Design of IMF Programmes in Aid Dependent Countries.

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The Problem

1. Several bilateral donors and a number of African Governments have expressed concern that the design of IMF programmes in aid dependent countries appears to have a persistent bias towards reducing aid dependence at a rate which may be preventing a feasible and desirable expansion of donor support for African public expenditure, support which could be financed by grants or highly concessional loans. DFID have become aware of differences in view between Fund and donors in Uganda, Tanzania, Mozambique, Ghana and Mali. The issue is also raised in the recent independent evaluation of the ESAF. The difference in view matters because, as will be explained in the next section, the design of the IMF programme determines how aid can be used within the budget, and specifically whether it can be spent or must be saved.

2. ESAF programmes usually target a reduction in the fiscal deficit before grants: this was the case in 39 of the 47 cases covered in the ESAF review. In the great majority of cases, where stabilization had yet to be achieved and where aid dependence was at unsustainable levels, the targeting of a reduced deficit was almost certainly appropriate. However, as macro-economic stability spreads to more countries, there will be an increasing number of cases where further reduction may be neither appropriate nor necessary.

3. The issue can be illustrated from the case of Uganda. As the fiscal deficit before grants began to be reduced from 1992 onwards, the Fund increased their demands for the speed of fiscal adjustment in successive Fund programmes. The benchmark for the overall deficit before grants for 1996, for example, was set at 9.7% of GDP in the FY 1993-95 programme. By the FY 1995-97 programme, the benchmark for the same year of 1996 was reduced to 6.1% of GDP, a reduction of 3.6% in the size of the 1996 fiscal deficit felt to be appropriate, with further tightening envisaged for subsequent years. The most recently approved ESAF aims to achieve an overall fiscal surplus after grants, with Government net lending to the banking system of nearly 4% of GDP. This implies that all concessional loans and some of the grant money are in effect being used to finance reserve buildup and lending to the private sector. Moreover, this channeling of donor support towards the private sector is occurring in a country with extremely low levels of public spending (18% of GDP), where a good case could be made that well targeted increases in public spending would crowd in higher private savings and investment. The independent ESAF evaluation also criticized the ambitious revenue targets, which levied highly distortionary taxes (e.g. petroleum taxes at twice the regional level), in order to fund growth of credit to the private sector via a banking system which was acknowledged to be in deep crisis and not operating as an efficient channel of financial intermediation. Despite this,

the programme was criticized in the Fund Board for too slow a pace of fiscal adjustment: it is clear that any modification of current practice will need to convince the Board as well as the Fund staff.

4. The Fund perspective, as reflected in comments on an earlier draft of this paper, is that aid levels are falling, and unlikely to be reversed; and that aid flows to individual countries are variable and unpredictable. A country which is dependent on donor support for funding recurrent costs is highly vulnerable not only to interruption of spending programmes when funds are delayed or canceled, but also to a loss of macro-economic stability as costs entered into with donor support may be difficult to get out of when support is no longer forthcoming. The Fund would therefore prefer to see continued progress towards a primary surplus, with donor support eventually confined to investment projects and to non-recurrent items such as retrenchment costs. They would prefer to see a strongly cautious bias in assumptions as to external support, given the uncertainty and the possible consequences of over-optimism for macro stability. Recent experience in both Tanzania and Uganda, with promised donor support failing to materialize, give added weight to these concerns.

5. Much of the new thinking on donor instruments for supporting reform at macro or sector level takes a much longer time frame in looking at aid dependence issues, and a more relaxed view on funding recurrent as well as investment costs. This approach is critical to the DFID White Paper, and to prospects for achieving the targets set out in the DAC paper on 'Shaping the 21st Century.' This reflects recognition that investments in development projects have run ahead of domestic resources to operate and maintain them, with the familiar consequences of schools without books, clinics without drugs, roads collapsing for lack of routine maintenance, and inadequate public sector pay. In these circumstances a dollar spent on the recurrent budget will yield higher benefits than a dollar spent on investment, and contributes more to sustainable development than further investment in expanding a capital stock which is beyond the resources available to operate and maintain it. Expenditure needs to be planned around the level which can be permanently sustained from growing domestic revenues **plus** reasonable assumptions about the likely level of external finance. Donors wish to enter an explicit dialogue with Governments on both the level of external support, and the balance of that support between different uses and between investment and recurrent expenditures. The dialogue will maintain pressure on Governments to raise resources domestically and to improve the allocation and management of public expenditure, while recognizing that very poor countries will continue to need and to receive aid for many years to come, and that aid should be given in whatever form contributes most to overcoming the key constraints on economic growth and sustained poverty reduction.

How the IMF Approach Limits Budget Support

6. The process by which the design of a Fund programme can place limits on the uses of aid funds is a subtle one, which does not normally require specific monitorable targets on the budget deficit before grants. It may therefore be worth giving a fuller explanation of how IMF targets constrain donor budget support. To keep the explanation accessible to a non-technical audience, the use of algebra has been confined to the Annex.

The IMF Financial Programming Model

7. IMF programmes aim to achieve reasonable domestic price stability and a sustainable balance of payments position. This is achieved by controlling the growth of domestic demand to a level consistent with targets for inflation and for the foreign exchange reserves, since the overall balance on external payments is equal by definition to the change in the foreign exchange reserves. The logic is that if domestic demand grows faster than the growth in domestic output, the excess will spill over into higher prices and higher import demand and hence a weaker balance of payments.

8. The key relationship which determines the rate at which the demand for domestic and foreign goods and services grows is that between the demand and supply of money. The demand for money is usually assumed to grow at the same rate as gross domestic product (GDP). The increase in GDP is composed of real growth in the economy, which is separately estimated outside the model, and inflation, for which the programme will establish targets. From the expected GDP growth and the inflation target, the IMF calculate the rate at which money supply can be allowed to grow if the inflation target is to be achieved. Although the normal assumption is that money demand will grow at the same rate as nominal GDP, there is scope to relax this assumption in situations where there is good reason to assume that willingness to hold money is changing: for example, a significant reduction in inflation will increase the demand for money (because the loss of purchasing power from holding it is lower), and will permit faster money supply growth without raising inflation.

9. The key program targets which are monitored by the Fund and which are the main focus of Fund conditionality therefore relate to the growth of the various components of money supply.

10. The rate of growth of the money supply is the sum of the increases in net foreign assets, and net domestic assets of the banking system composed of credit to the private sector, and net credit to Government. Net foreign assets (i.e. the foreign exchange reserves) are the key indicator for the balance of payments, and are the subject of an IMF target. There will also often be targets for the growth of credit to the private sector and of net credit to Government. This is to ensure that the overall money supply target is achieved without excessive Government borrowing squeezing out the private sector from access to credit. Thus an IMF programme will often have a separate target or ceiling for all three components of money supply growth.

External Assistance in the IMF Model

11. The key Fund target for the Government fiscal position is thus the ceiling on domestic financing of any deficit. In arriving at a figure for the ceiling on net credit to Government, the Fund will have looked in detail at the components of the budget and how it is financed:- expenditure, domestic revenue sources, and the alternative ways of financing any deficit, including the availability of concessional external resources for the budget.

12. When donors provide resources for balance of payments or budget support, the immediate effect is to increase the foreign exchange reserves, balanced by an equal offsetting decline in

net credit to Government as the local counterpart is paid into a Government bank account. The expected donor flows can thus help Government to meet the Fund targets on both foreign exchange reserves and the ceiling on net credit to Government, and will have been taken into account in setting those targets. Of course, if the donor flows are spent, the balances in Government accounts fall, and net credit to Government increases.

13. The point to note here is that donor resources are one of the fungible sources of finance for the budget, and it is the design of the Fund programme which determines how they are absorbed within the budget: embedded in the design of the programme is an implicit agreement about the extent to which donor flows will be spent or saved. This does not of course mean that the Fund programme will prevent individual donor commitments from being spent: but it does mean that the design of the programme will determine the extent to which the total donor flow contributes to higher Government spending, reduced Government tax revenue, or lower Government borrowing. This is simply the logical consequence of the primacy accorded to the Fund in negotiating a programme to secure and maintain macro-economic stability. However, particularly as countries move beyond the stabilisation phase, Government and donors have a legitimate concern to ensure that the Fund view on the appropriate role of aid within the budget is informed by, and consistent with, a broader consensus on the medium to long term development of Government expenditure and it’s financing from domestic and foreign sources.

14. If the Government receives and spends external flows in addition to those included in the Fund programme, the result is to break the money supply ceiling. (Unless the resources are entirely spent on additional foreign expenditure without generating counterpart funds, in which special case there is no increase in foreign reserves and money supply will be unchanged). To prevent surges in aid from breaching money supply targets, Fund programmes frequently require any increase in external resources above the programmed level to be initially saved rather than spent. For example, the Uganda ESAF performance criteria explicitly state that any excess in import support which is reflected in Government accounts must be offset by an equal increase in foreign exchange reserves and a reduction in Government net borrowing from the banking system. In other words, it must be saved. Fund staff stress that these automatic stabilisers are intended to ensure that erratic donor flows do not lead to a loss of fiscal control, and that the use of the flows will be considered together with the Fund at the next programme review: the Fund will normally be willing to adjust ceilings to ensure that a country does not risk losing access to concessional resources.

15. To summarise, the process by which views are formed on the appropriate role of aid in the budget remains one in which the donors do not directly participate, and in which the degree of consultation is variable and dependent on the Fund staff and the Government. The design of Fund programmes implies a view of the appropriate development of the fiscal deficit before grants, while the ceiling on net credit to Government gives the Fund the instrument of conditionality to enforce that view on countries wishing to remain on track. It is therefore important to ensure that the fiscal objectives are consistent not only with stabilization, but also with making best use of all of the resources available to the country in order to maximize growth and accelerate progress towards the international development targets.

16. The use of cash management systems in many Fund programmes adds an additional problem. In Tanzania, for example, budget spending is limited to the level of domestic revenue

collected in the previous month. Any shortfall in tax revenue requires an equal reduction in current expenditure which can not be offset by drawing on donor funds. If cuts have to be made in areas which donors had previously intended to reimburse, the results may be further amplified as expected donor disbursements are unable to be made. In economies where expenditures are dominated by debt service and salaries, it can easily happen that cuts fall on precisely the areas, such as non-salary spending on social sectors, on which donor aid is conditional.

17. The problems which are described in this paper apply mainly to forms of support which finance Government budgetary expenditures with significant local costs, typically the counterpart to balance of payments support and forms of direct budget support. Project spending typically escapes these disciplines (explicitly so in many cases, e.g. the wording of the condition in the Uganda case referred to above, which is not untypical, applies specifically to import support and to debt relief via the budget, but not to project aid). The argument is that project expenditure, and the finance for it, typically occur virtually simultaneously, often offshore and off-budget, and therefore have minimal effect on the net credit to Government from the banking system. Governments can therefore absorb extra aid as development projects, but this further exacerbates the problem of inadequate resources for operation and maintenance. It is little consolation that Governments get around the problem by miss-allocating recurrent support to the development budget, and by direct donor administered provision of recurrent support which escapes budget disciplines entirely. These practices work against efforts to establish capacity for sound public expenditure planning and management. Moreover, much depends on the type of project, and the way it is financed. The new style sector investment programmes, which provide support via the budget to the whole investment programme of a Ministry, would be caught in a way that direct support linked to individual contracts or projects would not be.

How would the design of IMF programmes be affected by increased budget support?

18. It may be helpful to discuss how IMF programmes might be modified to accommodate a higher level of aid financed budget expenditure.

19. If the aid inflow remains unchanged, but with more of it devoted to Government spending or to lower taxation rather than reducing Government indebtedness, then Government net borrowing would be higher. If not offset by lower private sector credit, this would imply a higher rate of money supply growth. Any inflationary impact will be offset to the extent that the extra spending is associated with higher real GDP growth, or loss of reserves as a result of higher import demand, or lower net lending to the private sector. All three effects could be significant. Firstly, if there is very distortionary taxation, or serious budget constraints on the effectiveness of core public spending programmes, then a higher Government deficit to alleviate the worst problems should raise the GDP growth even if adherence to the money supply ceiling requires it to be at the expense of lower credit to the private sector. This would be especially true if the donor flows form part of a strategy to address weaknesses in policy and management at the same time as transferring a higher level of resources to the budget. Secondly, some of the Government spending will lead directly or indirectly to higher imports. Lastly, lower private sector borrowing may also be beneficial if it is not the consequence of tighter credit constraints, but reflects the positive impact on private savings of more timely Government payment of bills, higher real public sector wages, lower spending on expensive alternatives to inadequate public

services, and a higher overall level of activity.

20. A related possibility is that aid previously managed outside the budget is transferred to Government budget control. In many African countries, there is a substantial discrepancy between donor funds as recorded in the balance of payments, and donor funds as recorded in the budget. The implication of the new priority which donors are giving to providing their support via Government's own procedures is that this gap will narrow, with more of the flow passing through the budget. For example, a significant proportion of project aid is administered by donors meeting the local costs of projects from donor controlled accounts in local banks. If the responsibility for managing these funds is transferred from donor to Government, and incorporated for the first time in the budget, there will be no change in the level of foreign exchange reserves (since the same amount of foreign exchange is being brought in), but an initial transfer of bank deposits from private to public sector. The fundamentals of the macro situation are unchanged, but the

budget deficit before grants will appear to have increased. If the movement towards sector budget support becomes significant , Fund programmes will need to be adjusted to accommodate the higher deficit. If a significant change occurs within year, application of the Fund stabilisation formula would require an increase in the foreign exchange reserve target, and a reduction in Government net borrowing. This would prevent Government from spending the deposits which had been transferred, and would mean the loss of the public expenditure previously supported from donor controlled funds. It is clear that, if the movement towards more budget support becomes significant, some mechanism is required for informing the IMF of such changes, to enable them to make the appropriate adjustments to the programme performance criteria and benchmarks. The cause of any consequent appearance of weakening in fiscal trends will also need careful explanation to the Fund board.

21. The Fund programme would also need adjusting if a country willing to enter a serious dialogue on medium term spending priorities succeeds in securing additional donor commitments. In these circumstances, the Fund programme needs to be adjusted to accommodate these flows, for example by targeting a more ambitious rate of GDP growth. This would generate a higher money supply growth target, and would permit higher spending financed by aid flows. The adjustments need not be large, especially as the first round effect on foreign exchange reserves would be offset as the effects of growth feed into higher import demand.

Conclusions

22. As Paul Collier, Alan Gelb, and others have argued, a strong case can be made for increased budget deficits in order to fund improved services in some reforming African countries. The partnership approach of the new British development white paper envisages increased support to countries committed to policies aiming at pro-poor economic growth. Once stabilisation has been achieved, the issues involved in determining the appropriate role for external assistance in budget financing are no longer exclusively macro-economic, and a wider group of stakeholders should be consulted. By nearly always targeting a reduction in the budget deficit before grants, the Fund may be preventing countries from spending at the levels which would be required in order to provide minimal social services and adequate maintenance

of infrastructure, let alone make progress towards the DAC targets. Aid is consequently being increasingly channelled towards reducing Government indebtedness. This was the right choice in the early years of adjustment, when countries were struggling with high inflation induced by Government borrowing from the banking system. It may still be the right choice in many countries, but it ought to be the result of an explicit discussion of development strategy which considers the respective roles of Government, donors, and the private sector, and of priorities for use of funds. Though the IMF take the lead responsibility for macro stability, they should not have sole responsibility on behalf of the donors for determining how aid funds will contribute to the budget, yet that is the implicit implication of present practice. These issues require micro-economic and sectoral judgements on which a wider group of stakeholders should be consulted.

23. The issue is not only or mainly a technical one, but reflects differences in perspective as to the long run role of aid, and the dependability of assumed future aid levels. At country level, part of the solution is to improve programme design by more intense dialogue between the Fund and donors on the role of external aid flows within specific programmes, to enable the Fund to factor in reasonable assumptions which reflect the donor policies and probable future commitment and disbursement levels of flows entering the budget. The donor record in honouring commitments in a timely fashion is not good, and improved dialogue needs to focus not only on the Fund but also on reforms to donor practice, to improve the predictability of donor support. Though some degree of caution is needed, projections based on a combination of analysis of past trends and of stated donor intentions suitably discounted for past experience should be capable of generating forecasts which are no less uncertain than those for many of the other variables underlying the IMF programme.

24. It should be stressed that the arguments of this paper do not imply criticism of the core of the Fund approach. However, the progress which has been made in some countries towards fiscal adjustment, combined with new approaches by the donors, with increased emphasis on supporting Government budgets, do require some adaptation of Fund practice. The main requirement is a commitment from Fund management to work more closely with the donor community when working up fiscal frameworks. The conclusions of such a dialogue would need to be fed into the documentation on Fund programmes and the Board discussion of them. The recent Uganda discussion demonstrates that this will require actions to persuade not only the Fund staff, but also the Fund board, since one motivation for tight fiscal targets is the hostility of the Board to programmes which do not feature "progress" towards a current budget surplus. This suggests that discussion of individual country cases needs to be supplemented by more general consensus building on the larger issues. Every opportunity should be taken to promote discussion of the issue.

25. A more participatory approach requires more than just asking donors passively to provide better information on their financing intentions, and then informing them of Fund conclusions on the fiscal framework. There needs to be an open dialogue, under Government leadership, on the contribution which aid flows can be expected to make to the budget into the medium to long term. Active Fund participation in the new style public expenditure reviews which are underway in Tanzania and Uganda would be one possible way to operationalise this.

26. Simply asking for a more open process for arriving at more realistic assumptions without

changing the approach will be helpful, but does not solve all of the problems. There may also be a case for re-examining some aspects of the underlying model; and there is certainly a case for developing less damaging alternatives to tight cash management, which is widely applied in Africa to achieve macro objectives, but at appalling costs to the disruption of spending programmes. There may be a case for research and workshops, to derive some recommendations for further discussion. However, the most immediate task is to modify the approach to external support in those poor and aid dependent countries where the Fund objective of continuously reducing budget deficits is in danger of becoming inimical to growth prospects and to the sensible use of aid.

Annex 1.

1. In the basic financial programming exercise the binding behavioural constraint is the demand for money (M_d), which is assumed to be a stable function of a few variables: real income (Y_r), a price deflator (P_d) and an assumption that money circulates at constant velocity (V), so that ,

$M_d V = Y_r P_d$ (1)

and $\Delta M_d = \Delta (Y_r P_d)/v$ (2)

where real income is treated as though I t were exogenous and inflation (in a simple model equated to ΔP_d) is a target variable. A simplifying assumption is that M_d is independent of the changes in domestic credit. These assumptions yield a unique value for the growth of money demand. The financial programming approach aims to achieve a growth of money supply which is consistent with the growth in money demand, and which is therefore also consistent with the projected growth of real income and the target inflation rate, yielding the equilibrium condition that:

$M_s = M_d$ (3).

2. The programming approach starts with the monetary balance identity, which expresses the change in the broad money supply (M_s) as the sum of its international and domestic components. For simplicity the domestic monetary system is assumed to have neither current income nor savings, and performs merely an intermediary role.

Monetary Balance Î M_s = Î NFA + Î NCG + Î DC_p (4)

where assets comprise: NFA is Net Foreign Assets of the banking system (in this simple model "reserves" (R) and "net foreign assets" are synonymous); NCG is net domestic credit to the government sectors; and DC_p is domestic credit to the private sector.

3. The objective of making progress towards balance of payments sustainability requires a target for NFA. Achieving this without exceeding the overall money supply target requires a ceiling on the growth of net domestic assets of the banking system (NCG + DC_p). In order to ensure that Government borrowing does not crowd out the private sector, there is often a sub-ceiling placed on NCG to enable explicit targets for DCp to be met without exceeding the

ceiling for money supply growth from (2) and (3).

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The Budget

4. Government spending is financed from taxes, grants from donors, or domestic or foreign borrowing:

$I_g + C_g = T_g + Gr_g + \Delta\, NCG + \Delta\, NPB_g + \Delta\, Fi_g$ (5)

where I_g is public investment, , C_g is recurrent expenditure T_g is domestic government revenue, Gr_g is grant funding, NCG is net domestic credit to the government sector from the monetary system; NPB_g is loans to the government from the private sector (i.e. non-bank borrowing instruments such as Treasury Bills); and FI_g is net foreign borrowing by the government.

5. An increase in Government investment or consumption spending financed by an increase in foreign grants leaves Government net borrowing unchanged. The problems, however, arise from the monetary effects if donor grants are spent via the budget.

External Grants and Financial Programming

6. Grant financing from external sources implies a positive change in reserves (Î NFA) which is initially offset by decrease in Î NCG, as the counterpart funds are paid to a Government account, typically in the central bank. This leaves money supply initially unchanged. However, if Government spends the external grant, Δ NCG will return to the initial level. Assuming that the receipts from the resultant government expenditure are initially held as currency in circulation (C) or bank deposits (D) (i.e. the money multiplier is unity), and there is no external leakage, the grant produces a one-for-one injection into the monetary base which (holding other components of money supply constant for simplicity of exposition) results in (Î $M_s)_t$ = Î NFA_t.

7. At this point, the difference between the money supply, determined by credit policy and the external payments (4), and the demand for money, determined by a demand for money function (1), is excess money supply (EMS) and breaches the programme targets.

$EMS_t = M_{st} - \underline{M}_{dt} = M_{st} - \underline{M}_{st\,-}$ (6)

where $(\underline{M}_s \;\&\; \underline{M}_d)_t$ represent discrete programme targets.

8. The ultimate impact of grant financed expenditure on the financial programme will critically depend on the money market clearing mechanism(s) which result from the intervention. In certain circumstances the feedback mechanism will tend towards a stable equilibrium, while in others it will destabilise it, i.e.:

EMS_{t+1} 2 0 or % (7)

9. By relaxing some of the restrictive assumptions of the simple programming model the

transmission mechanism can be identified as a function of credit policy, external flows (4), and the demand for money (1):

$$\hat{I}\ EMS = f(\hat{I}\ NFA, \hat{I}\ NCG, \hat{I}\ DC_p, \hat{I}\ Y_{r,} \hat{I}\ P_d, \hat{I}\ V)\ (8)$$

If there is excess capacity in the economy an increase in the money supply may increase real output ($\hat{I}\ Y_r$) with prices rising little or not at all. Both the Polak and IMF models, however, commonly assume that there is no excess capacity, in which case the rise in nominal income will merely reflect price increases ($\hat{I}\ P_d$), reducing the real demand for money and the real money supply, often with an uncertain impact on EMS_{t+1}. Finally, excess money could simply cause a one-off increase in imports, which would reduce NFA and thus the money supply.

10. Programming involves an iterative process of adjusting targets until all inconsistencies and implausibilities have been eliminated. Performance against programme targets should therefore also be assessed within the dynamic framework of the model, where the particular assumptions of closure are explicit, and have been taken into account (despite the difficulties in extending the model to include growth variables.) The shorter the programme reporting period the less likely is it that the transmission mechanism will have been able to work through the system.

Examples

11. The main paper considers various cases, of which two are illustrated here.

12. An increase in grant funding to the budget beyond programmed levels: This raises money supply via an increase in NFA, as in (4), and breeches IMF programme targets. The Fund therefore often require that additional budget support, beyond programmed levels, be saved via the mechanism of an equal upward adjustment in the NFA target and a downward adjustment to the NCG ceiling. This leaves ΔM_s as per the original programme, but prevents the Government from spending the extra aid. In terms of equation 5, the Gr_g increase has been offset by a reduction in Δ NCG, leaving Government unable to finance an increase in expenditure. If there is no ‘clawback’ clause on unanticipated external budget support, then spending will increase and the adjustment will take place via the EMS function mechanisms described in paragraph 9 and less formally in the main paper.

13. The second example assumes an unchanged level of aid grants to finance local Government expenditures, but spent via the budget instead of directly by the donors: If no offsetting action is taken, the amount of foreign exchange brought in by the donor, and hence Δ NFA, remains unchanged. All that has changed is that revenue and spending previously classified outside the budget and not captured in equation 5 has been brought within it. The domestic counterpart is now held in a Government account until spent, rather than in a private donor account, thus reducing net domestic assets of the banking system, by Δ NFA = -Δ NCG. Once the additional budget funds are disbursed the economy would be expected to revert back to its programmed state (assuming equivalent expenditure dynamics.)

14. However, a problem arises if the Fund treats the change as an increase in budget support

beyond programmed levels, and seeks to sterilise what it interprets as additional aid. Sterilisation would be ensured by requiring, for every dollar of budget support beyond the programmed level, an equivalent increase in the target for NFA and reduction in the ceiling on NCG. In terms of the money supply equation, 4, the total Ms growth is unchanged, with the increase in the NFA target offset by reduced growth of domestic credit, achieved by a lower ceiling on NCG. The economy is unable to revert back to its originally programmed state, but is left with the composition of money supply growth shifted towards lower domestic credit expansion, and more rapid accumulation of foreign exchange. In terms of the budget equation 5, Government receives a higher level of grants Grg offset by the lower ceiling on NCG, leaving it unable to increase on-budget spending. The funds have been transferred from donor control outside the budget, but Government is unable to sustain the expenditures which these funds previously paid for because of the sterilising cut in NCG.

15. The adjustment, via reduced absorption in the domestic economy, will be sharper than programmed or than warranted by the level of external receipts. The risk of this unintended effect illustrates the need for the Fund to be informed about changes in aid modalities as well as aid levels, to enable appropriate adjustments to be made.