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Minutes of Executive Board Meeting 07/57-2

10:06 a.m., July 6, 2007

2. Fiscal Policy Response to Scaled-Up Aid; Aid Inflows—The Role of the Fund and Operational Issues for Program Design

Documents: SM/07/199 and Supplement 1 and Supplement 2; SM/07/210 and Supplement 1

Staff: Gupta and Tareq, FAD; Plant and Alonso-Gamo, PDR

Length: 1 hour, 24 minutes

Executive Board Attendance

J. Lipsky, Acting Chair

Executive Directors	**Alternate Executive Directors**
	S. Kamara (AE)
L. Rutayisire (AF)	K. Assimaidou (AF)
J. Silva-Ruete (AG)	V. De la Barra (AG), Temporary
	W. Mañalac (AU)
	S. Rottier (BE), Temporary
	G. Samuel (BR), Temporary
H. Ge (CC)	
	A. Guerra (CE), Temporary
J. Fried (CO)	P. Charleton (CO)
	Y. Alvarez (CO), Temporary
	B. Claveranne (FF), Temporary
K. Stein (GR)	
A. Kishore (IN)	
	B. Marchitto (IT), Temporary
	H.Yamaoka (JA)
	D. Kihara (JA), Temporary
	M. Daïri (MD)
	S. Rouai (MD), Temporary
A.S. Shaalan (MI)	S. El-Khouri (MI)
	W. Schilperoort (NE), Temporary
	J. Sigurgeirsson (NO)
	A. Tolstikov (RU), Temporary
A. Alazzaz (SA)	
	C. Sucharitakul (ST)
T. Moser (SZ)	
	M. Kaplan (UA), Temporary
	P. Williams (UK), Temporary

B. Esdar, Acting Secretary
S. Maxwell/Y.P. Chia, Assistants

Also Present

African Department: A. Berg, D. Nellor, R. Nord. Asia and Pacific Department: D. Citrin, T. Rumbaugh, A. Zanello. European Department: T. Richarson. External Relations Department: S. Bhatia, J. Bisping, J. Mark, B. Sarr. Fiscal Affairs Department: I. Adenauer, A. Allen, T. Catsambas, A. Cheasty, V. Gunnarsson, S. Gupta, D. Last, S. Tareq. Independent Evaluation Office: M. Berndt, M. Kaufman. Institute: E. Tanner, E. Verreydt. Legal Department: I. Mouysset, M. Strauss. Middle East and Central Asian Department: J. Di Tata, J. Wakeman-linn. Office of the Managing Director: O. Brekk, G. Schwartz. Policy Development and Review Department: M. Allen, P. Alonso-Gamo, B. Barkbu, A. Ghosh, M. Hadjimichael, E. Harris, J. John, J. Kees Martjin, J. Zeuner. Secretary's Department: P. Gotur, L. Hubloue, P. Martin. Western Hemisphere Department: C. Macario. Senior

Advisors to Executive Directors: K. Acharya (ST), G. Collange (FF), N. Raman (ST), M. Sidi Bouna (AF), A. Tall (AF). Advisors to Executive Directors: H. Caracalla (MI), S. Cerovic (NE), M. Choueiri (MI), A. Eng (ST), S. Krishnan (IN), M. Lanz (SZ), L. Lindegaard (NO), I. Momo (AU), H. Ou (CC), V. Pillai (UK), J. Sulemane (AE), E. Uanguta (AE), F. Waqabaca (ST), T. Wezel (GR).

2. FISCAL POLICY RESPONSE TO SCALED-UP AID; AID INFLOWS—THE ROLE OF THE FUND AND OPERATIONAL ISSUES FOR PROGRAM DESIGN

Mr. El-Khouri and Ms. Beidas-Strom submitted the following statement:

We thank staff for a well-written and interesting set of papers, which provide some operational guidance for program design to ensure that high and volatile aid do not endanger macroeconomic stability. Within the contours of this objective, the papers put considerable emphasis on the appropriate mix of fiscal, external and monetary policies. The main approach taken to judge the most appropriate policy mix is an application of the "absorb-and-spend" framework to demonstrate the real resource transfers of scaled-up aid—a framework first introduced in September 2005. The papers also respond to some of the concerns raised by the Independent Evaluation Office in its recent report on the IMF and Aid to Sub-Saharan Africa, including how the absorb-and-spend framework allows for growth inducing pro-poor budgets. More directly, these papers assuage doubts on whether Fund-supported programs to low-income countries have accommodated more fiscal spending, while explicitly advocating the use of the fiscal deficit including grants as the key indicator of choice in cases of scaled-up aid. We welcome this approach and the case-by-case application of the staff guidance, with no specific prescription of quantitative absorption and spending thresholds. We are in general agreement with many of the staff's recommendations, and thus will limit ourselves to issues where we either are not in full agreement with staff or where we think further analysis is needed.

Application of the spend-and-absorb framework. Staff assesses the degree to which scaled-up aid was spent and absorbed and then advocates best practice for future program design. Few deviations from the spend-and-absorb strategy are envisaged, implying that such a strategy is consistent with real resource transfers without undermining macroeconomic stability. The basis of this implication and the emanating best practice is a broad examination of program conditionality and ten case studies of aid absorption and spending in low-income countries. However, no robust quantitative analysis is presented to corroborate this conclusion, pointing to a need for a more systematic application and substantive assessment of the spend-and-absorb framework. In addition, the case-study evidence presented could suffer from measurement error, since widening current account and fiscal deficits might have occurred for reasons unrelated to scaled-up aid. The original 2005 paper provided a clear mathematical methodology for disaggregating the changes affecting the current and fiscal accounts, including isolating the impact of exogenous shocks and other autonomous structural or changes in policies, besides those due to scaled-up aid. We hope that staff will review the findings on this basis, at least to substantiate and corroborate the best practice drawn for macroeconomic domestic policies. Specifically, we suggest this substantiation for staff's assertion that (i) the effect of aid-induced real appreciation on competitiveness is a concern but not a problem, and that (ii) scaled-up aid strengthens the case for flexible exchange rate regimes.

Spending aid and competitiveness issues. We welcome the guidance on safeguarding competitiveness at times of scaled-up aid, particularly the approaches advocated for mitigating the risks of Dutch disease. While this is useful to both staff teams and country authorities, overall we found the adverse impact on competitiveness underplayed. Staff clarifications are warranted particularly in light of the important work of Rajan-Subramanian which largely runs counter to the staff's finding. We see limited scope for the Fund's program design to "include targeted measures to minimize the risk of" such loss of competitiveness, since many of the measures listed lie outside of the Fund's core competences. In an area of core Fund competence, we were disappointed to read that "Fund staff should not be required to predict the magnitude of a possible real appreciation as a result of programmed higher aid." We believe that a greater effort by staff is needed in this area to better inform the appropriate macroeconomic policy mix going forward. Moreover, with the underplay of the loss of competitiveness in the papers, we see no reason to put the onus on the authorities to "incorporate concerns of real exchange rate appreciation on exports and how this will be surmounted over time" in their PRSPs, not in the least because of constrained technical capacity considerations on the part of the authorities.

Absorbing aid and exchange rate policies. Staff suggests that macroeconomic policies need to be coordinated in the face of scaled-up aid in order to reconcile aid absorption with price stability (or single digit inflation rates), while avoiding crowding out of private sector investment. To achieve this objective, staff favors the adoption of more flexible exchange rate regimes, despite what appears to be lacking supportive empirical evidence of such a stance. Furthermore, staff appears to underplay the costs of subordinating exchange rate stability in favor of price stability. For example, in cases of flexible exchange rate regimes, the difficulties of coping with exchange rate volatility are underplayed, while the costs of sterilization appear to be overplayed, particularly in the case of managed floats. Further empirical work should be undertaken on low-income countries that typically receive scaled-up aid to clear up some of these issues, including an estimation of (i) the quasi fiscal costs of sterilization, (ii) the size of competitiveness losses due to scaled-up aid, (iii) the costs of building up monetary and foreign exchange operations such that they could intermediate larger inflows, whether official or private, while maintaining the current exchange rate regime, and (iv) the costs of switching to a flexible exchange rate regime to contain inflationary pressures, and the full array of instruments such a switch would entail.

Finally, regarding the Fund work program on low-income countries, we wish to reiterate our view that the various work streams and upcoming policy papers, including this set, should result in specific recommendations that would feed into a recomposed comprehensive strategy to clarify the Fund's work in these countries. Moreover, we continue to believe that the proliferation of papers on various components of this work makes the task of arriving at a clearly defined and cost effective strategy more difficult.

Mr. Yakusha and Mr. Schilperoort submitted the following statement:

We thank staff for the high quality set of papers. The IMF has made considerable progress in recent years in accommodating the use of aid in programs, and to design them more supportive of pro-poor spending. We encourage staff to continue to implement improvements while taking into account the recommendations made by the IEO in its report on Aid to Sub-Saharan Africa. The current set of proposals forms a good starting point for delivering further progress. We can agree to most of the proposals presented.

On the Role of Donors

The papers rightly note that Donors have a responsibility in delivering improved outcomes. Overall aid inflows seem, however, to be falling behind the commitment by the G8 in 2005. Staff's comments are welcome on whether this is perceived to be a temporary setback. We note with serious concern that relative to GDP a large majority of PRGF-eligible countries did not see aid flows rise substantially over the past several years. In this regard, one could argue that the issue at stake is not so much the fiscal response to scaled-up aid, but more an effective use of aid flows in general. Apart from the level, the predictability and duration of aid flows make a difference in ensuring progress toward the Millennium Development Goals. Initiatives to ensure long-term and predictable aid flows, such as Dfid's 10-year commitment to development assistance to Rwanda and Ethiopia, are most welcome. Finally, donors play a crucial role, where warranted in close cooperation with the Fund, in providing technical assistance.

On Exchange Rates

Staff's finding that scaling-up of aid strengthens the case for exchange rate flexibility deserves in our view further argumentation. Many countries, including some in our constituency, currently deal well with increasingly large financial inflows without adopting a flexible exchange rate system. The paper rightly notes that a case can be made for mitigating short-term exchange rate volatility, but at the same time it states that a managed float system would be relatively hard to manage. Some of the argumentation used to build this case seems also to apply to fixed exchange rate systems, which according to staff do provide a viable framework. In our view, the country-specific circumstances determine which exchange rate framework is most appropriate, not scaled-up aid as such.

On Priority Spending

We welcome the fact that the share of programs that do not accommodate additional aid has fallen and that second-generation programs seek to safeguard priority spending. In this regard, the paper notes that six recent programs set a floor on poverty-related spending levels. While in principle floors on anti-poverty or social spending can be considered commendable, the benefits of protecting these expenditure categories have to be weighed against the importance of protecting other critical expenditures, notably those that promote growth and thereby might serve the poor in the long term. We note that the IEO stated in its evaluation of Fund aid to Sub-Saharan Africa that 'the increasingly widespread view is that SSA's public-expenditure pendulum has gone too far in the direction of pro-poor spending for safety net programs, at the expense of pro-growth spending for infrastructure'. Staff comments are welcome. Floors might well be useful as they enforce a critical evaluation on which expenditures would be most crucial in times of setbacks in revenue, but it is likely to depend on the country-specific situation whether these floors should be directly focused on pro-poor spending.

On Expenditure Smoothing

Staff rightly argues that spending should be anchored in a medium-term perspective, which would allow to smooth aid shortfalls over time. However, we would appreciate more clarification for staff's stance against a symmetric approach to aid surprises. Given difficulties in assessing whether windfalls or setbacks are temporary or structural, advising that the windfalls be spent, whereas setbacks should not lead to a policy reaction, might imply an upward path for the deficit. We wonder how this recommendation complies with recommendations in individual Article IV consultations, where the general policy advice seems to be that countries would be better off by saving at least part of windfall revenues. Also given recent experience with donor support falling behind commitments, one might wonder whether scaled-up aid can be taken for granted in the coming years, especially if the current benign international macro-economic environment loses momentum. In case of stagnant inflows, a symmetric approach could be more warranted.

The Malan report advises the Fund to refrain from continued financial commitment in LIC's. While this report builds the case that long-term financial involvement does not fit with the core mandate of the Fund, we wonder whether it might then be worth considering a role for the Fund in helping to smooth short-term aid fluctuations if this were relevant to preserve macro-financial stability.

On Cooperation with the Bank

The papers mention close Fund-Bank collaboration and intentions to further foster cooperation. While we certainly support good collaboration (who would not?) it will in our view be most effective if built on a clear demarcation of responsibilities between the two institutions. Unfortunately, the papers are not very detailed in this regard, leaving us somewhat uncomfortable that the Fund and the Bank invest in overlapping instead of complementary expertise, notably in technical assistance on public finance management.

Mr. Kiekens and Mr. Rottier submitted the following statement:

We welcome this interesting and well-structured set of papers and broadly share the analysis put forth in them. The conclusions provide important inputs and valuable tools for the Fund's assistance in low-income countries given the need to upscale aid, particularly in light of the Monterrey Consensus.

When designing a program and writing surveillance reports, the staff should aim at making the most possible accurate aid projections. This would mean that the staff should on the one hand not create unrealistic expectations and on the other not be overly cautious that additional aid cannot be absorbed. In this regard, aid projections should not be restricted to firm donor commitments. The staff could look at past commitments and disbursement patterns of a donor country in various countries to estimate how firm a commitment by this donor country is and how likely it is that it would be implemented. We agree with the proposal that deliberate over- and under projections of aid would require explicit justification.

Aid projections may not always close the fiscal or balance of payments financing gap. This gap could be justified within a medium-term framework. However, we do not support the projection of a financing gap in the main scenario to signal the need for more donor assistance. Nor do we support that the Fund adopt a more proactive role in mobilizing and coordinating aid. These tasks primarily belong to the World Bank.

We agree that the overall fiscal balance should be used for monitoring short-term fiscal developments and that the annual budget process should be linked to a medium-term fiscal framework and poverty reduction strategy.

We are in favor of including an operational framework for expenditure prioritization in programs. This framework should ring-fence priority spending. At the same time, the prioritization of expenditures should help avoid unsustainable and lasting financing gaps. Strengthening fiscal institutions, including public financial management to improve the efficiency of spending is also key. The staff also rightly stresses the importance of strengthening domestic revenue mobilization, without relying excessively on trade taxes.

We support the preparation of alternative macroeconomic scenarios based on higher aid assumptions. We agree that the Fund cannot focus on costs, which are difficult to assess, necessary to achieve the Millennium Development Goals. However, it should consider how to achieve macroeconomic stability under higher aid scenarios. It is also important to formulate scenarios for exceptional one-off aid increases. Too often, a one time exceptional aid increase leads to a permanent spending increase that cannot be financed in the medium term.

The Fund should assist members in reaching a stage where aid can be fully and effectively spent and absorbed. Assessing the transition path to reach the preconditions for this spend and absorb approach should be done case-by case. In this regard, today’s papers constitute an appropriate follow-up to last year’s analysis on the policy design in low-income countries.

At first, the staff states that a strategy of spending and absorbing can be implemented both in the context of a fixed and flexible exchange rate regime. Under the former, there might be risks of temporary inflation spikes whereas under the latter, there might be short-term exchange rate volatility. However, later, the staff seems to argue that a scaling up of aid is easier to manage under a flexible exchange rate regime. We would appreciate staff comments on whether this would affect staff's advice on the choice of an exchange rate regime.

We note that, based on empirical evidence, the staff is not that concerned about the effects of the Dutch disease. However, we do think that they should not exclude considering, maybe in an approximate way, future exchange rate evolutions resulting from the programmed higher aid.

Program designs should always draw on the results of the latest debt sustainability analyses. It is important to state explicitly why a specific definition of concessionality has been chosen in a program. Consistency across countries is highly desirable.

We do not agree with the staff on the lack of need to report on the use of MDRI resources. We expect all reports to specify whether this aid was efficiently used.

On the issues of governance and the composition of public expenditure, the Fund should focus on macroeconomic relevant aspects and rely on the World Bank for other aspects.

Poverty and Social Impact Assessments (PSIA) should remain the responsibility of the World Bank but could be used in Fund programs. However, a clearer cooperation framework on this issue should ensure the timeliness of adequate PSIAs to help in Fund programs.

Lastly, we would like to ask for a correction in paragraph 1 of the paper "Fiscal policy Response to Scaled-Up Aid." It states that at the Gleneagles Summit, donors committed to double aid to sub-Saharan Africa (SSA) by 2010. However, at that summit, only the G8 was present and made specific commitments. This does not mean that other donors, including countries in our constituency, do not have commitments, which they will implement.

Mr. Fried and Mr. Ladd submitted the following statement:

We thank the staff for analyzing, synthesizing and compiling into two compact documents the explanations that some staff, development partners and external stakeholders were apparently missing, according to the IEO's findings.

These papers respond well to the Board's call that Fund policies be clarified with respect to spending and absorption of aid, projections and alternative scenarios, coordination of fiscal and monetary policy in managing aid inflows, and public financial management in recipient countries.

As we said during the discussion of the IEO's report on Sub-Saharan Africa in May, it may be that unhappy observers disagree with the policies in whole or in part, rather than lack clarity on the matter.

SM/07/210, Aid Inflows—The Role of the Fund and Operational Issues for Program Design, puts seven questions to Directors, and we can easily agree on all seven points. We were struck by the passage in Paragraph 32: "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....". We agree with the staff on the need for clear understanding of the monetary authorities' objectives and reaction functions regarding inflation, real and nominal exchange rate stabilization, and reserve accumulation. All agents and observers must be clear on the classification of the exchange rate regime and the objective (singular) and/or constraints of monetary policy. Concern over real appreciation should not usually be permitted to impede aid absorption and the program framework should be crafted accordingly. This is all the more important given the relatively scant evidence on the existence of Dutch Disease.

SM/07/199 reinforces the critical importance of fiscal prudence. We agree that there are circumstances under which effective management might require that aid flows be saved temporarily. The exit from aid may require higher revenue effort, depending on the level of recurrent program costs. There is no question that Fund members, donors or recipients, regardless of income level, need appropriate fiscal institutions including the capacity, first to control spending and borrowing and second, to manage debt. We agree that recipient countries need strong PFM systems to manage resources, be they own-source revenues or aid inflows. What the priorities should be for a PFM action plan depend on what the actual weaknesses are in the current PFM system, but the core areas that the staff emphasizes should certainly be considered. To these technical capabilities, we would add the need for a mechanism for effective consultation on spending priorities in the short term, among ministries and legislators, and in the longer term, with other stakeholders. In its TA efforts, the Fund should respond efficiently to the expressed needs of the member, while focusing on its special expertise and coordinating with other donors and providers. Opportunities for cooperation with the Bank, other international agencies and donors, including cross-financing, should be examined and, if appropriate, pursued.

Both reports underscore the importance of the Fund's macro framework as the foundation for policy decisions. Given the critical importance of the macro framework, and the persistent complaints about Fund forecasting assumptions in LICs, the report would have benefited from a discussion of improvements in the Fund's ability to project key macroeconomic variables. While there is a hint of this in the reports, noting, for instance, that the staff's projections of aid flows have become more accurate, there is little else that speaks of the progress made on forecasting. Can the staff provide some insights into how the approach to forecasting these frameworks may have changed? For instance, do the staff generally make assumptions about the returns to public investment projects when making projections?

The reports also make clear the hardship caused by unfulfilled aid commitments and volatile aid disbursement. Donors should view the report as a wake-up call to ensure, at a minimum, a reduction in the volatility of aid flows. This would allow countries to focus less on guarding against aid shortfalls (or booms) and more on the intended outcome of the aid (development).

Mr. Sigurgeirsson and Mr. Lindegaard submitted the following statement:

Key Points

- The set of staff papers presents a timely and appropriate response to the challenges faced by LICs in an environment of increased and volatile aid flows. They also provide a useful clarification of the Fund's role in this area. In general, we find that in most cases there is no conflict between macroeconomic stability and essential development priorities. Nonetheless, mission creep beyond the Fund's mandate should be avoided.

- We can endorse the suggested approach to further strengthen fiscal institutions as well as the proposed best practices for future program design and policy advice. In particular, we welcome the recommendation to smooth public expenditure over the medium term. However, savings of development assistance should be a last resort and the Fund should seek agreement with the authorities and the relevant donors if savings are necessary for reasons of macroeconomic stability.
- We underline the need to cooperate effectively between the TA providers and the recipient country authorities in order to harmonize analytical work for public financial management.

Fiscal Policy Response to Scaled-Up Aid

Smoothing Out Public Spending

In view of the uncertainty and volatility of aid flows, attempting to smooth public spending financed by scaled-up aid is a sensible strategy. Moreover, in an environment of scaled-up resource flows, a medium-term perspective is appropriate. It is clear that macroeconomic stability, absorptive and institutional capacity constraints and debt sustainability of the country in question are critical determinants of an appropriate spending path.

Full spending and absorption of the aid should be the norm. However, there may be situations where temporarily saving part of scaled-up aid to be used later is prudent due to capacity constraints and serious risks to macroeconomic stability.

Strengthening Domestic Revenue Mobilization

Strengthening domestic revenue mobilization is crucial for achieving the MDGs and also a vital part of an exit strategy from heightened aid dependency. Furthermore, as domestic tax revenues are a relatively stable source of income (particularly compared to aid flows), they are key in maintaining fiscal sustainability and help guard against aid volatility. Broadening of the tax base, combined with revenue administration reforms, would often be the solution that should be encouraged to strengthen domestic revenue mobilization. As good governance and the quality of fiscal institutions have a strong positive correlation with the efficiency of aid spending, building high-quality fiscal institutions, including debt-management capacity, is also an integral part of any successful exit strategy.

Public Financial Management

By increasing transparency and enhancing good governance, strengthened public financial management (PFM) systems are an important component of strengthened fiscal institutions that are needed to ensure that resources are used effectively and to track poverty-reducing spending. Also, a well functioning PFM ensures that resources are allocated to priority areas. Improved transparency, budgetary control and anti-corruption efforts could potentially reduce the volatility of aid flows as donors' confidence increases. A well-prepared, focused and sequenced PFM action plan that is tailored to country circumstances, would contribute to more effective PFM reform.

We agree with the suggested short-term priorities for the PFM action plan. In addition, steps to more fully incorporate donor aid into the budget should be highlighted. Donor and Fund assistance should be aligned with national poverty reduction plans and implemented in accordance with the Paris Declaration on aid effectiveness. In the medium- to longer-term, reforms should be broadened to e.g. include developing debt management capacity and strengthening the PFM systems of sub-national governments as well as linking the PFM reforms to broader public sector and governance reforms.

Technical Assistance

Due both to the limited Fund resources available and the specialized Fund expertise, PFM TA from the Fund will necessarily have to focus on the Fund's core areas and remain within the agreed budget envelope. Also, efficient provision of PFM TA will call for effective coordination among all TA providers, which will be needed to leverage staffing and financing. Partnership arrangements should be encouraged where possible.

It will be equally important to coordinate effectively between the TA providers and the recipient country authorities to ensure harmonized analytical work for public financial management issues and successful reforms. While country ownership of the reforms is crucial, coordination of the activities could usefully be lead by a major donor in cases where country capacity is limited.

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

Projecting Aid Inflows

Improved accuracy in projections of future aid inflows is a positive development, and we agree that they should be based on an assessment of the best available information as opposed to relying solely on a needs-based assessment or firm donor commitments. We welcome the suggested preparation of alternative scenarios.

As noted by staff (SM/07/199, p. 7), ”the costs of overly optimistic aid forecasts are likely to be higher than the costs of overly pessimistic ones.” For one, shortfalls from planned public expenditure are often not self-correcting. Furthermore, continuous expenditure disruptions would imply dampened returns from aid, eroded donor confidence and even wider scale negative effects through e.g. disruptions in efforts to strengthen fiscal management and institutions. Thus, in calibrating the baseline projections, any ”deliberately optimistic“ assumptions should pay careful regard to these concerns.

Spending and Absorption of Aid

We support that Fund programs accommodate full spending and absorption of scaled up aid, but that appropriate attention must be given to macroeconomic stability. Deviating strategies of lower spending or absorption may be prudent in some, though exceptional circumstances, yet these should prove temporary and eventually be smoothed out in the context of the country’s medium-term framework. Such cases must nonetheless be clearly explained in the program documents and discussed thoroughly with donors in the concerned country. Care must be taken not to jeopardize essential development priorities.

Care must be taken that scaled up aid does not undermine recipient countries’ debt sustainability nor efforts to strengthen domestic revenue mobilization. Moreover, development of medium-term fiscal planning and other efforts to improve fiscal governance are of key importance in managing the increased inflows of aid.

While little evidence supports constraining spending of aid on grounds of possible Dutch disease effects, the scaled up aid needs to be accompanied by efforts toward more productive resource allocation in line with the authorities' development strategy. This would create sufficient economic space for the scaled up aid without losing competitiveness.

Policy Coordination

In the environment of scaled up aid flows, smooth policy coordination is essential to ensure macroeconomic stability. Such coordination and effective program design require a clear, shared understanding of the exchange rate regime and the objectives of monetary policy between the Fund and the country authorities. The importance of transparency should be underscored in this context.

We take note that the proposed strategy of spending and absorbing aid is compatible with each exchange rate regime, yet we agree with staff that the potential difficulties and costs related to policy coordination favor flexible regimes, especially in face of increased aid inflows.

Program Adjusters

We welcome the use of more accommodative adjusters aiming to smooth the path of fiscal spending within a medium-term budget framework. However, fiscal responses to unexpected inflows of aid must be cognizant of the risk of its impermanence and ensure sufficient flexibility in expenditure paths. The importance of advance plans for supplementary expenditure—set up in collaboration with the World Bank and other developing partners—should, therefore, be highlighted. In the same vein, it is important to safeguard priority spending as set in the authorities' medium-term framework even in cases of unexpected shortfalls.

Expenditure Allocation

The design of Fund programs should be mindful of expenditure allocation in general, yet close collaboration with the World Bank and other development partners is critical and mission creep beyond the Fund's mandate needs to be avoided.

Mr. Alazzaz submitted the following statement:

I thank the staff for the well-written papers that raise important issues for managing aid volatility as well as utilizing scaled-up aid and other flows in low-income countries (LICs) to help enhance growth and reduce poverty. The papers also appropriately respond to many findings and recommendations of the recent IEO report on the IMF and Aid to Sub-Saharan African. Moreover, I welcome the focus on further improving the effectiveness of the Fund's engagement with LICs including through advising on appropriate macroeconomic policies in the face of increased and volatile aid inflows.

Turning to the issues for discussion, it is reasonable to contend that expenditure plans financed by scaled-up flows should take a medium-term perspective in order to smooth the expenditure path. To this end, I fully endorse the suggestion that the decision on how much to spend should be based on country-specific circumstances including macroeconomic stability, absorptive capacity constraints, and debt sustainability.

I agree that effective use of aid flows may require that some of the aid be saved temporarily. Indeed, it might be useful to accumulate international reserves or to retire domestic debt in countries where the absorptive capacity is weak. Here, the focus should be on capacity building to utilize higher aid effectively in the future. Saving aid in some cases can also be useful such as in responding to aid volatility and sustaining spending during periods when aid falls short of expectations.

While debt relief under the MDRI and the enhanced HIPC Initiative has created space for new borrowings, it is important to prevent the build-up of unsustainable debt burden. In this connection, intensifying efforts to strengthen the debt management framework and capacity is essential. By improving debt management, countries should be able to identify existing and potential debt-related vulnerabilities and develop their medium-term debt management strategy. This should lead to borrowing, which is consistent with the country's development plans and limits the risks of debt distress and macroeconomic vulnerability.

I endorse the stress on strengthening domestic revenue mobilization to reduce aid dependency and maintain fiscal sustainability. To this end, broadening the revenue base and strengthening revenue administration are crucial for improving performance. This is especially the case in many LICs where lowering distortionary tax rates and liberalizing trade are needed to enhance competitiveness and promote private sector activity.

Enhancing public financial management (PFM) systems in LICs is crucial to improve the efficiency of spending, including by facilitating shifting of spending programs toward priority areas. In this regard, I agree that action plans to reform PFM should be based on a comprehensive diagnostic study of existing strengths and weaknesses and be consistent with each country's capacity to undertake such reforms. The stress in the short run on improving the budget classification system and strengthening internal controls on budget execution, accounting, and reporting also seems appropriate. In addition, medium-term reforms as outlined in the paper, especially the strengthening of PFM systems in sub-national governments that are increasingly becoming responsible for most of the poverty-reducing expenditures in many countries, are also useful recommendations.

Effective coordination among TA providers as well as between TA providers and the authorities is critical to the efficient implementation of PFM reforms. In this regard, it is important for the Fund to focus its PFM TA on its expertise in core areas and to strengthen coordination with other providers. I also agree that the Fund should put emphasis on country ownership of the reforms, learn from lessons of the past to use TA more effectively, and leverage the resources of staff from Fund headquarters as well as the Regional Technical Assistance Centers (RTACs).

Turning to the role of the Fund and operational issues for program design in the context of aid inflows, I broadly endorse the best practices that could be drawn based on the assessment of recent experience. On Fund aid projections, I agree these should be based on a comprehensive assessment of the best available information. I can also go along with the suggestion that while programs should have one baseline, it is useful to assist authorities in preparing alternative scenarios of scaling up. This should help countries absorb more aid without jeopardizing macroeconomic stability.

On spending and absorbing aid, it is important to continue to implement the Fund's strategy on a case-by-case basis. In this regard, the proposed framework for guiding staff advice and program design looks reasonable. I also endorse the proposal that strategies for spending and absorbing aid should be explained clearly, especially when full spending and absorption is not recommended for the near term. In addition, the coordination of fiscal, monetary, and exchange rate policies is a critical component of managing a surge in aid inflows. In this regard, assessing risks to competitiveness and implementing measures to safeguard it are essential.

On allocating expenditures, resource use, and meeting the MDGs, the staff rightly underlines the importance of collaborating closely with the World Bank and relying on the Bank and other development partners for sectoral assessments. I also welcome that staff will continue to assist the authorities in monitoring the use of scaled-up resources using PRSP-based definitions of priority spending.

Mrs. Mañalac and Mr. Momo submitted the following statement:

We agree that the Fund plays an important role in guiding low-income countries (LICs) design appropriate macroeconomic frameworks to help mitigate the challenges posed by high and volatile aid inflows. The Fund's policy advice and technical assistance remain crucial in allowing LICs to achieve macroeconomic stability and higher growth needed to help reduce poverty and attain the Millennium Development Goals (MDGs). It is therefore pleasing to note that the papers to be discussed have responded to some of the recommendations made in the IEO report on the IMF and Aid to Sub-Saharan Africa and in the Malan Report on Bank-Fund Collaboration. We thank staff for the informative set of papers, which provided a useful insight into the macroeconomic impact of scaled-up aid and operational implications for the design of Fund-supported programs.

We fully concur that strengthening revenue mobilization should be an integral part of the fiscal response to scaled-up aid, particularly with the aim to reduce aid dependency and maintain fiscal sustainability over the long run. We also support the emphasis on building appropriate fiscal institutions, including strengthening public finance management (PFM) systems and debt management capacities, to ensure that spending is efficient. We share the concern that following debt relief, excessive borrowing, particularly on non-concessional terms, could see an unsustainable debt position re-emerge. We, therefore, agree with the importance of the Fund assisting LICs to develop their own medium-term debt strategies. To maximize efficiency, the Fund should focus on its comparative advantage and be cautious about the extent to which it involves itself in donor coordination, as many donor programs extend beyond the Fund's mandate and staff expertise.

We broadly agree with the proposals on projecting aid inflows based on a comprehensive assessment of the best available information on what is likely to be available over the program period. This would go along with the notion of framing the budget within the available resource envelope. However, it is also important to ensure that the macroeconomic frameworks are consistent with the national development objectives, including meeting the MDGs. Estimating the cost of meeting the MDGs, preferably through the PRSP process, therefore, could be useful in guiding staff advice and program design on the spending and absorption of aid.

We also agree that Fund-supported programs should generally support the full spending and absorption of aid within the context of a multi-year fiscal framework. Moreover, strategies for spending and absorbing aid should be explained clearly and that when a country's circumstances change, the strategy should adjusted accordingly. Having said that, aid recipients (both program and non-program countries) should also seek to smooth public spending over the medium-term, taking into account their specific country circumstances and development needs. We also like the suggestion on building up reserve buffers (through build-up of international and fiscal reserves) to smooth expenditure against aid volatility. However, we would like staff to provide further clarification on how this would effectively work in practice, especially with respect to strategies on how to invest and manage these reserves.

As alluded to in our earlier views, the Fund should also pay some attention to infrastructure-related growth and competitive linkages and their possible macroeconomic implications for the programmed spending and absorption of additional aid. The Fund staff should collaborate with other development partners, including the Bank for sectoral assessments. The results of the analysis should be taken into consideration when designing Fund-supported programs. The division of labor suggested here would be beneficial as long as the Fund, Bank and other development partners involved in the different aspects of analysis communicate clearly, constructively and continuously to ensure the cohesiveness of the program.

We support the recommendation for greater coordination for fiscal, monetary and exchange rate policies in the context of managing aid inflows effectively. It would be helpful to review appropriate monetary conditions that should go in tandem with fiscal strengthening.

Ms. Agudelo and Mr. Samuel submitted the following statement:

We thank staff for a well-written and comprehensive set of papers on the Fiscal Policy Response to Scaled-up Aid and the Role of the Fund and Operational Issues for Program Design. The reports incorporate many lessons from previous work on the IMF engagement in low-income member countries, e.g. the reviews of the PRGF and fiscal adjustment in Fund-supported programs and there is much with which we find ready agreement.

Staff has outlined the changing circumstances in Low Income Countries (LICs), which make these subjects particularly relevant. They have noted the outlook for substantial increases in aid to LICs arising from the Monterrey Consensus of 2002 and the Gleneagles Summit of 2005. In addition, increased borrowing space created by the MDRI and HIPC, and the emergence of new donors mean that many LICs face the prospect of managing significant increases in resource flows. It is important that these flows achieve their intended goals, which include promoting higher and sustained growth, helping to attain the MDGs, and contributing to poverty reduction. Sound fiscal policy management is critical to ensuring that these flows are directed efficiently towards these aims while, at the same time, macroeconomic stability is maintained.

We concur with staff that framing spending programs taking a medium-term perspective would help to foster sound fiscal management and the more effective use of scaled-up aid. Some of the characteristics of aid flows as outlined by staff, such as earmarking by donors, requirements for counterpart funding, argue in favor of such an approach. While establishing a medium-term resource envelope would require difficult-to-obtain reliable information on the intentions of official and private donors, it would be important to seek innovative mechanisms to treat with this problem. We support the suggestion for governments to encourage private organizations to strengthen their representation in recipient countries as well as for official donors to persuade key private donors to participate in donor coordination structures. Nevertheless, medium-term flow projections would have to reflect the Fund's best estimates using best available information, with stringent efforts to avoid overly optimistic projections given that this could lead to severe fiscal adjustment should the projections prove to be inaccurate.

Staff is correct in arguing for improving the domestic revenue effort in LICs. Reducing dependence upon aid flows is critical and all opportunities must be taken to broaden tax bases and improve revenue administration over time where needed. In some countries, revenue reforms may also include rationalization tax incentives, liberalization of trade to facilitate aid absorption, and revising the tax structure in support of private sector development.

We welcome the reaffirmation that the Fund's advice and program design encourage the effective use of all available aid in recipient countries. However, we are aware that this is not always possible as the ability of a country to absorb aid is influenced by absorptive and administrative capacity constraints, debt sustainability considerations, spending efficiency, and the impact of spending on growth. In general, we agree that these factors should be taken into account when determining spending levels of aid inflows. Having said this, we believe that there is need for flexibility in the application of these considerations and for balancing the various trade-offs between and among them when assessing spending capacities. A case in point would be the well-known tension among the level of public investment, promoting private sector development, and maintaining debt sustainability. Where supportive conditions for the utilization of all received aid are not present, it would be prudent to save some aid in the short term and smooth spending over time. However, in view of the complications of adopting such an approach in all situations and sometimes inter-temporarily –including donors' reluctance to provide aid that is saved and domestic pressures for higher spending– the long-term focus should be on helping recipient countries to increase their absorption capacity.

The maintenance of macroeconomic stability is critically important, and due attention should be paid to the effects of increased spending on inflation, and interest rates. Given the limited evidence of aid-induced Dutch Disease in Fund-supported programs, we are also inclined to the view that aid expenditure should not be restricted because of competitiveness concerns, although—as noted by Mr. Kiekens and Mr. Rottier—future exchange rate trajectories resulting from aid expenditure should not be totally ignored. The inclusion of measures in Fund programs to minimize the risk to export industries and diversification is an appropriate supporting practice.

There is merit in having the medium-term spending path anchor the fiscal framework with the spending path consistent with macroeconomic stability and debt sustainability. Similarly, there are advantages in making annual fiscal balance targets consistent with the medium-term framework with the precise fiscal indicator to be targeted decided on a case by case basis. We welcome the approach to the use of specific expenditure ceilings in Fund-supported programs when spending is cast in a medium-term context, reserving their use for exceptional circumstances and where it is absolutely warranted by macroeconomic considerations. We believe that this approach could go a long way in improving ownership of Fund programs in LICs.

We appreciate the discussion of aid uncertainty and volatility and concur that these factors impose severe constraints on budgetary operations and fiscal policy implementation. We are in general agreement with staff on the suggestions for LICs in confronting this problem. However, we would like to stress the importance of the international community honoring their commitments to provide more predictable aid flows. At the same time, we would urge greater flexibility in the modalities of providing aid where possible, as some practices—for instance heavy earmarking and aid supplied outside the budget—complicate budgetary management. Having said this, we appreciate and commend the efforts of those donors who are already moving toward longer-term aid commitments.

Improving the institutional capabilities of LICs should be viewed as a vital component of the strategy to increase aid absorption and, moreover, to reduce dependence upon aid in the longer term. As highlighted by staff, this would involve strengthening fiscal institutions as well as debt management capabilities, areas in which the Fund is already providing meaningful assistance. We agree with staff that there is need to upgrade Public Financial Management Systems in LICs in order to improve budgetary planning, execution, and reporting. Improving budgetary systems would also have to encompass efforts to coordinate aid through extra-budgetary channels with budget priorities as well as to deal with the difficulties caused by earmarking. In principle, we are in agreement with the formulation and implementation of PFM action plans. It would be vital, however, that due cognizance be taken of country capacity. In this regard, we view the "platform approach" as useful in achieving buy-in and ownership. The international community should be invited to support the implementation of action plans through technical assistance in priority areas. For its part, the Fund should provide assistance in areas of its core expertise while leveraging and coordinating financial arrangements with donors and other technical assistance providers.

Mr. Moser and Mr. Lanz submitted the following statement:

We welcome this discussion and the effort to review and clarify the Fund's role in low-income countries (LICs), as suggested by the medium-term strategy and the IEO report on the IMF and Aid to Sub-Saharan Africa. We broadly agree with the thrust of the staff papers, but see a need for more precise guidelines in some instances. Also, in some cases, particularly where collaboration with other institutions is important, the papers identify the issues that have to be addressed but fall short of explaining how it will be done.

By way of general comments, we would like to sound a note of caution on the following points:

First, the Fund should exercise prudence and avoid raising unrealistic expectations with regard to aid flows. OECD statistics cited by staff show little evidence of a substantial scaling up. The Fund provides most added value by basing program design and policy advice on realistic aid projections; we do not see an active role for the Fund in aid mobilization.

Second, absorptive capacity is key and needs to be carefully assessed to ensure that additional aid can be used effectively. Particularly, the importance of administrative capacity to deal with higher aid flows and greater aid fragmentation should not be underestimated.

Third, the problem of aid dependency is a serious concern that has not received sufficient attention in the present set of papers. The staff emphasizes problems of aid volatility without discussing underlying issues of aid dependency and insufficient mobilization of domestic revenue. Given the Fund's expertise and authority in the area of tax policy, we would have expected the FAD paper to dwell on this issue. Particularly, we would have appreciated operational guidance not only on the expenditure/PFM side, but also on the revenue side. We encourage further work on this issue.

Given our agreement with the thrust of the staff papers, our following comments focus on issues that require further clarifications and on issues where we disagree:

On aid projections, we would like the staff to elaborate on the statement that baseline projections "should not be restricted to firm donor commitments" (SM/07/210, paragraph 16). Also, we understand that the rational for alternative scenarios will be further discussed in the forthcoming paper on the Fund's role in the PRS process, but we see a need for further guidance on the use of such scenarios: On what assumptions should such calculations be based? What are the criteria for calculating such scenarios? How many scenarios should be calculated? How do such scenarios address the issue of administrative absorptive capacity?

We agree on the importance of protecting priority spending, but we do not agree that the Fund should assume responsibility to alert donors to the need of additional financing (SM/07/210, paragraph 51). This should be the authorities' responsibility. At the same time, we call upon donors to increase their efforts to improve aid predictability by following best practice principles, i.e., by entering multi-year commitments, setting transparent disbursement guidelines, and aligning disbursements with the budget cycle.

On debt sustainability and the use of the Debt Sustainability Framework: We do not agree that debt relief has created room for substantial new borrowing, as stated in paragraph 57 of SM/07/210. In our view, this gives the wrong message and invites another debt cycle. Moreover, while the Fund has an important role in disseminating the results of debt sustainability analyses and in supporting debt sustainability with appropriate program conditionality as laid out in Box 5 of SM//07/210, the negotiation of appropriate levels of concessionality should be the sole responsibility of the recipient country authorities and not of the Fund (Paragraph 18).

On safeguarding competitiveness, we note that current research suggests that the risk of Dutch disease should not be overestimated. However, with respect to the guiding principles proposed by staff we would prefer a more cautious stance. Exchange rate surveillance and balance of payments issues are the Fund's core area of expertise and we need our advice in this area to be solid.

On public financial management (PFM) diagnostics and assessment tools, and subsequent action plans, there is an urgent need to clarify the role of these tools and avoid overlap. Specifically, what is the IMF's involvement in the PEFA Framework? What is the role of fiscal transparency ROSCs? What is the framework for follow-up to these assessments needs? The staff papers clarify the Fund's expertise in the area of PFM and thus the areas of collaboration with other TA providers, but they do not spell out how such collaboration is executed. Is there a clear division of labor between the Fund and the Bank?

On budgetary flexibility regarding wage bills: We agree that wage bill ceilings do not necessarily have to be part of program conditionality, but such ceilings should also not be ruled out. They can be relevant and helpful in accompanying more comprehensive public sector reforms. In any case, the use of wage bill ceilings must be well justified and appropriate time horizons defined. More generally, we wholeheartedly agree that program documents should provide better explanations of program design, and we fear that the recent trend to shorter program documents is counterproductive in this sense.

On the use of Poverty and Social Impact Analysis (PSIA), we ask the staff to clarify the policy proposed in paragraph 65 of SM/07/210. We assume that "not being responsible for" means that the Fund will not conduct PSIAs, and we agree. However, what exactly does being "proactive in discussing PSIA needs" mean?

On monitoring resource use: We do not think that Fund staff should endeavor to undertake periodic systematic assessments of poverty-reducing expenditures. This should be done by development partners that carry fiduciary risks.

On fiscal policy design and growth, the staff notes in paragraph 70 of SM/07/210 that an "explicit development of growth-oriented fiscal policy scenarios to inform the design of an overall macroeconomic policy package is desirable." We would like to know what this implies for Fund program design? Again, collaborative efforts in this respect are in order, but we need to have a clearer understanding about the division of labor and purpose of such efforts.

Finally, an area that should be further discussed is fiscal decentralization and sub-national government spending. Fiscal decentralization can lead to greater spending effectiveness but it also greatly complicates the coordination of fiscal and monetary policies and raises additional issues of absorptive capacity. Further work on this topic would be useful.

Mr. Ge and Mr. Ou submitted the following statement:

We thank staff for the well-written papers on this important issue—a welcome step in the Fund's medium-term strategy (MTS) toward helping the LICs design and maintain macroeconomic policy frameworks to achieve the MDGs.

At the outset, we would like to emphasize the principle of a case-by-case approach in dealing with aid inflows and program design. As conditions in the LICs are particularly diverse, it is critical that advice is tailored to country-specific circumstances and that country ownership of programs is stressed. We are pleased the paper confirms and embodies these principles.

We also note that the aid inflows from G-8 countries have fallen behind their commitments made at the 2005 Gleneagles Summit; we encourage these countries to step up their efforts in this regard.

Due to their inherent volatility, it is difficult to project aid inflows precisely. Such projections are inclined toward underestimation to avoid the risk of being over complacent—a practice prevalent in older programs but quite harmful to long-term development in LICs. We also feel uneasy that almost all country cases show that NIR floors were exceeded and that actual aid absorption was substantially smaller than projected—and permitted—under the programs. The projection of aid inflows should be based on a comprehensive assessment of the best available information. In particular, we stress analysis of scenarios deviating from the baseline, which should be fully communicated to the authorities, equipping them with the flexibility to cope with aid inflow shocks. If the case justifies the use of deliberately cautious or optimistic assumptions, this logic must be made clear.

Basically, we agree with the proposed framework guiding staff's advice and program design on the spending and absorption of aid. We are pleased that Fund-supported programs have become generally supportive of the full spending and absorption of aid—a natural requirement for its full utilization—provided macroeconomic stability and the effectiveness of spending are maintained. In some cases, the recommendation of non full spending and absorption in the near term is justified. However, clear explanations are needed.

Large aid inflows can complicate the policy mix of incipient countries, especially those with weak macroeconomic fundamentals and institutions. To use the aid inflows efficiently, well coordinated fiscal, monetary, and exchange rate policies are necessary. Under managed floating rates, the management of scaled-up aid can be more challenging. However, it is difficult to generalize that floating rates can excel in the efficient use of aid and maintaining macroeconomic stability. Here again, a case-by-case approach should apply, the bottom line being that a member has a right to choose its own exchange rate regime. We concur that it is important to have a clear and common understanding of the exchange rate regime and monetary policy objectives.

We agree that program adjustments should be applied to support the smooth path of fiscal spending, subject to reserve adequacy, and that in case of higher-than-expected program grants, short-term spending increases should be allowed. The efficient application of adjusters depends on the recipient's ability to adjust its budget flexibly and its overall ability to absorb shocks. Domestic revenue mobilization should be strengthened and taken as an integral part of the fiscal response to scaled-up aid.

As a principle for the smooth public spending of recipients' aid over the medium term, programs should take account of a country's macroeconomic, sectoral, and administrative absorptive capacities together with its debt sustainability, and, under certain circumstances, allow saving part of the scaled-up aid, especially when the country faces capacity constraints. However, over-caution leading to biased underestimates should be avoided. As the paper indicates, achieving the MDGs requires greater—and more efficient—spending. We also hold that capacity can be improved in practice given measured costs. In addition, communicating program design and execution with donors is vital in attaining their understanding and longer commitment and in helping reduce aid volatility.

Exit strategy from heightened aid dependency should take a gradual approach, especial when higher domestic revenue to cover the increase in recurrent program costs and the building of appropriate fiscal institutions is likely. It is not necessarily wise to stick to aid as long as possible, but graduation from aid should be accompanied by the capacity to deal with macroeconomic stability and sustainable growth.

We support countries in developing a public financial management action plan focusing on core areas that are important for the effective utilization of resources. Capacity building like strengthening the framework of strategic planning and budgeting, improving budget classification, and strengthening budget execution and reporting systems, can lead the resource application in the short term. We also note that infrastructure construction is identified as a priority item in aid application in some country cases—a sign of sound development. We encourage staff to continue following this development and draw conclusions.

As clarified in the Managing Director's MTS, The Fund should support LICs and focus on its specialized expertise in core areas. Cooperation with the Fund and other development partners is a rational and necessary approach in the efficient use of limited resources. We concur that, in designing Fund-supported programs, staff should be mindful of their distributive consequences and the aspects of expenditure allocation that affect macroeconomic performance, while generally relying on the Bank and other development partners for specific analysis. With regard to PFM technical assistance, the Fund should also focus on its specialized expertise in core areas while leveraging staff resources and financing arrangements with donors and other providers.

Mr. Yamaoka and Mr. Miyashita submitted the following statement:

We thank the staffs of the Policy Development and Review (PDR) and Fiscal Affairs Departments (FAD) for their high quality papers and informative supplement.

We agree that the Fund's role in low income countries should take into account new challenges arising from increasing aid inflows. However, we also believe that the Fund's engagement with low income countries should continue to be focused on its core mandate of providing advice for sound macroeconomic policies, which are preconditions for sustainable growth and poverty reduction.

At the same time, in our view, the staff could have prepared one consolidated paper, rather than two separate papers, individually written by PDR and FAD. Consolidating both papers could have contributed to not only avoiding duplication but also conveying a more uniform message both internally as well as outside of the Fund.

Comments on "Fiscal Policy Response to Scaled-Up Aid"

Expenditure Path

We agree with the staff that a smooth path for fiscal spending in the context of the medium-term fiscal framework would be generally preferable, but the staff should adopt a case-by-case basis approach in due consideration to country specific factors. In particular, the efficiency of public spending is an important factor to be taken into account.

Revenue Mobilization

We appreciate the staff's emphasis that strengthening domestic revenue mobilization is an integral part of the fiscal policy response to scaled-up aid. Additionally, we believe that Fund staff should encourage authorities to sustain domestic revenue efforts without falling into complacency regarding aid dependency.

Public Financial Management

We fully agree with the importance of strengthening fiscal institutions, and support the proposed "platform approach" to building public financial management (PFM) systems. Having said that, while we share the staff's view that the Fund should focus its technical assistance (TA) on its core expertise areas, the areas of the Fund expertise are not necessarily clear. Therefore, we would appreciate the staff's further elaboration on what are the specific areas of Fund expertise in PFM TA, in the context of the differences with the World Bank's TA. Also, given that FAD's TA is provided in many fields related to fiscal policy other than PFM, including debt management capacity which the

Board discussed recently, we would invite the staff's comments on how the FAD prioritize their TA under the limited resources.

Comments on "Aid Inflows – The Role of the Fund and Operational Issues for Program Design"

Aid Projections

We agree that aid projections should reflect the staff's best estimate, based on all relevant and available information. At the same time, since the above-mentioned paper prepared by FAD notes that "the costs of overly optimistic aid forecasts are likely to be higher than the costs of overly pessimistic ones (Paragraph 7)," we underscore the importance of projecting future aid inflows prudently.

Alternative Scaling-Up Scenarios

Although we would not oppose the staff's preparation of alternative scaling-up scenarios, we are of the view that the objective of this exercise should be limited to assessing macroeconomic risks and fiscal sustainability associated with the inflows of scaling-up aid. We do not expect the Fund to take the leading role in aid mobilization, but to focus on providing sound advice on macroeconomic policies. In addition, we urge the staff to be prudent and reflect the medium to long-term impact of recurrent costs, or possible expenditure rigidities, associated with increased aid-financed projects under this alternative scenario. Furthermore, if a county is not likely to receive scaling-up aid in the foreseeable future, the staff should refrain from allocating their limited resources to prepare for such an alternative scenario.

"Spend and Absorb" Approach

While we generally agree on the full spending and absorption approach in the context of a medium-term fiscal framework, we underscore the importance of country-specific considerations, including the strength of a country's fiscal institutions.

Revenue Mobilization

In our view, in line with the paper by FAD, PDR's paper should have placed more emphasis on revenue mobilization as an important component of Fund-supported programs, rather than simply addressing the issue in one paragraph.

Exchange Rate Regime

The advice on how to absorb aid is the most important and challenging issue for the Fund's program in the context of dealing with increased aid inflows. In this same context, we agree with the staff's emphasis on the importance of a clear and common understanding of a country's exchange rate regime and monetary policy objectives. These efforts for mutual understanding should be the starting point for program design. At the same time, in light of aid inflows, we are cautious about adopting a too standardized approach in favor of a floating exchange rate regime. In our view, various factors besides aid inflows need to be considered to determine an appropriate exchange rate regime. Also, when the staff recommends that authorities allow more exchange rate flexibility, the staff should fully consider the reality in individual low income countries. For example, in the last Board paper on Rwanda, the staff appropriately highlights the difficulty of immediately increasing exchange rate flexibility due to the absence of hedging instrument for exporters.

Expenditure Allocation

We agree that the staff should be mindful of the program's distributive consequence and aspects of expenditure allocation that affect macroeconomic performance, even though this is not Fund expertise. We also stress that each country should take ownership regarding its expenditure allocation. With respect to the Poverty and Social Impact Analysis (PSIA), while the Fund is not responsible for conducting it, in light of the IEO's recommendations and the recent Board discussion on its Implementation Plan, more concrete action measures on how to incorporate the PSIA results into program design and how to improve the collaboration with the Bank on this front could have been presented.

Monitoring MDRI Resources

We are puzzled by the staff's remarks that "there should be no requirement to specifically identify what spending items relate to MDRI relief (Paragraph 66, first bullet)." In our view, as a provider of this significant debt relief, the Fund should monitor the utilization of freed-up resources by MDRI and ensure that those resources be spent for poverty reduction, In this regard, while we recognize the fungibility of resources, the Fund should be able to assess the impact of the MDRI on both overall fiscal expenditure and poverty-reduction-related expenditure items. Also, establishing a specific account for MDRI relief could be considered.

Wage Bill Ceilings

We have some reservations about the staff's view that wage bill ceilings should be used only in exceptional cases. Given the ongoing trend of shifting toward budget support and its fungibility, we believe that wage bill ceilings could play an important role in helping to resist political pressures for wage increases and to ensure macroeconomic stability. Also, in our view, excluding the wages of priority sectors from the wage bill ceiling or utilizing program adjusters could reduce the risks of impeding essential employment in priority sectors. In this regard, we would like the staff to further elaborate on the background of the staff's cautious stance on this front. Staff comments would be welcome.

Mr. Stein and Mr. Wezel submitted the following statement:

We thank the staff for a valuable and timely analysis that provides guidance for the implementation of the Fund's medium-term strategy in the area of assisting low-income countries with developing aid absorption strategies. We find staff's concept of distinguishing between absorbing and spending aid as well as the discussion of the implications of different exchange rate regimes particularly useful. While we agree with most of the staff's conclusions and suggestions, we do have some caveats regarding the issues for discussion.

Regarding the fiscal policy response to scaled-up aid, we agree with the recommendation that aid recipients should try to smooth public spending over the medium term subject to their macroeconomic, sectoral and administrative absorptive capacity, as well as debt sustainability concerns. If such capacity for efficient spending and absorption is not yet in place, saving some of the aid is a sensible option in the short run, all the more so as good governance and the quality of fiscal institutions are shown to have a strong positive correlation with the efficiency of spending. With the share of private aid flows in total inflows increasing significantly and private donors being adamant about timely spending of aid, such saving should, however, be limited in order to avoid negative repercussions for future aid flows. The suggested adjustors to support a smooth path of fiscal spending are one way to achieve a smooth expenditure path. This is even more true considering that aid is 40 times more volatile than tax revenues (SM/07/199 Paragraph 29) and that cuts in domestic spending in response to lower aid tend to be persistent and thus harmful to growth. However, given the fact that adjustors are a somewhat automatic tool, there might be practical problems with distinguishing between temporary and permanent changes in aid flows, and therefore discretionary judgment is clearly needed.

We attach priority to developing a public financial management system action plan focusing on core areas that are important for the effective utilization of resources, notably budget classification as well as strategic planning, medium-term budget frameworks and budget execution. Like staff, we believe that improving such systems can promote transparency and in turn help reduce non-productive spending, assuaging governance concerns donors might have. We are cautious, however, about the suggested approach to raising domestic revenue as a part of the exit from aid dependency. To increase tax revenue in low-income countries by way of strengthening revenue administration is a challenging endeavor, and some revenue measures such as a hike in indirect taxes might have adverse welfare effects on the poor. The case for an increase in domestic revenues in tandem with scaled-up aid should therefore be studied on a case-by-case basis. Moreover, the accurate projection of aid inflows based on a comprehensive assessment of the best available information is critical for aligning such external assistance with medium-term budget frameworks in a way that safeguards the stability of pro-poor expenditure. While we support the idea of presenting alternative macroeconomic scenarios based on higher aid, we caution against using more optimistic scenarios or the projection of a financing gap as reason for mobilizing additional aid, since donors could hold misjudgments against the Fund. Staff will need to justify deliberately optimistic assumptions case by case.

Regarding the operational issues for program design, we believe that Fund-supported programs should generally aim at full absorption and spending of aid if macroeconomic stability and spending effectiveness are expected to be maintained. However, in cases where capacity constraints are present, such a strategy may backfire in terms of higher inflation and certain Dutch disease effects, thereby also impairing sustained growth and poverty reduction. In some cases it may indeed be preferable to address existing vulnerabilities such as low international reserves first before fully absorbing the aid-related foreign exchange. Prepayment of expensive debt is, as suggested, also an option. This said, we note staff's empirical observation that a number of countries have been hesitant to direct the aid inflows to priority projects, equivalent to budget underexecution. Staff should therefore analyze the impediments to higher spending and, if deemed appropriate, make use of specific conditionality such as expenditure floors. At the same time, more frequent use of caps on public wage bills may be necessary to safeguard pro-poor capital expenditure.

Coordination of fiscal, monetary and exchange rate policies in the context of managing aid inflows is paramount for reconciling aid absorption with price stability, while also avoiding the crowding-out of private sector investment. In cases where incomplete absorption is the result of diverging priorities between monetary and fiscal authorities—i.e., scaled-up fiscal expenditure versus managing the exchange rate commensurate with monetary expansion—the staff should work with the authorities to devise a more appropriate macroeconomic policy mix. Especially in countries where aid inflows surpass domestic revenue, staff should clearly point out the potential stability risks associated with managed floating. We agree with Messrs. Fried and Ladd that concerns about real appreciation should not lead to protracted absorption of aid; instead, only structural policies such as trade liberalization and greater competition can provide a lasting remedy.

Staff's criticism of earmarking by private donors and the recommendation to compensate for earmarked private aid by redirecting planned public spending entail two risks. First, project aid might deliberately target a certain segment of society, which makes a reduction of public spending that targets a wider range of the population, arguably difficult. Second, donors may be discouraged if they find themselves unable to influence the actual spending on their projects. While we support the recommendation of better coordination with private donors, we caution that sometimes private donors might have their own agenda and thus limited interest in sharing information or contributing to budgetary planning.

Finally, we would like to point to the G8 Action Plan for Good Financial Governance as a helpful guideline in addressing further policy questions.

Ms. Xafa and Ms. Marchitto submitted the following statement:

We wish to thank the staff for a substantive and wide-ranging set of papers which we thoroughly enjoyed reading. Perhaps it could have been useful to discuss each paper separately given the abundance of food for thought, although we understand that the issues covered in the papers are very closely related.

We broadly share the insights and proposed guiding principles/best practices for program design aimed at making Fund support to low-income countries (LICs) more effective and relevant, particularly with a view to define an appropriate macroeconomic framework conducive to effective use of scaled-up aid, higher growth, and poverty reduction. We also favor the case-by-case approach advocated by the staff to better account for countries' specific circumstances and development needs. It goes without saying that overall consistency and equality of treatment needs to be systematically ensured.

We agree that aid projections should represent the best possible estimate conditional on the available information set. We believe, however, that making projections based on some notion of need does not respond to the quest for realism and we are not persuaded that estimating the cost of meeting the Millennium Development Goals (MDGs), for instance, strictly falls into the Fund's core mandate. In this connection, we reiterate our view that the Fund should not be held accountable for mobilizing aid, although it surely has a responsibility in advising its members on the macroeconomic impact of aid inflows and their use.

Staff could also assist country authorities in preparing alternative, more optimistic, scenarios illustrating how additional aid could effectively be spent. However, we fully agree with the staff proposition that Fund programs should be based on a single, realistic and cautious baseline scenario.

Full spending of aid, consistent with macroeconomic stability, aid effectiveness, and debt sustainability ought to be generally supported in Fund's programs. These results are more likely to be attained when aid is spent/absorbed in the context of a well-defined medium-term fiscal framework.

However, limited absorptive capacity constraints may call for a more gradual approach to aid spending. In helping LICs addressing these macroeconomic, sectoral, and administrative constraints, Fund staff should closely collaborate and rely on the World Bank and other development partners that have a core expertise in this field. A similarly prudent spending approach appears warranted for countries with high debt and/or low reserves, or countries emerging from conflict and other fragile situations. In fact, debt sustainability concerns should systematically inform decisions on the use of aid, especially when risks of debt distress are present. Aid (utilization) smoothing may also be a valuable option when a country needs time to adequately prepare for increased spending and maximize aid effectiveness.

To achieve the MDGs, LICs need not only more spending but better (more efficient, effective and transparent) spending. Enhancing governance and the quality of fiscal institutions, including public financial management, is crucially important in this respect.

At the same time, LICs should redouble their efforts to enhance revenue mobilization which, as the staff convincingly argue, in most cases does not require an increase in tax rates but simply a widening of the tax base as well as an improvement in revenue administration and collection.

While smoothing the fiscal spending path might be achieved by means of program adjusters, caution is needed as detecting temporary versus permanent deviations of aid with respect to programmed financing can be tricky in practice. Self insurance, i.e., the preemptive buildup of reserves to be used in case of aid shortfall, expenditure flexibility (where feasible), and prioritization of pro-poor and growth-enhancing spending may represent important elements in responding to aid volatility and in ensuring that programs are adequately funded.

On exchange rate issues, like Mr. Yakusha and Mr. Schilperoort, and Mr. El-Khouri and Ms. Beidas-Strom, we do not find the arguments in favor of greater exchange rate flexibility compelling, and we share the view that it is the individual country circumstances, rather than scaled-up aid itself, that should make the case for the adoption of a specific exchange rate regime. However, we also agree with Mr. Fried and Mr. Ladd that excessive preoccupation with exchange rate appreciation should not hinder the effective absorption of aid.

Like Mr. Yakusha and Mr. Schilperoort, and Mr. Fried and Mr. Ladd, we agree that reduced volatility and enhanced predictability, along with greater donor coordination, can significantly contribute to improve the development performance of recipient countries.

Poverty and social impact analysis and sectoral assessments should be carefully taken into account and support PRGF program design. Therefore, more effective collaboration with the World Bank and other development partners and reliance on their work is crucially important.

On a procedural note, regarding the implementation of the Board-endorsed recommendations of the IEO report on Sub-Saharan Africa (SSA), and more generally the role of the Fund in LICs, we believe that the various ongoing work strands should result in specific measures, responding to specific recommendations, crafting a comprehensive, clear and consistent strategy. In this respect, the idea circulated during the recent board meeting on the implementation plan of the IEO report in SSA, of having some sort of an umbrella paper, putting pieces together (including issues relating Bank-Fund collaboration), before we move to actual implementation phase is, in our view, worth considering.

Mr. Kishore and Mr. Krishnan submitted the following statement:

We thank staff for compiling a wealth of research and actual experience into two well-written analytical papers which raise pertinent issues for discussion. There is much in both the papers that we agree with. In all the staff has raised four issues for discussion on the Fiscal Policy Response paper and five issues in the Aid Inflows paper. On almost all these issues our response is in the affirmative. However, there are a few areas where we feel further clarity is required.

Aid Volatility

The key issue in both the papers is how to deal with aid volatility. Aid flows have been shown to be 40 times more volatile than tax revenue. Staff have taken aid volatility as a given and tried to work around it by suggesting better methods of projection, having alternative scenarios for scaling up and creating fall back positions in case the anticipated aid does not flow in a given year. We commend the staff for the skilful manner in which the issue has been addressed.

However, there is little analysis of the reasons for aid volatility. In producing an analytical paper of this nature, the Fund is basically responding to the needs of both the donors and the recipient countries and not just of the recipient countries. Even if the paper on "Aid Inflows" does not seek to address the MTS mandate of "informing donors when more aid can be absorbed effectively", to analyze responses to volatile inflows before looking at the causes for the volatility appears to be putting the cart before the horse. Fund's analysis and advice on the impact of aid and the operational guidelines which emerge from the discussions of these two papers, once implemented, will be important inputs for donors in deciding on the appropriate candidates to receive aid and also the timing and quantum of aid releases. In this context, we are of the view that the Fund, as represented by its Board of Governors, IMFC, Executive Board, Management and the staff should lose no opportunity to emphasize to donors that they are as responsible to ensure that aid flows are not volatile as the recipient countries are to ensure proper utilization of the aid flows. In this context, we welcome the instances of long-term donor commitment mentioned in paragraphs 31 and 32 of the Fiscal Policy Response paper and we would urge greater replication.

Would it be possible for the staff to comment in greater detail on the underlying reasons behind aid volatility and thereby throw up further issues which the Board could discuss and make the suggestions for improving co-ordination between donors and recipient countries as requested in the last issue flagged for discussion in the Fiscal Policy Response paper (p. 23)?

Program versus Project Aid

Do we take paragraph 29 of the Aid Inflows paper as an endorsement of program-based aid as against project-based aid, since program aid would fit in better with achieving macroeconomic targets? Would staff like to suggest that there need to be proportions in the total aid envelop for program and project based aid? Is that an issue which can be addressed as part of Bank-Fund collaboration issues?

Implications of Aid Absorption for Competitiveness

As far as issues relating to aid absorption and spending are concerned, the analysis contained in the staff paper is very elegant. We also support the view that such advice from the Fund should be carefully calibrated to suit the objective conditions obtaining in each country and we endorse the need for a case by case treatment within the broad parameters laid down. However, we feel that the staff paper has tended to underplay the risks of losing competitiveness within the proposed frame work. The background paper cites two of the most recent papers by Messrs. Rajan and Subramanian which have raised concerns on aid adversely affecting competitiveness. Further, in some recent case studies, it is found that it is precisely at the time that a country becomes a “mature stabilizer” and receives considerably stepped up foreign aid, that it also starts to attract greater private inflows both as Foreign Direct Investment and as remittances. Further, if at a crucial stage, due to poorly timed infusion of lumpy amounts of foreign aid, the economy becomes a victim of the “Dutch Disease” and the competitiveness of domestic industry is affected, the overall objective of ultimately becoming less aid dependent may not be realized. In this context, we would urge that the staff should give appropriately high priority to the risks of losing competitiveness while advising program countries.

Debt Sustainability

The issue of debt sustainability has been raised. Undoubtedly debt sustainability needs to be maintained, particularly in a context where the HIPC Initiative and MDRI have brought many LICs into a sustainable debt framework. However, it needs to be kept in mind that concessionality of assistance or loans is only one factor determining the borrowing decision. Timely availability and hassle-free disbursal are also important factors which determine why sometimes higher cost borrowings are preferred to concessional assistance. The Gleneagles commitment was to provide increasing grant finance to those countries benefiting from the MDRI in order to meet the financing costs of the MDGs. However, in the period since 2005 there is no evidence of a step up in the quantum of grant financing. Latest evidence also suggests that the level of aid, including concessional finance, has fallen in real terms. There is therefore no other recourse but to project finance at market determined rates to help these countries upgrade infrastructure in order to achieve MDGs. Countries are rational economic agents. Given a choice between grant finance and loans, it is obvious that the former would be the preferred choice. Similarly given a choice between uncertain concessional assistance and market based loans, the option that most countries would choose is also obvious.

Alternatives to Aid

Last, in the absorb and spend framework, the option of not absorbing and not spending the aid received has been likened to not receiving any aid at all. The paper also shows that aid is not an unmixed blessing and there are economic costs and need for skilful adjustment. We feel the paper may have been richer if a scenario of “no aid” and its implications could also have been included, in order for countries coping with adverse effects of aid volatility to examine the alternatives available to them to raise resources and speed up growth.

We look forward to very fruitful and stimulating discussions on these papers.

Ms. Sucharitakul and Mr. Waqabaca submitted the following statement:

We thank staff for the high quality set of papers and welcome the opportunity to discuss the Fund’s approach to the fiscal challenges of increasing aid flows. We find the aims of the documents well thought-out: to ensure that staff makes realistic projections on aid inflows; that analysis be undertaken given the specific challenges posed to the authorities when aid flows are scaled up; and practical policy actions be formulated to preserve macroeconomic stability. We are in particular agreement with the guiding principles espoused at the outset: that the desire to foster macroeconomic stability should not be at the cost of pro-poor expenditure choices. The absorb-and-spend framework is therefore a useful tool, allowing cases to be assessed systematically and comprehensively.

The Nexus between Aid Inflows and Monetary and Exchange Rate Policies

We were particularly interested in how monetary management is affected by aid inflows, given that this remains amongst the foremost challenges that a scaled up aid inflows pose to recipient countries. Like staff, we acknowledge that a proper understanding of the system of monetary management, which includes its aims, tools and limitations, is very important in ensuring staff's assessments are accurate and useful. We believe that in this context, it is advisable that staff use all the tools and taxonomical classification frameworks available to them, including on the exchange rate regime. We are uncomfortable, though, that such valid uses of these analytical tools could too easily go down an ideological route in favor of flexible exchange rates. Like Mr. Kiekens and Mr. Rottier, we note staff's inference that to cope with the scaling up of aid, greater exchange rate flexibility is called for, and join them in asking if this would affect staff advice going forward.

We agree with Mr. Fried and Mr. Ladd that aid inflows should not be unabsorbed, as unabsorbed aid is, eventually, unspent aid. At the same time, we cannot help but draw attention to the staff's conclusion that aid flows are both volatile and unpredictable, dependent on the fiscal priorities and conditions in donor countries. Thus, aid-recipient countries could hardly be faulted for trying to ensure as great a disbursement as possible be front-loaded in the face of the unreliability of future flows, notwithstanding public commitments. Staff rightly point out that this complicates fiscal management and also refer to the particular challenges to monetary management. We feel, therefore, that some action on the part of monetary authorities to preserve monetary stability is warranted. It suggests therefore that the critical point of evaluation is not whether absorption occurs but rather whether it moves in tandem with spending capacity. Thus, we fully endorse staff's view that these assessments be made over the medium term, particularly given the timing mismatches between receipt of funds and expenditure occurring. In this context, some aid remaining unabsorbed would not carry any stigma by itself.

Challenges for Fiscal Policy

On mobilizing aid, we are of the view that this role is outside the mandate of the Fund. The Fund should concentrate on its comparative advantage of providing the macroeconomic framework and proper policy advise that will improve macroeconomic performance that would in turn attract aid inflows and financial assistance.

As noted earlier, we find ourselves in broad agreement with staff that the appropriate time-frame for analyzing fiscal performance is over the medium term. We particularly welcome the proposed principle that staff, in conjunction with the World Bank and other institutions, seek to highlight expenditure choices that allow the authorities to make maximum progress towards the MDGs. We also find merit in the recommendation that the MTFF could be a useful resource in helping ring-fence priority expenditure items in the event aid were to dry up.

Going forward

We urge the Fund to assisting the aid-recipient countries in building capacity in terms of staff and institutions, including public financial management This, in the long run, would do more than anything else to improve the efficiency of aid use. Emphasis by the Fund in strengthening capacity both on the domestic revenue base and the countries' debt management and fiscal institutions would be in the right direction towards exiting from aid dependency.

Finally, on the Fund work program, as per our comments on the IEO Report on the IMF and Aid to Sub-Saharan Africa, we again emphasize in this case the need for staff to be provided a succinct and focused paper that pieces together specific recommendations that can guide the Fund's approach to the fiscal challenges of increasing aid flows. There is a need to distill the recommendations into practical guidance for country teams, especially since other reports such as the one by the IEO, cover some of the same ground. The fear is that the proliferation of papers not only runs the risk of fragmenting the recommendations, but also hinders the formulation of a clear strategy that will allow for better coordination and monitoring of progress amongst Fund departments.

Mr. Guzman and Mr. Guerra submitted the following statement:

We would like to thank staff for a comprehensive and clear set of reports. The role of the IMF in low-income countries is part of the Medium-Term Strategy and a fundamental element for increasing the legitimacy of the Institution. The issues presented in these papers are at the heart of many of the current policy discussions: the coordination between the IMF and the World Bank; the role of the IMF in helping authorities manage aid flows; the definition of the role of the IMF in low-income countries and the communication strategy; and, among others, the IEO recommendations for Sub-Saharan Africa.

The General Framework for Guiding Staff Advice

We concur with staff that the followed approach should take into consideration that countries at various stages of development face different needs and constraints that ought to be taken into account from the outset in fiscal policy design. This should be the main guiding criteria for staff, specially when advising low-income countries. We believe that Fund-supported programs should generally support the full spending and absorption of aid with due consideration to macroeconomic stability and the effectiveness of expenditure. This view should be part of our communication strategy regarding low-income countries.

We must regard the multi-year fiscal framework as a best practice, but we caution that for the framework to be effective it has to take into consideration the institutional and legal context in which the fiscal programming is made. In particular, the ownership by country authorities of the medium-term fiscal framework is a necessary condition. The best way to ensure this medium-term perspective is to support the member country authorities' efforts to make this exercise part of the legal framework. In this sense, the fiscal policy response to aid inflows has to be placed—to the extent possible as stated in the 2007 Surveillance Decision—within the context of the examination of the member's planned conduct of policies for the medium term, including the most relevant contingencies.

We agree that the projecting of aid inflows should be based on the available information and that the use of assumptions, deliberately cautious or optimistic, should be clearly explained. Making assumptions that deviate substantially from the expected scenario can give wrong incentives to governments and lead to inefficient expenditure planning. For example, a cautious scenario for aid flows can influence the structure of public expenditure, leaving certain investment projects contingent on extra inflows and affecting the project's efficient implementation.

There should be a close collaboration with the World Bank for sectoral assessments. In particular, Fund-supported programs should rely on the Bank and other development partners for specific analyses of the distributive consequences of public expenditure. In this regard, we concur with staff that the IMF should assist country authorities in monitoring the use of scaled-up resources using PRSP-based definitions of priority spending. Special consideration should be given to the use of floors for anti-poverty spending. Also important is that Fund guidance should emphasize the need to restrict the use of wage bill ceilings to exceptional circumstances. In case that the authorities decide to implement temporary wage ceilings, these should be applied with flexibility taking into consideration safeguards for priority sectors.

Coordination of Fiscal, Monetary, and Exchange Rate Policies

The coordination of fiscal and monetary authorities is essential for the efficient managing of aid inflows. Fund advice should aim at reconciling aid absorption with monetary stability, while trying to avoid crowding out of private sector investment. Care should be taken to include the institutional relationship of monetary and fiscal authorities, specially in regard to central bank independence. We do not agree with the view that program adjusters should include the sale of reserves to finance a lower-than-expected aid flow. We caution that the sale of reserves by the central bank to finance a smooth path of fiscal spending is not a role that we should recommend for monetary authorities, in particular:

It can jeopardize the development of an independent central bank.

It can complicate the coordination of the country authorities.

It changes the nature of international reserves to include other functions that can become priorities. Therefore, the authorities are forced to establish rules on the optimal levels of international reserves contingent on fiscal developments.

Fiscal authorities should look for other means of temporary financing without central bank intervention—e.g., they should consider other foreign sources of financing in order to avoid private sector crowding out.

Public Financial Management Framework and Technical Assistance

We strongly support the view that countries should aim at developing a Public Financial Management action plan supported by technical assistance from the IMF. The plan should focus on core areas that are important for effective utilization of resources, taking into consideration the particular circumstances of the country. Country authorities will surely have increased benefits from actions taken to improve budget classification, strengthening budget execution and reporting systems. Of particular importance is the strengthening of the budget administrative capacity of sub-national governments. As noted in the report, in many countries the local authorities carry out an important part of social expenditure, while lacking the necessary administrative resources. We strongly believe that a PFM should include subnational governments.

Finally, recognizing the importance that technical assistance has for PFM, we believe that the Fund should coordinate its activities with other institutions and donors in order to be more effective.

Mr. Duquesne and Mr. Larsen submitted the following joint statement:

We thank staff for the comprehensive set of papers they have circulated for today's meeting. Given the amount of work and analysis put in these papers, we would have seen merits in informal exchange of views between the staff and Directors prior to this meeting. We believe this could have raised the quality and the effectiveness of the dialogue.

We see today's discussion as a sign of the Fund's renewed commitment to playing a stronger role in supporting its low income countries members. We welcome that signal. We note that these papers—and this work—also form an important "underpinning" to the Medium-Term Strategy.

We support and endorse most—if not all—of the best practice recommendations in "Aid Inflows—The Role of the Fund and Operational Issues for Program Design" (SM/07/216) and "Fiscal Policy Response to Scaled-Up Aid" (SM/07/199). We would strongly encourage Management and staff to take a flexible approach to their implementation based on individual circumstances.

We reconfirm our support for and endorsement of the proposals and approaches to:

- Spending and absorbing aid. We continue to believe that this is a useful framework. The matrix (Box 1) is a very useful dissemination of the key issues. Of course, spending and absorbing aid effectively remains the clear primary objective and it should be pursued in all countries over the medium- to long-term. The other three situations may be appropriate on a temporary basis, for the reasons outlined, but they should not be a substitute objective.

- Scaling-up. We continue to believe that providing macroeconomic frameworks and policy advice to low-income countries on the impact of scaling-up are consistent with the Fund's comparative advantage and core mandate. Assessing and understanding the possible and potential macroeconomic effects—and setting out alternative scenarios—is an important work in and of itself. However, it is also an important platform for others actors, especially the World Bank, to take forward the analysis on the microeconomic impact.

As part of this work, we support the pragmatic approach adopted to issues like Dutch Disease remains appropriate (although we strongly support the point made by Messrs. Fried and Ladd in this regard).

- Coordination and clarifying fiscal-monetary policy objectives. The papers provide some helpful elaboration and advice on the theme of ensuring monetary policy and fiscal objectives are better coordinated. The undertaking to seek more explicit clarification on objectives in discussion with country authorities and setting these out in program documents is welcome. We also support the points made by Messrs. Fried and Ladd here.

We strongly support the new(er) proposals and approaches on:

- Wage ceilings. The Fund's recognition of the problems with current and past practice in this area is welcome and we support the recommended approach. In our view, Fund practice to date has involved an excessive and over-persistent use of wage bill ceilings as a (blunt) proxy for the need for medium-term public sector reform. Not only is such an approach 'second best' in term of tackling the underlying issues, it also undermines the ownership essential to-long term and lasting fiscal sustainability.

The recommended guidelines are welcome (Executive Summary and paragraph 26 of SM/07/199): more selective use of ceilings only for "exceptional" cases; the need for explicit justification in documents; that any ceilings should accommodate spending from scaled-up aid; safeguarding priority sectors; and regularly reassessment in program review. We look forward to their implementation.

- Fiscal balance. We welcome the recommendation that the standard fiscal balance measure should be taken as inclusive of grants (Executive Summary and paragraph 25 of SM/07/199). In our view, this change sends a strong behavioral and presentational signal that the fiscal target should allow for the full spending of external grants.

- Increasing domestic resources. We very much share the staff analysis of the causes of low domestic revenues: a combination of narrow bases and weak administrative capacity. This is compounded with the transitional arrangements for implementing trade agreements, especially given the effect of a tax transition in which domestic tax takes over import duties. We fully support the need to pay specific attention to that and other revenue policy and administration issues when designing programs or medium-term budget analysis.

- Allocating expenditures and monitoring resource use. We are of the view that the Fund should give more attention to distributional consequences of spending composition. In this regard, closer cooperation between the IMF and the World Bank is vital to achieve a better trade-off between economic stability and pro-poor growth. Greater attention should also be given to integrating the Poverty and Social Impact Analysis (PSIA) into program design, with the Fund focusing its efforts on the impact of the macroeconomic policy on poverty.

- Aid projections. The projection of aid inflows is crucial to the design of programs since it guides policy and decision-making. It is important therefore that the projection of aid inflows be based on a comprehensive assessment of the best available information and should be not biased toward "optimism" or "pessimism." In our view, individual staff reports should set out the basis and source for the aid projections being used and presented. We strongly support the presentation of alternative (more ambitious) macroeconomic scenarios. We also support the point made by Messrs. Fried and Ladd on the need for donors to become more predictable and long-term in their actions. Without such predictability, the job of national economic institutions is much harder.

- Use of program adjusters. We support the messages in both main papers that there is now to be a presumption that windfalls should accommodate higher spending and shortfalls should be financed (Paragraph 30 of SM/07/199 and paragraphs 49-50 of SM/07/210). We support this shift and see it is as fully consistent with the overall messages on the full spending of aid and definition of fiscal balance to include grants. We hope that this shift in policy will also lead to a real shift in program design. In this regard, we note that the evidence on current practice (Table 1 of SM/07/199/Supplement 1) suggests the 'balance of presumption' between the 'anti-spending' asymmetry to a "pro-spending" asymmetry currently favors the former.

- Greater and better explanation of program design in staff papers. We agree with this approach and believe it is overdue. In our view, an important aspect of accountability and transparency is providing more explicit and greater detail, in program documents, as well as through in-country discussions, of the thoughts behind and reasons for individual program design. In particular, we support the idea that any deviations from the best practice principles and guidelines (e.g., on full spending of aid, wage ceilings etc) should be underpinned by explicit analysis and justification provided in program documents.

- Aid effectiveness. The importance of aid effectiveness, including in more effective and informed macroeconomic management, and the Fund's role as an advocate is recognized (rightly) in the papers. We particularly welcome the recognition of the problems caused by off-budget aid, earmarking of aid and vertical funds (Pages 18 and 19 of SM/07/199) and the advantages of using country systems and increasing dialogue with donors.

- Strengthening public financial management. It is worrisome to note that, despite sustained efforts in many countries, progress has been uneven. We believe that the strengthening of the PFM should be a priority, and we agree with staff that the development of more realistic action plans are necessary. We also share staff's view that the medium-term expenditure framework (MTEF) is an essential tool to better guide the planning and budgeting of public expenditures. But we also have to recognize that it is a complex and challenging process that needs to be approached cautiously and on a step-by-step basis, with respect to the existing capacities. We also agree that a gradual move toward a result-oriented budget would help strengthen accountability and assess the effectiveness of programs but it is obvious their implementation requires significant capacities and resources to be successful and must be executed carefully and gradually. The Fund must continue to play a major role, in collaboration with other development partners and regional institutions (such as AFRITAC) in supporting the development of medium-term action plans for PFM reform, in the spirit of the Paris Declaration.

On the reserve buffer, we have serious reservations about the implicit costs involved in what is said about "self insurance" and the appropriate size of reserves. The papers recommend a reserve buffer—over and above that traditionally recommended for import cover—to cover for aid volatility. This recommended cover is very substantial—an additional cover of 50-100 percent of annual aid financed spending is recommended (Paragraph 30 of SM/07/199)—and very conservative.

The problems with such an approach could, in our view, be exacerbated if the additional cover were to be combined with the idea that "reserve adequacy" (Paragraph 49 of SM/07/210) should be attained as a prerequisite for the full spending of aid. This also appears inconsistent with the staff analysis on how monetary policy can impede absorption (Paragraph 26 of SM/07/210).

The approach proposed by staff also seems a particularly expensive and inefficient way of dealing with the problem of aid volatility, and puts all the costs and onus on the national authorities. In our view, the preferred approach is to use the other tools for coping with volatility (as outlined in the other bullets of paragraph 30 of SM/07/199) and also exploring alternative solutions to smoothing the expenditures path, for example, innovative financings such as counter-cyclical loans (which could allow to defer reimbursements in case of exogenous shocks on the exports).

In our view, the opportunity costs of the size and form of self insurance seems excessive and out of line with the general tenor of the approach in the papers, i.e., staff programs should, wherever possible, encourage a "spend and absorb aid effectively" approach, and could send the wrong signals to donors about the benefit and use of their aid. Consequently, we believe it is both premature and inappropriate to formalize these recommendations into guidelines to staff and further work on the costs and benefits of such an approach is needed before we proceed.

Debt sustainability. The guidelines surrounding the use of the joint Debt Sustainability Framework have been much discussed in this Board (and in the Bank Board) and become well established. We believe that it is appropriate that the Fund (and Bank) should be stressing adherence to the DSF by all creditors (and the authorities) when coming to their concessional lending (and borrowing) decisions. This will balance a flexible approach between countries needs for financing the MDGs and maintaining debt sustainability. That said, we are concerned by the papers' excessive focus on the levels of concessional borrowing/lending and little—if any—coverage of the more worrisome impact that non-concessional borrowing will have on future debt sustainability (Paragraphs 58-59 of SM/07/210).

Mr. Silva-Ruete and Mr. Dela Barra submitted the following statement:

We thank the staff for a set of well-written papers, which address important issued for recipient countries raised in the Medium-Term Strategy (MTS) and the Independence Evaluation Office's (IEO) Report on the Evaluation of the IMF and Aid to Sub-Saharan Africa.

Fiscal Policy Response to Scaled-Up Aid

The paper on Fiscal Policy Response to Scaled-Up Aid has been elaborated using empirical experience as well as background research, discusses key fiscal measures needed to ensure appropriate use of aid flows to low-income countries, and considers IEO recommendations. Mainly, we feel that the staff continues to be overly focused on macroeconomic stability, leaving authorities little room for employing aid flows to enhance their absorptive capacity in the short term. In this regard, smoothing public expenditure over the medium term subject to their current absorptive capacity will likely delay poverty reduction. Saving scaled-up aid is probably not the appropriate strategy for these countries. As regards aid projections, the report mentions that "[…] overly optimistic or pessimistic projections should be justified, as they may complicate fiscal management," reflecting a conservative approach. We are more comfortable with the guiding principles provided in the paper, Aid flows—The Role of the Fund and Operational Issues for Program Design (SM/07/210). We recall that the IEO, in its report on aid to Sub-Saharan Africa, pointed out that external observers perceive the IMF as blocking the use of aid. In the same vein, the IEO called for a more proactive attitude to mobilizing resources, which was endorsed by the Executive Board.

The report mentions recent reviews about wage ceilings and updates baseline and alternative scenarios—including those that consider "scaled-up aid," in line with IEO recommendations on aid to Sub-Saharan Africa.

Regarding the need to reduce aid dependence, recipient countries should adopt policies geared to increase domestic revenues and stress institution-building. Priority should be given to allocating available resources to enhance the absorptive capacity through health, education, and infrastructure spending. Even if implementation of these policies is delayed, aid flows should be used as they are received.

Building up reserve buffers as a tool to deal with aid volatility seems reasonable. Nevertheless, it is preferable to rely more on long-term commitments from donors. In this regard, we believe that interaction with donors to make them aware of problems caused by aid volatility should be pursued more actively, especially by resident representatives.

We agree with the staff that Public Financial Management (PFM) is useful to secure effective public expenditure. Implementation ownership is a crucial, and therefore we support the "platform approach." Lack of capacity to design appropriate spending, which would lead to inefficiencies and increased debt burden, should be addressed in close coordination with the World Bank. We support the use of technical assistance to help countries to develop PFMs. We strongly support the leverage of IMF resources and financial arrangements with donors to enhance recipient countries' absorptive capacity. The IMF should be involved in effectively targeting expenditures funded with external aid.

Aid Flows: The Role of the Fund and Operational Issues for Program Design

The methodology used in the paper is based on findings from the recent experiences with Fund-supported programs, namely, LIC case studies.

Aid projections. We are glad that the paper considers the IEO's recommendations in this field. The guiding principles for the design of future programs are useful and reflect a more flexible approach—especially fostering poverty reduction through accommodating aid flows. In practice, the staff points out that, while case studies confirm that PRGF-supported programs have become more accommodating of pro-poor spending, this level of accommodation may have not fulfilled country expectations.

We concur with the staff's opinion that reliable information is necessary to project aid inflows, but a more proactive approach should be adopted. In this regard, for example, IMF country representative officers should be in close contact with donors and lenders to access accurate information.

Spending aid. The guiding principle about the full use of aid, provided that it does not jeopardize macroeconomic stability, is commendable.

Absorbing aid. We agree that aid absorption can be carried out in the context of any standard exchange rate regime, and that interventions may be reasonable in light of sharp exchange rate movements. Also, it is necessary to ensure coordination between the monetary and fiscal authorities and to avoid crowding-out of private sector investment. The application of program adjustors may allow a smooth path of fiscal spending.

Aid volatility. We support the use of IMF-supported programs to offset aid flow volatility. In the same vein, flexibility in dealing with temporary deviations from forecasted foreign financing will help countries to achieve program goals.

Safeguarding competitiveness. The staff report mentions that Dutch Disease is not necessarily associated with higher aid, and therefore it cannot be used as an argument against aid scaling-up.

Other issues. Debt sustainability model can provide useful guidance in a context of scaled-up aid flows. We support the staff recommendation to use World Bank input in dealing with limited micro-absorptive capacity. We would like to ask the staff to provide greater detail in this respect.

Finally, we welcome the staff's guidance on the importance of distributive implications, progress towards MDGs, selective use of wage bill ceilings, priority spending, collaboration with the World Bank to analyze expenditure composition, and achievement of MDGs in relation with IMF-supported programs.

Mr. Gakunu and Mr. Sulemane submitted the following statement:

We thank Management for making today's discussions possible and staff for the well-written papers which highlight proposals for carrying forward Board-endorsed recommendations arising from the IEO Report on the IMF and Aid to Sub-Saharan Africa (SSA). Given the linkages between the two sets of papers, this gray addresses issues raised in both papers, based on the experiences of our countries with Fund programs and the adaptability of these programs to growth and poverty reduction challenges.

General Comments

There are indeed fundamental obstacles to effective use of scaled-up aid to SSA, but none of these is immutable, especially in light of recent improvements in macro-fiscal stability and building accountable and transparent public financial management systems. For their part, donors have, in the context of the Paris Declaration, also committed themselves to a significant program of aid reform including flexibility in aid delivery mechanisms. Yet, as noted by the IEO report, while the scaling up of aid to SSA should allow for increased fiscal space for expenditure programs to spur sustainable high growth and reduce poverty, the current design of Fund programs does not take into consideration a suitable fiscal framework to accommodate these objectives while maintaining macroeconomic and fiscal prudence. Furthermore, as pointed out by staff, the spending of project aid is controlled by donors and is often not channeled through the budget. This resulted in targeted donor aid policies benefiting some countries to the detriment of others. Unfortunately, the papers under consideration do not seem to address this challenge, going forward.

Aid Projections

The SSA regional outlook, dated March 14, 2007, noted that excluding Nigeria's special program of debt relief, ODA flows to SSA have been basically flat since 2003. We also concur with the view expressed in the staff reports that, at present, there is no scaling up of aid in SSA and that the aid surges that have been observed in recent times relate to emergency situations, natural disasters, post-conflict situations, and the cost of building democracies. While the non materialization of promised aid remains an issue, the concern for us also is that the nature of aid projections in Fund programs is not consistent with donor commitments including those made at the 2005 Gleneagles G8 Summit to sharply increase aid to SSA. The scenario often taken by staff, by projecting a sharp increase in aid in the early years and a tapering off during outer years, is certainly not compatible with the aspirations of countries as outlined in their PRSPs, MDGs, and other long term development perspectives. This is largely a result of the singular focus of Fund programs on minimal balance of payments support without adequately reflecting sectoral challenges. In this respect, we agree with Messrs Kiekens and Rottier that aid projections in Fund programs need to be broadened, including pledges, firm commitments, disbursements, etc. Also fiscal or balance of payments financing gaps should be based on a much longer-term perspective and not restricted to the medium term alone.

Aid, Growth, and Competitiveness

We agree that aid contributes to economic growth in the context of macroeconomic policy. There is however a need to build in Fund programs alternative growth scenarios based on higher aid assumptions. Attention must also be given to different country specific circumstances and the non-linearity in the contribution of aid to economic growth arising from the interaction between aid and macroeconomic policy. In addition, drawing from the staff papers, we can deduce that more studies are needed to understand the relationship between aid and growth, as well as aid and inflation. No doubt, the most appealing aid-growth scenario must be seen in the context of how aid can be used to support the key drivers of growth, including infrastructure, value-added productivity and private sector development.

On competitiveness issues, we welcome the guidance by staff, including on managing the Dutch Disease, but note that improving competitiveness has never been adequately reflected in country programs. In particular, we are of the view that the issue of aid in a dynamic framework can be approached in a way that takes into account productivity in both the traded and non-traded sectors, including accounting for processes of learning-by-doing and dynamic comparative advantage.

Data Issues

The analysis on aid should take into account data definitions, sources of aid and reporting mechanisms both from the donors and recipient countries. This will avoid creating the misunderstanding of concepts and allow the use of common language in dealing with this subject. Generally, there are differences in data on aid among the sources. For example, OECD/DAC publishes data on aid (commitments and disbursements) based on donors self-reporting, while governments collect data on donors' commitments and disbursements, with some captured by the domestic institutions and others not captured at all.

Applicability of the Spend and Absorb Framework

We note the staff's assessment of this framework and its future applicability. The analysis is however based on an accounting framework a la Financial Programming, which is a short run analysis, taking institutions as given and without considering supply-side effects in a more long term perspective. We believe that the continued reference to fiscal consolidation and accumulation of reserves across the board in Fund programs ignores the substantial resource requirements necessary for many countries, especially in the aftermath of natural disasters, conflicts, undemocratic systems, etc as well as the strong political momentum towards achieving high sustainable growth and poverty eradication. Further more we concur with Mr. El-Khouri and Ms. Beidas-Strom that in many country circumstances, scaled-up aid only explains part of the widening current account and fiscal deficits, others being exogenous shocks and structural policy changes. Priority spending is a dynamic process which depends on the stage of development of the given country. Anti-poverty and social spending should avoid mechanical applications of decisions taken in the international arena. In this regard, and to increase ownership first, we should start by taking into account the designed home grown strategy, while ensuring that aid flows match the priorities designer's under the specific conditions of a country.

Aid dependency is a major concern, but reducing this requires a structured exit strategy that should include significant external support for increasing domestic revenues and building appropriate fiscal institutions. This effort should stress on improving the efficiency of the tax system and administration, as well as the development of a wider tax base that helps in the creation of value added in the economy. This means supporting the development of a domestic productive and profitable private sector. Country experiences also show very little possibility of saving out of scaled up aid, given the existing large resource gaps.

Monetary and Exchange Rate Issues

We note staff's focus on a flexible exchange rate as central in managing aid flows. We would suggest further elaboration on this argument. Most of the countries in Sub-Saharan Africa are supply-constrained economies. We think that more focus should be placed on analyzing the robustness and flexibility of the product and labor markets, as well as the development of a strong financial sector.

Aid Volatility

We agree on the need to develop appropriate mechanisms within country-donor cooperation programs that can reduce the volatility of aid flows. In this regard, predictability and longevity of aid flows are important as has been done in a number of countries by DFID through multi-year commitments. Aid volatility has complicated fiscal policy management in Burundi as shortfalls in budgetary assistance led the authorities to cut programmed expenditures most of the time, including capital spending. It was also the case for Zambia, and more recently in Sierra Leone, where aid shortfalls led to slippages in program performance. In some countries, the introduction of contingent budgeting has helped to mitigate the effects of aid shortfalls while protecting poverty expenditures. The Fund should play a more proactive catalytic role in supporting countries to mobilize programmed budgetary assistance.

Ms. Lundsager and Mr. Kaplan submitted the following statement:

We thank PDR and FAD staff for an intriguing set of papers. In conjunction with identifying best practice, the papers helpfully synthesize existing work on accommodating aid flows, much of it generated within the Fund, in a manner that is useful to Board members and we hope to Fund staff. Publication of these documents will also advance the public's understanding of the work of the Fund in low-income countries.

In the Summing Up of the IEO study of the Fund's role in sub-Saharan Africa, Directors confirmed the importance of accommodating higher aid flows through higher spending and net imports, provided that this would not jeopardize macroeconomic stability. They considered that this approach should continue to be implemented on a case-by-case basis and in the context of a multi-year strategy—with the general objective being to bring all low-income members to a situation in which aid can be fully absorbed and effectively spent.

These papers help to fill in the details of this general policy guidance. In this context, we see these papers as a useful response to the IEO's recommendations in its review of the Fund's role in sub-Saharan Africa. With that said, we note that considerable ambiguity remains on how to operationalize the Board's general guidance, and we have questions on the practicable applicability of the guidance provided to the staff on several key issues.

For example, the guidelines suggest that countries should consider holding reserves against aid volatility over the medium term, in the form of a cushion of 50-100 percent of annual aid flows, on top of the familiar 3 months import coverage. How should a mission chief evaluate the country circumstances that would facilitate building such a buffer into program conditionality?

The paper similarly proposes that the staff assist authorities on ways to surmount limits to microeconomic capacity to use aid, but are not given specific guidance on how or when to bring in other development partners, including the World Bank. We continue to favor a bright line test between the roles of the Bank and Fund in sectoral and microeconomic expertise. We have remaining doubts on whether the range of technical assistance provided by MCM and FAD meets this test.

We also wonder about how much of best practice, for example, the development of medium-term fiscal plans, can be realistically accomplished in many of the low-income members seeking assistance from the Fund. We encourage the staff to promote members' aspirations for thoughtful and prioritized contingency plans. We caution the staff, however, that a higher priority should be placed on ensuring relevant and practicable advice consistent with each country's administrative capacity.

Similarly, we note the staff's preference for corner solutions on exchange rate regimes, and the particular advice for increased flexibility. An increased focus by the Fund staff on exchange rate concerns, in light of the 2007 Surveillance Decision, will be helpful in further analyzing the evidence, or lack thereof, for aid-induced Dutch disease. Although the paper suggests that aid inflows have limited impact on competitiveness, many authorities are clearly worried about real exchange rate appreciation. We see a critical role for the Fund in advising low-income members on the design of exchange rate policies and further exploring the link between exchange rates, growth, and poverty reduction.

The authors' observations are particularly insightful on the negative impact on rational planning for spending and absorption caused by poor coordination of fiscal and monetary policy. Still, the fact remains that countries frequently overperform on NIR targets, and authorities do not always have clear communication of their policy objectives. This argues for a cautious and realistic approach to medium-term program design.

We agree with the paper's proposal to discuss explicitly the trade-offs between stability and saving versus current spending and investment. We appreciate that so doing may increase the domestic pressures for current spending. When there is a strong case for reducing vulnerabilities or cementing macro stability, however, we expect the staff will be able to make the case.

We agree with the paper's recommendation that out-year budget forecasts can be built around plausible assumptions of future aid levels, rather than the traditional approach of assuming only what donors have firmly committed. However, the Fund has been notoriously bad at predicting trends beyond the one-year horizon, such as growth in GDP and exports. There is a clear risk to members' fiscal and external position by not making a conservative and clear-eyed assessment of likely flows.

On the role of the Fund in developing alternative aid scenarios, we note that the Summing Up from the IEO discussion revealed that most Directors believe that "the Fund's role should be limited to assessing the consistency of additional aid flows with macroeconomic stability and the absorption capacity of the country, with more normative advice and the preparation of less likely aid scenarios falling outside the Fund's mandate." The Fund staff has a value-added role to play in helping authorities think through the macroeconomic implications of plausible aid increases. Paragraph 20 in the staff paper, however, suggests that alternative scenarios "can be used by the authorities in their efforts toward aid mobilization," a phrasing that we think could imply a fundraising role for the staff that we reject.

Finally, we support the staff's recommendation that aid projections (and related targets) exclude potential lending if it does not conform with the concessionality requirements laid out in the DSF.

Mr. Rutayisire submitted the following statement:

We welcome the opportunity offered by today's discussion, and thank staff for the set of interesting and insightful papers. At the outset, we would like to emphasize that the papers make, in our view, too much a case for the recipient countries to tackle aid, while leaving little room for the donors to play a critical role. In many instances in the papers, it could have been argued more strongly for a more predictable and better coordinated aid. In our view, the problem of aid should also be tackled upfront, when and from where it is provided. The Paris Declaration, which calls for better aid coordination on the part of donors, is critical in that regard.

It is also important to have a clear understanding of what aid is not. The paper SM/07/199 in its very introductory section explains that "many countries are benefiting from high commodity prices." This is certainly not a form of aid. In this instance for example, the paper fails to focus on the real flows of aid, that is ODA mostly.

Furthermore, we regret the negative connotation entailed in the choice of words such as “donor proliferation” or “aid dependency.” We would appreciate their rewording before the publication of the report. Instead of donor proliferation, we would suggest the use of the term “increase in the number of donors,” instead of “aid dependency” we would prefer the use of “high share of aid per capita.” Factually we are not sure whether the increase in the number of donors matters more than the overall additional resources available to LICs. We note that on the later, the level of support falls short of the pledges raised at the Monterrey Conference. Debt relief under HIPC and MDRI initiatives, which has been very helpful to LICs in recovering debt—and sometimes fiscal—sustainability has not been accompanied by aid additionality, which carries weight in explaining the below-potential rates of growth in LICs, especially in Africa.

Having said that, we agree with staff on the need to adapt fiscal policy to the prospects of scaling up of aid. We also broadly agree on the need for LICs to establish a medium-term resource envelop and defining an expenditure path. In the latter regard, it should be born in mind the necessary efforts by these countries to close the infrastructure gap, which often proves significant and growth-restraining. We can only share the recommendations laid out as regard the close monitoring of spending, good governance and, very importantly, the quality of fiscal institutions. On wage bill ceiling, one must be cautious on making it “more flexible by using temporary and flexible employment contract” or “contracting out services” (Paragraph 30 of SM/07/199). Social and political economy considerations should be weighted in more carefully.

Aid Volatility

While we note the costs associated with scaled- up aid, including the risk of Dutch disease and challenges to the conduct of fiscal policy, we would like to emphasize that the benefits felt by recipients far outweighs any potential cost. Moreover, empirical evidence—see for instance the IEO report on Aid to Sub-Saharan Africa—do not show that Dutch disease have been observed in countries that have received increased aid in Africa. As for staff econometric evidence that scaled up aid could hinder some export led growth strategies, we had hoped for more detailed views given that many countries, including East Asian economies, recently succeeded in lifting themselves out of poverty while benefiting from both scaled up aid and the pursuit of an export-led growth strategy.

The Role of Low-Income Countries

In keeping with commitments made in Monterrey, many LICs have made significant progress in improving governance. My authorities view a sound fiscal framework as an essential tool to improve governance through increased transparency and improved allocation of resources. We share staff's view on the importance of a medium term fiscal policy framework. A medium-term framework integrated with the PRSP and the Debt Sustainability Analysis provides an anchor to macroeconomic stability and pro-poor growth spending.

Nonetheless, we underscore the need for country ownership and flexibility in the implementation of the guidelines specially in post-conflict countries. Due consideration should be given to member country circumstances, especially in light of the significant resources required to implement MFS or public financial management reforms in the context of weak capacity.

On public spending, we do not agree that smoothing spending over the medium term should be the only option. As the staff report indicates, in some circumstances such as in humanitarian emergencies, a frontloading of spending may be required. These circumstances should also include post-conflict countries and countries acutely lacking basic infrastructure.

With respect to the use of aid, we wish staff had considered more options beyond saving, front-loading and smoothing. We wished staff had considered for instance how changing the repartition of aid between consumption and investment would have helped address concerns raised aid scaling up. Moreover, we see merit in the use of resource windfalls to repay domestic debt, including liabilities to the Banking sector in order to revitalise the private sector and financial intermediation.

On operation implementation, we concur on the need to develop a Public Finance Management (PFM) action plan focusing on areas critical to the optimal allocation of resources. We are of the view that short term priorities should take into account each country specificities. We have found helpful the discussions on intermediate steps in Box 4 and table 1 of supplement 2 of SM/07/199.

From the staff report, we have the impression that the LICs are starting from the ground up. The report do not properly acknowledge the progress made by these countries including in the context of Fund supported programs. We agree that further improvement are needed which can be built on the achievement made so far. In the past often, lack of donor coordination and delays in fulfilment of aid pledges negatively affected the implementation of public financial management reforms.

On the Role of the Fund

Fiscal policy being a core mandate of the Fund, we are of the view that the Fund should take the lead in ensuring that the macro framework is adequate. Many countries highly valued the technical assistance provided by the Fund in the fiscal area and we call for more resources to be allocated in support of this core mandate of the fund.

We would therefore welcome a coordination of technical assistance between donors to avoid duplication of scarce resources. We also encourage staff to take the lead when necessary to coordinate donors assistance specially when risks to the fiscal framework are high. Coordination of technical assistance and technical assistance advice is also needed. It is interesting to note that the staff reports do not agree on the range that defines the medium term. It will be even harder to agree on a medium term framework when there is no consensus on what the medium term horizon means. We would therefore welcome a coordination of advice between IMF staff as well!

It is clearly within the fund’s mandate to intervene should fluctuations in aid give rise to short term external stability concerns. Beyond this we welcome further consideration on innovative financing of development or the role of market based instruments to mitigate the effect of aid uncertainty.

On operational issues for program design, we broadly agree with the proposed framework for guiding staff advice and program design. However we wish to emphasize the need to give due consideration to the member countries authorities projections of aid inflows should they be different from staff’s assessment. With respect to program adjustors, we consider them as ad hoc arrangements. With increased certainty of aid inflows as should be expected with aid scaling up, focus should be on getting the medium term budget framework right so as to made significant progress toward achieving poverty reduction, rather than on adjustors.

Role of Donors

My authorities thank donors for their continued support as they strive to reform their economies in order to lift their populations from poverty. We commend initiatives by donors to increase their level of support, improve the coordination predictability of aid. In that respect we specially welcome the Millennium Challenge Account initiative or the DFID's innovative initiative to ensure predictable aid flows. We are very interested in the idea of expanding a donor peer review mechanism for aid delivery, predictability, and effectiveness (Paragraph 32 of SM/07/199).

We share staff recommendation to donors in Box 5 of Supplement 2 SM/07/199. It is also worth noting the lessons drawn in paragraph 44 of SM/07/199. Oftentimes, technical assistance donors or aid donors impose technical assistants from their own country, regardless of their competency or expertise. This practice should be revised if one wants to tackle the effectiveness problem of technical assistance or other forms of aid.

Exit Strategy

We agree that higher domestic revenues will help alleviate the need for aid inflows and provide a buffer against aid inflows volatility. While we agree that building appropriate fiscal institutions including the capacity to manage debt are important goals we are of the view that these goals should be part of an overall strategy to a higher and more diversified growth rate in order to ensure that countries are less susceptible to exogenous shocks including those originating from volatility and dependence on raw materials.

Moreover, such an overall strategy should include measures to mobilize foreign direct investment and gaining access to international capital markets. We regret that the set of papers did not dwell further on the role of fiscal policy and domestic policies in general in laying the ground for an orderly exit from reliance on aid through these channels.

Mr. Williams made the following additional statement:

I would like to start by referencing where I agree with colleagues' statements that have been circulated.

First, I would agree with Mr. Kiekens and Mr. Rottier that projections in Fund-supported programs should include where possible the best estimates of the level and timing of disbursements. I recognize this is a difficult and more challenging task than even commitments, but nevertheless some attempt to capture that would be useful.

I also agree with Mr. Kiekens and Mr. Rottier that justification for a specific definition of concessionality should be included in the staff reports. What is more, justification should also make much clearer the definition of concessionality and its relationship to the joint debt sustainability assessment and the dealt sustainability framework.

I also must agree with Mr. Kiekens and Mr. Rottier on the finer points of clarification of donor commitments. Perhaps the paper rather than delete that section could set up the commitments made by EU member states on which there is a Fund target and timetable.

I agree with Mr. Gakunu and others that there have been many large commitments made in the world, but unfortunately to date the delivery of these has been rather poor and some attempt to highlight that would be useful. I agree with Mr. Rutayisire's point about aid proliferation. While I recognize these are agreed terms, I think they have rather negative connotations and perhaps donor practice is quite negative on the whole, but we do not need to justify that.

My last question is related to the envisaged process going forward. After this meeting, what is next? There are a diverse set of views, including on the recommendations made by the staff. Piloting a way through is going to be tricky, and I am not sure what the next steps look like, so some clarification would be helpful.

Mr. Claveranne noted Mr. Rutayisire's point on the vocabulary used in the report and supported his call for a rewording of the words “donor proliferation” and “aid dependency”, which were not positive. Second, it was worth repeating a point made in the joint gray statement by Messrs. Duquesne and Larsen on the process of the documents being discussed. There would have been merit in an informal exchange of views between the staff and Directors before the current meeting, as it could have raised the quality and the effectiveness of the dialogue, and ensured a better integration of the views and recommendations of Directors.

Mr. Tolstikov made the following statement:

At the outset, let me thank the staffs of PDR and FAD for their well-written, comprehensive and thought-provoking set of papers. This is a significant step forward in formulating the principles of the Fund’s work in low-income countries in the presence of large and increasingly unstable aid flows. At the same time, while we broadly agree with the proposed guiding principles and best practices, we, like other Directors, believe that in some instances the staff guidance could be more precise and coherent. As the Executive Directors in their Grays have already examined the proposed documents thoroughly, I will only make a few additional comments.

First, when we discuss the recent evolution of the role of aid flows in low-income countries and corresponding challenges to the macroeconomic policies, the emphasis on the increasing aid volumes may be misleading. In fact, over the last four years the ODA to PRGF-eligible countries has stagnated if measured in relation to their GDP. However, the growing share of aid is provided by the so-called “emerging” donors and private donors, thus increasing the average number of donors and complicating monitoring and coordination of their activities. In addition, the recent shift from multi-year project aid to direct budget support, which is usually subject to annual approval, can further raise the volatility of aid flows. In fact, the real problem today is not the scaled-up aid, but the aid that is more volatile, less predictable and less manageable.

In this regard, we support the first guiding principle that aid projections in the Fund programs should represent the best possible estimate of what is likely to be available and not be based on the notion of development needs or promises for a scaling up of aid. It should be clearly stated in the program documents.

Staff can assist the authorities in developing the alternative macroeconomic scenarios based on the presumption of higher aid flows. However, this should not be regarded as a mandatory element of the Fund-supported programs and included into operational guidelines.

On the issue of smoothing public spending over the medium term, we have an impression that staff’s theoretical considerations are not fully consistent with policy guidelines.

Staff indicate several possible constraints for full spending of aid increases. On a micro-level, administrative or sectoral absorptive capacity could be inadequate and, therefore, the increased spending would be inefficient. In such cases, it would be justified to save part of the aid windfall. Going forward, fiscal reserves could be spent when aid inflows unexpectedly drop, thus securing a smooth expenditure path.

While admitting these considerations, staff claim in the same paper that "in most cases, best practice would be to allow for short term spending increases in case of higher-than-projected program grants. On that basis programs could incorporate adjusters to allow higher spending. This approach should be considered best practice". And in fact, statistics confirm that the PRGF-supported programs have become more accommodative of spending unanticipated program aid. How does this correspond with the conclusion that [quote] "a preferable approach would be to smooth spending over the medium term?" (SM/07/199, p.10). Staff comments are welcome.

If we agree that a smooth spending path is a preferable approach, we should admit that reserve buffers should be accumulated, as proposed by staff. Other proposed measures, which adapt the economy to aid volatility, mostly imply a reduction of unprotected spending, such as wages or investments. The recommended reserve cover of 50-100 percent of annual aid-financed spending may seem excessive, as noted by Mr. Duquesne and Mr. Larsen, and not appropriate for donors. On the other hand, the opportunity costs of keeping such reserves could be regarded as the price paid by LICs for poor donor coordination. Therefore, further measures to improve coordination between donors and the recipient countries should be implemented.

One of the most important measures in this regard is the strengthening of the fiscal management. The modernization of fiscal institutions in LICs is ongoing process, but the progress is slow and uneven. The introduction of the Public Financial Management (PFM) action plans, using the "platform approach" proposed by staff, may improve the sequencing of reforms and advance their implementation. We wonder, why the PFM action plans were not mentioned in the context of the Guiding Principles for Program Design?

In conclusion, I wish to note again that PDR and FAD staff have done a remarkable job. However, should their efforts be more coordinated and the recommendations more uniform, the message delivered to their audience could have been more clear and conclusive.

Mr. Rouai made the following statement:

We thank the staff for the comprehensive set of papers, which it is hoped will help the Fund design programs that accommodate the scaled-up aid necessary to move low-income countries closer to the MDGs. These papers offer a preliminary helpful follow-up to some of the concerns raised by the IEO in its recent report on the IMF and Aid to Sub-Saharan Africa, including with regard to the absorb-and-spend framework.

At outset we would like to indicate that the underlying theme and the sub-paper and the growing characterization of LICs as experiencing scaled-up aid could send the wrong message, that actual delivery of official aid is adequate and is commensurate with the need of low-income countries to achieve the MDGs. The evidence presented by the staff shows that aid is falling behind the G-8 commitment and there is no scaling up when aid is measured relative to GDP. In particular, about half of PRGF-eligible countries actually received less aid to GDP in 2005 than in 2000. For their part, Mr. Gakunu and Mr. Suleman rightly point out that ODA flows to sub-Saharan Africa have been flat since 2003. We are concerned that such measures could weaken the political support for additional aid, including IDA 15 replenishment.

The inclusion of private aid, current remittances, or even exports in a broader category of resource flows creates confusion, and could be counter productive. First, private aid by definition cannot be subject to the same political economy consideration as official aid. In this regard, does the call to official donors to reach out to key private donors to invite them to participate in the existing donor coordination structure imply that private aid should be subject to the same range of conditionality? Second, private aid does not affect the fiscal position and development, so paragraph 6 of SM/07/199 should be clearly qualified as addressing official aid alone. Third, remittances as well as export receipts remain under full control of their owner and are not available for public spending. Finally, we think this broader category of resource flows could discourage official aid mobilization efforts.

Turning to the issues for discussion, we generally agree with many of the staff recommendations and best practices proposals and we have the following comments. We share the concern expressed by some Directors regarding staff advice on exchange rate arrangements in relation to scaled-up aid and the emphasis being put on exchange rate flexibility. While we agree with the benefit of the exchange rate flexibility, we believe that country-specific circumstances and not the level of aid alone should guide the authorities in their policy choice. We agree also with Mr. Gakunu and Mr. Suleman that excessive emphasis on exchange rate flexibility could detract attention from pursuing flexibility in the product and labor markets, and developing the financial sector.

We share the concerns expressed by Directors regarding staff recommendations to rely on self-insurance to cover for aid volatility, by saving part of the aid. Paragraph 16 of SM/07/199 provides compelling reasons as to why such an approach has serious limitations. In our view, full spending and absorption should be the norm. It is not clear how the Fund could encourage self-insurance for LICs, while the same policy is being criticized when implemented by emerging market economies. We would have preferred that the staff emphasize the difficulty associated with aid shortfalls and encourage donors to reduce the volatility of aid flows. On the other hand, we support staff's advice to strengthen revenue mobilization and to set up appropriate fiscal institutions, including strengthening public finance management and debt management capacity with the objective of reducing aid dependency. The authorities' efforts in this area should be supported by adequate TA and coordination to enhance their aid management and absorption capacity.

On aid projections, we welcome recent improvements in forecasting aid inflows and we support staff suggestions to prepare alternative scenarios. We also support staff's recommendations to use wage bill ceilings selectively and to avoid their use over an extended period of time.

Finally, going forward, we see a need for a public clarification of the Fund's role in LICs. Among the elements of the medium-term strategy, the role of the Fund in LICs is receiving limited coverage. We propose to update the policy statement on the role of the Fund in LICs adopted by the Executive Board on August 2004. This statement clarifies the Fund's mandate and its relations to LICs and in the context of the international partnership to help these countries reach the MDGs. This statement sets out the Fund's work priority in low-income countries and identifies the instrument for its support. This statement, together with the similar statement on technical assistance, are true remits with less controversial names.

The staff representative from the Policy Development and Review Department (Mr. Plant), in response to questions posed by Directors, made the following statement:

This was a very interesting set of grays and we are appreciative of the comments of Directors. As in the discussion last week of the IEO report, many Directors called for some type of summary at the end of this process. We hear that call and we will look at the best form for doing that, once we have gotten through the other papers that are on the agenda over the next few months, including the papers on the Fund's role in the PRSP process, Bank-Fund collaboration, and considerations in emergency post-conflict assistance. With that package, we will then be in a position to think about how best to tie these things together. I recognize the need that many Directors have emphasized for a summary that is easily accessible to those outside the Fund, because sometimes the clear policy messages can get lost in the midst of many technical details.

One of the other general comments I would take from in the grays is that these papers very much bring to light the tension that is perhaps perennial but particularly severe in LICs of trying to get general statements about what the Fund's policy is in a particular area versus the notion that there are country-specific circumstances and that policy has to be implemented in a nuanced way. One example of this are the comments on Dutch disease. Our point in the paper was that we do not see a great deal of evidence of Dutch disease. Nevertheless, the concern should not be dismissed out of hand and it is one that missions have to keep in mind as they look at the economic situation in LICs. On the other hand, in the past some external observers felt the staff were seeing Dutch disease where it did not exist. Thus, it is matter of changing emphasis of the Fund's prior assumptions coming into a country, and what these papers try to do is to shift some of those priors.

Let me make a few comments on aid and how Fund-supported programs deal with aid. First, there were various comments about the lack of realization of donor commitments to scaling up aid. Staff is very concerned about that and management has been extremely vocal in voicing the institution's concern that the commitments have not yet been fulfilled. We do not view it as a permanent setback that aid levels have gone down and, in fact, many of the major donors have aggressive plans for disbursing a large part of aid in 2007, and very aggressive plans for 2008 to 2010. I would note that these are commitments and the proof will be when we actually see the aid being deliverd.

This paper does not focus on the process of aid mobilization; instead it looks at what problems scaled-up aid will pose for LICs, and recognizes clearly that the real problem right now is related more to volatility than scaling up. But in certain countries we have seen that scaling up has started to pose problems. It is appropriate that we think about those cases now in anticipation of what we hope is a much larger scaling up of aid over the next several years.

In that regard, we have made a case for basing macroeconomic scenarios on our best estimate of what donors will make available to countries rather than firm donor commitments. There had been a tendency in the past to only include in program the amounts that donors were willing to commit to publicly. We recognize that going forward, there are often times when donor commitments are implicitly made, and donors will tell the country off-the-record that money will be forthcoming, but probably owing to political or budgetary circumstances in their own country they do not wish to make those specific pledges public at the particular time the mission is in the country. There are also commitments to longer-term projects and longer-term budgetary financing that are involved and all of those should be taken into account so that the Fund is not biased in one direction or the other in how it puts together its medium-term program. This will also helps donors and countries alike have a good perspective on the money that is likely to come.

There is a question about what type of donor aid is the best kind of aid and if we are favoring budget aid or project aid. Clearly both have their advantages, and it depends very much on country circumstances. There are countries that have the capacity to manage a large amount of budget aid to make the appropriate financial and banking interventions to deal with fluctuations in that aid. There are other countries where project aid offers a form of aid that if it is not forthcoming, there is automatic adjustment in spending and that is useful, too. The important thing is to encourage donors to be clear in their commitments going forward, and to help the country develop a medium-term spending strategy that makes sense, in terms of the best estimate of what aid commitments might be.

There is a question about whether the adjustors for changes in aid should be symmetric and why we are arguing for lack of symmetry. In the context of development, we favor continuation of spending in case of negative shocks, and use of the aid in case of positive shocks. The reason for this is simply because the costs are not symmetric nor are the risks. We think it is an appropriate strategy in a development setting to favor spending and not choke off spending immediately, at least for the short term. I would note these adjustors particularly in program countries are only in place for the period between two reviews. Every six months the mission, with the authorities, has the opportunity to review if the volatility in aid is a permanent or temporary effect, talk to donors, and readjust the program. So, it is not that we are permanently ratcheting things up, but in a six-month period, donors may need some flexibility that favors the continuation of spending, until there is a concerted decision made that perhaps aid is going to be less than expected on a permanent basis. Of course, we hope the latter is not true.

There were various questions about how the staff conducts alternative scenarios. We emphasized that the alternative scenario should be done in the context of the PRSP or perhaps the debt sustainability analysis. There are appropriate areas for looking at what might happen, they can be based on a wide variety of different assumptions, typically, looking at how the PRSP might be scaled up in a reasonable way. Some countries may want do full MDG scenarios to see what it would take to reach the MDGs. The Fund could be helpful in looking at the macroeconomic impact of such scenarios. We have no particular orthodoxy on which scenarios should be done at particular times. The importance is for us to help the country develop its capacity to do scenario planning in the future, and to develop its strategic capacity for putting forth its development strategy in getting the support of the donors.

Another staff representative from the Policy Development and Review Department (Ms. Alonso-Gamo), in response to questions raised by Directors, made the following statement:

I will address some questions that were made about program design and the exchange rate.

There was a question regarding how has the staff's approach to macroeconomic frameworks changed. By reviewing staff papers and also the findings of the IEO, we find that since the start of the PRGF Fund aid projections have become more accurate, and macroeconomic frameworks have become more accommodative of aid. We have also made efforts to address earlier findings of excessive optimism in growth projections. On the latter issue, because of our increased collaboration with the World Bank in the framework of debt sustainability analysis (DSA), we have an important vehicle for sharing information on how the medium-term and the long-term perspectives match.

Regarding whether the Fund does the project-by-project analysis, the Fund's growth assessments are usually based on the analysis of the macroeconomic level looking at the sources of growth and the supply side and the demand impulses on the demand side. But in the context of perhaps large projects on nonconcessional lending, we are relying on the Bank to provide input on the returns from a specific project.

A somewhat related question that was raised is how we were conducting fiscal sustainability scenarios and the growth impact. Again, this ties with what we do in the context of the DSA—the more we look at the long-term projections and the different growth implications, the more different options of a fiscal path get interrelated with the growth.

There was a question on how we would evaluate the country circumstances that would facilitate building a buffer and how that ties into program conditionality. I will not go into the issue of the size of the buffer, which is better left for colleagues from FAD to discuss. In terms of how to take into account individual country circumstances, we would look into the degree of reliance on aid, the aid volatility, the size of the aid, and the kind of shocks that the country would be prone to. Also, we would not be saying that the country has to build the buffer overnight, but rather that it would be built over time and depending on the circumstances.

There were many questions about the exchange rate. Let me start by saying that the staff thinks that the strategy of spend and absorb can be implemented in each of the standard exchange rate regimes. It is not that we are saying that it has to be in a particular exchange rate regime. However, each regime poses different challenges for reconciling full absorption of aid with the need to avoid high inflation or excessive exchange rate volatility. A prerequisite for managing these challenges is a clear understanding of the exchange rate regime of a country and the objectives of monetary policy. And the optimal solutions have the advantage of clarity, but each brings its own set of challenges. In a flexible exchange rate automatically one is left with a full absorption of aid, and monetary inflation objectives are not affected. It is possible to have excessive volatility in the short term, and it can also lead to nominal as well as real inflation pressures, at least in the short run. The issue is how to manage the volatility and competitiveness issues.

With a fixed exchange rate regime, it is also possible to have a viable framework. There are many LICs that are part of a monetary union, and in those cases reserves can respond to the higher import demand, and higher aid absorption is also built in. What happens is a more or less temporary spike in inflation, as higher spending leads to an increase in the prices of nontradables. The issues of competitiveness are also there, but they are not coming from the nominal appreciation, but from inflation. Again, one has to manage those challenges.

The managed float poses the most challenges because experience shows that it is difficult to manage well. In all ten case studies presented in the background paper, we have had at least one more episode of what we would call mismanaged floating. It is because of the nature of regime—it is less transparent, and there can be divergent objectives that coexist. It may not always be clear to those involved, for example, that sometimes there may be a central bank that is aiming for exchange rate stability, whereas the fiscal authorities are aiming for low inflation, which can lead to a coordination problem. And, if the nominal appreciation is resisted in part by the central bank, or if aid-related foreign exchange is not sold by the central bank, it will result in an increase in base money and higher inflation. Inflation can be offset through sterilization, then there would be high quasi-fiscal costs, resulting in a suboptimal case, where there has been spending and not absorbing, and crowding out. These are some of the reasons why the staff views this regime as more difficult to manage.

The bottom line is that any exchange rate regime is fine as long as it is clear what the exchange regime is, what the challenges are, and the policies are coordinated accordingly.

The staff representative from the Fiscal Affairs Department (Mr. Gupta), in response to questions posed by Directors, made the following statement:

There were a number of questions, ranging from policy, technical assistance, and Bank-Fund collaboration.

One question sought clarification on how the smoothing approach would yield a symmetrical response to aid surprises. Expenditure smoothing is advocated because it helps to ensure that all spending programs are adequately funded. Under this approach, countries would respond in a symmetric fashion to aid increases and decreases. When aid is above projections or absorptive capacity constrains aid-financed spending, part of the aid flows would be saved, to be spent in the future. When aid is below projections, this approach would allow countries to continue financing programs by drawing down reserves, or through recourse to additional domestic funds, provided it is consistent with macroeconomic objectives.

There was a question on wage-bill ceilings, and why staff is so cautious about its stance on them. Our own review indicates that these ceilings are difficult to monitor and appear to have only limited effectiveness in protecting critical non-wage spending. Although designed as a short-term measure, these ceilings have tended to persist in the programs. A recent study by the Center For Global Development noted that such ceilings have been effective only when the loss of control over payroll threatened macroeconomic stability. This was the case in Zambia, for example. The study also concluded that wage-bill ceilings did not fit well with other efforts to protect priority spending and achieving the MDGs. For these reasons, staff has recommended that wage ceilings be used in Fund-supported programs only in exceptional cases, when wage-bill dynamics threaten macroeconomic stability. At present, there are nine PRGF-supported programs out of a total of

29, that have such ceilings, and only in three of those programs are these ceilings performance criteria. As countries develop the medium-term framework that the paper recommends, the need for such ceilings will be reduced because the allocations will be there for different programs in the medium-term context.

A question was also raised as to whether the pendulum has swung too far in the direction of pro-poor spending at the expense of pro-growth spending. In the papers we explain that expenditure composition does have an impact on growth. For example, infrastructure spending can boost growth over the short- to medium-term provided sound budgeting techniques are followed, projects are properly prioritized, and there are no leakages. On the other hand, growth effects of education and health spending through higher labor productivity are spread out over a longer time period. Many PRSPs with active donor participation have sought to increase social sector spending in order to make rapid progress towards the MDGs. As a result, spending on infrastructure has not grown as rapidly in many countries. There is a growing recognition now that this imbalance needs to be rectified.

Many grays refer to reserve buffers and my colleagues from PDR also mentioned them. The question was how would reserve buffers work in practice, and how would they be managed? The reserve buffers that we discussed in the paper are built up by saving aid. They would be no different from other kinds of reserves, and they would not be earmarked for fiscal purposes. Therefore, the same strategy for managing these reserves would be followed as for the rest of the reserves. The suggested size of 50 to 100 percent of annual aid spending as a reserve buffer is based on one study by the World Bank, and it is not a normative standard recommended by the paper. We simply noted that the reserves could be of this magnitude, but this is not something which is definitive.

There were a number of questions on technical assistance, and one question was what are the areas of Fund TA in public financial management (PFM) and are there clear division of responsibilities between the Bank and Fund in that regard. PFM is an area of shared responsibility between the two institutions, and PFM reforms often involve simultaneous efforts in all three areas of budget formulation, execution, and reporting. In practice, therefore, these kind of reforms are interlinked, and it is difficult to rigidly allocate specific responsibility to one institution or the other.

However, the Fund has insufficient resources to cover any one aspect of PFM for its entire membership. This means that the Fund has to collaborate with the Bank and other TA providers. In total, it has been estimated that there are over 50 TA providers in this area, and in some LICs, there are on average seven providers who are active. The focus of the Fund has been on areas which help to improve the macro-fiscal data and analysis, such as accounting, cash management, reporting, and control. Among other things, this focus allows reconciliation of monetary and fiscal accounts and ensures execution of the budget in line with the approved budget.

The Fund also gives priority to preparation of action plans for strengthening PFM systems. I would note that these action plans have an impact on program design. There is an active collaboration between the Bank and Fund in this area, besides being part of the Public Expenditure and Financial Accountability (PEFA) Program, which I will also address shortly. Bank and Fund staff participate in each others' missions, and the two institutions also share terms of reference and mission plans. So, there are a number of ways in which collaboration is taking place, and some work is ongoing as part of the follow-up to the Malan report where we will be trying to institute some new procedures to strengthen this collaboration further.

There was a question on what is the Fund's involvement in PEFA, and what is the relationship between the PEFA framework and fiscal ROSC. The IMF is one of the PEFA partners and is a member of its steering committee that meets twice a year—in fact, we just hosted recently the meeting of the steering committee. It also engages in specific PEFA activities such as reviewing the PEFA assessments done by various donors. There are some 48 assessments which exist to date.

The fiscal ROSC focuses on countries' institutions and vulnerabilities, and the concentration is more on transparency. Thus, it has a much narrower and specific focus than the PEFA framework, which assesses the whole range of country financial systems using 28 indicators. There is less focus in PEFA on transparency. However, the two instruments complement each other. PEFA assessments are used to diagnose strengths and weaknesses in the country's PFM systems, and to design action plans. A fiscal ROSC assessment also lays out a program of short- and medium-term measures to improve transparency in the country concerned, and both can lead to requests from the authorities for follow-up assistance from the Fund and other donors.

> There was a question on how FAD prioritizes technical assistance with limited resources. I will try to give a very simple answer to a rather complex issue. It has elements of both bottom-up and top-down approaches, and it can be broken down into four critical steps. The first step is that prior to the start of the fiscal year, FAD consults area departments on how it could best support their activities in the coming year. This discussion feeds into the resource allocation plan (RAP) for the coming year. The second step then entails FAD collaborating with the area departments in preparing regional strategy notes, which specify TA priorities by country and topic and these priorities are for each area including the financial sector, fiscal policy, and statistics. The third step is to align the RAP with the budget allocation provided by the Office of Budget and Planning. And finally, the RAP is revised during the course of the year in response to changing country circumstances, and emerging country needs. That is essentially how the budget process is determined in FAD.

Another staff representative from the Fiscal Affairs Department (Mr. Tareq), in response to questions raised by Directors, made the following statement:

> A question was raised regarding what is meant by the staff being proactive in discussing PSIA needs with country authorities and development partners. In the context of surveillance or program negotiations, Fund staff regularly discuss reform measures with country authorities. It is often the case that country authorities agree on the need for such reforms, but are concerned about the possible adverse impact on the poor and vulnerable sections of the population. In such cases, the Fund staff could discuss with the Bank and other development partners the need to conduct a PSIA to assess trade-offs between different reform options, and to suggest appropriate measures to mitigate any adverse impact on the poorer sections of the population.
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> There was a question regarding the underlying reasons behind aid volatility. A number of factors contribute to aid volatility. First, donors often do not enter into long-term commitments for aid disbursements, in particular for budget support, although there have been some notable exceptions recently. Second, the disbursements might fall short of actual commitments for a number of reasons on the donor side, including administrative reasons. And finally, there could be less than full compliance with donor conditionality and other associated requirements on the part of recipient countries, which can also disrupt aid disbursements. Therefore, more predictable and long-term commitments on aid flows are essential for reducing aid volatility; streamlining conditionality and reporting requirements would also help in this regard.

Mr. Kishore made the following additional statement:

Let me begin by expressing our satisfaction and appreciation for the quality of the papers and supplements that have been produced. They are analytical, informative, and indicative, and I would like to express our compliments to the staff in this regard.

Most of the questions which have been raised in various grays, particularly some of them raised by us, have been addressed. I have two comments and a few questions arising therefrom.

The first point relates to the conceptual framework for aid—its administration, regulation, utilization, notwithstanding, but the fundamental point is that the objective of the aid must be ultimately to ensure ending the requirement of any further aid by the recipient country. What do I mean by that? It means that it should not be sporadic, it has to be part of an overall strategy, it has to be part of a medium-term perspective. It has to be received well in terms of institutional capacities to absorb and utilize, and it must be given and received within the overall macroeconomic environment in which it is possible to put the aid to proper utilization, which is where the role of the Fund comes in the picture.

The need to scale up the aid is obvious, but a valid point has been made by the staff that the question of volatility is very crucial. Volatilities in aid are induced by various factors, some not intentionally. The crucial issues are can we reduce it, how do we do that, and what are the implications of it? One obvious thing which comes up and here, and I must appreciate the initiative taken by the United Kingdom on this behalf, is that there is a medium-term commitment to that, and perhaps these models could be replicated, as indeed been promised by some of the chairs here. This would put at least in medium term a kind of a credible flow pattern which will raise the level of comfort immediately, because volatility is not to my mind merely a responsibility of the recipient country, it is equally the responsibility of the donors, and this must be ensured.

I would appreciate the staff's clarification on whether there is a specific preference between program aid and project aid, because the operations and utilization of the timeframe, the implications, responsibilities, and frameworks are somewhat different.

The second request for clarification relates to exchange rate flexibility. The impression I have from reading the papers is that there is a minor bias in favor of exchange rate flexibility in terms of the low-income countries receiving aid. It might have some exchange rate implications, but country circumstances have been mentioned here, and that they have been taken into account. Does the staff think there is a conceptual or at an analytical level, a bias in favor of necessary flexibility, a priori?

Thirdly, there is the question regarding competitiveness. The paper underscores the point that there is an impact on competitiveness, but I think not sufficiently enough. Within the proposed framework, which is robust, the risk of losing competitiveness may be studied further. There are studies by Mr. Rajan and others who point out these kinds of problems. But, if there is a high priority to the risk of losing competitiveness, what kind of advice would be forthcoming from the staff in the context of advising the program countries?

Finally, there is the question about concessionality. The impression I got from the papers is that we are seeking to evolve a set of principles guiding responsible lending. I suppose countries which are sovereign are also rational economic agents, and they would exercise due precaution and care in terms of exercising their choice in favor of nonconcessional, market-rated project funding, should the concessional adequate funding not be forthcoming. This is related to the long-term or medium-term commitment regarding the flow of funds. I am glad the staff have pointed out very clearly that what has been observed is as a result of inadequate funding for MDGs.

Also, infrastructure investment has been much less than what was at one point in time considered to be desirable and this is on account of inadequate concessional funding. Indeed, between the loan and grant, the recipient country shall prefer grants, but should that not be forthcoming in adequate quantity, nonconcessional funding would have to be resorted to, so therefore economic analysis will have to say where does the comparative advantage lie in not undertaking the infrastructure development and social sector development, just because there are nonconcessional finances available, but no grants are available.

I finish by joining Mr. Rutayisire, and his expression about the sentiment on the need to be careful about the phraseology that we use in our reports. We all understand the problem, but I suppose it could be put in a fashion which is nonpejorative. I take comfort from an observation which came in the comments here, that the Fund is not engaging itself in the task of

> mobilizing aid, but we are creating an environment in which the scaled up aid will be absorbed and utilized and spent in a productive fashion.

Mr. Williams joined Mr. Kishore in thanking the staff for its substantive response to questions, and reiterated the high quality of the staff papers. He agreed with Mr. Kishore that, in reality, aid volatility was a two-way street—it included volatility of action by aid recipient countries as well as volatility of actions by donor countries. The latter was as serious as the former, and it was not clear whose volatility was causing the other's volatility. Everyone needed to take more action to deal with aid volatility.

On the issue of reserve buffers, where there was aid volatility, reserve buffers were high, so one could argue that aid recipient countries had to bear the full pain of the volatility of donor countries' actions, Mr. Williams continued. However, the reasons behind the staff's specific recommendation to build reserve buffers of 50-100 percent of annual aid-financed spending to reduce volatile aid flows were unclear. If the Fund were to recommend such a level of reserve buffers, which could be quite expensive and difficult to justify domestically and internationally, more research should be conducted on whether it was the appropriate level. Tanzania, for example, received approximately $250-300 million per year in budget support from the United Kingdom alone. It would be difficult to explain to the Tanzanian authorities and the British public that Tanzania might need to build high levels of reserves to guard against aid volatility, especially as some donors had made commitments to try and reduce that volatility. Therefore, a better justification for the staff's proposed level of reserve buffers, and a more sensitive approach to how it would be implemented, would be needed. Although the staff's recommendation was a medium-term objective, the level still appeared high. In addition, it did not seem fair that developing countries should pay the price for the volatility of donor countries' actions. It was also difficult to explain to the outside world that it would be better for aid recipient countries to save aid rather than to spend it because of the volatility of donor countries' actions. Until there was proper analysis on the appropriateness of the staff's recommended level of reserve buffers, the Fund should be cautious about endorsing that recommendation.

Mr. Moser said that the idea by the staff of putting together an umbrella paper to integrate all the various recommendations on managing aid flows was a good one. It would also help to follow up on the IEO's recommendations on IMF and aid to sub-Saharan Africa, provide the staff with clear guidelines, and improve communication to the outside world on the Fund's policy in low-income countries.

Regarding Poverty and Social Impact Analysis (PSIA), according to the FAD staff's response, it was clear that Fund staff would not conduct PSIAs, but instead be proactive in receiving the PSIAs undertaken by development partners in order to provide timely inputs for the design of Fund-supported programs, Mr. Moser noted. Could the staff clarify if such an understanding was correct?

On the Public Expenditure and Fiscal Accountability (PEFA) initiative, his chair understood that the Fund was a partner, Mr. Moser stated. His chair would be concerned if there were substantial overlaps between PEFA assessments and fiscal ROSCs. For instance, for Kenya, the Fund had conducted a fiscal ROSC one month after a PEFA assessment had been undertaken. Could the staff elaborate on the exact role of the Fund in PEFA assessments—did Fund staff participate in them, or did the Fund endorse PEFA assessments? Was there some kind of coordination with regard to the timing of fiscal ROSCs and PEFA assessments, taking into account country authorities' capacity?

The staff paper mentioned that an explicit development of growth-oriented fiscal policy scenarios would be desirable to inform the design of an overall macroeconomic policy framework, and there was a reference to a World Bank paper that had been discussed during the 2007 Spring Meetings, Mr. Moser remarked. Could the staff provide more information on that issue? Would that World Bank paper be taken as a basis when Fund staff designed Fund-supported programs? Or did Fund staff intend to incorporate that World Bank paper into guidelines for the staff?

Mr. Rutayisire reiterated that his chair had always said that the Fund should try to avoid policy frameworks that risk providing general prescription. From an operational point of view, according to feedback received by the Board from the staff on the program performance of low-income countries, there were certain countries that were ready for scaled-up aid. However, the framework proposed by the staff did not seem to distinguish well those low-income countries that were prepared for scaled-up aid. Donors had also made it clear that certain low-income countries, on the basis of their track record in policy implementation and design of poverty reduction strategies, were well suited for scaled-up aid. The general framework proposed by the staff should be able to classify low-income countries according to their readiness for scaled-up aid, which could then be taken into account in the design of policies.

On the issue of fiscal policy framework, experience from Fund-supported programs indicated that fiscal consolidation was not appropriate for certain low-income countries because the capacity to increase tax revenues was limited in the short run and even in the medium term, unless there were changes to the real economy, Mr. Rutayisire commented. There were examples of low-income countries that had not improved their tax revenue base from 12 percent of GDP. The staff's proposed framework should address how those countries could increase their tax revenues. If those countries received adequate and predictable aid to improve the real economy, they could eventually increase their revenue base and improve economic management.

Aid volatility did not necessarily mean the unreliability of aid flows, Mr. Rutayisire noted. Volatility in aid could be due to differences in the timing of donor countries' decision making. There had been efforts to reduce such uncertainty. For example, the Fund had been working with the World Bank in the area of aid securitization within the health sector, including on immunization programs. Such innovations could help reduce the uncertainty associated with the timing of donors' decision making. That aspect of aid volatility should be reflected in the staff papers, and an update on the progress made by the Fund in that area should be provided.

Mr. Kamara made the following statement:

> I commend again the staff for the useful papers, which provide substantial conceptual as well as practical aspects of aid management, particularly with respect to Africa. My chair is grateful for the staff's suggestions and recommendations. I would like to comment on two issues.
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> First, aid to Africa at the moment is inadequate, given the requirements of low-income countries there. Therefore, it is the responsibility of the Fund to assist low-income countries in mobilizing more aid. On the aid that is available to these countries, the Fund also has a role in providing advice on better management. On the next steps, we have not seen in the staff papers a strategy, going forward. I support the suggestion by the staff to consolidate all these various papers and recommendations into an umbrella paper, I hope that such a paper will provide practical guidance to mission chiefs, particularly on program design. My experience is that when the staff is in the field, there is little flexibility in the way that it can carry out program discussions with member countries. We have seen interim guidelines with respect to the revised 1977 Decision on surveillance. We expect to see also revised and new guidelines to mission chiefs on advising low-income countries on managing scaled-up aid.
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> On reserve buffers, it seems to be a good idea to accumulate a certain level of reserves because they support the exchange rate and strengthen the external account. However, at the end of the day, there are social and economic opportunity costs to a higher accumulation of reserves. For instance, in my own country, we face trade-offs in solving the energy crisis. The question is why do we have to build up three to four months of reserves instead of using the money to build a power plant that will provide energy to the population and boost economic productivity? In addition, if a country builds up reserves, it has to borrow funds from the central bank at higher interest rates. Therefore, there is a need for the staff to provide more practical

case studies about the extent to which reserve buffers could be used, taking into account the serious social and economic opportunity costs.

Regarding the PEFA initiative, it is just a way of consolidating most of the requirements in improving fiscal transparency and accountability. From my experience, the Fund should not put too much emphasis on PEFA as there are donors that have invested more in this area. For example, the U.K. Department for International Development has a permanent secretariat working on PEFA; the Fund could piggyback on its efforts. Also, a number of countries are developing public financial management systems that try to consolidate PEFA assessments, fiscal ROSCs, and all other requirements for managing and recording aid. On the issues of accounting and cash management, there is a program designed and fully financed by the European Union, which the Fund could take advantage of. Therefore, the Fund should look into coordinating with other development partners that have an comparative advantage on PEFA and other issues of fiscal transparency and accountability.

On the use of wage bill ceilings, the Fund has not focused its attention on all the related issues. It is not only about developing wage bill ceilings. There are countries where the minimum wage concept has been introduced and the minimum wage has increased, but they have not been helpful. This is because the Fund has not looked at the structure of the civil service. I do not think that the Fund has the capacity to assist countries in civil service reform. The only relevant aspect for the Fund is when the public wage bill is too high and has to be reduced. The only way to reduce it is to cut the size of the civil service. This was common in Fund-supported programs in the 1980s. I am glad that the philosophy to force countries to reduce the size of the civil service is no longer part of Fund-supported programs. Civil service reform is not easy in any developing country that has high unemployment, social costs, and political considerations. The public service is usually the biggest employer in many of these countries. So, if the Fund wants to challenge the size of the public wage bill, it is a question of looking at whether or not the size of the government is too large. In this area, the Fund should cooperate with the World Bank, which can provide valuable advice on civil service reform that does not entail serious political implications.

On the next steps, in addition to an umbrella paper summarizing the various recommendations, we expect to see the development of practical, revised guidelines for mission chiefs, so that they can be flexible in their discussions with the authorities in the field, taking into account country circumstances.

Mr. Claveranne supported the comments of Mr. Kamara and Mr. Williams on reserve buffers. However, he remained puzzled by the staff's response. First, the staff had explained that the reserves used to reduce aid volatility would be a different type of reserves. While that was understandable from a financial or fiscal perspective, it was doubtful that aid given to recipient countries could be set aside as another type of reserves. Mr. Kamara had rightly mentioned the social and political costs of building up reserves. It would be difficult to explain to lawmakers and the public in both donor and recipient countries that the aid provided should be set aside as reserves. Mr. Williams had mentioned that a recipient country could suffer from the unpredictable decision making of donors, but the same was also true for other donor countries. A donor country could be affected by the behavior of another donor country that did not fulfill its aid commitment, which could result in its own aid being put aside. At the moment, his chair was not convinced by the staff's recommendation to build reserve buffers to reduce aid volatility. Second, it was puzzling that the staff did not present alternative ways of addressing aid volatility. Other approaches were needed because the recommendation of building reserve buffers was sensitive from a political point of view. Therefore, further work was needed before the Fund developed guidelines to the staff in that area.

Mr. Kaplan said that the staff papers raised an interesting observation about the difficulties of managing and absorbing aid flows under a managed floating exchange rate. Perhaps it would not be appropriate for corner solutions on the exchange rate regime to be included in guidance to the staff, as member countries should be free to choose their own exchange rate regime. What did the staff intend to do with all the interesting findings on the inherent difficulties of managing aid flow in the managed floating exchange rate system? More generally, were the difficulties unique to aid inflows relative to other volatile inflows, such as income from commodities and favorable terms-of-trade shocks, and did that lead to the implication that low-income countries should have corner solutions on their exchange rate regimes? The Fund should conduct further research on those complex issues and their different implications for low-income and emerging market countries, and eventually incorporate the findings into operational guidance to the staff. His chair thus looked forward to an umbrella paper integrating the various recommendations on managing aid flows and to the incorporation of those findings into operational guidance to the staff.

On the issue of reserve buffers or reserve adequacy more generally, it was fair to conclude that a country facing volatile aid flows might wish to considering having a larger reserve buffer, Mr. Kaplan observed. On the other hand, the staff's recommendation of building reserve buffers of 50 to 100 percent of annual aid-financed spending, which was based only on a single World Bank study, was preliminary and should not be included in guidance to the staff. The Fund should undertake further research on that issue, and more generally on the adequacy of reserves in low-income countries.

Regarding the role of the Fund in assisting low-income countries manage aid flows, while the Fund could have a value-added role in helping the authorities assess the macroeconomic implications of aid inflows, his chair would be reticent about the Fund helping countries develop scaling up scenarios to meet the MDGs, or hypothetical scenarios of higher aid inflows that were unlikely to happen, Mr. Kaplan reiterated.

Mr. Guerra stated that the Fund should be cautious about developing guidance on reserve buffers, given the lack of agreement on the issue. His chair shared the concerns that had been expressed by some Directors, but also took note of the implications for the institutional framework, as building reserve buffers could complicate the coordination between the fiscal and monetary authorities. Unless the fiscal authorities set aside a specific amount of reserves to act as buffer against volatile aid flows, having a general guideline that reserves could help safeguard aid shortfalls could raise complicated issues related to the optimal level of reserves, the relationship between the central bank and the fiscal authorities, and the timing and amount of reserves that could be used. Therefore, further work by the Fund on those issues was needed.

The staff representative from the Policy Development and Review Department (Mr. Plant), in response to additional questions and comments by Executive Directors, made the following statement:

> In listening to Directors' comments, I think that the staff papers have achieved their intended purpose, which is to make clear that aid is a financial flow with real impact on the recipient country's economy, exchange rate, and reserves. In some sense, as Mr. Kaplan noted, there is not a fundamental difference between aid and other kinds of financial flows, such as those resulting from exports of natural resources. This is the main point of the staff papers, that aid is not benign and requires active management by the recipient country's monetary and fiscal authorities to make sure that it is effective. The management of aid requires a coordinated response, just like any financial flow. The staff is trying to fit aid flows into a traditional macroeconomic framework and make it clear that aid is a financial flow that cannot be set aside from the rest of the budgetary and monetary framework.
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> There was a question on whether or not there is an a priori best exchange rate system for a country receiving aid. The answer is no. The staff papers made clear that there are advantages and disadvantages to both the fixed and the flexible exchange rate regimes. What is important is a clarity of policy stance and signal. That is the problem with a managed float, particularly in developing countries, where the communication of information is not necessarily clear, where daily management of reserves is not possible, and where financial institutions are weak. The choice of the exchange rate

regime is a decision that has to be made at the country level in the context of the institutions and the policies of the country.

In the same vein, the issue about competitiveness is also complicated. Aid could, in theory, have an impact on competitiveness. The economic literature on this issue, such as the study by Mr. Rajan, is very much at the forefront, but there were many people who still raised questions about that study. Studies on the impact of aid on competitiveness should be undertaken at the global and intellectual level, but their implications will necessarily differ in light of country circumstances.

The issue of debt concessionality in low-income countries has been mentioned several times. When a low-income country contracts a nonconcessional loan, it spends more resources on debt servicing in the future than it would have under a concessional loan. So clearly a concessional loan is more beneficial. The question then becomes whether or not contracting a nonconcessional loan will generate so much more payment in the future than the country can afford. This is a complicated question, particularly in the those countries where the payoffs are disbursed and down the line. There is a tendency for the staff to stress the use of concessional loans first, but there have been instances where Fund-supported programs have accommodated a certain level of nonconcessional borrowing. The emphasis should be on making the maximum use of the potential resources that is available in what we hope is an international environment of considerably scaled-up aid.

On the role of the Fund in low-income countries, the medium-term strategy lays out the main issues, particularly regarding scaled-up aid. It is clear that the Fund should help the authorities consider the macroeconomic impact of scaled-up aid and how they intend to use the aid. The Fund should not play an active role in mobilizing scaled-up aid for countries. It is the country's responsibility to make the case for scaled-up aid to donors, but the Fund should help the country develop the analytical capacity to make that case.

The staff representative from the Fiscal Affairs Department (Mr. Gupta), in response to further questions and comments by Executive Directors, made the following statement:

> On the reserve buffers, Directors' comments are well taken. I would simply like to add that the staff paper only lists the recommendation of reserve buffers as one of many options for dealing with the uncertainty of aid flows. Of course, the staff's recommendation is based on one study, and more work needs to be done on it. The staff paper recognizes that there are limits to saving aid. Donors want to see the money spent, and there are political pressures in the recipient countries to spend the aid. So, there is clearly a recognition that this is not a strategy that should be followed ad infinitum. If one looks at the evidence for a number of countries in the late 1990s, many countries saved aid because the level of reserves was low. If you look across sub-Saharan Africa, the average level of reserves has risen in the last four to five years, and that has allowed those countries to withstand some of the shocks that they have faced in recent years. But, Directors' concerns are well taken, and clearly the staff's recommendation of building reserve buffers of 50 to 100 percent of annual aid-financed spending cannot be a prescriptive norm.
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> There was a question on the choice between program and project aid. Both types of aid flows, whether project or program, have their advantages. Project aid helps implement projects in countries that lack the capacity to do so. Program aid, on the other hand, has the advantage of supporting the budget and allows countries somewhat more flexibility to allocate resources consistent with their own priorities. In some situations, for instance in a post-conflict country, it is possible that project aid may be a more effective way to deliver aid, at least in the short term.
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> On the issue of PEFA and ROSC assessments, I would like to reassure Directors that there is an active mechanism of consultation between the World Bank and the Fund on the sequencing of fiscal ROSCs and PEFA assessments. The mechanism allows some time between the two assessments. One should not overlook the fact that the fiscal ROSC is an important instrument for fiscal transparency in advanced and emerging market countries. We have recently developed the revenue resource component of the fiscal ROSC, which is helping us to look at transparency of revenues in resource-rich countries.

Another staff representative from the Fiscal Affairs Department (Mr. Tareq), on the question of whether or not Fund staff would conduct PSIAs, replied that, in general, the staff would seek to integrate the results of PSIAs that had been undertaken by other development partners into Fund program design. However, for certain macro-critical reform measures, PSIAs might not be available or might not be available in a timely fashion. In those limited cases, Fund staff might undertake quick PSIAs in order to enable program countries to proceed with those reforms.

The Acting Chair (Mr. Lipsky) made the following summing up:

> 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.
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> 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.
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> 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.

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SHAILENDRA J. ANJARIA
Secretary