Criteria for general budget support and general sector support

Report commissioned by the Norwegian Ministry of Foreign Affairs

Hildegunn Kyvik Nordås

R 1998: 6

Chr. Michelsen Institute *Development Studies and Human Rights*

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Summary

This report assesses a set of criteria for providing development aid in the form of general budget support and sector support. The criteria are suggested by the Norwegian Ministry of Foreign Affairs and relate to good governance, structural reforms, the budget process, accounting, auditing and reporting. The criteria are assessed on the background of a discussion of how general budget and sector support work from a macroeconomic view. In addition an analysis of the workings of such support in combination with the most common conditions on which it is given is provided. It is recommended that budget or sector support should be given when the recipient government has adequate administrative capacity. Macroeconomic policy measures should be left to the recipient government in cooperation with the IMF in order to ensure internal consistency. Budget and sector support should be given under the condition of accountability and transparency. If these conditions are not fulfilled, debt relief may be considered as an alternative to sector or budget support.

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Overview and recommendations

This report assesses a set of criteria for providing development aid in the form of general budget support and sector support. The criteria are suggested by the Norwegian Ministry of Foreign Affairs (MFA) and relate to good governance, structural reforms, the budget process, accounting, auditing and reporting. The report is commissioned by MFA, but the responsibility for the views and recommendations herein rests with the author.

We start by raising some general issues related to transfers to least developed countries. We first argue that under any circumstances, new projects should not be approved unless existing structures are in good working condition. Second, we argue that borrowing should not take place unless the return on the loan-funded project is at least as high as the cost of the loan. Third, we argue that donors must ascertain that total transfers to the recipient country and corresponding programs are compatible with an effective and sustainable public sector. Finally, we argue that sector and budget support should be given when the recipient government has adequate institutional capacity.

Next, we provide an analysis of the macroeconomic impact of budget support. The interdependency of macroeconomic policy measures is emphasized. Therefore, we argue that macroeconomic policy making should be left to at the most one decision-making body for each policy measure. We go on to show how the different policy measures work under different policy regimes, and how transfers affect the stabilization efforts made by the recipient government. Two important conclusions are made: First, transfers have an expansionary effect on the economy, and often lead to a widening of the trade deficit. Second, transfers under the most common conditionalities imposed by ESAF programs are in principle equivalent to debt relief. Therefore, debt relief could be considered as an alternative to sector programs and budget support when the institutional capacity of the recipient government is weak.

The following recommendations regarding the suggested criteria for sector and budget support are made:

The good governance criteria: The criteria should apply to all recipients of Norwegian development aid, independently of the form the aid is given in.

The structural reforms criteria: It is sufficient to require that the recipient government has entered an agreement with the IMF on structural reforms.

The budget process: The criteria imposed should be related to accountability and transparency, not to any particular budgetary system.

Accounting and auditing: The conditions related to accounting and auditing should be emphasized and receive the highest priority. Reliable accounting and auditing should be made unconditional requirements for the public sector as a whole.

1 The mandate

The mandate for this report is to look at a set of suggested criteria for providing development aid in the form of general budget support or general sector support and assess the suitability of the criteria. The criteria are as follows:

Good governance:

- The country should observe international agreements on human rights;
- The country should be a democracy, or at least in a process of democratization;
- The country should be fighting corruption.

Structural reforms:

- The country must have entered an agreement with the IMF on structural reforms;
- There must exist a policy framework paper (PFP) which summarizes the country's policies on social and economic reforms and lays out the structural reforms which the donors have agreed to fund.
- The government must be committed to the above mentioned agreements.

The budget process:

- The recipient country must have a coordinated budget process established within responsible departments. The budget process should entail the entire public sector. The budget process must facilitate the operationalization of priorities.
- A process aiming at incorporating all donor funding in the budget must have been initiated.
- The budget process must be linked to a multiyear budget. This should contain a framework for long-term planning and the extrapolation of future current expenditure resulting from investment projects. At least such a framework must be under preparation.
- There must be a system in place which ensures that budgeted funds are disbursed to spending agencies.
- There must be a system in place which ensures that each spending agency adheres to the budget ceilings and that embezzlements are prevented.

Accounting and auditing:

- The recipient country must have an accounting system which corresponds to the budget system. Accounts must be prepared shortly after the fiscal year has ended.
- The sectors which receive Norwegian sector support must establish systems for reporting results and transactions in such a way that it is possible to undertake sound and complete accounting and auditing. Such systems must at least be under planning for the entire public sector
- The public sector accounts must incorporate all public sector activities and give an accurate picture of the public sector's expenditures and revenues. They must be sufficiently detailed to show the resources available to the sector program in question and the disbursements on each item.
- Discrepancies between the budget and the accounts should not reflect a systematic lack of budget discipline.
- The government accounts must show at a reasonable level of detail the funds going to sectors not involved in sector programs.

- Auditing must be performed by an institution independent of the spending agencies, including the ministry of finance. The audited accounts must be prepared according to international standards and must be completed within a reasonable period of time.
- Where the public sector undertakes off-budget activities, a consolidated budget and accounting must be prepared.

Sector reports:
- The responsible departments must prepare or plan to prepare performance indicators for the sector engaged in sector investment programs.
- The responsible departments must prepare or plan to prepare a system for reporting obtained results and achievements to donors. This system must as far as possible correspond with the needs of the recipient country.

During the assessment, we are asked to look at:

- The level of detail;
- the realism given the information available;
- whether the criteria introduce additional procedures on the part of the recipient;
- whether the recipient is capable of adjusting to the criteria within a period of 2-3 years; and
- whether the conditions can prevent mismanagement of donor funds.

1.1 Interpretation of the mandate

The criteria for giving general budget support are very much dependent on the objectives of such support. Since one of the suggested criteria is that the recipient has entered an agreement with the IMF on a reform program, we assume that the countries under consideration for budget support are among the 35 countries currently under an Enhanced Structural Adjustment Facility (ESAF) with the IMF. The majority of these countries are least developed countries in sub-Saharan Africa (Fisher 1997, Abed et. al. 1998), and a common feature is a relatively weak administrative and analytical capability. This assumption has important bearings on our recommendations.

Structural adjustment programs usually involve adjusting government expenditure to sustainable levels given the revenue potential. In addition, improving resource allocation and efficiency within the public sector are important objectives of the ESAF programs. Combined with a sound monetary policy these measures are expected to stabilize the economy. In particular, they are expected to bring down inflation. Finally, liberalization of internal and external trade are usually part of the program in order to induce a more efficient resource allocation in the economy as a whole. The structural adjustment programs in all these respects build on generally accepted principles for macroeconomic management.

The pre-ESAF situation was characterized by highly distorted economies with substantial imbalances. In fact, the average government deficit amounted to 13.8 percent of GDP for the ESAF countries before the program was initiated (Abed et. al.

1998). In addition the current account deficit was on (unweighted) average about 5.5 percent of GDP in the countries which entered structural adjustment agreements with the IMF during the period 1986-1988.[1] The average masks a large variation from a current account surplus of 3.3 percent of GDP in the Gambia to deficits of close to 17 percent of GDP in Mali and Malawi. In comparison, the current account deficit in Thailand in 1996 was about 8.5 percent of GDP. A deficit of this magnitude had been sustained for several years in Thailand. It was to a large extent financed through short-term capital flows. This put the Thai economy in a vulnerable position. Combined with a loss of confidence in the economy this is widely believed to have triggered the financial and currency crisis in 1997.

Both at the time the structural adjustment packages were introduced and now with the additional experience from the Asian financial crisis, it was clear that "business as usual" is not an option in the face of huge and accumulating macroeconomic imbalances. In this situation the necessary adjustment process produces winners and losers and may be painful for the latter. Structural adjustment programs are therefore usually combined with extended credit from the IMF and grants and loans from bilateral aid agencies. In this report we assume that one important objective with general budget support and sector support is to bolster structural adjustment while shielding crucial social expenditure. In addition the donors emphasize the objective of promoting recipient ownership of the programs related to sector support. The recipient is hence expected to initiate and run the projects and programs according to their own development priorities and strategies.

2 General considerations

2.1 Forms of development aid

The most common form of development aid is loans and grants to particular investment projects. In the early days of development assistance, project grants and loans totally dominated. However, a growing dissatisfaction with such aid emerged as the projects did not lead to the expected economic growth (World Bank 1995). The problem was that even where individual projects were considered reasonably successful, the macroeconomic impact appeared to be insignificant. This micro-macro paradox has been widely discussed in the literature.[2] As a consequence of the meager results on the macroeconomic level, a gradual shift in focus and emphasis towards the macro level arose. Development aid in the form of import support and general budget support were introduced as a response to the shift in focus and rapidly increased their share of total transfers.

General budget support and import support are equivalent if foreign exchange is not rationed and trade is free. In that case importers buy the foreign exchange provided by donors at the going exchange rate. The proceeds from sales of foreign exchange accrue to the government in the same way as budget support. In principle the same

[1] Author's calculations based on IMF (1998).
[2] See for example White (1992) for a survey focusing on the macroeconomic impact of aid.

reasoning applies if foreign exchange is rationed due to an overvalued exchange rate. In this case, however, donors and recipient governments can influence the allocation of scarce foreign exchange. If rationing is effective, it constitutes an additional policy measure for allocating resources to priority areas also in the private sector. However, rationing also creates distortions and rent-seeking behavior. In order to minimize these negative effects, both budget support and import support come with a host of conditionalities which aim at ensuring a more efficient resource allocation, at least within the public sector.

General budget support or import support did not entirely measure up to expectations. For example, it turned out to be difficult to collect the full amount of counterpart funds in several countries. That being the case, importers did not pay the full price of imports. As a consequence, local producers were put at a great disadvantage compared to imports. Sector investment programs (SIPs) were then designed in order to improve performance. The SIPs aim at ensuring that the sectors thought to be most critical for economic development receive adequate resources. At the same time recipient ownership and initiative are encouraged. Finally, an important argument in favor of SIPs is that they are supposed to reduce bureaucracy and administrative burden.

SIPs do not resolve all the incentive problems, however. Therefore they too come with an array of conditionalities. A number of performance indicators have been developed in order to monitor performance related to the conditions. Initially, conditions came mainly from the multilateral donors, as part and parcel of the ESAF programs. But bilateral donors have followed suit during the 1990s, imposing their own conditions. Recipient governments hence face an increasing number of policy conditions related to budget and sector support (Killick 1993). The reduced administrative burden of not having to confront a host of donors with different procedures at a project level may then be partly offset by new procedures. This is particularly the case when donors impose conditions in an uncoordinated way and the conditions as a result are internally inconsistent. Donor coordination, preferably by the recipient country, is therefore of utmost importance if SIPs are to improve the efficiency of development aid.

This very brief description of the changing forms of development aid illustrates, in our view, that there are certain problems and paradoxes related to development aid which occur irrespective of the form in which aid is provided. We suspect that they will not go away as a result of a more detailed and scientific approach to development lending as reflected in the conditions and performance indicators mentioned above. Expectations as to what budget support can achieve where other forms of aid have failed should therefore be realistic. The most central of these problems are further elaborated below.

2.2 Loans or grants; investment or current expenditure?

It is a general principle of economic prudence both in households, the private business sector and the public sector that borrowing should only be for investment purposes. This has also been a guiding principle for development aid. Thus, a condition for structural adjustment lending has been that local resources finance current

expenditure. By the same token, ESAF agreements usually involve shifting resources from the recurrent to the development budget in order to ensure that donor funds are used for investment.

Distinguishing between current and investment expenditure was easy when investment was defined as the accumulation of physical capital. As human capital has gained prominence in development and growth theory, the definition of investment expenditure has become less clear-cut. Recent developments in growth theory find that human capital accumulation is the engine of growth and that investment in physical capital plays a secondary role, or follows as a response to human capital accumulation (Lucas 1993). Expenditure assumed to contribute to the accumulation of human capital can be considered as investment according to this theory. Expenditure on education and health probably at least partly qualify as investment in human capital, and could be financed by borrowing.

Whichever way investment is defined, borrowing should not take place unless the expected economic rate of return on the investment is at least as high as the cost of obtaining the resources. The return depends on the absorption capacity of the recipient country and is not likely to be influenced by how development is funded.

In practice, development lending has led to a tendency to favor new projects at the expense of the operation and maintenance of existing infrastructure, particularly in the least developed countries (Tanzi 1990). It appears therefore that the volume of investment has been higher than what could be sustained by local resources. Jenkins (1997) has studied World Bank lending in this perspective. He found that the Bank did not assess the implications of investment projects for future current expenditure properly. He also argues that both donors and the recipient government have neglected financial viability in project appraisals until very recently.

The ESAF programs aim at addressing the problem of financial viability by incorporating both the revenue and the expenditure side of the budget. In addition, conditions on all other relevant policy measures are included in order to ensure stabilization of the economy and sustainability of the reforms. However, the assumptions on the resources which can be raised from local sources may be on the optimistic side in these programs. In an assessment of experience with ESAF programs, the IMF finds that revenue mobilization has fallen behind targets, particularly in the countries with the lowest local revenue/GDP ratio (Abed et. al. 1998). These findings underline the importance of incorporating careful financial viability analysis in the SIPs.

Even in the absence of rigorous analysis of financial viability, a simple general rule applies: *new investment projects should be approved only if existing investments are in good working condition.*[3] When this criterion is fulfilled, support may be given in the form of loans. If not, aid should preferably be given as grants aiming at operating and maintaining existing structures. In the latter case it is of particular importance to

[3] Provided that the investments were not "white elephants" in the first place. See Tanzi (1990) for further discussion.

have a realistic time schedule for the transfer of financial responsibility to the recipient country.

2.3 Fungibility

The fungibility problem of development assistance has been discussed at length in the literature. Usually it is seen as a problem that development assistance is used for projects which would or could have been implemented even in the absence of development assistance. Local revenue, which would otherwise have been spent on the donor-funded project is then spent on other projects or programs, or not collected at all. A recent study of the fungibility of aid (Feyzioglu et. al. 1998) finds that only a third of foreign grants and about two thirds of concessionary loans are used for government spending in a sample of 38 countries. The rest is used for tax relief. This is an efficiency problem only if local resources are better spent by government than by those who benefit from the tax relief. In a smaller sample of 14 countries no evidence of fungibility was found.

Turning to the distribution of aid on recurrent and investment expenditure, it appears that between two thirds and three quarters are actually spent on current expenditure. Again loans are less fungible in this respect than grants (Feyzioglu et. al. 1998). Recall, however from our previous discussion that expenditure on human capital accumulation may qualify as investment expenditure. The diversion of funds from investment to recurrent expenditure may therefore not necessarily be a problem.

Finally, fungibility is a problem if local resources are diverted to projects thought to be wasteful, for example sophisticated weapons systems. However, fungibility at the sector or project level is not a problem from an efficiency point of view when donors prefer to fund projects of top priority to the recipient, and as a result, the recipient can afford additional projects further down on the priority list. Particularly when the latter projects are economically and financially viable and contribute to development. In this case fungibility is an indication of efficient economic management.

When resources are fungible, transfers are not likely to affect total resource allocation much.[4] This is an argument for providing general budget support to developing countries which have fairly well managed public sectors, and development strategies acceptable to the donor(s).[5]

In the same way as a high degree of fungibility has positive aspects, a low degree of fungibility has negative aspects. Thus, when donors fund high priority projects that the recipient government can not afford, the recipient government almost per definition operates at an activity level which it, at least at the outset, could not sustain in the absence of donor funds. A key question then is when, or even if one can realistically expect the recipient government to take over the funding of the program in question. An indicative answer to this can be obtained by noting that investment projects and programs always have implications for future current expenditure. If

[4] It may, however, affect the exchange rate. If so, it will also affect resource allocation, but that will happen through price signals in the market.

[5] If development aid is needed at all in such countries.

current expenditure increases faster than GDP, then government expenditure increases as a share of GDP. Donor-funded, non-fungible projects/programs may then contribute to the expansion of the public sector beyond what is desirable or intended, irrespective of whether aid is given as project lending/grants, import support or sector support.

There is an unambiguous negative correlation between economic growth and government consumption relative to GDP (see for example Barro and Sala-i-Martin 1995). The poorest and most aid-dependent region in the word, sub-Saharan Africa, has generally a much higher ratio of public expenditure to GDP than developing countries elsewhere, and much higher than today's developed countries when they had a similar level of GDP per capita.[6] The region has also experienced slower growth. Assuming that the negative correlation between public expenditure as a share of GDP and growth involves some degree of causality, donors need to consider how much additional activity they should fund. This has to be evaluated against a presumption on what is the optimal size of the public sector.[7] SIDA (1995) realizes this and does not require that its funding is additional, while the Netherlands (1996) considers it to be important that aid is additional or non-fungible.

On the background of this discussion we would argue that the fungibility problem does not warrant too much concern from the donors' point of view. The crucial point is the absorption capacity of the recipient country – in particular its capacity for efficient resource allocation.

2.4 Is general budget/sector support appropriate when the recipient has a weak or a strong institutional capacity?

The Netherlands considers budget or sector support as a suitable form of development assistance when the recipient country has a strong institutional capacity (The Netherlands' Ministry of Foreign Affairs 1996). ECON (1996) argues that sector support, as opposed to project lending, is most suitable when the institutional capacity is weak. The reasoning behind ECON's conclusion is that a large number of uncoordinated projects is a larger administrative burden than a coordinated sector program. The World Bank (1995) reasons along the same lines, but nevertheless emphasizes the importance of institutional capacity as a key to ownership and success of sector programs. The Bank's suggested solution is to build capacity as part and parcel of the sector investment program.

When sector investment programs are introduced in countries with weak institutional capacity, there is a danger that donor coordination means that the donors more or less

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[6] In 1994, government consumption relative to GDP was 13 percent in all developing countries, 10 percent in least developed countries, 17 percent in sub-Saharan Africa and 17 percent in industrial countries (UNDP 1997). The corresponding development assistance as share of GDP was 1.4 percent in all developing countries, 17.5 in least developed countries and 12.6 percent in sub-Saharan Africa (UNDP 1997). Total public expenditure was about 10 percent of GDP in Europe in 1880 (and government consumption was less than that), when it had a comparable income level with today's developing countries.

[7] The optimal size of public expenditure is reached when the marginal cost of raising the extra revenue equals the social benefits of the extra expenditure.

take over the policy formulation and even the running of the sector in question. Donors thus gain much more influence than their contribution to the sector warrants.

If both institutional capacity and donor coordination are weak, sector programs easily end up as an exercise in lumping together existing projects under new headings on the planning ministry's (or planning division in the ministry of finance) computerized project database, and little else.

From this discussion we conclude that if local ownership is a priority consideration, general budget or sector support should be given when the recipient has adequate institutional capacity. Although we accept the argument that a coordinated sector program is a lesser administrative burden than a large number of uncoordinated projects, we would argue that it is better to limit the number of projects than to introduce sector programs in countries with very weak institutional capacity. Donors should in this case scale the total number of projects and the total amount of transfers to the absorption capacity of the recipient. When financial and institutional capacity is weak, donor coordination should probably be concentrated in the area of financial viability analysis as discussed above. In addition, debt relief could be considered an alternative to sector support in the case of weak capacity (see sections 3.1.2 and 3.2).

2.5 Summary and conclusions

A paradox related to development aid demonstrated in this section, is that aid appears to be most effective and efficient when it seems to be the least needed. The stronger the institutional capacity, the greater the absorption capacity for external capital inflows. This applies whether inflows are official or private, and irrespective of the form the development aid is given in. Weak institutional capacity goes hand in hand with low absorption capacity and low returns to investment, and again whether aid is given in the form of project lending/grants or program lending/grants. Capacity building, including accumulation of human capital and institutional infrastructure, therefore seems to be a key to success. This is usually a lengthy process, and it is not clear exactly how external assistance may accelerate it. Nevertheless, some general principles have been highlighted in this discussion:

- New investment projects should be approved only if existing investments are in good working condition.
- Borrowing should not take place unless the expected rate of return on the investment is at least as high as the cost of obtaining the resources.
- The total share of government consumption in GDP should be an important consideration when project and program aid are planned.
- The better the recipient government's institutional capacity, the more it makes sense to give loans and grants in the form of general budget or sector support.

3 How does budget support work?

A transfer has the same effect on the overall macroeconomic balance regardless of the form it is given in. The channels through which the economy adjusts to the transfer

are, however, different depending on the exchange rate regime and the form the transfer is given in. Consequently, the conditionalities attached to a transfer should be different depending on the macroeconomic context. We therefore focus on some basic macroeconomic relations before we discuss the particular conditions suggested in the terms of reference for this report. Consider the macro-economic identity:

$$T-G+S-I \equiv X-M+NTR+NINT$$

Where T is government revenue, G is government expenditure, S is private savings, I is private investment, X is exports of goods and services, M is imports of goods and services, NTR is net transfers from abroad and NINT is net interest payments and remittances from abroad. The right-hand side of the identity represents the current account on the balance of payment, or the external balance, while the left-hand side represents the internal balance. The identity implies that a government budget deficit combined with a savings/investment deficit in the private sector necessarily come with a deficit on the current account of the balance of payment.

The identity can be interpreted as follows:

1. If we keep the domestic private investment - savings balance constant, there is a one to one relationship between the government budget deficit and the current account deficit. Thus, a million-dollar increase in the government budget deficit widens the current account deficit by one million. Or equivalently, a million-dollar increase in transfers in the form of budget support narrows both the internal and the external balance by one million if government expenditure is kept constant.
2. If we keep the current account deficit and private savings constant, there is a one to one relationship between private investment and the government deficit. Thus, if the government deficit increases by one million, it is financed by private savings and private investment declines with one million.

This is of course a mechanistic way of analyzing the macroeconomic impact of general budget support. It does not take the dynamics of the adjustment process into account. Nevertheless, the identity always holds and is a good starting point for the analysis. It is immediately clear that a government deficit crowds out either local investment or net exports, or a combination of both. If the budget deficit is large compared to GDP and sustained, private investment may be insufficient to generate or sustain an income level compatible with a minimum level of welfare. Furthermore, it may lead to a permanent balance of payment crisis. These are important insights. The relations represented by the identity imply that balance of payment problems may arise from fiscal problems and are not necessarily rooted in international trade conditions.

The ESAF countries typically face credit constraints in the international financial market. The prevailing current account deficit can no longer be financed through the international financial market. The ESAF programs are designed to reduce macroeconomic imbalances. They aim at narrowing the left-hand side gap of the identity above through an increase in T, an increase in S and a reduced level of G. Such measures narrow the external imbalance by the same amount through mechanisms explained below. However, since there are few measures that directly

influence private savings,[8] and since increased tax revenue is limited by both a narrow tax base and administrative capacity (Fjeldstad 1995), it may take time to narrow the gaps demonstrated by the identity through T and S. The burden of adjustment then often falls on G and I to a larger extent than desirable. The credit facilities from the IMF and bilateral grants and concessionary loans are usually given in order to avoid this outcome.

The following sections analyze the macroeconomic impact of budget support given to a country under an ESAF program under different assumptions on the exchange rate regime and the degree of international capital mobility. When donor funds are fungible, the analysis also applies to sector investment programs. We start with the common case of fixed exchange rates and relatively low capital mobility. Next, we demonstrate the case with flexible exchange rates and a relatively low degree of capital mobility. We provide a stepwise analysis of the adjustment process - first the automatic adjustments to a transfer and next the additional policy adjustments incorporated in the ESAF program - starting with a situation where the macroeconomic imbalances are unsustainable.

3.1 Fixed exchange rate, low capital mobility[9]

A transfer in the fixed exchange rate, low capital mobility regime has the following impact:[10]

- Disposable income increases and aggregate demand with it.
- The interest rate declines and private investment increases as a consequence.
- Import demand increases as a result of the increase in total demand. Exports are unaffected. Therefore the trade deficit increases.
- Money supply increases.

The magnitude of the changes depends on the degree of capital mobility. In the extreme case when capital is perfectly mobile, the transfer will have no effect on interest rates, investment, or income. This is because the transfer adds to money supply which in turn puts a downward pressure on interest rates. A lower interest rate than the rest of the world is not possible with perfect capital mobility and the transfer will simply flow out again seeking higher returns elsewhere. In countries with a high degree of "capital flight," therefore, a transfer is equivalent with debt relief.

When capital mobility is low, on the other hand, a larger portion of the transfer remains in the country. The effects listed above are stronger the less mobile is capital.

The transfer adds to foreign reserves which is part of the money supply. An increase in money supply is compatible with a fixed exchange rate and no additional

[8] A higher real interest rate usually helps when financial markets are reasonably developed, but higher interest rates also reduce investment. The interest rate should in any case be positive in real terms in order to mobilize local savings and discourage unproductive investments.

[9] We define low capital mobility as the case where the balance of payments curve is steeper than the balance in the money market curve in a typical Keynesian macro model for an open economy.

[10] The analysis is based on a standard Keynesian macro model.

inflationary pressure if the supply side responds to the stimulus from the demand side. If it does not – if for example a lower interest rate fails to generate additional investments, the increased demand and money supply is more likely to lead to an increase in the rate of inflation.

From the list above, we can see that a transfer has one and possibly two effects which are contrary to the ESAF objectives, namely the widening of the trade deficit and a possible increase in the rate of inflation. The policy measures necessary to improve the external and internal balance then become even more important in the presence of transfers. We therefore turn to a discussion of a typical ESAF program in a regime with fixed exchange rates and low capital mobility.

3.1.1 ESAF and budget support

Consider a situation where there is initially a large government deficit and an unsustainable current account deficit. So far the current account deficit has been financed through short-term debt rescheduling, arrears and other ad hoc arrangements with creditors. Further, assume that the local financial markets are thin such that the government deficit has been largely monetized, leading to a relatively high rate of inflation. This country enters an ESAF agreement with the IMF and bilateral donors support the adjustment process by providing budget support or sector investment programs. Let us finally assume that the budget support and/or SIPs are initiated immediately after the ESAF has been agreed, and hence before any policy measures have taken effect. This is in fact the usual order of events (Abed et. a. 1998).

As explained above the budget support or SIP leads to an increase in aggregate demand, an increase in local investment and a larger trade deficit. It is also a danger that inflation may increase if the investment response to a lower interest rate is weak. The effect on the trade balance and the possible inflationary impact are undesirable and contrary to the objectives of the ESAF. Therefore, additional policy measures are necessary in order to obtain the objectives of the ESAF. These measures can be divided into two major categories:

1. Measures that improve the workings of the market;
2. Measures that regulate aggregate demand and the composition of demand.

The first category relates to removing distortions and introducing or improving institutions such that for example investors respond to the investment opportunities that arise from a lower interest rate. Or such that producers respond to the export opportunities that arise from a devaluation of the exchange rate (discussed below) and improved access to foreign markets. Such measures reduce the probability that higher demand or improved terms of trade generate inflation rather than a supply side response.

The second category relates to fiscal and monetary policy, trade policy and also exchange rate policy. Monetary policy has no impact on aggregate demand in the case of fixed exchange rates (see the appendix). Money supply does, however have an impact on inflation. This is the reason why ESAF programs emphasize the need for a