

INTERNATIONAL MONETARY FUND

**Aligning the Poverty Reduction and Growth Facility (PRGF) and the Poverty  
Reduction Strategy Paper (PRSP) Approach: Issues and Options**

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## EXECUTIVE SUMMARY

1. The poverty reduction strategy paper (PRSP) approach is now broadly accepted as the framework for bringing together national policies and donor support to help low-income countries make progress towards the Millennium Development Goals (MDGs). The Fund has adopted the PRSP approach as the framework for its support to these countries under the Poverty Reduction and Growth Facility (PRGF). The 2002 review of the PRGF reported on the progress made in aligning the PRGF and the PRSP, as well as identifying areas for further attention. This paper discusses the issues arising during this process of alignment and suggests approaches to dealing with them over the medium term.

2. The basic premise underlying this paper is that close alignment of the PRGF and the PRSP remains a key principle for further adapting the content and process associated with these programs. However, the modalities for this alignment will need to be tested in some areas and the pace at which this alignment can be realized in others will vary across countries. One important determinant of both is how effectively the PRSP process itself can be better linked with the national budget process. This in-country alignment of the PRSP and the budget process can be helped by the Fund and other donors in a number of ways, which are outlined in the paper. The paper also explores a number of other options for addressing issues raised in the 2002 PRGF Review regarding the design of PRGF-supported programs. The principal issues addressed in the paper are:

- *Enhancing the realism of the macroeconomic frameworks underpinning both PRSPs and PRGF-supported programs* through a sharper focus on identifying the sources of, and obstacles to, higher growth, as well as sensitivity testing for changes in the underlying assumptions.
- *Bridging the gap between the resources and actions needed to make progress toward the MDGs, as set out in the PRSP, and prudent economic management reflecting resource, administrative, and implementation capacity constraints.* One approach put forward in the paper would be to encourage the authorities to include in their PRSPs the medium-term macroeconomic framework underpinning the country's budget, as well as credible plans for achieving more ambitious goals by addressing associated institutional capacity, policy, and financing constraints. The use of contingent spending plans would facilitate adjustment in the event of unforeseen internal or external shocks.
- *Assessing and dealing with the macroeconomic implications of larger aid flows.* The basic presumption is that additional aid inflows should be accommodated by appropriate adjustments of the program's fiscal and financing targets, if they can be effectively absorbed and utilized without endangering macroeconomic stability. Fund staff will need to assist countries in assessing institutional and absorptive capacity constraints, as well as the impact of such flows on fiscal and external debt sustainability. Staff will advise the authorities in determining when debt sustainability concerns reinforce the need to

increase the grant component of such flows. The paper also reviews progress in public expenditure management and in poverty and social impact analysis of measures covered under PRGF-supported programs;

- *Making the PRSP itself a more operational basis for national policy and donor assistance* by strengthening its links to the annual budget process. Fund staff will need to engage early in the PRSP process to assist countries in this internal alignment;
- *Adapting the timing/cycle of PRGF-supported programs to reinforce the PRSP-budget link.* This could be achieved by starting a new three-year PRGF arrangement after a full PRSP has been completed, and adjusting the cycle of annual PRGF-supported programs to coincide with the preparation of the budget and the annual PRSP Progress Report;
- *Facilitating enhanced coordination across different development agencies to reduce transactions costs for PRSP countries.* For the Fund this would mean more systematic sharing of information with other donors (on the timing and results of negotiation and review missions, on the conditions and proposed timing of donor disbursements, and on technical assistance provided by the Fund), and taking account of the impact of policies supported by other donors in PRGF-supported programs.

3. This paper reports on work in progress. Following feedback from Directors, it will serve as the basis for outreach and feedback from low-income country officials, partner agencies, and other interested stakeholders; it will then be used to develop interim guidance for staff engaged in the design of PRGF-supported programs. This will be refined in the light of experience during the coming year, and any resulting modifications to staff guidance will be summarized in periodic progress reports on the PRSP/PRGF.

## I. INTRODUCTION

1. The poverty reduction strategy paper (PRSP) approach has become broadly accepted by low-income countries and the donor community as the framework for bringing together national policies and development assistance in support of these countries as they progress towards the Millennium Development Goals (MDGs). Over twenty countries have completed their PRSPs and a further thirty are embarked on this process. The quality of this first round of country strategies, and the inclusiveness of the participatory process underpinning their preparation, have varied depending on initial conditions and on the spirit in which they were approached. However, in virtually every case they have helped to focus public actions on the priorities for poverty reduction and they have often helped to stretch the envelope by bringing line ministries, parliaments, civil society, and other stakeholders into the debate on policy imperatives and tradeoffs. Internationally, an important positive development has been to clarify the link between PRSPs and the MDGs, with the former seen as each country's business plan setting out how to accelerate growth and make progress towards national development targets that are defined in terms of the commitments embodied in the MDGs. However, the agenda for further enhancing the effectiveness of the PRSP approach is still full, and staff recommendations in this regard will be covered in the joint Fund-Bank annual progress report on the PRSP approach scheduled for Fall 2003.

2. The Fund, along with the World Bank and many other development agencies, has committed to use the PRSP as the operational framework for its support to low-income countries under the PRGF and to align the content and process of its operations to reflect this new framework. The March 2002 Review of the PRGF (and the associated Joint Review of the PRSP) confirmed that the Fund-supported programs had indeed begun to change to reflect the new focus on poverty reduction and the reinforced emphasis on growth, but it also raised a number of issues where further progress was needed.<sup>1</sup> A further year of experience has helped to consolidate some of the gains, but it has also sharpened up some of the difficulties that are raised by the process of aligning the PRGF and the PRSP approach. This paper reports on these issues and on how the staff proposes to address them in the context of the Fund's work under the PRGF.

3. The focus here is on the links between the PRGF and the PRSP, but some of the options explored necessarily relate to the PRSP process in countries, since a basic lesson of the past two years is that alignment of the PRGF (and other donor-supported programs) with the PRSP will only become truly effective when the PRSP itself is closely aligned with the budget process in each country (see Box 1). This strengthened in-country link was a key

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<sup>1</sup> See *Review of the Key Features of the Poverty Reduction and Growth Facility: Issues and Options*, SM/02/51, February 14, 2002; and *Review of the PRSP Approach: Main Findings*, SM/02/53, March 15, 2002.

recommendation of the 2002 Joint Review of the PRSP and remains the premise underlying much of the approach set out in this paper.

### **Box 1. Defining the Concept of Alignment**

In the March 2002 Joint Review of the PRSP Approach, the term “alignment” is used in reference to procedures and processes, or content and policies.<sup>1</sup> For the purposes of this paper, a distinction is made between:

- **Temporal alignment**, either of a country’s own processes (for example, aligning the PRSP cycle with the national budget cycle), or of donor processes with the country’s processes (aligning the timing and different phases of donor programs with the budget/PRSP cycle); and
- **Policy alignment**, in the sense that policies supported by donor programs are derived directly from the PRSP. For the Fund, an important dimension of this is **macroeconomic alignment**, in the sense that the macroeconomic framework of the PRSP, of the associated annual budgets, and of the PRGF-supported program are broadly congruent.

Temporal alignment implies that donors organize their processes and procedures in such a way as to feed into and facilitate the country’s own processes, but not necessarily so as to make their internal processes entirely dependent on the authorities’ timetables. Policy alignment with the PRSP means that donor programs are drawn from the national strategies as set out in PRSP. Whereas PRSPs to date have set out policies in relatively general terms, donor programs are results-based and require more specific targets and measures. In cases where PRSPs lack specificity, it may be necessary for donors to include measures in their programs that were not specified or foreseen in the PRSP, but which are consistent with, and critical for, reaching the country’s growth and poverty reduction objectives. As the quality of PRSPs improves over time, it is expected that the measures in donor-supported programs would increasingly be derived explicitly from the PRSP.

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<sup>1</sup>See *Review of the PRSP Approach: Main Findings*, SM/02/53, March 15, 2002 (para. 50-53).

4. This paper is structured around issues of content, process, and documentation. Section II addresses issues in program design and content, specifically focusing on macroeconomic policy design, public expenditure management, and the staff’s approach to PSIA in Fund-supported programs. Section III describes possible process changes aimed at reinforcing country ownership and supporting effective implementation of the PRSP. Finally, Section IV discusses the adaptation of PRGF-related documentation to reflect more clearly the enhanced focus on supporting each country’s strategy for growth and poverty reduction.

The various options would be applied within the context of the existing overall PRSP/PRGF framework and modalities of the PRGF Trust instrument.<sup>2</sup>

5. While the final objective in each case is to ensure close alignment between national poverty reduction and growth strategies and the programs supported by the PRGF, the paper also recognizes that the path and pace for getting there will be heavily country-specific, since it depends on how quickly and effectively the content and process underpinning the PRSP can be strengthened to enable it to play the pivotal role that is envisaged under this approach. In some countries, capacity constraints may slow the alignment process considerably, and donors can help to accelerate this process by providing much-needed technical assistance to build national capacity in the relevant areas, and by making sure that their own requirements and processes in the interim reinforce, rather than distract from, the basic direction of change. In others, the constraints may be so binding that meaningful progress cannot be expected in the near term. Nevertheless, pragmatism and flexibility will be key watchwords during the interim phase to ensure that country needs are met without unnecessary disruptions of Fund support.

6. This paper reflects work in progress and is part of a broader work program on low-income country issues (see Box 2). It provides the basis for interim guidance to Fund mission chiefs and member country officials engaged in the design of forthcoming PRGF-supported programs. The options set out in the different sections will be tested during the coming year and refined through a number of channels, including:

- Feedback on this issues paper from Directors and, subsequently, from low-income countries, multilateral and bilateral agencies, academia, and non-government organizations actively working on these issues, including in the context of a planned technical workshop;
- The results of the IEO's ongoing evaluation of the PRSP and PRGF;
- The findings emerging from the ongoing research agenda of the Fund (summarized in Section II.F), the World Bank, and other concerned agencies. Preliminary findings will be discussed at an international research conference to be held in mid-2004 co-sponsored by the Fund and World Bank; and
- The continued insights from country authorities and mission chiefs on how their specific country case tests the general approach set out here or helps to make it more useful.

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<sup>2</sup> To the extent that experience in applying some of the proposed options (eventually) provides evidence that an adaptation of policies or instruments would be required to achieve the objectives of the alignment, staff will indicate this formally to the Board and seek approval for the necessary changes.

7. The staff intends to provide the next update on this work in the joint Fund-Bank report on progress in implementation of the PRSP approach scheduled for Fall 2003.

### **Box 2. The Fund's Work-Program on Low-Income Countries**

Aligning the PRGF and the PRSP approach is part of a broader agenda of work on low-income country issues which the Board will consider over the next six months. Specifically, in March 2003, in addition to this paper, the Board will have discussed joint Fund-Bank papers on:

- Topping-up and creditor participation under the HIPC Initiative, as well as a statistical update on the implementation of the HIPC Initiative, on which a technical briefing for staff from Executive Directors' offices is planned in late March;
- A review of Bank-Fund Collaboration on Public Expenditure Issues; and
- A proposal for the Development Committee to regularly monitor the policies and actions needed to achieve the MDGs.

Shortly after the Spring Meetings the Board will consider papers on:

- The role of the Fund in low-income countries over the medium term, along with a companion paper on helping (particularly low-income) countries deal with exogenous shocks;
- An initial review of debt sustainability in low-income countries, which would also serve as the Fund's contribution to a broader discussion and outreach effort on this issue over the summer.

## **II. PROGRAM CONTENT AND DESIGN**

8. A number of key issues emerged from the 2002 PRSP/PRGF reviews regarding the macroeconomic and structural content of national poverty reduction strategies, as well as the design of PRGF-supported programs. Principal amongst these were:

- concerns that the **projections** for growth and associated economic variables in many of these strategies, and also in associated PRGF-supported programs, **were often overly optimistic and inadequately substantiated** by an analysis of the underlying economic and structural policies required for such growth;
- a **disconnect between the macroeconomic frameworks** emerging from countries' PRSPs and those used for the national budget process and reflected in the PRGF-supported program;



- the recognition that the **macroeconomic impact of significant increases in aid-financed development spending** needed to be analyzed and reflected in the design of annual budgets and associated PRGF-supported programs;
- the need to clarify how the Fund could best contribute to the country-led effort to **analyze the poverty and social impact of the measures set out in the PRSP**, as well as how such analysis would inform the design of PRGF-supported programs; and
- the importance of **strengthening public expenditure policies and management systems**, so as to promote effective targeting of poverty-reducing spending.

#### A. Realistic and Better Substantiated Growth Projections

9. **Concerns about the optimism of growth projections** in PRSPs and associated PRGF-supported programs were raised during the PRSP/PRGF reviews,<sup>3</sup> and more recently, in the context of the worse-than-expected export growth outcomes for a number of HIPCs. For example, the recent IEO case studies of prolonged users of IMF resources found that projections of growth, savings, and investment rates were consistently higher than actual outturns.<sup>4</sup> There is also evidence that Fund staff projections have tended to be over-optimistic (Box 3).

10. Overly optimistic assumptions regarding growth, budget revenues, and exports can have severe adverse consequences when countries are forced to adjust mid-stream by reducing expenditure, incurring unsustainable levels of new debt, and/or resorting to inflationary sources of financing. Over-optimistic projections can also lead to complacency about the adequacy of existing policies and institutions when the strengthening of both may be key to achieving better growth performance and progress toward the MDGs. They can also undermine the credibility of Fund program design and policy advice, especially when countries deliver on the agreed policies. Moving to more realistic and better substantiated growth projections is therefore a key objective for both PRSPs and associated PRGFs.

11. Addressing the above issues entails action on a number of fronts. First, the **assumptions underpinning PRSP growth projections need to be more systematically tested** against past performance in the country and the experience of other countries. Where the projected performance is substantially better than past outcomes, the underlying sources

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<sup>3</sup> See *Review of the Poverty Reduction Strategy Paper Approach—Main Findings*, SM/02/53 Revision 1, March 15, 2002; *Review of the Poverty Reduction and Growth Facility: Issues and Options*, SM/02/52, February 15, 2002; and *Poverty Reduction Strategy Papers—Progress in Implementation*, SM/02/250, August 6, 2002.

<sup>4</sup> *Evaluation of Prolonged Use of Fund Resources*, IMF Independent Evaluation Office, EBM/02/100, September 23, 2002.

of improvement should be set out more explicitly through an **analysis of the sources of, and obstacles to, growth**, as well as of the policies that can accelerate and sustain growth at the level needed to attain the country's poverty reduction goals and objectives. Given the importance of a sound financial sector to private sector investment and sustainable economic growth, such analysis will also need to take into consideration the policies and measures being undertaken to strengthen this sector. This also holds true for the development of the economic infrastructure, and the legal and regulatory frameworks. Many countries will need support from their external partners—including the Fund—in addressing these complex analytical issues and choosing from the broad range of relevant policies to support higher levels of sustainable growth.

### **Box 3. Evidence on the Bias in Short-Term Macroeconomic Forecasts**

The Review of the PRGF found that PRGF-supported programs had more ambitious growth targets than the earlier ESAF-supported programs. More recently, a Bank/Fund study found that Bank and Fund staff export projections for many of the HIPC countries were higher than actual outcomes.<sup>1</sup> Other empirical studies have examined the evidence that staff forecasts have tended to have a positive growth bias and a negative inflation bias:

- A 1996 study comparing the average WEO growth and inflation forecast for the period 1977-94 found a significant positive bias in current-year and year-ahead forecasts for growth and a large negative bias for inflation forecasts for developing countries (analyzed in five regional groupings)—by contrast, the forecasts for industrial countries were generally found to be unbiased, serially uncorrelated, and efficient;<sup>2</sup>
- A later study (2001) found that the positive growth bias and negative inflation bias during the period 1990 -99 identified for a group of 36 African countries were also present at the individual country level, with the biases larger for non-program countries. The study also found that the growth bias was mainly concentrated in countries which experienced major conflicts;<sup>3</sup>
- A recent internal study of WEO forecasts for the period 1991 -2001 across all countries found a significant and persistent bias toward optimism in the projections over a one-, three-, and five-year time horizons for real GDP growth (averaging ½ percent per year, and over 1 percent per year for low-income countries); the current account deficit (1–1½ percent per year and double that for low-income countries); the debt-to-GDP ratio (1–1½ percent per year); and inflation (4½–5 percent in the low-income countries).

It is important to note in this context that Fund staff projections are not meant to be unconstrained forecasts, but rather are *conditional expectations*, expected outcomes based on the assumption that a program is fully implemented and that exogenous factors such as adverse terms of trade developments, conflict or drought do not arise. Deviations from the projections are thus inevitable if any of these assumptions are not met.

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<sup>1</sup> See Annex IV, *Status of Implementation of the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative*, SM/02/264, August 16, 2002.

<sup>2</sup> Michael Artis, "How Accurate are the IMF's Short-Term Forecasts? Another Examination of the World Economic Outlook," *IMF Working Paper*, WP/96/89, 1996 .

<sup>3</sup> Dennis Botman and Francesco Caramazza, "What Underlies the Positive Growth Bias in the IMF's Short-Term Forecasts for Growth and Inflation in Sub-Saharan Africa", unpublished manuscript, 2001.

<sup>4</sup> Atish Ghosh and Bikas Joshi, "How Good (or Bad) are Fund Projections?", internal note, 2003.

12. **A more systematic analysis of growth prospects also needs to be an integral part of PRGF-supported programs.** The proposed redesign of PRGF documentation discussed later in this paper (see Section IV) is partly intended to reflect this heightened focus. It should be recognized, however, that there is no single, generally accepted model that can quantify the effect of policies on medium-term growth with any precision, and Fund staff should therefore not be expected to provide such precision. When assessing sectoral growth prospects, Fund staff would draw upon the expertise of the World Bank.<sup>5</sup> To underscore that growth projections in these countries are inherently imprecise, **staff will explore in its reports the major downside risks and uncertainties in the PRGF-supported program projections** with regard to both exogenous factors (including shortfalls in foreign assistance) and slippages in program implementation. This will be done qualitatively and, to the extent possible, quantitatively through **sensitivity and/or alternative scenario analyses.**<sup>6</sup> Staff assessments of the authorities' macroeconomic frameworks and growth projections will also need to be strengthened in the joint staff assessments (JSA) of the PRSP or PRSP Progress Report.

13. Finally, to assist the authorities in developing realistic macroeconomic and growth frameworks, **Fund staff should engage early and actively in the PRSP process** with countries and other development partners to discuss the underlying macroeconomic assumptions of the PRSP, commensurate foreign assistance, and the principal policy measures and institutional changes that are needed. As noted in Section III below, the Fund Resident Representative has an important role in this regard. It is clear, however, that this more active role implies a greater input of staff resources into the PRSP process.

### **B. Aligning Macroeconomic Frameworks in PRSPs, National Budgets, and PRGF-Supported Programs**

14. A key objective in striving for greater realism in the macroeconomic projections underpinning the PRSPs is to establish a firm basis for sustained improvements in performance over time. The country strategy process embodied in PRSPs should provide the crucial link between national public actions, donor support, and the development outcomes needed to progress towards the MDGs. The macroeconomic framework and strategy underpinning a PRSP should therefore facilitate discussions in the country of the policy and institutional reforms required to achieve these outcomes, and provide a basis for discussions with development partners on mobilizing additional donor assistance required for progress

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<sup>5</sup> The World Bank has well-developed instruments for the analysis of growth policies and the identification of priorities, the results of which are presented in the Development Policy Reviews (DPRs), Country Economic Memoranda (CEMs), and associated analyses.

<sup>6</sup> For example, through more formal sensitivity analyses of the likely impact of deviations in key assumptions regarding commodity prices, foreign aid flows, drought, and other key macroeconomic parameters.

toward the MDGs. To this end, the strategy should formulate carefully designed domestic policy reforms that alleviate the obstacles to growth and, together with greater aid flows and more conducive policies for trade and market access, can help countries to achieve more rapid growth and greater poverty reduction.

15. However, experience to date suggests that many countries have based the macroeconomic framework underpinning their PRSPs on the assumption that sufficient concessional foreign assistance would be forthcoming to finance the spending required to achieve their poverty reduction goals, and that absorptive and administrative capacity constraints would not impede the accommodation of this higher spending. They have often assumed significant improvements in growth performance and poverty outcomes without specifying how these improvements are to be achieved. The frameworks have also often not been consistent with those used by country authorities in setting forth their annual budgets, which were generally derived from more conservative assumptions regarding expected aid flows, growth, and other key macroeconomic variables, and which also served as the basis for the design of PRGF-supported programs.<sup>7</sup> This has led to **criticisms that countries' annual budgets and the associated PRGF-supported program are disconnected from the PRSP process.**

16. While the shortcomings of the above situation are self-evident, the solutions are not so simple. In the staff's view, and reflecting preliminary consultations with countries and stakeholders, one approach would be for countries to include in their PRSP the current medium-term macroeconomic framework, but then also set out credible plans for achieving more ambitious targets cast against the backdrop of its longer-term poverty reduction goals and objectives. These plans would generally need to cover the strengthening of policy and institutional measures and the provision of greater financial support on appropriately concessional terms by the country's development partners.

17. The use of contingent spending plans can be useful tools for facilitating adjustment to unforeseen changes in the underlying assumptions.<sup>8</sup> Any mid-course adjustments to the macroeconomic framework should be presented in the country's subsequent annual PRSP Progress Report.

18. **The baseline macroeconomic framework and contingency spending measures would also serve as the basis for the macroeconomic programming in PRGF-supported**

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<sup>7</sup> As noted above, even these more conservative assumptions have sometimes been overly optimistic.

<sup>8</sup> For example, the PRSP could usefully indicate how unanticipated additional resources would be used (i.e., priority poverty spending, build-up of reserves to further buffer against shocks, etc.) while maintaining growth and macroeconomic stability, or what corrective spending and/or revenue measures would be undertaken in the case of resource shortfalls.

**programs**, and would be updated in the light of any major developments during the programming period—the revised version would underpin the subsequent annual or supplementary budget and be reflected in the annual PRSP Progress Report and/or subsequent full PRSP. This practice is already being followed by some countries. For example, Albania issued a letter in June 2001 (as a supplement to the PRSP presented to the Executive Boards of the Bank and the Fund in January 2001 that revised and updated the PRSP framework to take account of delays in privatization and budgetary support for energy imports. The impact of these changes was already reflected in the PRGF-supported program.

19. Given the added complexity regarding the proposed approach, it is useful to consider whether there are any alternatives. One would be for the PRSP to be based solely on existing institutional capacity, policies, and resource availability. This would clearly undermine the PRSP's basic objective of setting forth a more ambitious strategy for reducing poverty and achieving more rapid progress towards the MDGs. Another would be for the PRSP to set goals which are unconstrained by policy or institutional capacity or by limits on the possible availability of, or potential for the absorption of, additional resources. This would risk making the PRSP less operationally relevant and undermine its usefulness for both the national authorities and development partners. In addition, since the PRGF would continue to support the more conservative budget-based macroeconomic framework, this would do nothing to address the disconnect between the PRGF and the PRSP. Consequently, the staff believes that the above approach provides a better foundation on which to proceed.

20. At present, because of data and capacity constraints in many low-income countries, dialogue with Fund staff on the macroeconomic framework and on alternative policy options has been limited; the macroeconomic framework contained in the PRSP has often been incomplete; and the framework presented in the PRGF-supported program has often been based on estimates and analysis by the authorities and Fund staff. Legitimate questions can be raised, therefore, as to whether this approach will further strain the administrative and technical capacity in most low-income countries, as well as place an excessive burden on Fund staff. However, some countries have already begun developing flexible macroeconomic frameworks with contingency spending plans, while others have developed multiple scenarios, but without the benefit that would come from their alignment. For example, Senegal and Niger have both taken the two-scenario approach in completing their full PRSPs.

21. The Fund can assist in this effort by helping national authorities to identify the sources of (and constraints to) growth and to formulate appropriate policies to improve overall performance; integrate their PRSP into the existing budgetary and planning processes; and ensure the realism of the assumptions underpinning the macroeconomic frameworks on which their poverty reduction strategies are based. Fund mission teams will continue to encourage the authorities to prepare their own macroeconomic frameworks with contingent spending plans as the basis for program discussions, but given institutional capacity constraints, it may take some time before countries can engage in broader and deeper discussions and analysis of the macroeconomic frameworks, as well as of policy choices in PRGF-supported programs. The Fund will continue to help countries build capacity in

macroeconomic and financial programming, and staff will need to be prepared to assist the authorities in these efforts when requested.

### C. Accommodating Higher Aid Flows

22. Under the PRSP approach, countries with sound poverty reduction strategies and public expenditure management systems should benefit from higher aid flows.<sup>9</sup> In turn, it is expected that **the fiscal and financing targets in PRGF-supported programs will accommodate higher poverty-reducing spending** in cases where additional foreign aid flows are on sufficiently concessional terms and where they can be spent productively without undermining macroeconomic stability and/or fiscal and external debt sustainability. At the same time, a substantial and rapid increase in concessional flows, and the lack of predictability as to their timing, can raise a number of issues that both national governments and their development partners should consider in assessing the impact of these flows, including with regard to institutional and absorptive capacity constraints, monetary policy, competitiveness, and fiscal and external debt sustainability. The Fund can make an important contribution to the effective use of additional development assistance by assisting countries in thinking through and assessing these issues. In this regard, the following considerations are likely to be relevant.

23. In assessing the macroeconomic implications of higher aid flows and associated poverty-reducing spending, **consideration will need to be given to whether there is sufficient absorptive capacity in the economy, as well as administrative capacity within the government, to accommodate these flows.** Equally important, there is a need for good governance in employing these additional funds. If not foreseen and carefully planned, a rapid increase in aid flows is likely to be associated with a decline in the quality of expenditure and can raise important questions about transparency and accountability in the use of these resources. It is essential, therefore, that countries think through and put in place appropriate mechanisms to safeguard the use and deployment of these funds.

24. Larger inflows of concessional assistance could have **implications for fiscal sustainability**, particularly if they take the form of debt rather than grants. Country authorities will therefore need to consider both the quality and effective targeting of the proposed spending financed through these inflows, as well as the implications of the higher aggregate spending on the medium-term fiscal outlook. In doing so, they should also take into account the recurrent cost implications of such spending within the context of an

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<sup>9</sup> These higher aid flows are expected to include additional bilateral development assistance; debt relief under the Enhanced Heavily Indebted Poor Countries (HIPC) Initiative and other debt relief initiatives; special global initiatives, such as the Education for All Fast Track Initiative, and the Global Fund to Fight AIDS, Tuberculosis, and Malaria; and other international support for poverty reduction, including from private philanthropic organizations.

appropriately designed multi-year public expenditure framework, backed by adequate public expenditure management (PEM) procedures.

25. Larger flows of concessional debt could also have **implications for external debt sustainability**, particularly in some HIPC countries where the debt prospects remain fragile. Fund staff will continue to coordinate closely with World Bank staff at an early stage to quantify and substantiate the likely impact of higher aid flows, and countries will need to strengthen their overall debt management capacities. To the extent that the analysis projects a worsening of the debt indicators beyond the appropriate thresholds of sustainability, staff would advise country authorities to seek to increase the share of grants or the degree of concessionality of new aid inflows, or to cut back on non-priority spending. In the coming months, staff will be examining issues of debt sustainability in low-income countries, including those emerging from the HIPC framework, and will reflect on how these constraints can best be reflected in program design.<sup>10</sup>

26. **Competitiveness issues could be an important consideration in some aid-dependent economies.**<sup>11</sup> If aid flows are largely used to finance imports, then there would be only a minimal effect on domestic demand and, in turn, the domestic wage and price level. However, to the extent that aid flows are spent on non-traded goods, the relative price of these goods could increase, resulting in a sectoral reallocation away from the production of tradable goods. In cases where resource utilization is low (i.e., where there is slack in the economy), an aid-induced increase in aggregate demand could stimulate a supply response instead of a price response. If, however, the country's unemployed labor resources are low or unskilled and/or if the capital stock is at full or near-full capacity, pressure would be placed on prices and wages in the non-tradable sectors. This, in turn, could place pressure on the real exchange rate, thereby undermining competitiveness. The reduction in the relative size of the tradable goods sector could also undermine the country's external sustainability. An appreciation in the real exchange rate may not necessarily be problematic to the extent that aid flows are considered to be sustainable and nontraditional exports growth remains healthy. This may, however, raise important questions regarding aid dependency.

27. How significant these issues are will depend on the circumstances in each country, but the review of country experience with Fund-supported programs suggests that this should

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<sup>10</sup> Fund staff will also be prepared to re-examine the appropriate levels of Fund financial assistance to the country, in light of the relative degree of concessionality of PRGF resources vis-à-vis support from other agencies. This issue will be considered in the forward-looking paper on the Fund's role in low-income countries over the medium term.

<sup>11</sup> More analytical and empirical work is needed to strengthen the Fund staff's capacity to estimate the economy-wide implications of additional poverty-reducing spending on external competitiveness, real domestic interest rates, and inflation. This is a priority area of the work program of the Fund's Research Department.

not pose an insurmountable problem for most. Even in cases where countries believe that they need to cap aggregate spending at a specific level on macroeconomic stability and/or sustainability grounds, additional priority spending for poverty reduction could be accommodated by cutting back spending in non-priority areas.

28. In the few cases where the authorities believe that the negative macroeconomic consequences of higher externally-financed poverty-reducing spending outweigh the benefits, countries could instead save these resources for the future; reduce their domestic indebtedness, thereby freeing up resources for poverty reduction in subsequent periods when capacity constraints have been addressed; or build up their net international reserves to further insulate the country (and the poor) against the effects of exogenous shocks.<sup>12</sup> In such cases, or where the staff believes that the macroeconomic consequences outweigh the benefits of higher spending in the immediate period, the associated program documents will need to explain why the Fund should support such a stance.

29. In the case of the global funds that have been created to accelerate progress in specific areas of poverty reduction (i.e., the Education for All Fast Track Initiative, the Global Fund for the Fight Against AIDS, TB and Malaria, etc.), development partners and low-income countries should work closely together to ensure that the level of resources being made available can, in fact, be absorbed by the domestic economy without causing significant macroeconomic instability that could undermine the poverty reduction effort. Again, the presumption should be that these funds would underwrite additional high priority expenditures but, depending on the extent of the institutional and absorptive capacity constraints, resource flows may need to be re-sequenced in order to maximize the desired impact. With regard to the Education for All Fast Track Initiative, Fund staff has been working with its counterparts in the World Bank to ensure that any macroeconomic issues raised by the proposed increase in external support are identified and resolved on an early basis. A similar exercise will soon be underway regarding the Global Fund for AIDS, TB and Malaria (GFATM).<sup>13</sup>

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<sup>12</sup> The case for using donor assistance to build-up reserves or pay down domestic debt should ideally be presented in the PRSP as part of the country's overall strategy. It is worth noting that, in a number of countries, government recourse to domestic financial markets has contributed to keeping real interest rates at high levels, with adverse consequences for private investment.

<sup>13</sup> This would help preclude situations such as that which occurred in Uganda in late 2002, where the Finance Ministry was initially reluctant to accept a substantial grant from the GFATM unless it could be used to replace already budgeted health spending, owing to concerns about the macroeconomic effects of overshooting existing expenditure ceilings. Similar issues have arisen in Tanzania and Mozambique.



#### **D. Improving Public Expenditure Policy and Management**

30. Improvements in public expenditure policy and management are critical for increasing the overall effectiveness of development programs, strengthening governance in general, and increasing transparency and accountability with regard to the use of external assistance, including debt relief. Improved public expenditure management systems are also a key requirement for many donors to move to more predictable, multi-year aid commitments in the form of budget support. However, many countries continue to suffer from weaknesses in this area that would retard progress in alignment and impinge upon their ability to absorb higher aid inflows efficiently.

31. Assisting countries in strengthening public expenditure policy and management is an area of shared responsibility between the Fund and the Bank.<sup>14</sup> The scope of this work in both institutions has expanded significantly in recent years, particularly in PRSP countries, and now covers a wide range of institutional issues, including: policy and budget formulation; budget execution and accountability; and service delivery and development impact. The Fund and the Bank have been working to enhance further their collaboration on public expenditure issues. A recent joint paper to the Executive Boards of the two institutions proposes a **new framework for support to countries and collaboration among external partners on public expenditure work**,<sup>15</sup> based on: (i) a government-articulated public expenditure reform strategy set out in the PRSP or other country-owned documents; (ii) an integrated and well-sequenced program of diagnostic work; (iii) coordinated provision of technical assistance for the implementation of the reform strategy; and (iv) periodic reporting on public expenditure policy, financial management, and procurement. Operationally, the framework would require early consultation among country teams and formalized exchange of information on mission planning and needs for expenditure work by both institutions; more frequent cross-participation on missions; and strengthened joint work on fiscal Reports on Standards and Codes (ROSCs) and Country Financial Accountability Assessments (CFAAs).

32. The Fund's work on expenditure issues has focused on core areas essential for macro-fiscal management, including reforms in budget preparation, execution, and reporting, and short-term expenditure rationalization. Improvements in these areas are necessary if budgets are to become the central tool of pro-poor public policy. Moreover, **the translation of the PRSP's objectives into concrete policy commitments and measures reflected in the**

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<sup>14</sup> The Development Committee in September 2002 called on the IMF and the World Bank to scale up and intensify their efforts in assisting countries to mobilize domestic resources and improve the quality of public expenditure. See "Joint Ministerial Committee of the Board of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries, Development Committee Communiqué, Washington, D.C., September 28, 2002.

<sup>15</sup> See *Bank/Fund Collaboration on Public Expenditure Issues*, SM/03/73, February 19, 2003.

**budget is at the heart of the staff's proposals for aligning the PRGF** and other donor support programs with the PRSP (see next section).

33. The Fund supports countries' efforts in these areas through policy advice (in the context of surveillance), and by proposing specific policies to be carried out in the context of Fund-supported programs, often supported by targeted conditionality.<sup>16</sup> The Fiscal Affairs Department (FAD) provides extensive technical assistance (TA) in support of the design and implementation of treasury systems for commitment control, monthly expenditure reporting, and short-run cash and arrears management, as well as capacity building in macro-fiscal management.<sup>17</sup> Moreover, FAD has been increasing its emphasis on upstream technical assistance that establishes broad strategies and monitors their progress, while support for detailed aspects of their implementation is left to other providers of technical assistance.

#### **E. Poverty and Social Impact Analysis of Key Measures in PRGF-Supported Programs**

34. Poverty and social impact analysis (PSIA) of key macroeconomic, structural, and sectoral reforms is an important tool that low-income countries should systematically employ in assessing policy choices and tradeoffs. While over time it is expected that these countries will carry out and integrate PSIA into the design of their poverty reduction strategies, they face a number of challenges at present which impede their ability to do so, including data, analytical, and institutional capacity constraints. There is a need, therefore, for development partners and others with competence in this field to provide substantial technical assistance to low-income countries to build up their capacity to conduct PSIA over the medium term, while carrying out such analyses themselves during the interim as an input into the national policy debate.

35. Since the September 2002 progress report on the PRSP/PRGF, work on PSIA issues has advanced on three fronts. First, the evaluation of **a series of country case studies** supported by the World Bank, the Fund, and the U.K.'s DFID has improved the

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<sup>16</sup> The average PRGF-supported program contains 10 measures in the area of fiscal adjustment and public sector reform, with an emphasis on improving public expenditure management.

<sup>17</sup> Relatively more of the available resources for technical assistance by FAD were allocated to UFR work in FY 2001-02, (particularly in HIPC), reflecting a joint effort with the Bank in 2001-02 to assess public expenditure systems in HIPC and their capacity to track poverty-reducing expenditures. Most of the TA activities were in support of capacity building and HIPC-related work, which has a clear poverty reduction focus. See *Actions to Strengthen the Tracking of Poverty-Reducing Spending in Heavily Indebted Poor Countries (HIPC)*, SM/02/30, January 30, 2002 and Supplement 1; and *Review of Technical Assistance Policy and Experience*, SM/02/180, June 13, 2002, paragraphs 18-21.

understanding of what can be done to assess the poverty and social impact of different types of policy reforms using varying analytical techniques (see Box 4). This work complements the development by the Bank of a “User’s Guide to Poverty and Social Impact Analysis”, which sets out tools and approaches for conducting PSIA, and of a “Toolkit for Evaluating the Poverty and Distributional Impact of Economic Policies”, which aims to provide practitioners with tools to quantify the distributional impacts of alternative policy choices or specific exogenous shocks.

36. Second, discussions with the Bank have clarified the respective roles of the two institutions in this area. Vis-à-vis the Fund, the World Bank is the lead agency on PSIA since these analyses often focus on structural and social issues which are within the Bank’s core areas of expertise.<sup>18</sup> The Bank is therefore expected to take the lead in assisting countries in carrying out PSIA of major policy reforms, including in applying existing techniques more systematically, in building in-country capacity, and in undertaking research to improve the applicability of new analytical techniques over time. To operationalize the above approach, Fund staff is meeting with its World Bank country team counterparts in the context of the enhanced framework for Bank/Fund collaboration to exchange views and reach understandings on the priority reform issues for PSIA.

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<sup>18</sup> See *Poverty Reduction Strategy Papers—Progress in Implementation*, SM/01/268, September 14, 2001.

#### **Box 4. Country Case Studies on Poverty and Social Impact Analysis**

In February 2002, the World Bank, the Fund, and the United Kingdom's Department for International Development (DFID) launched a coordinated joint effort to examine systematically the practical implications of undertaking PSIA of policy reforms in key sectors.<sup>1</sup> As part of this effort, eleven case studies in low-income countries were undertaken. While these case studies have played a useful role in advancing the knowledge base on PSIA, further work is required to derive useful results, particularly regarding policy trade-offs. The case studies demonstrated that:

- **It is possible to do PSIA in-country and contribute to an informed exchange on the poverty and social impacts of alternative policy choices.** There is generally enough data, information, and knowledge (though some of it is untapped) to permit at the least an assessment of the potential poverty impacts;
- **Different tools and methods can be used in the analysis**, although the relationship between policy and outcome is complex;
- **There is no single set of techniques applicable in all cases**, and the analysis needs to be suitably disaggregated to be valuable as a tool of policy. It may focus on the impact of one reform on a particular vulnerable group (e.g., the removal of subsidies on irrigation water on mountain communities in Armenia);
- **To be valuable as an input into the policy debate, the PSIA should be part of a country's established systems** (e.g., featuring as a priority in the PRSP) and undertaken with a clear understanding of the country's political context. Donor involvement in this analysis needs also to be better organized and coordinated.

<sup>1</sup> The case studies concerned reforms in utility sectors (Armenia, Guyana, Honduras, Pakistan); agriculture (Chad, Guyana, Indonesia, Malawi, Uganda); fuel (Mozambique); and the fiscal deficit (Rwanda).

37. Third, experience to date in incorporating PSIA into PRGF-supported programs has been limited as those donors with expertise in this domain are still only in the early stages of providing such support, and Fund staff lacks the expertise to carry out comprehensive PSIA itself. Expectations regarding the scope and breadth of these analyses in the immediate future should therefore be tempered, as it will inevitably take time before PSIA will be systematically carried out by countries and/or development partners in light of existing constraints. In the interim, however, **the documentation for the majority of PRGF-supported programs will continue to provide a description of any PSIA that has been carried out in the country as it relates to the measures supported under the program.**<sup>19</sup> Going forward, this approach should be **generalized to all PRGF-supported programs** and

<sup>19</sup> At the March 2002 PRGF Review, Directors called for systematic treatment of these issues in PRGF documentation.

progressively **broadened to cover how these analyses and discussions have affected policy choices.**

#### **F. Forward-Looking Macroeconomic Analytical Agenda**

38. A number of macroeconomic management issues faced by PRSP countries require additional research to increase the understanding of growth and poverty reduction linkages. Fund staff is contributing to this research effort in areas that are critical to PRSP development and implementation, and reflect the institution's core competence.<sup>20</sup> These include: linkages between macroeconomic policies, growth, and poverty reduction; addressing vulnerability and exogenous shocks;<sup>21</sup> and accessing capital markets. As part of this work, **a technical workshop in April 2003** (co-sponsored by the Fund, the Bank, DFID, and the Netherlands) will enable participants from low-income countries, bilateral and multilateral donors, academia, and civil society organizations involved in relevant macroeconomic analytical work to discuss selected macro-related issues, as well as to identify a set of topics for research over the medium term. Subsequently, the Fund and Bank staffs propose to organize **a joint research conference on macroeconomic management and growth in low-income countries in mid-2004**. This would provide a forum for development partners to share preliminary results from their medium-term research efforts, drawing on the research agenda identified during the technical workshop.

### **III. PRGF PROCESS CHANGE—ALIGNMENT WITH THE PRSP PROCESS AND ENHANCED DONOR COORDINATION**

39. Despite initial expectations, many donors have not yet changed their own processes, procedures, and reporting requirements to facilitate alignment with the PRSP approach. These changes are needed, first, to facilitate the substantive alignment between the PRSP and donor-supported programs referred to above and, second, to use the PRSP process to reduce the transaction cost for low-income countries of dealing with multiple and often overlapping donor processes. **A key requirement for accomplishing this alignment is that the PRSP itself be anchored in the budget**, toward which donors can orient their support, and around

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<sup>20</sup> Staff is preparing and will widely disseminate a pamphlet summarizing the research being undertaken at the IMF, and are developing a web page on the IMF's external web site which highlights both past and ongoing internal research on these issues.

<sup>21</sup> The Fund is carrying out research on the impact of exogenous shocks on growth, as well as on the development of an appropriate set of policies to reduce vulnerability to such shocks. Findings from this research effort will be presented in a paper on exogenous shocks to be considered by Executive Directors in mid-2003.

which they can adapt their procedures. This section elaborates on the issues raised by such alignment.

### A. Linking the PRSP and National Budget Cycle

40. In order to be the framework for the interaction of low-income countries and their development partners, **the PRSP itself must be made more operationally relevant**. The Joint Review of the PRSP Approach recommended as a good practice that countries should “reassess the timing and linkage of their PRSPs to enhance the likelihood of effective integration and mainstreaming with other government processes,” especially the budget. In the start-up phase, most PRSP cycles did not respect this approach, but going forward, the staff remains convinced that **the internal alignment by the country authorities of the PRSP’s content and cycle with the annual budget cycle** is the key to making the PRSP more operational and an effective framework for donor coordination. This internal alignment would relate both to the initial PRSP itself and to subsequent annual PRSP Progress Reports.

41. One way to achieve this would be to **strengthen substantially the annual PRSP Progress Report so that it becomes the essential tool for the authorities in translating the strategic objectives of the PRSP into operationally relevant policies to be reflected in the budget**, rather than a simple report to donors on PRSP implementation. In it, the authorities would examine the implementation of the PRSP over the past year, and adjust their strategy and policy commitments for the coming year on this basis. The Progress Report could then serve as an input into sectoral allocation decisions in the budget preparation process, and feed into revisions of the medium-term expenditure framework (MTEF). Over time, as it comes to contain quantified reports on implementation, detailed policy commitments, and more precise targets and indicators for measuring performance in the coming year, it may be expected to play an increasingly important role in monitoring and evaluating performance relative to existing donor programs. Eventually, the Progress Report may supplant many of the individual documents and reports that donors presently require and become the basis for their support programs and related conditionality, especially those that are linked to the budget process alone. This could generate a substantial reduction in transaction costs for the country and donors alike, and could contribute significantly to enhancing the overall effectiveness of aid and strengthening country ownership of the reforms supported by donors.

42. The transition to this ideal situation, in which PRSPs provide a sufficiently detailed blueprint for reform, are integrated into a medium-term budget framework, and prioritize across needs, will be **a gradual and long-term process**.<sup>22</sup> It needs to be approached flexibly and take account of each country’s individual circumstances, including the time that will be

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<sup>22</sup> A full mapping of the PRSP into a medium-term fiscal framework would require aligning the budgetary functional/program classification with the PRSP’s definitions of sectors and programs.

needed in many countries to reduce or overcome severe capacity constraints, especially in budget management. The internal alignment of the PRSP and the budget cycle would thus also entail intensified efforts to strengthen fiscal management, particularly the adherence to the approved budget and the avoidance of extra-budgetary or unrecorded expenditures; and continuing improvements in public expenditure policy, to facilitate the translation of the PRSP's objectives into budget allocation decisions. Strengthening the country's capacity to collect, analyze, and disseminate the data needed for tracking poverty-reducing spending and monitoring results on a sufficiently timely basis would also be essential.

### **B. Enhanced Donor Coordination and the PRSP Approach**

43. A variety of donor harmonization initiatives have been launched over the past two years aimed at enhancing the effectiveness of aid, reducing the transaction costs of its delivery, and ensuring that the PRSP process does not become merely an additional burden on partner countries (see Box 5).<sup>23</sup>

44. As a contribution to this international effort, the staffs of the Fund and the World Bank have prepared a conceptual framework for aligning donor budget support with the PRSP.<sup>24</sup> It is articulated around the principle of individual and collective coordination of donor programs with the PRSP. Based on the premise that the PRSP is internally aligned with the national budget cycle as set out in Section III.A, the framework proposes that individual donors derive the content and conditionality of their programs directly from the PRSP whenever possible, ensuring that the problems of focus and overly burdensome conditionality of uncoordinated donor programs are addressed. Collective alignment across donors, accompanied by the simplification and harmonization of their requirements and procedures, would take place within a country-led coordination mechanism framed by the PRSP (see Box 6 for an illustrative example of the proposed alignment process).

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<sup>23</sup> This includes the work of both the OECD-DAC and the Strategic Partnership with Africa (SPA) over the past two years. Donor alignment is the centerpiece of the SPA agenda for the SPA-6 period, covering 2003-05.

<sup>24</sup> The staffs presented a joint concept note as a background piece for the High-Level Forum on Harmonization in Rome in late February 2003. The proposed coordination framework builds on existing and established good practices, and was discussed in detail with the co-chairs of the SPA Technical Group (the European Commission and the UK's Department for International Development - DFID) to ensure its consistency with the results of the action learning missions the group conducted in Ethiopia, Rwanda, and Senegal (Box 5). The framework was then presented informally in January 2003 at the SPA Plenary meeting, where participants broadly endorsed it, and encouraged the Bank and the Fund to proceed with the planned test of the concept in a few African countries.

45. The coordination of donor programs with the PRSP and the budget cycle could also make it possible for some donors to make indicative medium-term commitments of financial assistance, enhancing the predictability of aid flows, and helping reduce the likelihood of resource shortfalls that could undermine PRSP implementation and force adjustments to the macroeconomic scenarios.

#### **Box 5. International Initiatives for Donor Coordination and Harmonization**

- The **multilateral development banks** have prepared proposals for harmonizing their procedures in the areas of environmental assessments, the evaluation of sector operations, procurement practices, and assessing financial management and accountability.
- The **OECD-DAC Task Force on Donor Practices** has produced a series of good practice reference papers in the areas of country analytic work and the preparation of projects and programs; measuring performance in public financial management; non-financial reporting and monitoring; financial reporting and auditing; and delegated cooperation as part of a framework for harmonizing and coordinating donor procedures. The **DAC** is also carrying out work on procurement, and deepening existing cooperative practices in the area of evaluation. It intends to track practical efforts by members to align their practices with the PRSPs, giving due consideration to country institutional capacity constraints.
- The alignment of donor support is the central element of the new agenda for the **Strategic Partnership for Africa (SPA-6)** adopted in Addis Ababa on January 17, 2003, which focuses on the practical implementation of the PRSPs. In preparation for this, the SPA Technical Group conducted Action Learning Missions to three African countries in September-October 2002 to discuss the coordination of budget support. Also in the context of the SPA, bilateral donors participated in the World Bank's Country Financial Accountability Assessment (CFAA) process in five African countries, with a view to exploring its potential to become a common mechanism for assessing financial accountability arrangements and elaborating comprehensive financial management reform programs in developing countries.
- The **European Commission** has decided to launch a pilot initiative on coordination and harmonization of policies and procedures among the European Commission and member states of the European Union, in preparation for the implementation of conclusions agreed on at the meeting of the Council of the European Union in Barcelona in May 2002.
- The agencies of the **United Nations Development Group** are expected to implement the harmonization of their programming processes by 2004.



**Box 6. Example of Synchronized Cycle for Budget, PRSP Review, and Budget Support**

The following is an illustrative example of the proposed alignment between domestic processes (the PRSP, the national budget cycle, and the annual Progress Report) and donor processes. It is derived from the results of the SPA Technical Group’s action learning mission Ethiopia in September 2002 on aligning budget support.

	<b>Government</b>	<b>Donors</b>
Oct. 2003	Draft PRSP annual review of 2002/03 Discussion of progress and policy implications	Review of performance (using PRSP review and JSAs) Discussion of key performance indicators for future Indicative budget support commitments PRGF discussions
Nov. 2003	Macro-framework finalised Regional grants legislated	
Dec. 2003	Medium-term Expenditure Framework (MTEF) published	
Jan. 2004	Budget information to sector ministries	
Apr. 2004	Preparation of budget  Finalization of government policy commitments for 2004/05	Confirmation of budget support amounts PRGF discussions
Jun. 2004	Approval of budget	

46. This framework, like other harmonization initiatives, draws on the principle that **recipient governments take the lead in the donor coordination effort**,<sup>25</sup> and are actively involved in the preparatory analytical work; in identifying priority areas to be supported by donors; and in strengthening their reporting and monitoring systems. Donors, for their part, would be expected to identify any specific additional requirements (e.g., fiduciary, accountability, or data provision) which need to be met by the country authorities, and seek to harmonize their requirements as far as possible around existing reporting formats and the partner country’s systems (including by using diagnostic work and

<sup>25</sup> This is one of the OECD-DAC Guiding Principles on Providing Coordinated Aid. See *Harmonizing Donor Practices for Effective Aid Delivery: A DAC Reference Document*, OECD, DCD/DAC/TFDP(2002)12, December 6, 2002.

fiduciary or other assessments carried out by other donors). Donors would also need to exchange views on what would constitute acceptable progress in each area, so as to minimize divergences of opinion at the evaluation stage,<sup>26</sup> and to exploit potential synergies across different donor programs.

47. **Many recipient governments will require well-coordinated technical assistance** from the donors in order to build-up the necessary capacity to fulfill the leadership role in donor coordination, although some have already begun to do so.<sup>27</sup> Many donors also face constraints—procedural, institutional, and legal—that limit their ability to coordinate with other donors. **Implementing the proposed framework** for aligning donor budget support for the PRSP **will therefore be a gradual process that evolves over time**, as countries and donors gain experience and practices change, and it may not be possible in some countries in the near term. Staff will assess the scope for moving towards this approach in individual country cases, depending on the interest and technical capacity of national authorities to take on the extra responsibilities set out above. A few PRSP countries have already indicated an interest in moving forward rapidly to test the limits of enhanced donor cooperation under existing institutional policies, and Fund staff has been working with the World Bank, the European Union, and other interested donors to follow up.

### C. PRSP Alignment and Donor Coordination: Implications for the PRGF

48. When the ESAF was transformed into the PRGF and the PRSP process was inaugurated, countries were at various phases of ongoing Fund-supported programs, which were renewed according to the situation in each country and the internal cycle of the programs themselves. In parallel, the preparation of full PRSPs has also advanced at a

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<sup>26</sup> More generally, two critical questions would need to be addressed in the coordination framework: first, how to deal with issues such as progress in improving governance or human rights, which are critically important to some donors, but for which objective, measurable criteria and benchmarks are often difficult to define; and second, what steps can be taken to avoid the total suspension of coordinated aid in the event of isolated slippages.

<sup>27</sup> For example, in Tanzania, nine bilateral donors and the EU have adopted a common performance assessment framework for the portion of their aid provided in the form of budget support; and the government has prepared a draft action plan on the harmonization of procedures for effectiveness in aid delivery, including channeling project aid through the Exchequer system to ensure predictability and integrate external finance into government budgeting and reporting. In Ghana, the government and a number of bilateral and multilateral donors have signed a memorandum of understanding for a joint approach to budgetary and balance of payments support that will require harmonization of disbursements based on joint monitoring of performance.

varying pace across countries. As a result, the coincidence of a new, full PRSP with a new PRGF arrangement has been the exception rather than the rule.<sup>28</sup>

49. The alignment of the PRGF with the PRSP (in terms of both content and process) is part of the broader ongoing international alignment effort summarized above. The principal implication for the Fund is the need for a closer **alignment of the PRGF-supported program cycle with the PRSP cycle**. Given the budgetary focus of Fund-supported programs, this would be facilitated by the internal alignment of the PRSP and budget cycles. This section describes options for facilitating the temporal and procedural alignment of the PRGF cycle with that of the PRSP and the budget.

50. One approach would be to **synchronize the cycles by initiating a new three-year PRGF arrangement shortly after a new PRSP** (replacing existing PRGF arrangements where necessary), which would be consistent with the medium-term three-year macroeconomic framework underpinning the new PRSP (see Section II above) and support the priorities set out in the PRSP in the Fund's core areas.<sup>29</sup> The internal alignment between the PRSP and budget cycles described above would also mean that the country's fiscal year would be the program year for the PRGF arrangement. The annual PRSP Progress Report would be timed so that the new budget and every second semi-annual PRGF review would follow closely upon its completion (reflecting the close link between the PRGF-supported program and the budget). Joint staff assessments of the new PRSP and the subsequent annual Progress Reports could examine the degree of PRSP/budget alignment, as well as the alignment of donor programs (including the PRGF) with the PRSP.

51. The above is the ideal scenario. Obviously, countries may occasionally experience delays in finalizing their PRSPs. In other cases, there may be a need for urgent support to a country that has recently experienced a change of government or a significant exogenous shock. In still other cases, the programs may go off-track. In such cases, flexibility may be required in terms of setting targets (i.e., it may be necessary to set targets for six months only) and/or other modalities of the PRGF-supported program. As in the past, PRGF-supported programs can respond flexibly and be modified as needed during reviews in order to accommodate any mid-course changes that the authorities may make.

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<sup>28</sup> Of twenty full PRSPs discussed by the Executive Board through end-January 2003, only Albania, The Gambia, Guyana, and Tajikistan have had new PRGF arrangements discussed with new, full PRSPs. In two of those cases (Albania and Guyana), the PRSP had been finalized several months before Board discussion and required a supplement to update its macroeconomic framework. The PRSP-supported program did not coincide with the budget cycle in any of the four countries.

<sup>29</sup> This may not always be needed and sometimes may not be feasible. For example, the staff proposal implicitly assumes a three-year PRSP cycle, but longer cycles (e.g. actual timing of countries' PRSPs vary from 3-5 years) are possible.

52. In terms of donor coordination, Fund staff already works closely with the key donors in each country to discuss the consistency of program design, financing assumptions, and the key elements of program conditionality. This covers exchanging information with donors on the timing and conditions of disbursements, the modalities for informing them of the status of program reviews, and taking due account in the design of Fund-supported programs of relevant policies supported by other donors. As the PRSP process becomes a stronger common operational framework for the support of all development partners and donor coordination picks up steam, these links will be further reinforced, particularly with donors who are providing program support conditioned on indicators of macroeconomic and structural progress.

#### **D. Capacity-Building Efforts**

53. The ability of many countries to deepen their ownership of the PRGF-supported program by taking primary responsibility for policy formulation and program design will be limited over the short term by constraints on institutional, technical, and administrative capacity. These constraints may also impede progress in many areas critical to donor alignment with the PRSP approach. For example, weak budget management systems may hinder the internal alignment of the PRSP with the budget cycle; and constraints in the area of statistical capacity may also undermine the ability to monitor progress toward the objectives of the PRSP and the MDGs. **Coordinated and well-targeted donor support for countries' efforts to develop capacity in PRSP-related areas will thus be required.** For the Fund, this has taken the form of participation in PRSP workshops, both from headquarters and by the resident representatives (see Box 7), to discuss the overall macroeconomic framework and specific policy objectives in the IMF's core areas of expertise; and the provision of technical assistance in financial sector policy, fiscal policy, and statistical systems (particularly in helping countries participate in the General Data Dissemination System (GDDS), and through regional technical assistance centers such as AFRITAC).<sup>30</sup> It also includes training and learning events organized by the IMF Institute, both at Fund headquarters and in the regional training centers, in general macroeconomic policy formulation and financial programming, as well as in specific PRSP-related topics.<sup>31</sup>

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<sup>30</sup> The AFRITAC work program is drawn from the issues identified in the PRSPs of the participating countries, and the work program matrix includes explicit references to how the individual technical assistance outputs fit within each country's PRSP. Particular care was taken to coordinate the technical assistance provided through the AFRITAC with the activities of other providers in order to avoid overlaps and ensure that such coordination is systematic.

<sup>31</sup> There was a marked increase in technical assistance associated with the HIPC initiative in FY 2002, as well as follow-up to FSAPs and standards and codes work, and statistical improvements related to participation in the GDDS. Much of the assistance provided was in

(continued...)

### **Box 7. The Role of the Resident Representative in PRSP Countries**

Considerable responsibility falls to the Fund's resident representatives in PRSP countries in the effort to reinforce program ownership by enhancing and deepening the policy dialogue with the country authorities and civil society. Resident representatives have closely followed the participatory PRSP process, both as observers and occasionally, at the request of the authorities, as active members of thematic groups setting out policy priorities in areas of the Fund's core expertise. Through their regular contacts with civil society organizations, parliaments, and line ministries—with which Fund negotiating missions may not always have regular interaction—they have facilitated a better understanding of the macroeconomic frameworks underpinning the PRSP, including the financing constraints and the costs of failing to reform; the objectives of the PRGF-supported programs and their link to the poverty reduction strategy; and the rationale for, and acceptance of, program conditionality.

In some cases, where the authorities have indicated the willingness to take the lead in preparing a macroeconomic framework and drafting a letter of intent, the resident representative has acted as a sounding board for a discussion of policy objectives—outside of the formal framework of program negotiations, this interaction had tended to allow the authorities greater room for experimenting with different policy mixes. Finally, as the coordination effort among donors picks up steam, resident representatives have often been the first point of contact with other donors on PRSP-related matters. This role is particularly important for contact with donor agencies that have delegated much of the operational responsibility for program monitoring to their field offices.

Moving forward, these existing good practices should be systematized, and resident representatives should be equipped and ready, whenever the authorities request it, to play an active role in the PRSP process, in both advisory and participatory capacities. They will need to be fully integrated into the mission team's work on alternative policy options, in order to be able to advise the authorities on the range of outcomes that could be supported under the PRGF; and their advice on the planning and preparation of program negotiations (both with regard to program content and timing issues) will take on greater importance. They will also be well placed to provide an input with regard to the political constraints that authorities face and assume more responsibility for keeping other donors informed of the status of the Fund-supported program and helping to synchronize donor missions.

54. The Fund is also focusing on developing the ability of staff to support the effective design and implementation of PRSPs and PRGF-supported programs (Box 8). PDR has

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areas that are considered as capacity building and are directly linked to poverty reduction. See *Review of Technical Assistance Policy and Experience*, SM/02/180, June 13, 2002 (para. 15-16).

conducted a series of PRGF Mission Chief seminars on specific topics of interest,<sup>32</sup> and training is provided to staff on negotiating and influencing and media relations skills to facilitate the open discussion of policies, trade-offs, and constraints with a wider public audience. Fund staff has also participated in specially designed training courses offered by the World Bank Institute's Macroeconomics and Policy Assessment Skills (MPAS) program, aimed at building analytical and practical skills in the quantification and evaluation of the poverty and distributional effects of adjustment policies.

### **Box 8. Fund Involvement in the PRSP Participatory Processes**

The PRSP in each country is based on a participatory process designed by the authorities to solicit ideas from the poor, from civil society organizations, and from donors, and to involve all stakeholders in the poverty reduction effort. Because each participatory process is unique to the institutional arrangements and economic situation of the country, the Fund staff's role in the participatory process has varied considerably across countries. Some examples illustrating the different modalities of Fund involvement include:

**Sri Lanka:** The PRSP benefited from wide-ranging consultations over a four-year period, including with Fund staff. Notably, the IMF mission chief and resident representative participated in a donors' forum to ascertain the views of external stakeholders; the macroeconomic framework was developed in consultation with staff; and the draft PRSP benefited from staff comments at various stages.

**Guinea:** The IMF mission chief and the resident representative participated actively in preparatory workshops that fed into the PRSP; the resident representative attended several of the regional PRSP consultation events and was an active member in one of the PRSP thematic groups; and staff was invited to participate in the final PRSP validation event. The mission chief also participated with the authorities in a series of meetings with civil society to explain the agreed macroeconomic framework and its link to the PRSP.

**Ghana:** In the interests of ownership, the government organized the PRSP participatory process on parallel tracks, with priority given (especially in the early stages) to workshops, community meetings, and other events in which only Ghanaians participated; consultations with donors and the international financial institutions took place separately. Along with other development partners, Fund staff provided comments on successive drafts of the PRSP, as well as advice and technical support on the preparation of the macroeconomic framework and the costing exercise.

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<sup>32</sup> Recent topics have included poverty and social impact analysis; the implications of the recently concluded biennial review of surveillance; macroeconomic issues related to aligning the PRGF with the PRSP approach; Fund/Bank collaboration in program design and conditionality; and statistical dimensions of the PRSP/PRGF.

#### IV. ADAPTATION OF PRGF DOCUMENTATION

55. The expectations set out for the PRGF and the PRSP process at the time of the transformation of the ESAF into the PRGF implied substantial changes to the substance and form of PRGF-supported programs, although the operational implications were expressed in general terms. With the benefit of three years of experience, the strengths and weaknesses of the PRGF and the PRSP documentation have become evident. In particular, the 2002 review of the PRGF noted that some aspects of PRGF design and the PRSP approach, which are central to the reorientation of Fund concessional assistance, are often not evident in PRGF staff reports and LOIs/MEFPs or are addressed only in very general terms. The review also found that there was uneven coverage of key PRGF features across PRGF staff reports. As a result, the Board called for more systematic treatment of these requirements.

56. The staff is in the process of formulating an approach to **redesigning PRGF documentation to ensure a more systematic treatment of key issues, while reducing the burden of documentation requirements** on countries, staff, and Board members. This approach would address three broad sets of issues: (i) demonstrating more clearly how the PRGF-supported program supports the objectives of the country's PRSP, including its strategy for progressing toward the MDGs; (ii) showing how the design of the program has evolved through interaction with authorities, indicating more clearly how policy choices have been made; and (iii) rationalizing reporting requirements, so that necessary information is available while not overburdening authorities, the staff, and the Board with redundant information.

##### A. The Relationship of the PRGF-Supported Program to the PRSP– Program Design and Policy Choices

57. The review of the PRGF found that while the content of PRGF-supported programs was broadly consistent with PRSPs and I-PRSPs, the linkages between the PRGF and the PRSP were often not clearly evident. Directors therefore considered that documentation for PRGF-supported programs, as well as JSAs, needed to set out more clearly the program's role in the context of the overall poverty reduction strategy, and explain how the specific program measures in the PRGF-supported program relate to the PRSP.<sup>33</sup>

58. The manner in which the PRGF-supported program is derived from the PRSP is not generally self-evident. It was recognized from the outset that if the PRSP contains only general policy directions, then the Letters of Intent and Memoranda of Economic and Financial Policies (LOI/MEFPs) would need to flesh out specific, dated actions in support of the agreed strategy around which the full specification of a PRGF-supported program would

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<sup>33</sup> See *Summing Up by the Acting Chair Review of the Poverty Reduction and Growth Facility*, BUFF/02/40, 03/15/2002.

be articulated.<sup>34</sup> In such circumstances, staff reports need to explain how the specific elements of the PRGF-supported program relate to the PRSP. Furthermore, all staff reports should reflect the policy dialogue between staff and authorities and the evolution of program design in response to changing circumstances. The specific approach to achieving these goals will vary according to the stage of the PRSP process, the PRGF arrangement, and other country-specific circumstances.

59. One option under consideration would be to **redesign the first PRGF staff report accompanying a new PRSP or a request for a new PRGF arrangement to ensure that the key aspects of PRGF design and the PRSP process are evident** when a new PRGF arrangement is first considered by the Board. Under this option, the initiating staff report would:

- Begin by framing the PRGF-supported program in the terms of the country's objectives and goals for accelerated growth and progress towards the MDGs, as set out in its PRSP;
- Place particular emphasis on showing how the macroeconomic framework and structural reforms supported by the PRGF are linked to the PRSP and annual budget and how they would contribute to poverty reduction and growth, including the program's contribution to overcoming the identified obstacles to growth;
- Highlight the program's role in ensuring efficient use of public resources, and indicate the extent to which poverty and social impact analysis (PSIA) has affected the authorities' policy choices;
- Identify those aspects of the PRSP that would be monitored under the Fund-supported program;
- Set out in a standard format in the policy discussion section how the Fund staff participated in the PRSP process and the envisaged process for future participation;
- Take particular care to describe the policy dialogue with the authorities and other development partners, to make clear how the policy choices have been reached.

60. **PRGF staff reports presented in the context of new budgets and new annual programs** (but not new PRSPs or Article IV consultations) **would focus on program commitments for the coming twelve months**, particularly as they relate to the budget cycle, but they would *not* be expected to reassess the basic design of the program unless there were significant changes.

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<sup>34</sup> See *Poverty Reduction and Growth Facility – Operational Issues*, SM/99/293, 12/13/1999, paragraph 31.



61. **Staff reports for program reviews** which fall between Article IV consultations, full PRSPs, or new budgets, would be relatively succinct and **focus largely on program implementation and the specification of near-term policies and conditionality** for the coming six to twelve months. Any significant changes in macroeconomic circumstances or program design would be noted.

62. **All program documents (including, where possible, LOIs/MEFPs) would make clear the links between PRSP priorities and program conditionality**, explicitly identifying the role PSIA has played in program design. When the PRGF-supported program needs to be modified to address changed circumstances, the authorities' LOI/MEFP would present their rationale for adopting the new policies. The staff report (or LOI/MEFP) would explain how the new policies relate to the goals of the PRSP, as well as how the new developments and policies would be reflected in the PRSP process going forward.

63. Consistent with the guidance on surveillance, **Article IV staff reports (and country strategy papers)** prepared in the months before a new PRGF arrangement or at times of extended program interruptions should present an opportunity to step back from the immediate context of the program and **provide a fresh perspective of the macroeconomic stance and related policies**. This could then feed into the authorities' subsequent PRSPs and the design of the associated PRGF-supported programs.

## **B. Rationalizing PRGF Reporting Requirements**

64. There is now an **implicit** expectation that *all* PRGF country documents should cover a wide variety of issues and topics comprehensively, even if little has changed since the last review of a topic. However, much of the information covered by such reporting changes slowly (e.g., sources of growth, progress toward reaching the MDGs, poverty and social impact analysis, or structural conditionality) or only at discrete intervals (pro-poor and pro-growth budgeting, public expenditure management).

65. In order to meet the objective of ensuring regular reporting on certain topics, while allowing flexibility to mission teams as to the timing of such reporting and avoiding overly complex rules, **all PRGF staff reports could contain a series of boxes on critical areas requiring regular reporting**. These would be updated once a year in step with the mission's work cycle, unless there were significant changes that warranted a more frequent revision; they would simply be repeated if there was no new information. Staff has yet to come to closure on the topics for which this approach might be employed. Possible areas from which the topics for the boxes could be chosen include: sources of growth and developments in the implementation of the growth strategy; progress toward the MDGs (including most recent measurements of poverty); progress on PSIA,<sup>35</sup> pro-poor and pro-growth budgeting;

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<sup>35</sup> When PSIA is directly relevant to program design choices, its impact would be described in the staff report.

structural conditionality; other donors' participation in PRSP implementation; public expenditure management; developments in the country's statistical system and progress towards the GDDS; and finally, the PRSP process and the Fund's role in it. Future guidance to staff will specify which topics should be reported on in these annual boxes.

66. The transition from present practices to the new documentation described above would entail up-front costs, particularly in terms of the first staff report for a new PRGF request and setting up the boxes referred to above. However, with subsequent reports more tightly focused and better coordinated with Article IV reports, the documentation workload over the course of the PRGF arrangement may be expected to diminish.

## V. NEXT STEPS

67. The present paper has set out the work under way to address three sets of issues associated with the PRGF and the PRSP approach that are of importance in achieving better alignment of the PRGF in support of PRSP implementation. These are: (i) content issues concerning macroeconomic policy design; (ii) process issues aimed at facilitating country ownership of the PRSP process by aligning the PRGF cycle with the PRSP and the national budget; working within country-led donor coordination frameworks; strengthening the role of resident representatives; and building the capacity in the partner country and among the staff to effectively implement PRSPs; and (iii) internal changes to PRGF documentation requirements to further facilitate the alignment.

68. In taking this work forward, staff is seeking feedback on the proposals for dealing with the following issues:

- The general thrust and priorities of the alignment effort with regard to content issues, particularly as concerns the basic premise that the linkage between PRSPs and PRGFs, and that support should be provided to help countries take on the leadership and coordination role that is implied by this approach;
- The approach being explored for dealing with the key central macroeconomic design issues, specifically: enhancing the realism of macroeconomic projections; the use of multiple macroeconomic frameworks; and accommodating higher aid flows;
- Process changes aimed at aligning the PRGF with the PRSP and the national budget cycle, including the option of starting a new three-year PRGF arrangement after the completion of a new full PRSP, with the annual PRSP Progress Report used to update the strategy between full PRSPs; and
- The rationalization of the documentation requirements of the PRGF, in order to clarify the link to the country's PRSP and reduce the overall burden of formal reporting requirements.