



**POLICY OPTIONS AND CHALLENGES
FOR DEVELOPING ASIA—
PERSPECTIVES FROM THE IMF AND ASIA
APRIL 19-20, 2007
TOKYO**



JBIC

JAPAN BANK FOR INTERNATIONAL COOPERATION

**BUDGET SUPPORT AND AID EFFECTIVENESS,
EXPERIENCE IN EAST ASIA**

HIROTO ARAKAWA

JAPAN BANK FOR INTERNATIONAL COOPERATION

*Paper presented at the Conference: POLICY OPTIONS AND CHALLENGES FOR DEVELOPING ASIA
—PERSPECTIVES FROM THE IMF AND ASIA*

*Organized by the International Monetary Fund (IMF) and
Japan Bank for International Cooperation (JBIC)*

April 19-20, 2007

Tokyo, Japan

The views expressed in this paper are those of the author(s) only, and the presence of them, or of links to them, on the IMF website does not imply that the IMF, its Executive Board, or its management endorses or shares the views expressed in the paper.

Budget Support and Aid Effectiveness, Experience in East Asia

For

IMF – JBIC Seminar:

“Policy Options and Challenges for Developing Asia –
Perspectives from the IMF and Asia”

April 20, 2007

Hiroto Arakawa

Executive Director

Japan Bank for International Cooperation



Contents

- I. Introduction
- II. Characteristics and Risks of Recent International Capital Flows
- III. Policy Framework Recently Developed by the IMF
- IV. Japan's Experience in the ODA Program for Vietnam Using the Above Policy Framework
- V. Discussion on the Selection of Appropriate Aid Modality
- VI. Conclusion: Policy lessons

I. Introduction

- Background 1: Ample flow of private capital
 - favorable international financial conditions (FDI, Loans, Remittances, etc.)
 - **the fiscal space created** after the debt relief initiatives—heavily indebted poor countries (HIPC) and multilateral debt reduction initiative (MDRI)
- Background 2: Significant part of donor aid flows are recently provided in the form of budget support, rather than project aid.
- These trends, while welcomed, need to be reviewed carefully as they carry some risks in the overall economic management.
- Review of Japan's experiences in East Asia

II. Characteristics and Risks of Recent International Capital Flow

- Private flows such as FDI and loans are growing significantly
- Official flows:
 - a new trend emerges as the non-traditional donors (such as China, India and Brazil) expand their flows to the poorer countries among developing countries.

Table 1. External financing: all developing countries
(in US\$ billions)

	1998	1999	2000	2001	2002	2003	2004	2005
Current account balance	-89.2	-3.5	47.8	20.5	72.0	123.8	158.3	245.8
Financial flows:								
Net equity flows	179.4	195.9	182.9	183.3	166.1	186.8	248.8	298.9
Net FDI inflows	172.4	183.3	168.8	176.9	160.3	161.6	211.5	237.5
- East Asia and Pacific	57.8	50.8	44.3	48.5	57.2	59.8	64.6	65.3
- Europe and Central Asia	27.4	29.7	30.2	32.7	34.9	35.9	62.4	75.6
- Latin America and the Caribbean	74.1	88.3	79.3	71.1	48.2	41.1	60.8	61.4
- Middle East and North Africa	2.7	2.4	4.1	3.4	3.7	5.6	5.3	9.1
- South Asia	3.5	3.1	4.4	6.1	6.7	5.6	7.2	8.4
- Sub-Saharan Africa	6.9	9.0	6.5	15.0	9.5	13.6	11.3	17.6
Net portfolio equity inflows	6.9	12.6	14.1	6.4	5.8	25.2	37.3	61.4
Net debt flows	54.3	16.3	-1.0	-1.5	10.7	72.8	119.1	120.1
Official creditors	34.3	13.9	-5.7	27.4	5.2	-12.3	-28.7	-71.4
(By creditors)								
World Bank	8.7	8.8	7.9	7.5	-0.2	-0.9	1.3	0.7
IMF	14.1	-2.2	-10.7	19.5	14.0	2.4	-14.7	-41.1
Others	11.5	7.3	-2.9	0.4	-8.6	-13.8	-15.4	-31.0
(By debtors)								
- East Asia and Pacific	14.7	12.5	7.0	3.2	-7.9	-7.4	-5.5	-1.9
- Europe and Central Asia	7.5	-0.6	0.0	2.2	2.7	-6.8	-10.5	-30.9
- Latin America and the Caribbean	10.9	1.6	-11.1	20.4	12.8	4.9	-10.5	-36.5
- Middle East and North Africa	-1.6	-2.5	-2.7	-1.2	-2.5	-2.5	-4.1	-2.4
- South Asia	2.3	2.5	0.5	2.2	-2.4	-1.7	1.0	3.4
- Sub-Saharan Africa	0.5	0.4	0.7	0.6	2.6	1.2	0.8	-3.2
Private creditors	19.9	2.5	4.7	-28.9	5.5	85.1	147.8	191.6
Net M L T debt flows	85.7	22.0	11.5	-6.2	1.2	30.2	77.8	122.3
- East Asia and Pacific	-3.5	-10.9	-13.1	-13.0	-12.5	-9.2	9.1	15.8
- Europe and Central Asia	29.7	17.6	11.4	5.5	21.1	32.2	64.6	81.3
- Latin America and the Caribbean	55.3	19.5	8.0	-0.6	-11.4	3.2	-3.9	18.5
- Middle East and North Africa	1.8	-1.4	0.8	3.8	4.5	0.2	2.3	3.7
- South Asia	3.7	-2.1	3.9	-2.0	0.6	1.3	3.9	0.6
- Sub-Saharan Africa	-1.3	-0.7	0.4	0.1	-1.0	2.5	1.7	2.3
Net short-term debt flows	-65.8	-19.6	-6.8	-22.7	4.2	54.9	70.0	69.3
Change in reserves (- = increase)	-16.4	-33.2	-45.4	-81.7	-171.9	-291.6	-404.8	-393.0
Memoranda:								
Bilateral aid grants (ex. Tech. coop grants)	26.7	28.5	28.7	27.9	32.5	43.7	50.3	52.6
Net private flows (debt+equity)	199.3	198.3	187.7	154.4	171.5	271.9	396.6	490.5
Net official flows (aid+debt)	61.1	42.4	23.0	55.3	37.7	31.4	21.6	-18.8

Source: World Bank (2006)

Official donor assistance modalities

- Substantial amount of Budget-Support type development aid.
- Some donors argue that the Budget Support is a superior type of development aid compared with the project-type development aid.
- Budget Support are expected to have the following roles and practices (OECD-DAC 2005):
 - reinforce partner country's ownership
 - alignment to partner country's policy and priorities
 - enhance the performance and accountability of partner country's public financial management (PFM) systems
 - reduced transaction cost (?)
 - predictability of aid (?)

Risks Associated with Increasing Capital Flow

- FDI:
 - directed to the resource-extracting sectors, which are not labor-intensive that can help income generation of the ordinary poor people.
- Portfolio capitals:
 - quick in running away once the market sentiment turns bearish, and carry a significant risk of volatility in the capital flows
- Aid flows from emerging donors:
 - do not attach policy improvement requirement when emerging donors extend finance.
 - do not always participate in the donors' coordination effort for policy harmonization.
 - sometimes exceeds the appropriate level conceptually shared by the traditional donors.

III. Policy Framework (by IMF)

New approach trying to give another view point on the fiscal management

1. Background

- “How to utilize the limited resource wisely” to the new emerging question, i.e., “how to manage the significant inflow for sustainable economic management.”
- Programs being supported under the MDGs are mostly spent on the domestic recurrent expenditures.

2. Four Scenarios

(1) To absorb and spend

- the textbook response to aid; no effect on inflation nor exchange rate

(2) Neither absorb nor spend

- may be a good way of building up international reserves from a precariously low level or of smoothing volatile aid flows; no effect on inflation nor exchange rate

(3) To absorb but not spend

- substitutes aid for domestic financing of the government deficit; appropriate under high inflation

(4) To spend but not absorb

- common but **problematic**; pressure on inflation from monetary expansion
- ➔ If sterilization, interest rate rises and private investment is crowded out

3. Risks from Long-term Fiscal Sustainability

Social sector projects/programs consist of recurrent expenditures (wages, etc.)



Once started, difficult to cut back recurrent expenditures

4. Appropriate Policy Choices under Growing Capital Flow

- Budget support aid should better be spent and absorbed.
(Project aid on economic infrastructure as well as emphasis on economic sector for program contents are such options.)
- In allocating fiscal expenditures supported under budget support programs, the government should not neglect the economic sectors which can help remove the supply bottlenecks of the economy.
 - Other supporting measures to raise the supply responsiveness such as the business environment improvement to attract more foreign investment should better be accompanied.
- The government should endeavor to raise its own domestic revenues in order to fund the social sectors continuously even without donor support.
 - This can be achieved by overall tax reform, but the development of infrastructure too can help raise revenues by utility charges.

IV. Experience of Budget Support Program in Vietnam

1. Emphasis on Infrastructure in PRS

■ First PRSP (CPRSC) in 2002

- Lack of enough attention to economic growth through infrastructure

■ PRSC-3

- “Infrastructure” explicitly included in the framework

■ “Connecting East Asia” Study launched in 2003 (Published 2005)

2. Joint Initiative for Improvement in Investment Environment

■ Lack of Proper Investment Climate

- Overly rigid regulations, non-transparent tax and customs
- No protection of intellectual property rights
- Inconsistent laws
- Inadequate infrastructure (high utility costs), etc.

■ Joint Initiative between Vietnam and Japan

➔ The Action Plan in Dec. 2003 (with 125 sub-items)

3. Aid Coordination and Harmonization

- 5 Banks initiative in procurement
 - Prime example: Public Procurement System
 - Local Competitive Bidding ← Project Level
 - Now LCB Standard for use in Vietnam's overall procurement systems
- With JICA's well-focused T/A
- Public Expenditure Management (PFM, MTEF)
- Improvement of business investment environment

4. Evaluation of Japan's (Donor Community) ODA Strategy in Vietnam

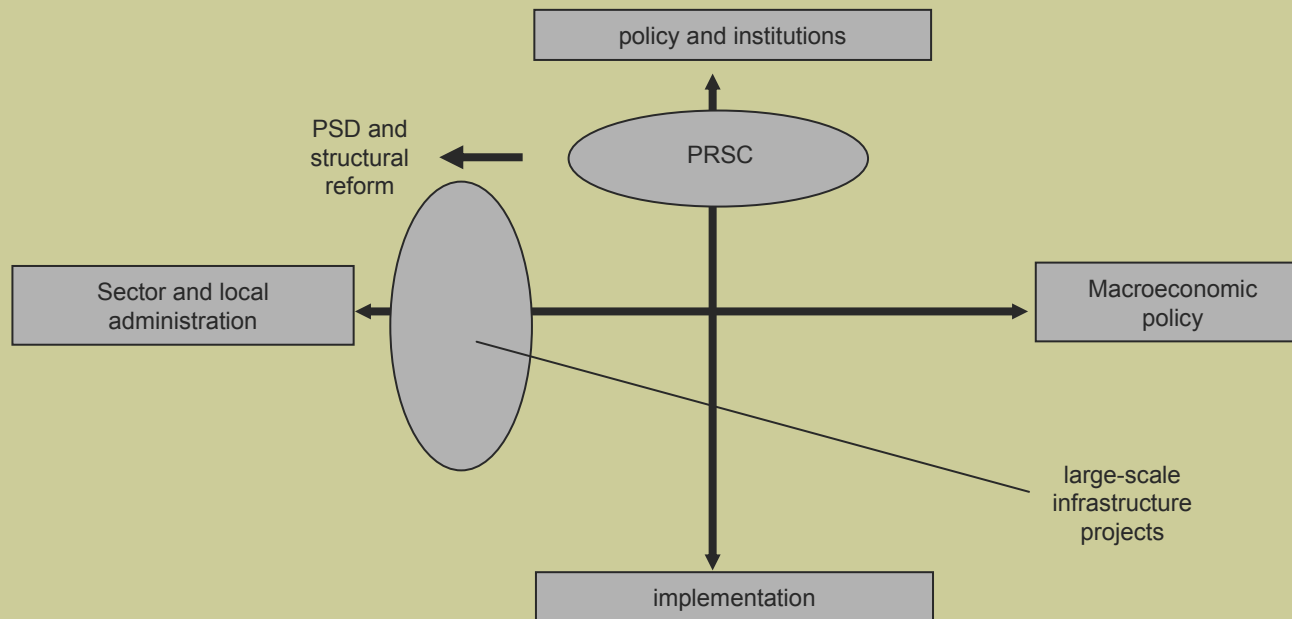
- Economic growth orientation through private sector
- Coordinate with donor communities to redirect policy dialogue to cover the importance of infrastructure
- Harmonization of policies and procedures
- Emphasis on economic sector either through projects or policy reforms with Budget Support (PRSCs)

Issues of Macroeconomic Management and JBIC Loans

Challenge of economic management	JBIC's loan program
Aid fund should be spent and absorbed to avoid inflationary and appreciation pressure.	Most JBIC loans are extended in the form of project aid. Except for certain portion to be locally spent, project aid will be spent and absorbed.
Expenditure needs to be allocated to those items not competing with the domestic demand to avoid inflationary pressure.	Infrastructure projects require relatively high import contents for commodities and services which are not locally available. Expenditures on these items generally do not compete with the local demand, and consequently do not have inflationary pressure.
Expenditure to programs with less flexibility should be avoided.	Capital expenditures are relatively easy to adjust in accordance with the funding (although it is not desirable to discretionarily adjust the construction pace.) Once the projects are completed, the subsequent expenditures are relatively small for operation and maintenance.
Improve the supply response of the economy to mitigate the inflationary pressure.	Most investors find the lack of appropriate infrastructure services as one of the most serious impediments in starting their business. Promotion of private business through infrastructure projects will improve the supply response of the economy. <i>Vanguard</i> effect could be another factor which promote the FDI and thereby the supply side response.
Enhance the government revenue for the sustainable funding of social programs	Although the tax reform and the tax administration reform should not be neglected, the economic growth itself has the revenue enhancing effect. Also the well-designed utility projects can add another source of public revenue in the form of user charge.

V. Discussion on the Selection of Appropriate Aid Modality

Vietnam: Effects of Different Aid Modalities on Policies and Systems



Source: Ohno and Niiya (2005)

VI. Conclusion: Implications to Future Assistance ~ A way forward

- Choice and sequence of aid modality should cater to the country's priority development agenda.
- *“There is no aid modality which is inferior or superior to other aid modalities. What is important is to choose the most appropriate modality of aid in response to the development needs, and the respect for the various modalities of aid is necessary”* Kitano (2006).
- Care attention to possible impacts of Budget Support on Macroeconomic Management.

A Remark from a Partner Country

“Since the reforms of the country system would have significant effect not only on ODA-related stakeholders but on a full range of others as well, the recipient government’s strong ownership and leadership is essential. Reforms may take a long time, but their impact would be much greater than any impact gained from establishing a dual system. Respecting the Government’s ownership and self-determination, a patient approach is necessary in implementing or supporting these capacity developments.”

- by Dr. Duong Duc Ung, Director General, Ministry of Planning and Investment, Vietnam; message at High Level Forum, March 2005)

Thank you !



April 20, 2007

IMF – JBIC Seminar:
“Policy Options and Challenges for Developing Asia
- Perspectives from the IMF and Asia”

21

