may be of little value for guiding monetary management, and NIR targets would be exceeded as long as the monetary authorities give priority to resisting aid-induced appreciation pressures. In order to address these complications, and effectively promote aid absorption, it is important to have a clear understanding of the monetary authorities' objectives and reaction functions regarding inflation, real and nominal exchange rate stabilization, and reserve accumulation.<sup>43</sup> Policy coordination between the fiscal and monetary authorities should be ensured in the context of the program discussions. In case of persistent problems, the central bank's formal objectives could be reevaluated, since the pursuit of multiple monetary policy objectives can complicate policy making in the event of a conflict.<sup>44</sup>

40. **The NIR/NDA conditionality framework for monetary policy is most conducive to supporting scaling up.** Fund conditionality has supported macroeconomic stability, by ensuring reserve adequacy (through the floor on NIR) and a prudent monetary stance (through a ceiling on NDA or reserve money) aimed at price stability. The choice between an NDA or a reserve money ceiling merits careful consideration.

- A reserve money ceiling provides a monetary anchor that can help curtail money growth. It can also promote foreign exchange sales, and hence absorption.
- However, aid volatility may complicate adherence to a reserve money ceiling. As aid is received and deposited, NIR rises and NDA falls, with no change in its sum (i.e., reserve money). The subsequent spending, however, may involve a temporary rise in reserve money, as the fiscal authorities draw down their aid-based deposits (bringing NDA back up) while net imports—to be accommodated by foreign exchange sales (and, thus, a fall in NIR)—have not yet moved up in response. In this situation,

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<sup>43</sup> In case of ambiguities, staff could usefully discuss and monitor the central bank's cash flow plan, and its consistency with the program and with a spend-and-absorb approach.

<sup>44</sup> See (IMF 2004a). While the central bank's operational independence is key to effective and credible monetary policy, and to overcoming problems of fiscal dominance, goal independence is not.



selling foreign exchange early in order to adhere to a reserve money ceiling could entail sharp exchange rate swings.<sup>45</sup>

- On balance, in most cases, the optimal design may involve NDA and NIR performance criteria complemented by an indicative ceiling for reserve money.
- The importance of maintaining an adequate reserve buffer for handling shocks—including temporary aid shortfalls—supports the need for a floor on NIR.
- In the context of large scaling up, however, problems have often involved excessive rather than too little reserve accumulation. NIR-based conditionality cannot by itself address the latter concerns, given the unpredictability of foreign exchange inflows from many sources beyond aid. These concerns should, instead, be addressed through an understanding with the monetary authorities on absorption and exchange rate flexibility, or with the fiscal authorities on matching limited absorption with spending restraint. More generally, these issues highlight the importance of coordination concerning the policy mix between the fiscal and monetary authorities.

#### **D. Managing Aid Volatility**

41. **Aid inflows tend to be both volatile and unpredictable.** Bulir and Hamann (2006) show that aid inflows are typically much more volatile than domestic tax revenues, that commitments are a poor predictor of disbursements, and that both volatility and unpredictability have been increasing in recent years. The recent shift from project to program support can raise volatility, as program aid tends to be subject to annual approval and can be sensitive to political considerations, whereas project aid is often committed in advance for several years. Moreover, spending tends to adjust automatically with changes in project aid. Unpredictability is a concern for both aid commitments and the subsequent disbursements.

42. **Aid volatility complicates fiscal policy, given the desirability of a smooth expenditure path.** If budgetary expenditures could be easily reduced when aid falls, there would be no issue of budget sustainability. However, in practice, such flexibility is limited. It is difficult to design programs with built-in flexibility for expansion and contraction, especially with respect to entitlements and wages. Moreover, when governments cut back expenditure, including on operations and maintenance, there can be a significant fall in the rate of return on aid-financed projects.<sup>46</sup> Finally, there is an important sectoral dimension: while aid may materialize as expected in *aggregate*, there may be less aid than budgeted in

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<sup>45</sup> This is a specific example of the more general argument in IMF (2005b), that the NIR/NDA setup provides more flexibility in accommodating frequent unforeseen changes in velocity or the money multiplier.

<sup>46</sup> See Heller (1979).

important sectors where expenditures (e.g., HIV/AIDS treatment) are difficult and costly to cut back temporarily.

### Assessment of Current Practice in Fund-Supported Programs

43. **The case studies show that large aid volatility during the first years of the decade complicated aid forecasting in Ethiopia and Ghana, resulting in cautious baseline projections and a build-up of a prudent reserve buffer.** Both programs continued to underestimate aid flows even recently. They also limited the spending and absorption of aid in order to rebuild reserves, which had fallen to two months of imports or less. Early on, the Ghana program also adopted a domestic debt repayment strategy for the use of windfall revenue from incremental aid. As aid flows became more predictable, Ghana increasingly spent scaled-up aid.

44. **The broader examination of program adjusters reveals that unanticipated aid disbursements are subject to various combinations of conditionality.** A review of fiscal deficit targets, net domestic financing ceilings and adjusters in 26 first- and 34 second-generation PRGF-supported programs shows that different types of aid were treated differently in between two (usually semi-annual) program reviews (Table 1 and Figure 3). In this context, it is important to note that if program adjusters do not accommodate higher spending in the case of higher aid, the program is not necessarily a binding constraint. Higher spending may not be feasible in the short run, for example given the need for a supplementary budget or prepare expenditure plans. Moreover, the scope for higher spending is always reassessed at the next program review.

- Fifty-two out of the 60 programs in the sample accommodated unlimited spending of additional *project support grants* in between program reviews.<sup>47</sup> This included 22 first-generation and 30 second-generation programs.
- Half of the programs—22 first-generation and 30 second-generation programs—accommodated unlimited spending of additional *project support loans* in between program reviews (provided borrowing was concessional).
- Almost half of the programs—12 first-generation and 13 second-generation programs—accommodated unlimited spending of additional *budget support grants*. In addition, one first-generation and five second-generation programs allowed the spending of additional funds up to a limited amount.

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<sup>47</sup> Both Rwanda programs and the second-generation programs with Afghanistan and Benin limited the spending of all windfall grants (for both budget and project support) until the next program review. The most recent Grenada program allows only social spending and only up to a maximum amount.

- Several programs with mature stabilizers accommodated unlimited spending of additional *budget support loans*—two first-generation and five second-generation programs.<sup>48</sup> Furthermore, one first-generation and five second-generation programs allowed the spending of additional funds up to a limited amount.

Additional aid	Spend all		Spend some		Do not spend	
	first	latest	first	latest	first	latest
Program grants	12	13	1	5	13	16
Project grants	22	30	0	1	4	3
Program loans	2	5	1	5	23	24
Project loans	12	18	0	1	14	15

Aid shortfall	Cut fully		Cut some		Do not cut	
	first	latest	first	latest	first	latest
Program grants	12	11	12	12	2	11
Project grants	24	32	0	1	2	1
Program loans	5	12	16	12	5	10
Project loans	20	30	2	1	4	3

Source: IMF country reports.

1/ The review includes 60 programs: all 34 current or recent PRGF-supported programs (second-generation programs) and the first annual programs of the 26 existing predecessor arrangements since 1999, when the PRGF was established (first-generation programs).

45. **Three-quarters of PRGF-supported programs allowed at least some spending to continue in the face of shortfalls of budget support.** But only a few programs, including more recently Afghanistan, Guyana, and the Kyrgyz Republic, allowed project spending to continue on the same scale when foreign funding fell short of programmed amounts.

46. **Since 1999, PRGF-supported programs have become more accommodative of spending unanticipated inflows of program aid, and offsetting shortfalls in program support** (Table 1 and Figure 3). More programs now attempt to protect spending levels from shortfalls in budget support than before—which was the result of a gradual evolution rather than any discrete shift. Twenty-one out of 34 second-generation programs permit domestic borrowing up to the full amount of an unexpected shortfall in budget support compared to seven out of 26 first-generation programs. In addition, the share of programs that do not

<sup>48</sup> Bangladesh (first- and second-generation programs), Ghana, Guyana, Rwanda, Tanzania, and Zambia (first- and second-generation programs).

accommodate additional aid has fallen.<sup>49</sup> Furthermore, second-generation programs seek to safeguard priority spending. Six recent programs set a floor on poverty-related spending levels compared to two earlier programs. The prevalence of program ceilings on the public sector wage bill—in an effort to prevent a rapid rise in wage costs from crowding out other expenditures—decreased from late 2006 to March 2007, from eight programs to three, compared with two first-generation programs.

**47. Monetary adjusters for above- and below-program budget support mirrored the fiscal ones:**

- About half of the first- and second-generation programs allowed additional *budget support grants* to be at least partially absorbed (i.e., did not require a matching accumulation of international reserves).
- Twelve percent of first-generation and 30 percent of second-generation programs allowed additional *budget support loans* to be at least partially absorbed.
- About two-thirds of second-generation PRGF-supported programs relaxed international reserves conditionality for some or all of a shortfall in budget support grants or loans. This compared to 54 percent of first-generation programs in case of a shortfall in grants and 81 percent in case of a shortfall in loans.

**Guiding Principles for Program Design**

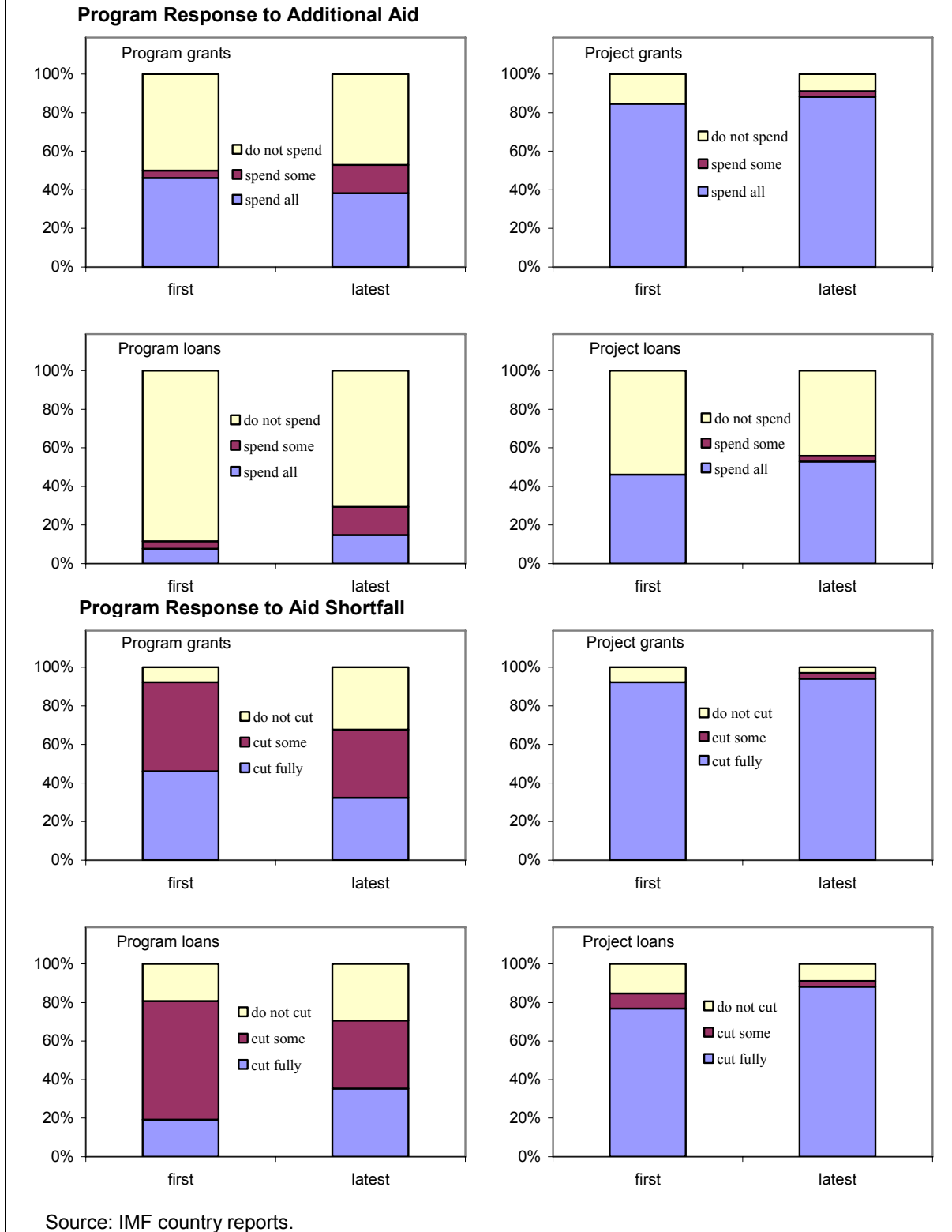
48. Fund-supported programs should promote a smooth path of fiscal spending, in the context of a medium-term budget framework (MTBF).<sup>50</sup> Temporary deviations from the predefined medium-term path of foreign financing are best absorbed through domestic borrowing, financed through reserve drawdowns. In that way, spending plans would not be interrupted, while the reserve response implies that the change in domestic borrowing by the government would not result in inflation or crowding out. However, persistent shortfalls will eventually require (gradual and well designed) expenditure adjustments, as reserves cannot close a lasting financing gap. Indeed, a spend-and-absorb approach calls for an eventual

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<sup>49</sup> It is important to note that if program adjusters do not accommodate higher spending in case of higher aid, the program is not necessarily a binding constraint. Higher spending may not be feasible in the short run, for example given the need for a supplementary budget. And in any case, the scope for higher spending would be reassessed at the time of the next program review.

<sup>50</sup> For a further discussion of the optimal expenditure path, see IMF (2007b).

**Figure 3. Treatment of Unanticipated Aid**



adjustment to both scaled-up and to lower aid, even if there is expenditure smoothing in the short to medium term. Staff advice on the design of the medium-term expenditure path and on the adjustment strategy should incorporate the following elements:

- *Identification of aid shocks.* The possibility that shortfalls may be temporary supports the case for short-term financing of deviations from the predefined fiscal path, at least until its persistence can be determined. However, it is often difficult to distinguish temporary from permanent aid shocks. Thus, it is important for the authorities and Fund teams to stay in close contact with major donors to understand the nature of aid fluctuations.
- *Self-insurance.* Expenditure smoothing using central bank reserves calls for self-insurance through the prior build-up of sufficient international and fiscal reserves. This, in turn, may require some initial deferral in the spending and absorption of scaled-up aid. The use of a target level of reserves from a fiscal viewpoint, in addition to the traditional external viewpoint (in months of imports) can guide these efforts.<sup>51</sup>
- *Expenditure flexibility.* Given the risk that scaled up spending paths may need to be revised down, it is important to examine the realism and flexibility of expenditure paths for broad spending categories (such as wages, entitlements programs, and major investments). Staff should also discuss the recurrent costs of capital projects proposed for scaling up, such as operations and maintenance, which may curtail budgetary flexibility over the longer term.

49. **In terms of program conditionality, the case for expenditure smoothing suggests that program adjusters should allow shortfalls in program aid to be financed domestically once reserve adequacy has been achieved.** At the time of the next review, the mission and the authorities should then assess the need for changes in the spending path. Project spending tends to be relatively flexible and is often donor controlled. Accordingly, in principle, program adjusters may assume project spending to be tied to actual disbursements, with no impact on domestic financing and NIR.

50. **In most cases, best practice would be to allow for short-term spending increases in case of higher-than-expected program grants.** In principle, the logic behind expenditure smoothing would call for saving positive aid surprises until their permanency can be properly assessed. This is indeed how the adjusters in the Nicaragua, Rwanda, and Uganda programs work. However, the existence of urgent spending needs and donor expectations likely justify a more flexible approach. The authorities and the staff could discuss in advance plans for

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<sup>51</sup> In particular, policies may target a level of reserves that covers some months of (foreign-financed) government expenditure. For a simulation of the use of active fiscal programming and reserve management to stabilize aid-based spending, see Eifert and Gelb (2007).

supplementary expenditure guided by the expenditure priorities in the authorities' PRSPs and MTBFs. On that basis, programs could incorporate adjusters to allow higher spending (possibly with a cap) covered by higher-than-expected program grants (and loans—in the absence of debt sustainability concerns). This approach should be considered best practice and has been followed in the Mozambique and Tanzania programs. For countries where aid volatility is high and international reserves are low, however, a case can be made for a more symmetric approach to aid surprises. Adjusters could also be more liberal in combination with cautious (commitment-based) aid forecasts (as discussed in paragraph 17).

51. **In seeking to protect essential expenditures against the impact of large and sustained shortfalls in aid, program design should draw on the prioritization of expenditures in the authorities' medium-term framework.** If aid shortfalls are forcing serious spending cuts, it will be important to avoid disrupting necessary expenditures for selected sectors. A key requirement for facilitating expenditure-switching to more critical sectors is the existence of an operational framework for expenditure prioritization. Moreover, the MTBF could usefully identify ring-fenced priority spending that should be protected from spending cuts.<sup>52</sup> This exercise could also inform program design. In case resources are projected to fall below the level required for safeguarding essential expenditures, staff could alert donors to the need for additional financing, and the program could accommodate domestic borrowing and/or a drop in reserves to lower levels.

### **E. Safeguarding Competitiveness**

52. **Increased aid-based spending could induce a real appreciation that might adversely impact export growth—the so-called Dutch disease.**<sup>53</sup> Exports, and manufacturing production in general, are often considered to have positive externalities on longer-term productivity, e.g., through learning-by-doing. In addition, a real appreciation resulting from a temporary surge in aid could be short-lived, but could still entail high adjustment costs if exporting firms lay off skilled workers, or even close down, thereby hindering a subsequent recovery.<sup>54</sup>

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<sup>52</sup> See IMF (2007b and 2007c).

<sup>53</sup> Higher public spending increases the demand for nontraded goods, which is likely to raise their relative price (i.e., a real appreciation), unless all aid is spent directly on imports or there was ample excess capacity in the economy. The real appreciation, in turn, will shift production away from traded goods, including exports, toward the nontradable sector. The real appreciation and export contraction are, in principle, regular market responses to a change in demand. See Adam (2006).

<sup>54</sup> This involves a distortion if the contraction is excessive, for example as a result of underdeveloped capital markets or the maintenance by individual firms of collective assets (like a specialized common pool of labor).

## Assessment of Current Practice in Fund-Supported Programs

53. **While risks of Dutch disease are a concern, the case studies suggest that they have not posed a generalized problem.** There is some cross-country econometric evidence that higher aid has undermined growth in labor-intensive export-oriented sectors.<sup>55</sup> However, there have been no clear country case studies demonstrating aid-induced Dutch disease.<sup>56</sup>

54. **In case of a sustained real appreciation, staff reports generally discuss risks to competitiveness.** However, programs have not restricted the use of aid because of a need to avoid or cure Dutch disease. Rather, they have included targeted measures to minimize the risk to export industries and diversification through enhancing their competitiveness. For example, the PRGF-supported program for Rwanda—which faced Dutch disease risks— included the development and execution of action plans for promoting exports in 2004 and 2005, while accommodating a large increase in aid inflows. For Zambia, the need to allow firms to finance temporary losses due to real appreciation motivated the emphasis in the June 2006 program on the authorities’ financial sector development plan, parts of which were supported by conditionality.

## Guiding Principles for Program Design

55. **Given the scant empirical evidence, generally Fund-supported programs should not constrain aid-based spending on the grounds of risks to competitiveness.** Only in exceptional cases would such risks provide a compelling argument against scaling up.<sup>57</sup> Concerns about possible Dutch disease effects should be incorporated in the authorities’ development strategy (as reflected in the PRSP) which should discuss how initial adverse effects on competitiveness and exports are to be surmounted over time. The Fund should help the country assess risks to export competitiveness, and closely monitor the related evidence in the aftermath of scaling up (Box 4). At the same time, Fund staff would not be required to predict the magnitude of a possible real appreciation as a result of programmed higher aid.<sup>58</sup>

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<sup>55</sup> For example, Rajan and Subramanian (2005).

<sup>56</sup> As suggested in IMF (2005b) this may be due to the monetary authorities’ resistance to nominal appreciation, and the resulting squeeze of private spending offsetting real appreciation pressures. Developments in Zambia in 2005 illustrated how debt relief can encourage capital inflows. These flows amplified real appreciation pressures (mainly due to improving terms of trade), thereby hindering economic diversification.

<sup>57</sup> One option would be to smooth the pace of scaling up spending and absorption over time. Accumulating foreign exchange reserves to help smooth the real exchange rate path for a given fiscal spending profile might be advisable only as a temporary response to higher project aid—that cannot be saved or postponed. In this distinctly second-best situation, domestic sterilization would generally be preferable to financing the additional expenditure with seigniorage and inflation, in view of the adverse effects of inflation on poverty.

<sup>58</sup> In the absence of reliable exchange rate projections, the baseline macroeconomic framework presented in staff reports could remain based on the standard assumption of a constant real exchange rate, while the text of

(continued)



56. **Possible adverse effects of aid on competitiveness underscore the importance of using aid well.** Even with an initial contraction of exports, the net effect of scaling up on long-term growth could well be positive, provided aid is used effectively. In particular, aid can be used to address bottlenecks from infrastructure, for example, and thus contribute to lowering production costs and promoting exports over the medium term.

#### **Box 4. Assessing and Managing Risks to Competitiveness**

Adverse effects of higher aid on competitiveness merit close scrutiny in case:

- The increase in public spending is concentrated on nontraded goods and services (including labor).
- There is little or no spare capacity in the economy. The analysis may need to focus on critical components that are in short supply rather than on generalized unemployment of factors.
- The ability of consumers to switch from domestic to imported goods is limited as a result of trade restrictions or high transportation costs.
- Firm-level investment climate surveys indicate that real wages pose a binding constraint on exports (rather than, for example, infrastructure shortages).

Signs of actual Dutch disease may include:

- A severe real appreciation of the exchange rate (preferably measured using relevant production costs, including wages, rather than the CPI).
- A strong contraction in manufacturing production or exports (unrelated to other exogenous events).
- Signs of emerging bottlenecks in manufacturing production or exports, including declining investments.
- The scope for exporters to withstand a temporary appreciation is hindered by insufficient access to credit.

Possible approaches to limit the risks of Dutch disease could include steps to:

- Promote the adaptability of the export sector to exchange-rate changes, by enhancing the availability of bank credit (while safeguarding credit quality).
- Limit the real appreciation by:
  - Trade liberalization, which would ease the pressure on the nontradable sector, as more goods would effectively become tradable.
  - Increasing productivity in nontraded goods production, thereby limiting the resource shift away from traded goods production.
- Boost exports over the medium term by supporting productivity in the tradable sectors by:
  - Targeting expenditure increases to overcoming bottlenecks (for example, concerning infrastructure or education).
  - Improving the business climate, if possible, guided by a recent Diagnostic Trade Integration Study.

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the report would flag whether changes in this rate are likely. This could include some general indication of the direction and possible magnitude of the changes, including in the case of a peg or a heavily managed float. Projections of the medium- and long-term implications of scaling up for the real exchange rate require detailed understanding of sectoral changes in demand and supply (including productivity changes induced by the scaling up), and have been prepared by World Bank staff for some countries, including Ethiopia.

## F. Maintaining Debt Sustainability

57. **A crucial objective of program design is to help ensure that scaling up is consistent with a sustainable debt position.** HIPC Initiative and MDRI debt relief have created room for substantial new borrowing that can be used to make faster progress toward achieving the MDGs. However, excessive borrowing could contribute to the reemergence of unsustainable debt burdens, particularly if new debt is nonconcessional.<sup>59</sup>

### Assessment of Current Practice in Fund-Supported Programs

58. **Controlling the pace of debt accumulation has always been a component of program design in LICs.** However, until the introduction of the Debt Sustainability Framework (DSF) in 2005, programs did not explicitly consider medium-term debt sustainability, instead focusing on overcoming short-term financing constraints.<sup>60</sup> All programs included a performance criterion (PC) limiting new nonconcessional external debt, in some cases to a zero ceiling. However, for most members, there was no ceiling on medium- and long-term concessional borrowing and thus on overall debt. Also, only about half of the pre-2005 PRGF-supported programs had fiscal conditionality that extended to the overall deficit, which would have limited recourse to external financing.

59. **Against this background, the Fund and Bank Boards in September 2004 called for a strengthening of control over excessive borrowing—including on concessional terms—guided by structured debt sustainability analysis.** Specific instruments included more systematic use of limits on the overall fiscal deficit (including grants) for countries where debt sustainability is a concern and conditionality related to the net present value (NPV) of external debt.<sup>61</sup> The immediate impact of the new approach has been limited so far. In particular, NPV-based conditionality, theoretically the most attractive measure, is difficult to use. Only the PRGF arrangements for Guyana and Rwanda have an indicative ceiling on the NPV of external public and publicly guaranteed debt, introduced in July 2004 and January 2007, respectively. The 2005 arrangement for the Kyrgyz Republic has a separate ceiling on the contracting or guaranteeing of concessional external debt in addition to a zero ceiling on nonconcessional borrowing.

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<sup>59</sup> Furthermore, foreign grants can also have an impact on debt sustainability, through their effects on growth, the real exchange rate and, in case of monetary sterilization, domestic interest rates.

<sup>60</sup> Programs were often designed in the context of the process for securing debt relief under the HIPC Initiative, which limited the adjustment required for ensuring debt sustainability. See IMF (2005a and 2006b).

<sup>61</sup> See IMF and IDA (2004), IMF (2004b), and IMF (2005b).

**60. Quantitative conditionality to contain risks of debt distress has been complemented by structural measures, including:**

- Putting in place adequate procedures for approving and monitoring external debt, as in Uganda (2006).
- Strengthening investment project selection and prioritization, with independent feasibility studies, as in Albania (2004) and Guyana (2006).
- Developing sustainable medium-term debt strategies, which may require technical assistance.

**Guiding Principles for Program Design**

**61. Guided by the DSF as updated in 2006, programs can use a variety of tools to limit the risks of debt distress (Box 5).** Especially close scrutiny of scaling-up scenarios is suggested when: (i) current or projected risks of debt distress are above or close to the high end of the moderate range or the country moves to a higher risk category; (ii) scaling-up scenarios imply a need for sharp shifts in fiscal policy, the investment rate, the financing mix, productivity growth, or other key policy variables; and (iii) key assumptions from the previous two or three DSAs, and hence debt projections, have proven significantly too optimistic; or (iv) debt has grown rapidly—defined as an annual change in the NPV of debt of 5–7 percent of GDP or more.<sup>62</sup>

**Box 5. Supporting Debt Sustainability**

The November 2006 Board paper on “*Applying the Debt Sustainability Framework for Low-Income Countries Post Debt Relief*,” (IMF 2006c) provides several specific suggestions for program design.

**For most low-income countries, nonconcessional borrowing should in general be discouraged.** For countries with a debt burden well below the thresholds, an adequate policy environment (including debt-management capacity), and viable investment projects for which no concessional financing can be found, nonzero limits may be appropriate. On the other hand, for countries with a higher risk of debt distress, the minimum grant element (for defining concessional loans) may be increased above the standard of 35 percent.

**Where there is a moderate or high risk of debt distress, programs may incorporate conditionality on total or external borrowing or on the NPV of external debt.** Such conditionality may not be necessary where there is sufficient absorptive capacity and adequate debt-management framework.

**In countries with high or rapidly growing domestic debt and/or limited debt management capacity, conditionality may reflect the desire to lower the stock of domestic debt by limiting aid-based spending in the short run—thus shifting from domestic to (lower-cost) foreign debt.**

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<sup>62</sup> For further details on the DSF and its application, see IMF (2006b and 2006c).

62. **In case of scaling up using borrowed resources, scenario analysis can help assess associated risks.** There is some tension between the conservative projections recommended for DSF medium-term scenarios, and the desire not to under-project growth in outer years, so as not to unduly constrain borrowing. This tension underscores the importance of including an alternative “high investment-low growth” scenario in case the baseline assumes that ambitious scaling up will lead to sizeable growth dividends, given the mixed evidence on the growth effect of higher aid.

### G. Managing Limits to Micro-Absorptive Capacity

63. **Limits to the returns on public investment and micro-absorptive capacity constraints can argue for a gradual approach to raising the level of public spending.** While, overall, the literature is inconclusive, the bulk of studies support the contention that aid can positively influence growth, conditional on good policies, and institutions.<sup>63</sup> The successes show that quite rapid progress toward meeting the MDGs is possible. However, additional public investments are potentially subject to diminishing returns, as large aid inflows can strain the administrative capacity of recipient governments, and there is some evidence that efficiency declines with the volume of investment.<sup>64</sup> Fund staff is not expected to evaluate absorptive capacity since this would require in-depth microeconomic assessments. Collaboration with the World Bank and key donors should help ensure proper evaluation of the growth effects of higher levels of public investment.

64. **Weak governance and poor quality of fiscal institutions can also call for a gradual approach to raising aid-financed spending.**<sup>65</sup> The relative efficiency of (pro-poor) spending is strongly correlated with the strength of governance and fiscal institutions.<sup>66</sup> The development of medium-term fiscal planning will help improve governance and should have high priority among fiscal structural reforms. Governments should also develop the capacity to estimate sectoral resource needs. Large spending initiatives should be preceded by pilots whenever possible. The fiscal institutions that need special attention in order to maximize the

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<sup>63</sup> See the background paper. Public investment can also improve the productivity of other factor inputs (“crowding in”), since public investment can induce more private investment and make private investment more productive (see Collier and Dollar, 2002). However, Leite and Tsangarides (forthcoming) find little robust evidence for crowding in effects.

<sup>64</sup> See Appendix III of IMF (2006c).

<sup>65</sup> See IMF (2007b and 2007c).

<sup>66</sup> Aid flows can weaken ownership and management of public resources through the relaxation of the public budget constraint and the weakening of domestic accountability. More generally, large aid inflows can generate perverse incentive effects, similar to natural resources, giving rise to corruption and rent-seeking behavior (Braeutigam and Knack, 2004).

benefits of scaled-up aid include: (i) expenditure planning instruments; (ii) budgeting processes (with a view to improving results orientation); (iii) expenditure tracking systems; and (iv) accounting, control, and reporting systems.<sup>67</sup>

## H. Allocating Expenditures and Monitoring Resource Use

65. **In designing Fund-supported programs, staff should be mindful of their distributive consequences and aspects of expenditure allocation that affect macroeconomic performance.** On these issues, staff should collaborate closely with the World Bank, and rely on the Bank and other development partners for sectoral assessments. In the context of scaling up, specific concerns relate to impact of the composition of higher spending on the real exchange rate, debt sustainability, and fiscal sustainability. Poverty and Social Impact Analysis (PSIA) helps in designing programs that incorporate the interests of the poor and mitigate the adverse impact of reform measures on the most vulnerable segments of the population. Accordingly, while staff is not responsible for conducting PSIAs, it should be proactive in discussing PSIA needs with the authorities and development partners, and take into account pertinent PSIA results.

66. **The Fund should support efforts to make progress toward the MDGs through expenditure policies and monitoring.** PRGF-supported programs have been broadly successful in expanding social spending—on average, education and health spending has risen by 0.6 percent of GDP a year, double the increase in non-PRGF countries.<sup>68</sup>

- Staff reports should discuss increases in donor resources—including those resulting from HIPC and MDRI relief—and the effects of such scaling up at the macro level on expenditure allocations and key projects, with emphasis on poverty-reducing activities. At the same time, given the fungibility of resources and, especially for the outer years, the lack of a counterfactual, there should be no requirement to specifically identify what spending items relate to MDRI relief.
- Floors for anti-poverty or social sector spending should be incorporated to support the expansion of social programs and other priority spending. Five out of 25 PRGF programs in Africa during 2001–05 included these.<sup>69</sup> Three further PRGF programs, while not having explicit conditionality of this kind, had quantitative targets for increasing poverty-reducing or social spending.<sup>70</sup>

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<sup>67</sup> See IMF (2007c) for details and recommended actions.

<sup>68</sup> See Selassie et al. (2006).

<sup>69</sup> Ghana, Mauritania, Rwanda, Sierra Leone, and Uganda.

<sup>70</sup> Democratic Republic of Congo, Ethiopia, and São Tomé and Príncipe.

- Where conditionality seeks to limit spending to protect fiscal sustainability or macroeconomic stability, social sectors need to be protected. In case of a need for spending cuts, staff routinely supports efforts to identify wasteful spending and restrict the cuts to nonpriority outlays.

67. **Wage bill ceilings should be used selectively and made more transparent.** In the face of wage pressures crowding out priority spending, a number of PRGF arrangements have included ceilings on government wage bills in their conditionality, often in conjunction with civil service and payroll system reforms. As of June 2007, conditionality on the wage bill was in place in eight out of 29 PRGF arrangements, of which four were performance criteria. In general, these performance criteria have not imposed a ceiling (or hiring freeze) on the health or education sectors, and they have been revised during program reviews to incorporate new information on expected aid flows and desired staffing and wage levels (such as in the cases of Malawi, Senegal, and Zambia). However, although wage ceilings have been conceived as short-term measures, in practice they have shown a high degree of persistence. Recent Fund guidance emphasizes the need for avoiding the use of wage bill ceilings over extended periods of time, for flexibility in its application (with adequate safeguards for priority sectors), and for clear justification in program documents.<sup>71</sup>

68. **Reporting and conditionality should, in principle, make use of PRSP-based definitions of priority spending.** Priority poverty-reducing spending is defined in most PRSPs, and staff reports are already reporting on such spending when feasible.<sup>72</sup> As these national definitions lack cross-country comparability and no other agency is collecting these data, country reports should also continue to show expenditures on health care and education. Moreover, staff will endeavor to undertake periodic systematic assessments of poverty-reducing expenditures in order to assess the use of aid across recipient countries.

69. **Concerns about overly-constraining definitions of priority spending will need to be addressed through PRSPs, where such spending is defined.** The recent IEO report noted the growing recognition by all stakeholders that more fiscal space is needed for infrastructure spending. The Fund, with the donor community, has shown flexibility by incorporating changes in the definition of priority spending in countries where the authorities' classification has evolved. In Rwanda, energy-related outlays were included in priority spending when shortages and blackouts threatened growth. In Chad, priority spending was expanded to include judicial reforms important to establishing rule of law. In Uganda, priority spending expanded to include infrastructure spending in rural areas. At the same time, a too-expansive definition of priority spending might introduce rigidities and limit the scope for adjustment, either to shocks or changing objectives.

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<sup>71</sup> See IMF (2007a and 2007b).

<sup>72</sup> See IMF and World Bank (2005).

70. **Fund staff should collaborate closely with Bank staff to take account of analysis and advice on how aid, revenue, and the composition of public expenditure might be used to improve growth prospects.** Recent findings by the World Bank staff confirm that fiscal policy design is a determinant of growth. The quality of governance and management in the public sector, the composition of expenditure, the level of expenditure, tax policy, and budget processes all have a major influence on the growth impact of fiscal policy. An explicit development of growth-oriented fiscal policy scenarios to inform the design of an overall macroeconomic policy package is therefore desirable.<sup>73</sup>

71. **Staff should also seek to address the more strategic question of whether aid is supporting growth and helps achieve the MDGs.** Staff reports should address progress toward achieving the MDGs, and the extent to which the use of the additional resources is effectively guided by medium-term planning. On these issues, staff will need to work with the authorities and other development partners, notably the World Bank, which is developing a more comprehensive results reporting system. Local NGOs and other groups may also be able to provide useful information on the effectiveness of spending.

#### IV. SUMMARY AND CONCLUSIONS

72. **The Fund plays an important role in helping LIC members manage aid inflows effectively.** Higher aid can allow faster progress toward the MDGs, but can also create macroeconomic challenges. In this context, and in line with the MTS, the Fund can help countries design appropriate macroeconomic frameworks. The recent Board paper on the DSF and the forthcoming paper on the role of the Fund in the PRS process clarify several operational issues in this regard. This paper seeks to clarify the key principles for program design and related policy advice.

73. **Since the introduction of the PRGF in 1999, the Fund's approach to aid management has evolved.** Program design changed to accommodate the spending of (more) aid in program baselines; and there has been a partial move toward accommodating the spending of unanticipated aid and offsetting unanticipated shortfalls. Nevertheless, aid volatility has often complicated fiscal policy.

74. **Actual aid absorption was substantially smaller than projected and permitted under most Fund-supported programs.** Generally, a reluctance by the monetary authorities to allow their currencies to appreciate led to larger-than-programmed international reserves, creating inflationary pressures. Real appreciation has often been a concern, but rarely a problem.

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<sup>73</sup> See World Bank (2007) for details.

75. **The following best practices for future program design and policy advice can be drawn from this study:**

- *Aid projections:* Fund aid projections, both on the immediate forecast and in subsequent years, should represent staff's best estimate of the amount of aid that will materialize, based on all available information. While programs should have one baseline, Fund staff should assist authorities in preparing alternative scenarios of scaling up.
- *Spending aid:* Fund-supported programs should generally support the full spending and absorption of aid, provided macroeconomic stability is maintained, and taking into account specific country circumstances and development needs. Fund-supported programs should rarely constrain aid-based spending on the grounds of risks to competitiveness. Micro-absorptive capacity constraints can, however, argue for a gradual approach to raising public spending. Specific conditionality (such as spending floors) can be incorporated to support the expansion of poverty-alleviating programs.
- *Absorbing aid:* The monetary program should seek to combine absorption of aid with price stability and reserve adequacy. It is essential to have a clear and common understanding of the exchange rate regime and monetary policy objectives. In general, scaling up strengthens the case for exchange rate flexibility, while managed floating can raise difficult challenges for program design. Scaling up ties in with the NFA/NDA conditionality framework for monetary policy.
- *Aid volatility:* While aid disbursements are often volatile, Fund-supported programs should promote a smooth path of fiscal spending. Once reserve adequacy has been achieved, program adjusters should allow temporary deviations from programmed foreign financing to be absorbed through domestic borrowing, financed through reserve drawdowns.
- *Allocating expenditures, resource use, and meeting the MDGs:* Fund staff should collaborate closely with the World Bank, and rely on the Bank and other development partners for sectoral assessments. Staff will continue to assist the authorities in monitoring the use of scaled-up resources using PRSP-based definitions of priority spending.

76. **The paper also underscores the importance of better explanations of program design in program documents.** This applies, in particular, in the case of deviations from the identified standard best practices.

77. **The narrow implementation of these recommendations for program design should not entail considerable additional resource needs.** This paper aims to support the quality of program design and policy advice by clarifying the analytical framework and best



practices, but does not call for additional exercises. However, it does assume that adequate resources are available for effective collaboration with the World Bank, donors, and other development partners—an issue that will be discussed in a forthcoming paper on the role of the Fund in the PRS Process.

## V. ISSUES FOR DISCUSSION

78. Directors may wish to discuss the following issues:

- Do Directors agree with the proposals on projecting aid inflows based on a comprehensive assessment of the best available information, and explaining the use of deliberately cautious or optimistic assumptions?
- Do Directors agree with the proposed framework for guiding staff advice and program design on the spending and absorption of aid? Do Directors agree that Fund-supported programs should generally support the full spending and absorption of aid—in the context of a multi-year fiscal framework—provided macroeconomic stability and spending effectiveness are maintained? Do directors agree that strategies for spending and absorbing aid should be explained clearly, in particular when full spending and absorption is not recommended for the near term.
- Do Directors agree with the recommendations for the coordination of fiscal, monetary, and exchange rate policies in the context of managing aid inflows, aimed at reconciling aid absorption with price stability, while avoiding the crowding out of private sector investment?
- Do Directors agree with the proposed application of program adjusters to support a smooth path of fiscal spending, subject to reserve adequacy?
- Do Directors agree that in designing Fund-supported programs, staff should be mindful of their distributive consequences and aspects of expenditure allocation that affect macroeconomic performance, while generally relying on the Bank and other development partners for specific analyses?

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