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The Acting Chair's Summing Up
Fiscal Policy Response to Scaled-Up Aid; Aid Inflows—The Role of the Fund and Operational Issues for Program Design
Executive Board Meeting 07/57
July 6, 2007

Executive Directors welcomed the opportunity to discuss issues related to the management of scaled-up aid and the Fund's role in this regard. They noted that the staff papers provide important guidance for Fund engagement in low-income countries (LICs) in the context of the Fund's Medium-Term Strategy (MTS), which called for a more focused engagement in these countries, with emphasis on the provision of advice on appropriate macroeconomic policies in the face of increased and volatile aid inflows. Directors considered that, in conjunction with identifying best practices, the papers usefully synthesize recent work in the Fund on accommodating scaled-up aid flows. The staff papers should also be viewed in the context of the recent IEO report on the IMF and Aid to Sub-Saharan Africa, which noted scope for further clarification of the Fund's policies relating to the management of aid.

Directors concurred that the Fund should help countries create and maintain an enabling environment for the use of aid, although most emphasized that the Fund should not actively engage in mobilizing a scaling up of aid resources. At the same time, Directors noted that so far scaling up of aid has not been widely observed across LICs. Directors reiterated that, in line with the MTS, engagement of the Fund in LICs should continue to be focused on its core areas. They welcomed the finding that Fund-supported programs have become more accommodating of the use of aid, and more supportive of pro-poor spending.

Directors supported the focus in staff reports on identifying best practices for the design of macroeconomic and budgetary policies in Fund-supported programs in the context of scaled-up but volatile and uncertain aid flows. Directors also concurred on the importance of program documents providing clear explanations of program design, in particular, in instances of deviations from the identified best practices.

Aid Projections and Alternative Scenarios

Directors were of the view that the Fund's baseline aid projections should represent the staff's best estimate, based on all available information, of the amount of aid that is expected to materialize, both in the immediate future and in subsequent years. Deliberate over- or under-projection would require explicit justification. Furthermore, in the context of

Fund-supported programs, aid forecasts should also be consistent with the maintenance of debt sustainability. Directors confirmed that Fund-supported programs should be based on a single baseline scenario. Nevertheless, they noted that the staff should be available to assist the authorities in preparing alternative scenarios of scaling up, which could be presented in Poverty Reduction Strategies and Article IV reports. These scenarios should also be consistent with maintaining macroeconomic stability and ensuring debt sustainability.

Spending and Absorbing Aid

Directors considered that Fund-supported programs should generally support the full spending and absorption of aid, provided that macroeconomic stability is maintained. Deviations from a full spend and absorb approach including trade-offs made in order to implement policies that reduce vulnerabilities, for example to help overcome problems of inflation, low reserves, and/or high debt, should be explained clearly in program documents. In this context, Directors supported the formulation of a conceptual framework to guide country teams in giving advice to LICs on a case-by-case basis, without specific quantitative performance thresholds for the spending and absorption of additional aid.

Directors noted that actual aid absorption has been substantially smaller than envisaged under most Fund-supported programs, often reflecting a reluctance by the monetary authorities to allow their currencies to appreciate, while creating inflationary pressures. Directors noted that Fund-supported programs have not generally restricted aid-based spending because of concerns regarding competitiveness. Rather, programs have included targeted measures, as for example, in addressing infrastructure bottlenecks. Several Directors thought that further consideration should be given to the issue of safeguarding competitiveness in the context of scaled-up aid.

Medium-Term Frameworks and Expenditure Smoothing

Directors stressed that, in an environment of scaled-up aid, macroeconomic policy formulation should be based on a longer-term view of spending plans and potential resource availability. They noted that medium-term frameworks are the appropriate policy tools for this purpose. In light of their weak capacity, many LICs will likely require technical assistance for preparing such frameworks. Basic medium-term frameworks should draw upon the macroeconomic scenarios developed in the context of debt sustainability analyses. More complex medium-term budget and expenditure frameworks could be developed in a phased manner consistent with strengthening of capacity, and will require close collaboration among the Fund, the World Bank, and other development partners at the country level.

Noting that aid disbursements are often volatile, Directors saw merit in smoothing expenditures over time so that programs are adequately funded. Accordingly, most Directors noted that, when aid falls short of projections, program adjusters should allow higher domestic financing and reserve drawdown in order to maintain spending levels, provided an adequate level of reserves has been achieved and macroeconomic stability is preserved. In this context, Directors noted that aid flows are similar to other flows that affect the balance of payments, and should be factored into planning for stability in reserves and public finances. A number of Directors questioned the rationale of the recommendation to use reserve buffers specifically to smooth volatile aid flows and asked for further analytical work on this issue, in particular on the appropriate level of reserves for such a strategy of self insurance. With regard to instances in which aid is higher than expected or absorptive capacity constraints prevent its full spending in the short run, most Directors agreed that part of the aid would be saved, to be spent in future. However, Directors also noted that, in countries where macroeconomic stability has been achieved, program adjusters could be designed to allow for short-term spending increases in cases of higher aid inflows than expected, with adequate safeguards to protect spending effectiveness. Furthermore, to help protect essential expenditures against the impact of shortfalls in aid, Directors emphasized the need for systematic expenditure prioritization, and for protecting priority spending in the context of medium-term planning and program design. Directors also emphasized the critical role of donors and donor coordination in improving the predictability and delivery of aid.

Directors underscored the need for careful monitoring of spending to ensure debt sustainability. They noted that inefficient spending will simply add to debt burdens without improving economic and social outcomes. In this regard, Directors emphasized that the Fund should rely on the World Bank and other development partners for monitoring sectoral spending. Directors also considered that reforming fiscal institutions and strengthening governance would have a significant bearing on the efficiency of spending.

Coordination of Fiscal, Monetary, and Exchange Rate Policies

Directors underscored the importance of coordinating fiscal, monetary, and exchange rate policies in managing aid inflows, including the need for a common understanding of the objectives of the exchange rate regime and monetary policy. Many Directors noted that, while a strategy of spending and absorbing aid could be implemented under any exchange rate regime, scaling up strengthened the case for exchange rate flexibility, while a regime of managed floating could pose difficult challenges for policy and program design. A number of other Directors, however, did not find the argument in favor of exchange rate flexibility compelling and considered that further empirical analysis is needed to support this view and afford a better understanding of the related policy choices. In any event, Directors saw a continuing critical role for the Fund, in its surveillance and program work and consistent with its mandate, in advising member countries on exchange rate policies. Such advice would include an assessment of the implications of scaled-up aid, while continuing to pay due regard to country-specific circumstances and policies. More generally, Directors recommended that monetary programs should seek to reconcile the absorption of aid with price stability and reserve adequacy, while avoiding the crowding out of private investment.

Directors considered that the standard NIR/NDA conditionality framework is generally conducive to supporting scaling up.

Wage Bill Ceilings

Directors recognized that the use of overall wage bill ceilings in Fund-supported programs has reflected valid concerns regarding macroeconomic stability and the need for protecting critical non-wage spending and public investment. These have been designed as short-term measures when first-best options have not been available, including in post-conflict countries. Directors welcomed the declining incidence of such ceilings in Fund-supported programs, and hoped that the use of medium-term expenditure frameworks and strengthened budget and payroll systems will gradually obviate the need for such ceilings. However, as this will take time and LICs will need substantial technical assistance from the Fund and other providers to develop such systems, ceilings in exceptional cases may be needed based on macroeconomic considerations. Such ceilings should continue to be flexible enough to accommodate spending of scaled-up aid, particularly in priority sectors such as health and education. Directors called for staff reports to justify in a transparent manner the use of wage bill ceilings and for a reassessment of their need and rationale at the time of program reviews.

Avoiding Long-Term Reliance on Aid

Directors considered that measures for eventually reducing reliance on aid should be an integral component of macroeconomic policy for managing scaled-up aid. Such a strategy should emphasize domestic resource mobilization through broadening the revenue base by reducing exemptions and improving revenue administration. Equally, strengthening fiscal institutions and debt management capacity should be part of that strategy.

Strengthening Public Financial Management (PFM)

Directors underscored that strengthening fiscal institutions and public financial management systems is critical for effective utilization of scaled-up aid. They called upon LICs to prepare appropriately sequenced and prioritized action plans for strengthening their PFM systems, based on a diagnostic assessment of existing systems. Action plans should prioritize the reform measures consistent with local capacity to undertake such reforms. In the short run, focus should be on improving budget classification systems and strengthening internal controls, accounting, reporting, and preparing sectoral ceilings and forward estimates. Medium-term reforms should focus on areas where change will occur more gradually, such as strengthening treasury systems, debt management, and key accountability institutions such as national audit offices. With the growing trend towards decentralization, Directors emphasized the need for effective PFM systems at sub-national levels where much of the social spending takes place.

Directors stressed the need for continued donor support to LICs for developing and implementing the PFM action plans, including for technical assistance. Given the Fund's limited resources and specialized expertise in core areas, collaboration with other providers is essential to avoid wasteful overlap and conflicting advice. The Fund should appropriately leverage staff resources and explore financing and partnership arrangements with the World Bank and other providers. Noting that several operational issues related to scaled-up aid would benefit from strengthened collaboration between the World Bank and the Fund, Directors looked forward to staff proposals on the follow up to the report of the External Review Committee on IMF-World Bank Collaboration.

Directors welcomed plans for the issuance of further guidance to Fund staff on macroeconomic policy design in LICs in the context of scaled-up aid, taking into account the views expressed by Directors at today's meeting. Noting that the present papers offer advice on one important aspect of the Fund's work in LICs, they stressed the need to integrate these recommendations with other related ongoing work in the Fund, so as to prepare a comprehensive operational framework for guiding the Fund's role in LICs.