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IMF Backs Plan to Reduce Global Imbalances

AFP

Oil producers could help tackle imbalances by boosting spending.

The IMF plans to follow up on its first multilateral consultation, aimed at reducing imbalances in the global economy while maintaining robust world growth, by monitoring the policy commitments of the five major players involved: China, the euro area, Japan, Saudi Arabia, and the United States.

IMF estimates suggest that, once implemented, these policies could result in a reduction in the U.S. current account deficit of about 1–1¾ percent of GDP, accompanied by reductions in surpluses elsewhere.

In July, the IMF's Executive Board met to take stock of the experience with the first round of multilateral consultations, conducted between June 2006 and March 2007, and to draw lessons for the future. The 24 Directors, who together represent the IMF's 185 member countries, said the consultation had helped deepen agreement on a coherent medium-term approach that would reduce the imbalances while supporting global growth.

In 2000, when the IMF first warned policymakers that imbalances in the global economy could derail global growth, the U.S. current account deficit stood at 4 percent of GDP. Today, that deficit has risen to more than 6 percent of GDP and is matched by large current account surpluses elsewhere, especially in China, Japan, and oil-producing countries.

(continued on page 165)

IMF Moves to Clarify Aid Role

Under scrutiny from critics and its own official watchdog for its approach to the use of aid in low-income countries, the IMF is taking steps to clarify its role in advising members in the face of high and volatile aid inflows.

At issue is the need to achieve higher levels of economic growth to reduce grinding poverty in many parts of the world while avoiding destabilizing lurches in the economy triggered by sudden inflows of aid that can highlight economic bottlenecks and cause inflation and exchange rate volatility, which could make the poor even worse off.

Eric Miller/Picturedesk

Market in Rwanda, a country already receiving some scaled-up aid.

The IMF's Executive Board met on July 6 to consider how the 185-member institution can promote the effective and sustainable use of aid, and endorsed a number of recommendations about how to make maximum and best use of such aid.

The discussion was based on two sets of staff papers published on July 19—one on overall program design issues ("Aid Inflows—The Role of the Fund and Operational Issues for Program Design") and the other on fiscal policy issues ("Fiscal Policy Response to Scaled-Up Aid"). The outcome of this discussion

(continued on page 162)

Update

World Growth Solid Amid Market Fears

IMF Managing Director Rodrigo de Rato said on August 22 that despite recent financial market turbulence, the global economy is still expected to perform well this year, but uncertainty remains about the implications of the ongoing liquidity sqeeze for financial markets and for the real economy. The IMF is expected to publish its next forecast for the world economy in mid-October.

Also in this issue

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IMF Clarifies Aid Role

(from page 161)

will be integrated with related work in the Fund, such as last year's update of the debt sustainability framework, to present a comprehensive operational framework for guiding the Fund's role in low-income countries.

Unpredictable aid flows

The international community has committed to supporting low-income countries in their efforts to meet the Millennium Development Goals (MDGs) by scaling up aid and improving aid delivery.

Although official development assistance to low-income countries fell slightly in 2006 compared with the previous year, aid from "emerging donors" and other private flows, particularly from health funds, are on the rise (see "Where's the Money?" page 164).

External assistance can offer additional resources for countries to pursue development goals, but can also be unpredictable and can create challenges for macroeconomic management, including if aid volumes were to increase sharply.

The IMF plays an important role by assisting countries in creating and maintaining an enabling macroeconomic environment for the effective use of aid. Helping countries design policy frameworks that support sustained growth and poverty reduction while maintaining macroeconomic stability and debt sustainability is an integral part of the Fund's Medium-Term Strategy (MTS).

In particular, the MTS calls upon the IMF to help low-income countries put in place the policies and economic institutions that will permit them to make use of scaled-up aid in a sustainable manner.

Accommodating the use of aid

Since the launch in 1999 of the Poverty Reduction and Growth Facility (PRGF)—the IMF's primary lending instrument for low-income countries—Fund policies with respect to aid have evolved in a number of important ways.

- IMF-supported programs have become more accurate—that is, less cautious—in predicting aid flows.

Red Cross immunization line at Tchadoua, Niger:

- Programs have increasingly allowed the spending and absorption of aid (see below).
- Increasingly, unanticipated aid flows can be spent, and unexpected aid shortfalls can be offset through higher domestic borrowing or reserve drawdown.
- Concerns related to competitiveness (often referred to as "Dutch disease"—meaning the harmful effects on exports of a sizable worsening of a country's competitiveness as a result of booming inflows of foreign exchange) have not led to limits on the use of aid.

Response to concerns

The recent Board discussion responded in part to concerns raised by the IMF's Independent Evaluation Office (IEO) about the IMF's role in aiding sub-Saharan Africa. Its report, released in February, noted that there was scope for clearer guidance on a number of issues, such as aid projection, accommodation of additional aid flows, and the examination of alternative scenarios in assessing the amount of aid that can be absorbed effectively.

Building on the experience with IMF-supported programs, the Board endorsed a number of program design principles

Issouf Sanogo/AFP

Governments often lack information on private aid flows.

from all sources—public and private. Given that aid disbursements are often volatile and uncertain, there is merit in smoothing expenditures over time so that all programs undertaken are adequately funded.

Effective use of aid flows may require that in certain cases some of the aid be saved temporarily. Limited absorptive capacity—macroeconomic, sectoral, and administrative—may constrain some low-income countries' ability to use aid effectively in the short run. Saving a part of the aid flows to finance higher expenditures in the future, when capacity constraints are less severe, may be an appropriate initial policy stance for those countries to an increase in foreign aid. However, there can be limits to how much aid a country can save. For example, the scope for saving project aid would be limited because its use depends on the project cycle. In addition, donors may be reluctant to continue providing aid if it is consistently used to build up reserves. Finally, aid recipients face domestic pressures to spend aid to improve economic and social outcomes.

Beyond the emphasis on spending and absorbing, the paper lays out best practices for program design in a number of more specific areas. These include:

- Aid projections should reflect the best estimate of likely assistance based on all available information, not solely on firm commitments by donors. Deliberate over- or underprojection of aid should be explicitly justified.
- IMF staff should stand ready to help countries design alternative aid scenarios that would be consistent with macroeconomic stability. These scenarios are expected to be presented in Poverty Reduction Strategy Papers and/or IMF annual assessments known as Article IV reports.

(continued next page)

aimed at maximizing the effective use of aid while maintaining macroeconomic stability and debt sustainability.

In general, it was established that IMF-supported programs should promote the full use of aid—that is, the spending and absorbing of aid—provided macroeconomic stability is maintained and country-specific circumstances and development needs are taken into account. The spending of aid (by the government) is reflected in a widening of the fiscal deficit, while aid absorption is defined as a widening of the current account deficit, reflecting the transfer of resources from abroad through higher imports.

For countries not in a position to use aid fully (for example, when doing so would jeopardize macroeconomic stability), the IMF will provide advice on how to address constraints. Program documents will also be expected to explain clearly how programs are designed and to justify deviations from a full spend-and-absorb approach.

In an environment of scaled-up aid, macroeconomic policy formulation should be based on a longer-term view of spending plans and resource availability. These plans should be consistent with available financing

Wage Ceilings: For Exceptional Use Only

The IMF Executive Board clarified policies about the use of wage bill ceilings in IMF-supported programs. Wage bill ceilings are caps on government spending on civil service wages. The proportion of programs with wage bill ceilings under the IMF's Poverty Reduction and Growth Facility (PRGF) has declined from 40 percent during 2003–05 to about 32 percent as of June 2007.

Only 3 out of 28 PRGF arrangements—those for the Central African Republic, Chad, and Malawi—had limits on the wage bill as a quantitative performance criterion; another 6 programs include them as indicative targets (a weaker form of conditionality).

Wage bill ceilings can help restrain wage spending in cases where such expenditures threaten macroeconomic stability and squeeze out other priority spending (such as on medication and schoolbooks). Although designed as a short-term measure, such ceilings have tended to persist in programs and have not always been efficient in achieving their objectives. Although wage bill ceilings have been implemented flexibly, they have been criticized on the grounds that they have prevented countries from increasing employment in critical sectors such as health and education.

As countries strengthen their budget and payroll systems and formulate fiscal policy using medium-term frameworks, the need for wage bill ceilings as a means for controlling wage and employment costs is diminishing. However, developing these systems in low-income countries will take time. In the interim, there may be a need for wage bill ceilings on occasion. Such ceilings will be used in exceptional circumstances and will be based on the following criteria:

- ***Clear justification.*** The rationale for wage bill ceilings should be guided by macroeconomic considerations. Program documentation should justify their use in a transparent manner, including their consistency with the MDGs.
- ***Limited duration.*** Wage bill ceilings are a temporary device. Governments should tackle the root causes of wage-related fiscal problems, such as the need for civil service reform and strengthened payroll management.
- ***Sufficient flexibility.*** Wage bill ceilings should be flexible enough to accommodate spending of scaled-up aid, particularly for sustainable donor-financed employment in priority sectors such as education and health.
- ***Periodic reassessments.*** The need and rationale for wage bill ceilings should be reassessed at the time of program reviews.

Where's the Money?

At the 2005 Gleneagles summit, the Group of Eight (G8) leaders promised to double aid to sub-Saharan Africa by 2010. Two years later, there is little sign that the promise is translating into increases in overall aid to most sub-Saharan countries. Excluding debt relief, aid to sub-Saharan Africa from the world's major donors—grouped in the OECD's Development Assistance Committee (DAC)—was static in 2006, leaving a challenge to meet the Gleneagles commitment.

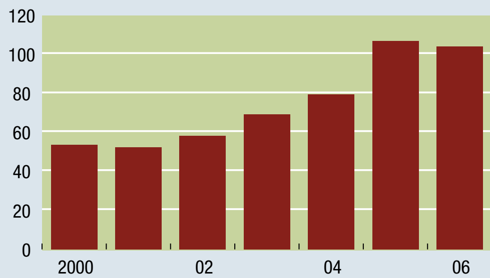
Aid to all countries (including middle-income recipients) declined, in constant 2005 dollars, to $103.9 billion in net aid in 2006, down 5.1 percent from 2005 (see chart). This figure includes $19.2 billion of debt relief, notably exceptional relief to Iraq and Nigeria. Excluding debt relief grants—which were at a record high in 2005 as a result of the first phases of several large Paris Club debt relief operations—net aid fell by 1.8 percent in 2006, according to preliminary data published by the OECD (the Paris-based Organization for Economic Cooperation and Development).

On balance, according to the World Bank's *Global Monitoring Report 2007*, there is "scant evidence of any substantial scaling up of aid on the horizon."

Further to climb

Official development assistance (ODA) fell slightly in 2006, but is still almost double levels at the start of the decade.

(ODA, billion dollars)



Source: OECD.

However, the overall picture may not be so bleak. Although, in real terms, the decline in official development assistance in 2006 was the first reduction since 1997, aid levels were still the highest recorded, with the exception of 2005 (see chart).

In addition, although aid recorded by the DAC fell, other forms of aid are on the rise, including from private sources, health funds, and emerging market donors, such as China. China's official assistance to Africa in 2006 was estimated at $19 billion, and it has said it will step up aid further. Overall aid from private sources doubled during 2001–05 to $14.7 billion, according to the World Bank. Global funds to combat HIV/AIDS are estimated to reach $9 billion in 2007, according to the United Nations Development Program.

Nevertheless, according to several recent studies, further progress toward the Millennium Development Goals (MDGs) would require substantial net increases in official development assistance. Estimates by the World Bank and the United Nations suggest that additional official assistance of about $40–60 billion a year would be needed to meet the MDGs.

Based on the 2005 G8 commitment in Gleneagles to double aid to Africa, the OECD estimates that assistance from the DAC countries would rise by $50 billion in real terms between 2004 and 2010.

- Programs should reconcile the full use of aid with price stability while avoiding the crowding out of private investment. Achieving this requires the effective coordination of fiscal, monetary, and exchange rate policies. It is important that programs be based on a clear understanding of the authorities' exchange rate regime because this determines how absorption might take place.
- Minimum levels of poverty-reducing spending could be used in IMF-supported programs to protect and expand priority outlays.
- Given the limited evidence of negative effects on competitiveness from increased aid inflows, spending should in general not be constrained due to Dutch disease concerns unless a competitiveness problem emerges. Emphasis should be placed on steps to strengthen competitiveness, for example by channeling aid toward productivity-enhancing expenditures such as infrastructure investment.
- The Debt Sustainability Framework should be used to keep debt levels manageable and assess whether the concessionality of aid flows is appropriate.
- The IMF should coordinate with the World Bank and key donors if microeconomic concerns regarding the ability to use aid effectively arise.
- Strengthening domestic revenue mobilization should be an integral part of the macroeconomic policy response to scaled-up aid. Such a strategy should emphasize broadening the revenue base by reducing exemptions and improving revenue administration.
- Close monitoring of spending is important for ensuring debt sustainability. Inefficient spending will add to the debt burden without significantly improving economic and social outcomes. Good governance and quality of fiscal institutions have a strong positive correlation with efficiency of spending.
- Poverty and social impact analysis (PSIA) should be taken into account where appropriate to incorporate the interests of the poor and help mitigate any adverse effects of reform measures. IMF staff would not be expected to conduct PSIA work, but to rely on the work of the World Bank and other development partners, with close collaboration expected on spending composition and PSIA.
- Ceilings in IMF programs that limit the public sector wage bill should be used only in exceptional circumstances when warranted by macroeconomic considerations (with clear justification in program documents). They should be designed flexibly to accommodate scaled-up spending, particularly in priority sectors such as health and education (see "Wage Ceilings: For Exceptional Use Only" on page 163).
- Strengthening fiscal institutions and public financial management systems is critical to effective utilization of scaled-up aid. Countries should prepare appropriately sequenced and prioritized action plans for strengthening these systems based on diagnostic assessments of existing systems. ■

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Plan to Reduce Global Imbalances

(from page 161)

There are those who argue that these imbalances are sustainable and that the world economy will continue its impressive expansion. But many others, including the IMF, do not think imbalances of this magnitude are sustainable in the long run and believe that action is needed to reduce them before they unravel in an abrupt and disorderly way.

IMFC strategy

Since 2004, the IMF's International Monetary and Financial Committee (IMFC) has called for joint action to address the risks posed by the imbalances. The IMFC Strategy, as these recommendations have become known, has evolved over time, reflecting the changing nature of the problem.

But, in April 2006, imbalances were still growing, and IMF Managing Director Rodrigo de Rato felt that more urgent action was required. He suggested that the problem be addressed in a framework involving only the key players. The objective of the first multilateral consultation, as this process is now known, was to seek to reduce the imbalances while maintaining the robust growth enjoyed by the world economy in recent years.

A new forum

The purpose of a multilateral consultation is to bring together a small group of countries to promote dialogue on, and, eventually, a common solution to, a particular problem of systemic importance. To ensure a free and frank exchange focused on policy implementation, the consultations are informal and confidential and involve only high-level policymakers.

The United States, China, the euro area, Japan, and Saudi Arabia all agreed to participate in the first round of multilateral consultations. Some of these economies are direct parties to the imbalances, through current account deficits or surpluses, and some represent large shares of global output. The IMF invited them to participate because those five economies could, as a group, play a major role in reducing the imbalances and sustaining world growth at the same time.

The consultations began with discussions between IMF staff and each participant, followed by three meetings involving all five participants. The last of these meetings took place in March 2007. In mid-April—just ahead of the meetings of the IMFC—the five participants and the IMF issued a joint report, in which the participants stressed that reducing global imbalances is a multilateral challenge and a shared responsibility, and that an orderly unwinding of imbalances would benefit all countries in the world. They reaffirmed their commitment to the strategy that had been set out by the IMFC a year earlier and agreed to publish detailed statements of their policy intentions.

A set of policy plans

Taken together, these policy plans will help countries make significant progress in all the key areas of the IMFC Strategy. At their July 20 meeting, the IMF's Executive Directors particularly welcomed the individual policy plans of the five participants—even if those plans did not always match the level of ambition advocated by the IMF in its dealings with those economies. The Directors felt that the publication of these policy intentions provided a valuable road map for the future, enhancing public scrutiny and helping foster confidence that the international community was working together to address the problem.

Monitoring will be key

Looking ahead, the IMF's Board emphasized that the multilateral consultation would ultimately be judged by progress toward reducing the imbalances and sustaining global growth, and by implementation of the policy plans. In that regard, some of the Directors felt that specific time frames and benchmarks would have made it easier to keep track of implementation. IMF staff will continue to monitor progress both in Article IV consultations with the five economies and in the *World Economic Outlook* and the *Global Financial Stability Report*, the IMF's two flagship publications. The Directors also stressed that while the five economies will have to play a key role in facilitating an orderly adjustment, other countries must play their part.

More generally, the Directors considered that the new approach constituted a valuable new instrument for enhancing and deepening the IMF's multilateral surveillance. They underscored that involvement of the Board and the IMFC at the appropriate time is crucial to give the process legitimacy and to allow the international community to assess results. ■

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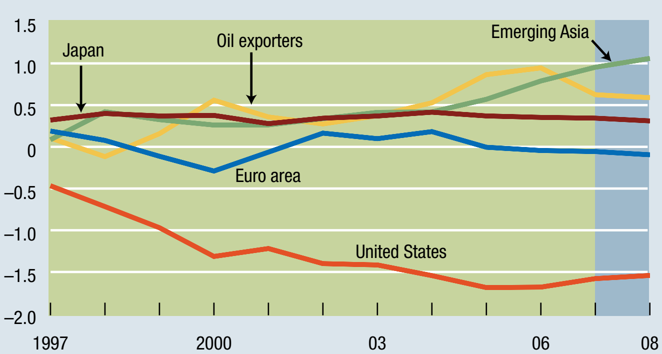
A mirror image

The current account deficit of the United States has been matched by surpluses elsewhere, particularly in emerging Asia and in oil-exporting countries.

(current account balances, percent of world GDP)



Source: IMF staff.