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The Macroeconomic Impacts of Counterpart Funds

Prepared by Jean A.P. Clément*

Authorized for Distribution by Reimer O. Carstens

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Abstract

This paper analyzes the macroeconomic impacts of the creation, accumulation, and use of counterpart funds. It draws attention to the importance of including counterpart funds in the design of macroeconomic policies to ensure their consistency. It shows that the creation or accumulation of counterpart funds in most cases is deflationary while their uses are inflationary. One conclusion is that "untied" counterpart funds are more appropriate for countries implementing an adjustment program.

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The Macroeconomic Impacts of Counterpart Funds

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Summary

Since the 1950s, the sharp increase in foreign aid to developing countries, together with a growing use of counterpart funds, has revived the discussions among economists and officials on the use of such funds. Because the definition of these funds varies widely, a great deal of confusion exists with respect to their macroeconomic impact. Moreover, the literature on the macroeconomic effects of counterpart funds is very thin. This paper offers a definition of counterpart funds, reviews their historical development, and analyzes their macroeconomic impacts through a detailed consideration of their effects on money supply, including net foreign assets and net credit to the government, and on the overall budget balance, including its financing.

The paper shows that the creation or accumulation and the use of counterpart funds have important macroeconomic impacts and should be fully integrated in the design of macroeconomic policies to ensure consistency between instruments and objectives. The paper also shows that the time factor is important as the creation or accumulation and the use of counterpart funds can have opposite effects on money supply and on the overall budget deficit. In most cases, the creation or accumulation of counterpart funds is consistent with other macroeconomic policy objectives aiming at reducing money supply, while the use of these funds has the opposite effect. If the creation and use of counterpart funds are simultaneous, then the effect on money supply depends on the type of use that the government makes of them. The effect on the overall budget depends crucially on the sources of counterpart funds.

One of the main conclusions of the paper is that the more stringent the conditions for the use of counterpart funds imposed by donors on the recipient government, the more likely it is that the counterpart funds will accumulate over time, which thus increases the possibility of inflation at a later stage. Also, stringent conditions often lead to the creation of a number of special accounts outside the budget which render the monitoring of public expenditure difficult. Hence, in a macroeconomic sense, "untied" counterpart funds, as opposed to "tied" counterpart funds, appear to be more appropriate when the recipient countries are implementing an adjustment program with the support of the Fund and the World Bank.

Background

Since the 1950s, the sharp increase in foreign aid to developing countries, together with a growing use of counterpart funds, has revived the discussions among economists and officials on the use of such funds. Donors have often tried to control the use of their aid through the designation of a special account for counterpart funds. These funds have often accumulated over time due to difficulties encountered by the recipient countries in maintaining the original schedule for their uses. This paper shows that the creation, or accumulation, and use of counterpart funds have macroeconomic impacts--impacts that tend to be overlooked by the donors and the recipients of foreign aid. ^{1/} The paper draws attention to the importance of including the counterpart funds in the design of macroeconomic policies to ensure their consistency. The paper is divided in six sections: the introduction offers a definition of counterpart funds; Section 2 briefly reviews their historical development; Section 3 traces their sources in the balance of payments; their impacts on monetary policy and on budgetary policy are analyzed in Section 4 and Section 5, respectively; and Section 6 summarizes the conclusions of the paper.

1. Introduction

Although the notion of counterpart funds is well known to economists and officials from foreign aid donor and recipient countries, the definition of these funds varies widely. Therefore, a great deal of confusion exists with respect to the macroeconomic impact of these funds, which often renders exchange of views difficult and leads to wrong policy recommendations. In this paper, counterpart funds are defined as the local currency proceeds of the sales of commodities and of foreign exchange provided by foreign aid in the form of grants or loans to the recipient government. This definition excludes all capital imports other than aid, and recipients other than governments. Also excluded under this definition are local currency funds raised by a government without the sales of commodities or the receipt of foreign exchange through foreign aid--for example, funds raised by the recipient government to finance the local cost of a project. In addition, the sources of counterpart funds are to be traced first in the balance of payments of the recipient country as a transaction between the donor and the recipient government. Under our definition, the donor is usually a government, but it can also be an international organization.

Foreign aid can take the form of grants or loans. Grants can be either commodities or foreign exchange. Commodities can be capital goods, spare parts, raw materials, or consumer goods. Counterpart funds accrue to the recipient government only upon the sale of the commodities or the foreign exchange in the domestic market. The accrual of the

^{1/} The paper limits itself to the description of the direct macroeconomic impacts of the creation, accumulation, and uses of counterpart funds, and therefore does not describe their indirect impacts on economic variables such as wealth and consumption.

counterpart funds to the recipient government is permanent only if the local currency proceeds are generated through the sale of foreign aid obtained through a grant. The accrual to the government is temporary when the local currency proceeds are generated through the sale of foreign exchange obtained from a loan. ^{1/} The loan will have to be serviced according to its terms and the recipient government will have to raise the corresponding amount of local currency. An important difference between foreign aid in foreign exchange and foreign aid in commodities is that the former can be sold by the recipient government to the central bank, the commercial banks, and other entities in the public sector, as well as to the nonfinancial private sector. For commodities, the choice is restricted mainly to the nonfinancial private and public sectors. The type of buyer of foreign aid has important consequences for the macroeconomic impact of the counterpart funds.

Nonproject foreign aid is the major source of foreign exchange that generates counterpart funds, while project foreign aid generates counterpart funds only when it covers the procurement of goods and services sold locally in domestic currency. Another important distinction is whether the domestic counterpart funds are tied or untied--in other words, whether or not the donor demands from the recipient government that a separate counterpart fund account be created corresponding to the type of foreign aid provided and that its counterpart funds be "tied" ^{2/} to the financing of predetermined expenditure. In contrast, "untied" counterpart funds can be used at the discretion of the recipient government and are similar to any other nonearmarked budgetary resource.

Finally, aid donors may require that part or all of the counterpart funds be owned either by the recipient government or by the donor government or, sometimes jointly. In the monetary survey, ^{3/} foreign-owned counterpart funds are usually included in foreign liabilities as "foreign lending funds" whereas country-owned counterpart funds are usually included in "government deposits," although in some instances, particularly for purposes of historical analysis, they are distinguished from the usable government deposits by being classified as "government lending funds."

^{1/} In some cases, loans correspond to the "value" of a commodity shipped by the donors to the recipient country, e.g., the value of 10,000 tons of wheat to be repaid over 25 years.

^{2/} Another term frequently used is "earmarked."

^{3/} See International Monetary Fund, A Guide to Money and Banking Statistics in International Financial Statistics, (Washington: International Monetary Fund, December 1984), pp. 481-84.

2. Historical developments

Counterpart funds are not a new phenomenon. ^{1/} Russia, which was facing deep financial problems in the late 1890s, financed a large share of its defense expenditures through the use of local currency counterpart funds from foreign private loans. During the 1920s, several Latin American and European governments--particularly Germany--also resorted to such practices. With the crisis of the 1930s, several of these debtors defaulted and foreign loans dried up. This experience showed that untied counterpart funds were often used to finance budget deficits, which together with lax monetary policies, resulted in high inflation rates. Furthermore, the default of several governments made it obvious that attention had to be given to the repayment capacity of the recipient country, and thus to the terms of foreign assistance.

This reasoning shaped the type of foreign assistance provided after World War II. Foreign aid in the form of official grants developed while donors were more eager to determine their use jointly with the recipient country. The label "counterpart funds" became widely used for the local currency proceeds of foreign grants or loans.

According to Lachman (1968), "Pre-Marshall Plan assistance to Italy during 1943-48 provides a good illustration of how the various elements of local currency policy and administration originated and developed; a process that reached maturity in the Marshall Plan, and what many consider as hypertrophy under the U.S. Public Law 480." ^{2/} Under the first agreement between the Italian Government and the United Nations Relief Rehabilitation Agency (UNRRA) of 1945, part of the aid goods could be distributed through sales, and the sale proceeds were to become the property of the Italian Government. At the same time the Italian Government took on the obligation to cover the domestic cost of the program. The second agreement of 1946 stipulated that the Italian Government's use of the counterpart funds should cover the administrative and program expenses including those of international organizations. The use of the remainder would be determined jointly between the recipient and the donors. The third agreement of 1947 insisted that the sales proceeds had to be collected promptly. Italy then benefited from two successive grants-in-aid programs from the United States Government (U.S. Public Laws 84 and 389). The latter program--the Interim Aid Agreement, signed by Italy and the United States in January 1948--stipulated that the counterpart funds originating from the sale proceeds of the grants in commodities would be used for the local currency administrative expenses of the U.S. Government for the activities deriving from the agreement; the effective reduction of the Italian public debt and the irrevocable retirement of money from circulation;

^{1/} For a good description of historical developments of counterpart funds, see Lachman, Alexis E., The Local Currency Proceeds of Foreign Aid, Development Center Studies, (Paris: OECD, 1968).

^{2/} See Lachman, op. cit., p. 23.

and such other purposes, including measures to promote Italian monetary stabilization, that were mutually agreed to between the two governments. As noted by Lachman, "these provisions represented a fundamental departure from previous agreements. Anticipating the Marshall Plan legislation to this effect, the Agreement set the stage for a policy of utilizing counterpart funds in the fight against inflation."

The features of the creation, accumulation, and use of the counterpart funds described above are broadly the same as those related to foreign aid to developing countries. However, the possibility of using counterpart funds to achieve certain macroeconomic objectives such as the fight against inflation has been lost to some extent and a more microeconomic approach has been followed, leading to the development of "tied" aid, whereby the counterpart funds are used to finance specific projects. Moreover, in several instances the counterpart funds are held by the donors. A good example of such practices is the aid provided by the United States under its P.L. 480 (Title I), which governs the sales of foreign currencies.

The developments in the policy of the World Bank concerning counterpart funds are also very instructive. First, its Articles of Agreement (Article III, Section 4(vii)) state that "loans made or guaranteed by the Bank shall, except in special circumstances, be for the purpose of specific projects of reconstruction or development." Second, Article IV, Section 3(a) states that "it is the Bank's established practice not to finance the whole cost of any project or program." Hence, a Bank loan covers only the direct foreign exchange costs of a project. Until this tied approach was relaxed in the 1960s, World Bank loans did not generate counterpart funds, and the recipient governments had to find their own means of financing the local currency expenditures related to their projects. This represented direct support for the balance of payments without any direct impact on the money supply, as the goods and services imported in the context of a particular project were simultaneously financed by drawings on the related loan. However, since the 1960s, World Bank loans can generate counterpart funds, principally in two instances. In the case of project loans, counterpart funds may arise when a recipient government on-lends the proceeds of the Bank loan to sub-borrowers with faster repayments scheduled than those for the Bank loan itself. In the case of program loans and credits, which are invariably made to the recipient government, counterpart funds are acquired by the government in payment for the foreign proceeds of the loan (credit), which the government makes available to local residents. This "new" policy allows for the creation and the accumulation of counterpart funds. The Bank has generally sought the government's agreement to assign these funds to its development budget and require that the counterpart funds be directed into a special account from which withdrawals may be made to finance expenditures within the framework of the government's development plans. In some cases, however, by agreement with the government, the counterpart funds may be allocated to more specific, high-priority categories of development expenditure, for example, the local cost of investment projects,

including those financed by the Bank. However, the Bank does not require the right of prior approval for counterpart expenditures.

The use of the resources of the International Monetary Fund does not result directly in the creation of counterpart funds by the recipient government. The use of Fund resources is generally considered a means of providing balance of payments support and not budgetary support. 1/ In the monetary survey the use of Fund resources is classified in the net foreign liabilities of the central bank. 2/

This brief review of historical developments has shown that the concept of counterpart funds is not a new phenomenon, and that the crisis of the 1930s led to a shift in aid policies, whereby the donor countries began to pay more attention to the terms of their aid while becoming more stringent in the use of the counterpart funds. This tightening has often slowed the effective use of the counterpart funds and has resulted in their accumulation in a number of developing countries. While donors recognize to a certain extent that money is fungible, they regard the designation of a special account for the counterpart funds as a way of controlling the use of counterpart funds 3/ and as an occasion for discussing the budgetary or sectoral policies of the recipient government. However, this objective may overlook the fact that directing counterpart funds toward narrowly defined expenditures can be circumvented if offsetting adjustments are made elsewhere in the government budget. It also tends to forget the lesson of the Marshall Plan that the counterpart funds have macroeconomic effects. The creation of a counterpart fund account generally implies a shift of local currency from the nongovernmental sector to the government, and it brings additional revenue and financing to the recipient government.

3. The balance of payments

The source of the counterpart funds is foreign aid. The recording of this foreign aid in the balance of payments will depend on its nature. 4/ If foreign aid takes the form of a grant in kind or in foreign exchange, it will be entered as an official unrequited transfer (grants) in kind or in foreign exchange. If the official grant is in kind, the transaction will be recorded under imports of goods (or services) with a counterentry under "official grants." The external current account, including official grants, will remain the same after

1/ With the exception of countries belonging to the West African Monetary Union where Fund resources can be used as a means to provide budgetary support.

2/ See IMF, op. cit., pp. 299-305.

3/ In some cases, the use of counterpart funds is earmarked to the financing of imports from the donor country "certificate of origin,"

4/ For the accounting treatment of foreign aid in the balance of payments, see International Monetary Fund, Balance of Payments Manual (Washington: International Monetary Fund, 1977).

the grant in kind has been entered. Hence, the direct impact on the overall balance of payments will be nil, and thus no change in net international reserves will be recorded. ^{1/} If the grant is in foreign exchange, it will be entered as an official grant with no counterentry in imports of goods or services. The external current account, including official transfers, will improve by the amount of the grant. Hence, ceteris paribus, the overall balance of payments will also improve by the same amount, i.e., net international reserves increase.

If foreign aid takes the form of a loan, its drawings will be recorded at the level of the capital account as inflows. Subsequently, when the loan is serviced, the interest payments will be entered in the services account and its amortization recorded in the capital balance as outflows of capital. The drawings of the loan, ceteris paribus, will improve the capital account commensurately. The overall balance of payments will also be improved by the same amount as net international reserves increase.

It is worth noting that the increase in net international reserves will take place only under a fixed exchange rate system. Under a floating exchange rate system, foreign aid in the form of foreign exchange, ceteris paribus, will result in an appreciation of the exchange rate of the currency of the recipient country. This last point has sometimes been overlooked by donors.

4. Counterpart funds and monetary policy

To analyze the role of counterpart funds in monetary policy, we need to trace the impacts of their creation or accumulation and their use (Table 1).

a. Creation or accumulation of counterpart funds

First, we will analyze the impact of the creation or accumulation of counterpart funds from foreign grants in kind. As we have seen in the preceding section, net international reserves are not affected directly by this type of aid. When the goods are sold to the nongovernmental sector, the effect is a decrease in money in the hands of the public and an increase in government deposits. The different steps of the transaction are as follows: (1) Importers pay the government for the aid in kind by drawing on their accounts with the commercial banks. Government deposits in the commercial banks increase by the same amount. Total deposits in the commercial banks remain the same. The only change is an increase of government deposits and a decrease of nongovernment deposits. If the government deposits the counterpart funds

^{1/} The paper does not analyze the case where aid in kind substitutes for imports of the private sector that would otherwise have taken place. Depending on the changes in the behavior of the public and the private sectors, the substitution effect can range from zero to one.

Table 1. Creation or Accumulation and Use of Counterpart Funds—
Their Impacts on Net Credit to Government and Money Supply

Sources of creation of counterpart funds										
Foreign aid in commodity grants					Foreign aid in grants or loans in foreign exchange					
Bought by the private sector using				Bought by the private sector to finance imports using				Bought by the Central Bank		
Cash balances		Deposits in commercial banks		Cash balances		Deposits in commercial banks				
commercial banks	central bank	commercial banks	central bank	commercial banks	central bank	commercial banks	central bank	commercial banks	central bank	
Direct effects on:										
Net foreign reserves	0	0	0	0	0	0	0	0	+	+
Money supply	- 1/	-	-	-	-	-	-	-	0 1/	0
Net credit to the government	-	-	-	-	-	-	-	-	-	-
Use of counterpart funds 2/										
Money supply										
a. Repay debt to central bank	0 1/	0	0 1/	0	0 1/	0	0 1/	0	0 1/	0
b. Repay debt to public	+	+	+	+	+	+	+	+	+	+
c. Finance budgetary expenditure	+	+	+	+	+	+	+	+	+	+
Net credit to the government										
a. Repay debt to central bank	0	0	0	0	0	0	0	0	0	0
b. Repay debt to public	+	+	+	+	+	+	+	+	+	+
c. Finance budgetary expenditure	+	+	+	+	+	+	+	+	+	+
Simultaneous creation and use of counterpart funds 2/										
Money supply										
a. Repay debt to central bank	- 1/	-	- 1/	-	- 1/	-	- 1/	-	0 1/	0
b. Repay debt to public	0	0	0	0	0	0	0	0	+	+
c. Finance budgetary expenditure	0	0	0	0	0	0	0	0	+	+
Net credit to the government										
a. Repay debt to central bank	-	-	-	-	-	-	-	-	-	-
b. Repay debt to public	0	0	0	0	0	0	0	0	0	0
c. Finance budgetary expenditure	0	0	0	0	0	0	0	0	0	0

Note: - effect is a decrease, + effect is an increase, and 0 effect is neutral.

1/ The commercial banks' potential to expand credit is higher.

2/ Use of counterpart funds owned by recipient governments.

at the central bank, total deposits of the commercial banks decrease while government deposits at the central bank increase commensurately. (2) In the second step, the importers sell the goods to the public, and the public either uses its deposits at the commercial banks or its idle cash balances held outside banks to pay for the goods. The importers in both cases deposit the proceeds of their sales in the commercial banks. If the public uses its idle cash balances, the potential of the commercial banks to expand credit is higher than if the public uses its deposits. In addition, if the government deposits its counterpart funds in the commercial banks, they then have a greater potential to expand credit. In all cases, however, the effect is a reduction of money held by the nongovernmental sector. At the same time, net credit to the government decreases, as the buildup of counterpart funds represents an increase of government deposits. Thus, *ceteris paribus*, the impacts of the creation and accumulation of counterpart funds for aid in kind are clearly deflationary.

When the foreign aid takes the form of a grant or a loan in foreign exchange, the effects are different. As we have seen above, the first effect of this transaction is an increase in net international reserves. When the recipient government receives the foreign exchange from the donors it sells it to the central bank. The central bank buys the foreign exchange through the issuance of high power money. The government can deposit the proceeds of the sale in the central bank or in the commercial banks. If it deposits the counterpart funds in the central bank, the effect on money supply is neutral; if it deposits them in the commercial banks, the effect on money supply is still neutral; however, this enhances the banks' potential to extend credit. In both cases, net foreign assets increase and net credit to the government is reduced.

When the foreign aid takes the form of a grant or a loan in foreign exchange, and if the creation of counterpart funds is linked to the purchase of the foreign exchange by the nongovernmental sector to finance imports, the impact on money is different. No change in net international reserves will occur. When the private sector buys the foreign exchange from the central bank, counterpart funds are created, resulting in a decrease of money in the hands of the public, either through a decrease of idle cash balances or through a decrease of private deposits in the commercial banks. If the government deposits the counterpart funds in the commercial banks, the deflationary impact just described remains. However, compared with the case where the government deposits its counterpart funds in the central bank, the potential of the commercial banks to extend credit is enhanced. This potential is even greater if the private sector has used its idle cash balances to purchase the foreign exchange.

The creation and accumulation of counterpart funds are in most cases deflationary as there is a shift of money from the private sector to the governmental sector in parallel with a decrease in net credit to the government (Table 1). This deflationary impact is accentuated even

more when the counterpart funds are deposited at the central bank. This effect is reinforced by the decrease in the potential of the commercial banks to extend credit when the private sector draws down its deposits in the commercial banks to buy the commodities or the foreign exchange provided by the donors. Thus, the accumulation of counterpart funds may reinforce other macroeconomic policies aiming at reducing inflationary pressures and narrowing the balance of payments deficit.

b. Use of counterpart funds

The time factor is very important when analyzing the effects of the creation, the accumulation, and the use of counterpart funds. Indeed, the timing relates directly to transactions effected within a fiscal year or calendar year for the balance of payments, versus transactions effected over a longer period. In this subsection, we assume that there is no simultaneity between the creation and use of the counterpart funds. "Use" of these funds will take place after the goods obtained through the foreign aid have been consumed by the private sector, or after the foreign exchange has been used to finance private imports, or after the foreign exchange untied to private imports has been sold directly to the central bank by the recipient government.

The recipient government may use its counterpart funds to repay a debt to the central bank, to repay its debt to the public, or to finance expenditure that it may have otherwise not undertaken.^{1/} Depending on the sources of the counterpart funds the effects on money supply will be different. To isolate these effects we will assume that the timing of the creation of counterpart funds differs from their use by the recipient government.

In the first example, the recipient government uses its untied counterpart funds to repay a debt to the central bank. The repayment results in a decrease in the central bank's claims against the government and a decrease in government deposits. Net credit to the government thus remains unchanged. The effect on the money supply is neutral. The recipient government can also use its deposits in the commercial banks to repay a debt to the central bank. In this case, net credit to the government from the commercial banks increases, while the reserves held by these banks at the central bank decrease. Simultaneously, net credit to the government from the central bank decreases. Thus, total net credit to the government from the banking system does not change, as the decrease in net credit from the commercial banks is matched by an increase in net credit from the central bank. The potential

^{1/} For a detailed analysis of macroeconomic impacts of domestic debt management, see Clément, Jean A. P., "Politique de gestion de la dette publique, les pays membres de la CEE," Institut Universitaire de Hautes Etudes Internationales, 1981; and Clément, Jean A. P., "Views on Domestic Public Debt Management" (DM/84/20, International Monetary Fund, March 9, 1984).

of the commercial banks to extend credit is reduced, as their reserves at the central bank have decreased by the amount of the debt repaid to the central bank by the government. As the repayment by the government of its debt to the central bank has a neutral effect on the money supply, it is consistent with macroeconomic policies aiming at reducing a balance of payments deficit or inflationary pressures.

A second example is the recipient government's use of its counterpart funds to repay maturing indebtedness to the public, a use that is possible only with untied counterpart funds. If the source of the counterpart funds is the proceeds of the sale of commodities, and if the counterpart funds are deposited at the central bank, their use leads to the restoration of the cash balances of the public or to an increase of private deposits in the commercial banks. Thus, net credit to the government increases as does money supply. This conclusion still holds when the source of the counterpart funds is the proceeds of the sale of foreign exchange to private importers. If the foreign exchange is not sold to private importers but to the central bank, and the government uses its counterpart funds at the central bank to repay its debt to the public, then this transaction is clearly inflationary. Indeed, net credit to the government increases, as does money supply as well as money in the hands of the public. The latter can take the form of an increase in cash balances or in private deposits in the commercial banks. The latter is potentially more inflationary as it enhances the commercial banks' potential to extend credit. If the balance of payments of the recipient country is in deficit and it faces inflationary pressures, the use of the counterpart funds to repay maturing indebtedness to the private sector might aggravate these disequilibria.

In the third example, the recipient government may use the counterpart funds to finance expenditure that it might not otherwise have undertaken. The effects of the operation are the same as in the second example. Money supply increases, as does net credit to the government. However, the use of the counterpart funds to finance additional government expenditure will differ from the use of these funds to repay debt in two respects: first, the public holdings of government securities will not be reduced; second, aggregate expenditure of both the government and the private sector may be increased. Thus, the use of counterpart funds to finance additional government expenditure might be inconsistent with macroeconomic policies aimed at narrowing the overall balance of payments deficit and reducing inflationary pressures.

The uses of accumulated counterpart funds by the government are clearly inflationary, except in the case where the government repays its debt to the central bank. The effects described in this paper are the direct effects; to refine the analysis one would have to take into account the propensities to consume, to import, to save, etc. The message here is that once counterpart funds are accumulated their spending adds to inflationary pressures. If the counterpart funds are integrated in a well-designed macroeconomic financial program, then their use can alleviate some bottlenecks on the supply side. The

simultaneous effect of the creation and the use of counterpart funds is neutral on the money supply, except when they are used to repay the domestic debt owed to the central bank (Table 1).

5. Counterpart funds and budgetary policy

To trace the impact of the creation, accumulation and uses of the counterpart funds we define the overall budgetary deficit as:

$$\text{Overall Deficit} = \text{Revenue (R)} - \text{Expenditure (E)} \quad (1)$$

If net foreign financing and nonbank financing is nil, then we have,

$$R - E = - \Delta \text{NCG}, \quad (2)$$

where ΔNCG is changes in net bank credit to the government (flow); when $E > R$, ΔNCG increases (-); when $E < R$, ΔNCG decreases (+); and when $R = E$, $\Delta \text{NCG} = 0$.

The impact of counterpart funds on budgetary policy will depend crucially on the timing of their creation, accumulation, and use (Table 2). 1/ To analyze this impact we assume as in the previous section that there is no simultaneity.

a. Creation or accumulation of counterpart funds

We assume that the budget is in equilibrium, and that the sources of counterpart funds are first grants either in commodities or in foreign exchange and then loans in foreign exchange.

When the sources of the counterpart funds are grants, equation (2) is transformed as follows,

$$R + g - E = \text{Surplus} = - \Delta \text{NCG}, \quad (3)$$

where g stands for grants. Hence, as grants are recorded above the line, the overall budget is in surplus and net credit to the government decreases.

When the sources of the counterpart funds are loans, equation (2) is transformed as follows,

$$R - E = 0 = \Delta \text{NCG} - \Delta \text{NFF}, \quad (4)$$

where ΔNFF stands for changes in net foreign financing (flow). As ΔNFF is recorded as a financing item in the budget, its increase does not affect the overall budget balance. However, the drawings on a foreign loan increase NFF, and as a financing item they are recorded with a minus sign (-). The effects of the drawings are a decrease in

1/ For the accounting treatment of counterpart funds in the Government Finance Statistics see, International Monetary Fund, A Manual on Government Finance Statistics (Washington: International Monetary Fund, 1986), p. 103.

Table 2. Creation or Accumulation and Use of Counterpart Funds--
Their Impacts on the Budget

Sources of creation or accumulation of counterpart funds								
	Grants	Loans						
Direct effects on:								
Overall budget balance	surplus	0						
Total net financing	-	0						
Domestic	-	-						
Net credit to the government	-	-						
Domestic debt <u>1/</u>	0	0						
Foreign	0	+						
Use of counterpart funds to								
	<u>Finance expenditure</u>	<u>Repay debt to central bank</u>	<u>Repay debt to public</u> <u>1/</u>	<u>Repay foreign debt</u>				
Overall budget balance	deficit	0	0	0				
Total net financing	+	0	0	0				
Domestic	+	0	0	+				
Net credit to the government	+	0	+	+				
Domestic debt	0	0	-	0				
Foreign	0	0	0	-				
Simultaneous creation and use of counterpart funds								
	<u>For which the sources are grants</u>				<u>For which the sources are loans</u>			
	<u>Finance expenditure</u>	<u>Repay debt to central bank</u>	<u>Repay debt to public</u>	<u>Repay foreign debt</u>	<u>Finance expenditure</u>	<u>Repay debt to central bank</u>	<u>Repay debt to public</u>	<u>Repay foreign debt</u>
Overall budget balance	0	surplus	surplus	surplus	deficit	0	0	0
Total net financing	0	-	-	-	+	0	0	0
Domestic debt	0	-	-	0	+	-	-	0
Net credit to the government	0	-	0	0	0	-	0	0
Domestic debt	0	0	-	0	0	0	-	0
Foreign	0	0	0	-	+	+	+	0

Note: 0 effect is neutral, + effect is an increase, - effect is a decrease.

1/ Held by nonfinancial and nongovernmental sector.

net domestic financing through a decrease in net credit to the government. Thus, the increase in net foreign financing is balanced by a decrease in domestic credit; the effect on total financing is thus neutral.

b. Use of counterpart funds

To analyze the impact of the use of counterpart funds we start with a budget in equilibrium and analyze successively four possible uses of these funds by the recipient government.

First, when the recipient government uses its counterpart funds, for which the sources were grants or loans, to finance expenditure equation (2) is transformed as follows,

$$R - E - E_{cf} = \text{Deficit} = - \Delta NCG, \quad (5)$$

where E_{cf} stands for expenditure financed through the use of counterpart funds. Thus, total expenditure increases, resulting in a deficit, which is financed by an increase in net domestic financing, or in other words, through an increase in net credit to the government.

Second, when the recipient government uses its counterpart funds, for which the sources were grants or loans, to repay its debt to the central bank, equation (2) is transformed as follows,

$$R - E = 0. \quad (6)$$

Indeed, the repayment of debt to the central bank, as we have already seen in the previous section, has a neutral effect on net credit to the government, and as this operation is recorded below the line, the overall balance of the budget is preserved. ^{1/}

Third, when the recipient government uses its counterpart funds, for which the sources are grants or loans, to repay its debt to the public, equation (2) is transformed as follows,

$$R - E = 0 = - \Delta NCG + D_p, \quad (7)$$

where D_p stands for the amortization of domestic government debt due to the public, i.e., nonfinancial and nongovernmental sector. Again, as this transaction is recorded below the line as a financing transaction, the overall budget balance is not affected. However, net credit to the government increases commensurately with the increase in domestic debt amortizations. Thus, net domestic financing is not changed.

Fourth, when the recipient government repays its foreign debt using its counterpart funds, for which the sources were grants or loans, equation (2) is transformed as follows,

^{1/} For a detailed description of domestic public debt management in the budget, see Clément, Jean A. P., op. cit. (1984).

$$R - E = 0 = - \Delta NCC + ED, \quad (8)$$

where ED stands for amortizations of external debt. This transaction is also recorded below the line as a financing transaction; thus the overall budget balance is not affected. However, net credit to the government increases along with commensurate increases in amortization of external debt. Thus, net domestic financing increases while net foreign financing decreases. Hence, total financing is not changed.

The effects of the simultaneous creation and use of counterpart funds are detailed in Table 2. The effects are neutral on the overall budget balance when the sources of the counterpart funds are grants and when they finance additional budgetary expenditures, or when the sources are loans and the counterpart funds are used to repay domestic debt owed to the central bank or to the public, or to repay foreign debt. The overall budget shows a surplus when the sources of the counterpart funds are grants, and when they are used to repay domestic or foreign debt. Finally, the overall budget is in deficit when the sources of the counterpart funds are loans and when they are used to finance expenditure. The effects on domestic and foreign financing of the budget differ in each case as shown in Table 2. These results have an important bearing on the conduct of both monetary and credit policy.

6. Conclusion

The main conclusion of this paper is that the creation, accumulation, and use of counterpart funds have important macroeconomic impacts and should be fully integrated in the design of macroeconomic policies to ensure consistency between objectives and instruments. The paper has shown that the time factor is very important, as the creation or accumulation and the use of counterpart funds can have opposite effects on money supply and on the overall budget deficit. In analyzing these effects, it is crucial at the outset to define: (a) the sources of counterpart funds, i.e., foreign aid can take the form of grants in kind, grants in foreign exchange, or loans, (b) the ownership of the counterpart funds, i.e., the donor or the recipient government, (c) the sources of financing of the purchase by the public of foreign aid, i.e., cash balances or deposits in commercial banks, (d) the location of counterpart funds, i.e., the recipient government can deposit the funds in the commercial banks or in the central bank, and (e) the different possible uses by the recipient government of counterpart funds, i.e., the government can increase expenditure, or repay its domestic debt to the central bank or to the public, and repay its foreign debt. The analysis shows that in most cases the creation or accumulation of counterpart funds is consistent with other macroeconomic policy objectives aiming at reducing money supply, while the use of these funds has the opposite effect. If the creation and use of counterpart funds are simultaneous, then the effect on money supply depends on the type of use that the government makes of them. The effect on the overall budget balance depends crucially on the sources of counterpart funds, as grants

are registered above the line, whereas loans are considered as a financing item. The effect on domestic financing and that on foreign financing differ in each case.

The review of historical developments of the counterpart funds has shown that their macroeconomic effects were fully recognized by the proponents of the Marshall Plan. However, since then, donors have tightened the conditions of their aid to developing countries through the designation of a special account for counterpart funds as a way of controlling their use and as an occasion for discussing the budgetary or sectoral policies of the recipient government. However, the donors often overlook the fact that money is fungible, and that directing counterpart funds toward narrowly defined expenditures can be circumvented if offsetting adjustments are made elsewhere in the budget. They also tend to forget the lesson of the Marshall Plan that counterpart funds do indeed have macroeconomic effects. The more stringent the conditions for the use of counterpart funds imposed by the donors on the recipient government, the more likely it is that counterpart funds will accumulate over time, which thus increases the possibility of inflationary policies at a later stage. This paper shows the importance of aid coordination as well as its integration into the budgetary process. Stringent conditions often lead to the creation of a number of special accounts outside the budget; the proliferation of these accounts renders the monitoring of counterpart funds difficult, and thus increases the likelihood of conflicts between their creation, accumulation, and use with other macroeconomic policies. Hence, one wonders if in a macroeconomic sense "tied" counterpart funds as opposed to "untied" counterpart funds are appropriate, particularly in cases where the recipient countries are implementing an adjustment program with the support of the Fund and the World Bank. Generally, these programs include a sound public investment program and a close monitoring of government expenditure. Thus, the donors should be reassured that with counterparts funds fully integrated in the design of macroeconomic policies these funds, like any other budgetary resources, will finance sound appropriate government expenditure.

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