IMF Publication

Staff Guidance Note on the Use of Fund Resources for Budget Support

INTERNATIONAL MONETARY FUND

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In consultation with the Finance, Legal, and other departments

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March 23, 2010

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I. INTRODUCTION[1]

1. This note provides operational guidance and background information on the use of Fund resources for budgetary financing. It does this in the context of concerns expressed by some Executive Board Directors that, by providing such financing, the Fund might be held accountable for the quality of budgetary spending; that repayment could be subject to country budgetary processes; and that budget financing is the role of other institutions.

2. The note clarifies that use of Fund resources for budget support is consistent with the Fund's mandate and legal framework provided a BoP need exists and the resources are used in support of policies that will address the member's BoP problem. It also shows that use of Fund resources for budget support is appropriate when restoring domestic and external stability in the context of a balance of payments crisis calls for a larger fiscal deficit than could be financed from external or domestic sources. In a similar vein, the note summarizes relevant analytical considerations, highlighting that fiscal needs are seldom disjointed from BoP needs, and that Fund financial support often addresses both, irrespective of whether disbursements are made to the Treasury or central bank. Finally, the note provides guidance on key operational aspects, including communications and safeguards issues.

3. Both direct budget support (channeling of Fund purchases to the member via the Treasury) and indirect budget support (channeling of Fund purchases to the member via the central bank to finance the budget) have been widely used in past Fund arrangements, and are not temporary features of the current crisis. However, the incidence of direct budget support has increased in recent years, as (i) the global financial crisis and the required flexible fiscal response, and (ii) institutional changes in member countries, especially the move to greater central bank independence, have both called for lending to members to be channeled through Treasuries rather than central banks.

II. LEGAL FRAMEWORK FOR USE OF FUND RESOURCES[2]

A. General BoP-Related Conditions

4. The Fund's Articles (Article V, Sections 3(a) and (b)) establish two key conditions for the use of Fund resources: (i) a member should only purchase when it has a BoP need, and (ii) a member must "use" Fund resources to address the underlying BoP problem in a

[1] Prepared by Lorenzo Giorgianni, Jan Kees Martijn, Donal McGettigan, and Christian Mumssen (SPR), Ross Leckow and Ceda Ogada (LEG) and David Andrews and Tore Hauge (FIN). Staffs of SPR (Emerging Markets and Low-Income Countries Divisions), FIN, and LEG stand ready to clarify any further questions staff may have.

[2] See Annex II for more elaborate discussion.

manner that provides adequate safeguards (i.e., ensures repayment to the Fund) (Annex I).[3] Consistent with the Articles, Fund financial support and associated fiscal, monetary, and exchange rate policies, including in the context of a Fund program, have the *aim of smoothing BoP adjustment*.

5. Article V, Section 3(b)(ii) identifies three forms of BoP need relating to: (i) "balance of payments", which requires an above-the-line deficit (below the line transactions include official external borrowing and debt restructuring, and grants from foreign official agencies), (ii) "reserves position", which requires a determination that *gross* (rather than *net*) reserves are inadequate, and (iii) "developments in reserves", which arises in a limited number of cases (e.g., members that issue reserve currencies). These BoP criteria are exclusive—i.e., no other form of need can justify a purchase—but alternative—i.e., *any* one of these need criteria is sufficient. In practice, the concept of BoP need is broad particularly as reserve adequacy can be gauged taking into account the future evolution of a variety of parameters (e.g., imports, external debt, monetary aggregates).

B. GRA Financing

6. For GRA financing through Stand-By Arrangements (SBA), arrangements under the Extended Fund Facility (EFF) and the Flexible Credit Line (FCL) the *approval of an arrangement* is possible without an actual BoP need.[4] However, any member *requesting a purchase* must represent it has some form of actual BoP need.[5] Although this need should be actual at the time the purchase is requested, data lags require a forward-looking perspective. In other words, gauging reserve adequacy, for example, may require use of projected debt levels or other such measure and assessment of the BoP need relative to these projections. Similarly, in practice, to accommodate data lags, any assessment of whether there is a BoP deficit can be conducted within a broad time horizon of one year backwards and forwards around the date of a purchase request.

7. Consistent with Article I(v) and Article V, Section 3, the member purchasing from the Fund must also "use" resources to address an underlying BoP problem. Such use is broad in scope, and the Fund does not attempt to track its disbursements (to gauge, for example, whether the actual foreign exchange purchased from the Fund is used for international payments) as money is fungible and it would be difficult, if not impossible, to monitor what happens to foreign exchange once it has been purchased from the Fund. Rather, a member will be considered to be using Fund resources to address its BoP problem, if it is

[3] Conditions for concessional facilities for low-income countries (LICs) are generally similar but differ in some respects. See Section II. C and Annex I. B for details.

[4] However, in the case of extended arrangements, while legally possible, the Executive Board has taken the policy position that use of such arrangements on a precautionary basis should be discouraged.

[5] Although remedial action under Article V, Section 5 can be taken by the Fund where a member makes a purchase without having a corresponding BoP need, this provision has not to date been applied by the Fund.

implementing policies designed to resolve its BoP problem, typically through ex post conditionality and its overall macroeconomic program. Moreover, the member's program will need to be structured in a manner that envisages that the amount equivalent to the foreign exchange purchased from the Fund will be used to meet a BoP deficit or to strengthen reserves. It should be clarified that, while financing under the Flexible Credit Line (FCL) does not entail ex post conditionality and the establishment of a Fund-supported program, the FCL's strict qualification requirements serve as ex ante conditionality to give assurances that policies will remain very strong during the life of the arrangement. Also, it should be noted that, while purchases under the first credit tranche and Emergency Assistance entail little conditionality, members are nonetheless required to elaborate and implement a set of policies designed to address their BoP problems. Similarly, reserve tranche purchases are unconditional and can be made solely on the member's representation of BoP need.[6] The remainder of this note will focus on situations where Fund resources are used in the context of a Fund-supported program.

C. Concessional Financing

8. For concessional financing under the Poverty Reduction and Growth Trust (PRGT), the BoP needs test applicable to the Standby Credit Facility (SCF) and Rapid Credit Facility (RCF) is the same as for GRA financing. For the ECF (as for its predecessor, the PRGF), Fund financial support is intended to address a "protracted BoP problem" (see Section II, Paragraph 1(b)(2) of the PRGT Trust Instrument). Under this approach, the Fund examines the components of the BoP rather than the overall BoP position and also a variety of indicators.[7] In addition, while a protracted BoP need must be judged to exist at the time of approval of the arrangement, in contrast to use of GRA, SCF or RCF resources, use of ECF resources does *not* require that there be an actual BoP need in order for a member to request disbursements. Similar to use of GRA resources, a member supported under the Fund's concessional facilities is required to put in place policies aimed at addressing BoP difficulties. Again, similar to GRA financing, in broad terms, such programs are designed in a manner that envisages that the foreign exchange purchased from the Fund will help address the member's BoP difficulties. More specifically, under the PRGT Instrument, the purpose of PRGT financing looks not only to the BoP of eligible members but also to the achievement or maintenance of stable and sustainable macroeconomic positions consistent with strong and durable growth and poverty reduction (Section I, Paragraph 1(a)).

[6] Finally, use of SDR allocations is altogether unconditional and there are prima facie no restrictions for using such resources for budget support.

[7] Besides the behavior of the current account deficit and declining reserves, this might include other indicators such as stagnant exports or imports, a deterioration in the terms of trade, or a worsening of external finance conditions.

9. Again similar to GRA financing, in broad terms, such programs are designed in a manner that envisages that the amount equivalent to the foreign exchange purchased from the Fund will be used to meet a BoP deficit or to strengthen reserves.

D. Summary of Legal Framework

10. As long as the BoP-related conditions outlined in the preceding paragraphs are met, Fund resources may be used within a member's domestic economy to finance the budget and such use would be consistent with the Fund's legal framework. This is the case for both direct budget support via the Treasury and indirect budget support via the central bank.

III. Analytical Considerations

A. Linkages Between BoP and Budget Support

11. From an ***economic*** perspective, budget and BoP financing needs are closely intertwined. For instance, expansionary fiscal policy will typically widen the current account deficit somewhat, while a sudden stop of capital inflow will tend to limit the government's access to budget financing. Similarly, there is significant overlap between external budget support and BoP support: any type of external budget support to a government is also *de facto* BoP support, as it allows for a higher level of international reserves and/or larger external payments; conversely, an external loan to a central bank often entails an implicit element of budget support as it allows the central bank to increase credit to the domestic economy, including directly or indirectly to the government, for a given international reserves objective.

12. Given the economic linkages discussed above, it would be expected that the Fund's BoP support loosens not only external but also domestic financing constraints. In the most immediate sense, the Fund's BoP support provides liquidity to the member country, which can be used to (i) build reserves and/or (ii) provide liquidity to the public or private sector associated with the making of external payments. By relaxing external liquidity constraints, Fund BoP support would tend to also reduce the need for retrenchment in the public and private savings-investment balances, thus enhancing domestic policy options (allowing less contractionary fiscal, monetary, exchange rate policies) and cushioning private sector adjustment (e.g. investment, import declines). This helps smooth the macroeconomic adjustment required for restoring a sustainable external position.

13. It could thus be argued that Fund BoP support *typically* entails some degree of implicit budget support. Specifically, that it creates room for a less contractionary fiscal stance than would have been needed in the absence of Fund support in order to address the country's BoP difficulties. The extent to which a member uses this additional fiscal space is difficult to quantify in practice as it would require specification of a counter-factual macroeconomic scenario without Fund support. In general, any combination of "absorption" and "spending" of Fund resources may be appropriate for addressing BoP difficulties under

different circumstances (see Annex II)[8] and *some* change in the fiscal path will often be appropriate.

B. Direct Versus Indirect Budget Support

14. In theory, the desired macroeconomic adjustment path can be achieved irrespective of whether Fund financial support is channeled through the Treasury (direct budget support) or the central bank (indirect budget support). For instance, if the primary objective is to build the country's international reserves, disbursements to the Treasury can be appropriate as long as the fiscal stance is not changed and the government saves the funds as deposits at the central bank. Conversely, within the umbrella of a BoP need, if the objective is to accommodate a fiscal stimulus through external financing, disbursements to the central bank can be used to on-lend directly (via central bank credit) or indirectly (via looser monetary policies) to the government.

15. Therefore, both direct and indirect budget support can be appropriate (and have been used extensively) in the context of Fund-supported programs. Direct budget support can be particularly useful or even necessary when the institutional setting or market constraints prevent an appropriate fiscal policy response.[9] This can be the case when the Fund's provision of foreign exchange to the central bank does not support the domestic liquidity needed to finance the budget deficit. Examples include cases where:

- An independent central bank cannot lend (for legal or institutional reasons) to the central government while the domestic banking sector is too shallow or fragile to provide the necessary budget financing;

- The country's central bank plays a relatively passive policy role, for instance under a currency board or in fully dollarized economies.

16. From the Fund's perspective, Fund resources are made available to the member (Article V, Sections 2(a) and 3)). Accordingly, whether Fund resources are channeled via the Treasury or the central bank, as a legal matter, it is the member (i.e., the state under international law as represented by its government) that is the sole obligor to the Fund and is liable to make repayments to the Fund (Article V, Section 7). In this regard, the fiscal agent of the member—through which all financial transactions between the Fund and a member

[8] Stylized examples include: (i) saving the Fund resources as reserves with an unchanged fiscal stance (no spending, no absorption) or with a larger fiscal deficit (spending, no absorption), and (ii) use of Fund resources for external payments with an unchanged fiscal path (absorption, but no spending) or with a larger fiscal deficit (absorption and spending).

[9] See Annex III for a description of recent examples of direct budget support under Fund-supported programs. A particular example of budget support concerns members of a monetary union. For example, in the CFA franc zone, the regional central bank unconditionally provides credit in the (domestic currency equivalent) amount of Fund support to the relevant government, which is a form of indirect budget support.

must take place (Article V, Section 1)—is simply an agent of the member and is not itself liable for repaying the Fund.

IV. Operational Aspects of Fund Budget Support

A. Documentation and Accounting

17. Irrespective of whether Fund financing is channeled to the central bank (including for indirect budget support) or to the Treasury (for direct budget support), documents related to a Fund arrangement should explain the need for and role of Fund financing as follows:

- Demonstrate the existence of a BoP need by describing current and capital/financial account developments and projections, the associated financing outlook, and outline how the member's reserves measure up against relevant indicators such as imports, short-term external debt, monetary aggregates, and so on.
- Describe the authorities' (program) objectives and proposed policy mix.
- Include a full discussion of access and how proposed access levels have been determined.
- In cases of direct budget support, explain the institutional rationale (e.g., currency union rules, central bank independence). Staff may also wish to discuss the impact, if any, of the provision of such support on central bank independence. Also discuss how direct budget support is consistent with the objectives underpinning the use of Fund resources, including how the intended use of direct budget support will help the member achieve these objectives, drawing as needed on the analytical underpinnings discussed above. In particular, justify how Fund resources will help smooth economic adjustment in the short run and how the authorities' overall (program) policies will help the member overcome its BoP problem over time.
- Discuss the exit strategy, including how the member can move away from Fund financial support once the Fund arrangement ends. In cases of direct budget support, staff should take a particularly close look at risks of prolonged dependence on Fund financing.[10] This could for example be covered under overall program discussions—for instance with fiscal and external financing needs falling as shocks pass and as the (program) policies are implemented—and by means of the usual capacity to repay and debt sustainability analysis.
- Explain how policies (under the Fund-supported program) provide adequate safeguards that the Fund will be repaid (including through addressing the member's

[10] To the extent that a member's BoP problem is resolved under a Fund-supported program, but a budget problem remains, under its Articles, the Fund would not be allowed to continue to finance the member.

underlying BoP problem). See subsection IV B. below on safeguards issues in cases of direct budget support.

18. Program accounting conventions should also be discussed as needed. In particular, program documents should explain how program targets, including on NIR and NDA, fit in with the overall program objectives and whether there is a need for monitoring composite central bank-Treasury aggregates.

- In a typical Fund-supported program (where budget support, if any, is indirect), the Fund purchase is deposited into a central bank account, with no change in either NIR of the central bank (gross reserves increase, as do central bank liabilities to the Fund) or NDA (no central-bank Treasury transaction).

- In the case of indirect budget support, this remains the case until the money is lent to and drawn by Treasury (reducing NIR, with the reduction dependant on sterilization and demand effects, and increasing NDA).

- In the case of indirect budget support, where the central bank assumes the Fund liability and the money is deposited to a Treasury account at the central bank, there is also no immediate impact on NIR of the central bank (gross reserves increase, as do central bank liabilities to the Fund) or NDA (the purchase credited to the government's account is offset with a corresponding claim by the central bank on the government).[11] When the money is used by Treasury, NDA increases and, reflecting either demand pressures or the use of reserves to sterilize the monetary impact, NIR falls.

- In the case of direct budget support, where Treasury assumes the Fund liability and the money is deposited to a Treasury account at the central bank, NIR of the central bank increases (gross reserves increase, while central bank liabilities to the Fund remain unchanged) and NDA declines (as government deposits held at the central bank increase). As the money is used, and government draws down on its deposits, NDA increases, while, again depending on whether reserves are used to sterilize the monetary impact, NIR falls.

19. In past programs involving direct budget support (or Treasury assuming the Fund liability), including Turkey (2001), composite NIR and NDA measures are used as program parameters, adding together central bank and Treasury positions. For instance, where Treasury assumes the Fund liability and the money is deposited to its account at the central bank, while central bank NIR increases, composite NIR remains unchanged (central bank gross reserves increase, while Treasury liabilities to the Fund increase). Similarly, while

[11] See Annex V for discussion on channeling Fund resources through either the central bank or Treasury.

central bank NDA declines, composite NDA remains unchanged (with increased government deposits at the central bank lowering central bank NDA and increasing Treasury NDA).

20. Finally, as described in paragraph 13 above and Annex V, when a purchase is made, the member (i.e., the state as represented by its government) is the sole obligor and is liable to make the necessary repurchases. The fiscal agent acts as intermediary to represent the member in its financial dealings with the Fund. From the perspective of the Fund, it is irrelevant whether the central bank or the Treasury is the fiscal agent, since it is the member country that controls whether Fund financing can be used for budgetary support. In all cases, provided the BoP-related conditions described in Section II above are met, the fiscal agent—be it the Treasury or central bank—can instruct the Fund as to whether Fund resources should be channeled through the Treasury, the central bank, or indeed some other entity.

B. Safeguards Considerations for Direct Budget Support

21. Direct budget support raises various safeguards concerns, including the possibility that Fund repurchases may become subject to the budget process. While program design and, in FCL arrangements, members' policy track records are the ultimate safeguard that the Fund will be repaid, safeguards assessments conducted by the Finance Department are also used to ensure the temporary and appropriate use of Fund resources (Annex IV).

22. Under current Fund policy, safeguards assessments are conducted at central banks, not Treasuries. This is because Fund disbursements are almost always channeled to central banks in their capacity as reserves managers, even where the money is to be used for budget support by the Treasury. However, in these latter cases, safeguards assessments have also sought assurances in the form of a clear framework between central bank and government on the modalities for repayment of Fund financing. Moreover, the current risk assessment framework for exceptional access cases, including that involving direct budget support, pays particular attention to fiscal risks such as the public sector debt burden and the ability of the government to mobilize resources.

23. The Executive Board has supported the focus of safeguards assessments on central banks, although, at the August 2009 informal briefing on UFR for budgetary support, several chairs echoed concerns over whether these assessments are sufficient in a world of increased direct budget support. This issue will be addressed as part of the safeguards policy review in 2010. In the meantime, country teams should focus their attention on ensuring adequate safeguards to the Fund through all means available, including program discussions and design, and existing platforms to strengthen fiscal transparency and accountability, including, where available, fiscal ROSCs or Public Expenditure and Financial Accountability reports (PEFAs).

C. Communications Strategy for Direct Budget Support

24. In line with the discussion during the August 2009 informal briefing of Executive Directors referred to above, Fund-supported programs that entail direct budget support

require clear communication on the objectives and modalities of the program. In particular, Directors emphasized that the Fund should minimize any misperceptions that it is moving in a new direction by providing direct budget support or that it has abandoned the BoP criterion for Fund lending enshrined in the Articles. Accordingly, communication should consist of the following:

- At the outset, set out clearly to stakeholders the rationale for using direct budget support. While each case will differ, the common element is that members seeking direct budget support face a BoP need, part of which is fiscal in nature, with Fund support helping smooth the adjustment needed. Explain the institutional reasons behind direct budget support provision.

- Indicate that direct budget support has always been possible under appropriate circumstances. That said, explain how the recent crisis has increased the need for flexible fiscal responses (and budget support) where warranted and that the move towards greater central bank independence has increased the need for direct, rather than indirect, budget support.

- In cases where the Fund might be accused of supporting “undesirable” forms of spending, indicate that the Fund provides overall BoP and budget support, and does not provide specific project financing.

- Where safeguards concerns are raised, indicate that the Fund continues to safeguard its resources in cases of direct budget support. At the broadest level, the policies underpinning a Fund-supported program continue to provide the ultimate safeguard, whether or not there is direct budget support. In terms of safeguards assessments conducted by the Finance Department, in most cases of direct budget support, the funds are lodged by Treasury at the central bank, which in turn is subject to formal safeguard assessments. Moreover, where there is lack of clarity, staff seeks to ensure understandings between the central bank and the government on the modalities of repayment to the Fund. Finally, fiscal targets, which are used to help safeguard fiscal sustainability, and other aspects of Fund surveillance, including fiscal ROSCs, can help provide further safeguards to ensure the Fund will be repaid.

ANNEX I. LEGAL FRAMEWORK

The legal framework underlying Fund support is set out below. This comprises both the provision of financial assistance under the General Resources Account (GRA), and under the Poverty Reduction and Growth Trust (PRGT), and an analysis of permissible uses of such financial assistance.

A. GRA Framework

For GRA financing, the legal framework is set out in the Fund's Articles. Under the Articles, the Fund's general resources may only be used to address a member's BoP problem. The relevant provisions focus on the BoP of members.

- Article I stipulates that the purpose of GRA financing is to provide members with the "opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity" (Article I (v)).

- Article V, Section 3(a) requires the Fund to adopt policies on the use of GRA resources, including policies on stand-by or similar arrangements, that will assist members in solving their BoP problems in a manner consistent with the Articles, and establish adequate safeguards to ensure that the Fund is repaid. In this regard, among the policies the Fund has adopted are those on special facilities, access, phasing, conditionality, full program financing, external arrears, debt sustainability, misreporting, safeguards assessments, post-program monitoring, repurchases and overdue financial obligations.

- Article V, Section 3 also prescribes that general resources only be used by a member that represents it has a BoP need because of "its balance of payments or its reserve position or developments in its reserves" (Article V, Section 3(b)(ii)).

Existence of BoP Need

The Fund has developed a broad operational framework for making the necessary judgments on the existence of a BoP need:

- A member has a need "because of its balance of payments" when it has an above-the-line BoP deficit. A country's overall BoP is calculated by making a distinction between (i) "autonomous transactions" that are undertaken for their own sake and that give rise to the country's overall BoP surplus or deficit ("above the line" transactions) and (ii) those other transactions that are undertaken for the purpose of financing a BoP deficit or an increase in reserves ("below the line" transactions). Such financing transactions include official external borrowing, certain external transfers, such as official external public debt restructuring and grants received by the government from foreign official agencies. While, in most cases, transactions can be readily classified

on the basis of standard accounting definitions, the member will be given the benefit of the doubt in any case of uncertainty.

- A BoP need arising from a member's "reserve position" will be based on an analysis of its gross reserve position in light of the member's specific circumstances. In determining whether a member has a BoP need on this basis, the Fund examines two questions: (i) what is the level of the member's reserves? and (ii) are they adequate? With respect to the first question, the member's reserve position takes into account the member's gross (rather than its net) reserves: it is a stock concept that is measured at a point in time. With respect to the second question, the Fund exercises judgment and applies a wide range of criteria including the volume of the member's foreign trade, the variability of exports and imports, the size of the member's quota in the Fund, the past behavior of reserves, the size of gross and net reserves and their prospective developments, the traditional level of reserves maintained by the member, seasonal factors, monetary aggregates, and the size of short-term foreign exchange liabilities.[12]

- A BoP need arising from developments in a member's reserves addresses cases in which members may have a need to use the Fund's resources to settle balances among themselves (for example, within a regional multilateral body) without having a BoP deficit or a need to build up reserves. This category has, in the past, mainly dealt with a relatively limited set out circumstances faced by countries that issue reserve currencies or that have made loans to the PRGT. The provision has little operational consequence for staff's work and is thus not further elaborated in this guidance note.

The three BoP need criteria are exclusive. No other form of need (e.g., the need to finance a budget deficit in the absence of a BoP need) can by itself form the basis of a purchase under the Articles.

At the same time, it is important to note that the criteria are alternative rather than cumulative. A member's request would satisfy the condition of need if *any* of the three criteria is met (e.g., a member enjoyed a strong reserve position but was experiencing a BoP deficit).

Magnitude of the BoP Need

The concept of BoP need is further clarified below as follows:

- Actual need is a BoP need that the member is presently facing (a need that has materialized). While such an actual need does not have to exist at the time of approval

[12] At the same time, given that the concepts of BoP deficit and reserve position are alternative criteria; one factor that is not taken into account in assessing the adequacy of a member's reserve position is whether the member has a BoP deficit.

of the arrangement, a member must have an actual need when it requests a purchase under an arrangement. However, this assessment of need is a complicated one and is, to a large extent forward-looking. Although reserve levels and developments are typically available with a short lag, assessments of BoP need from a reserve adequacy angle depend on projections of the variables against which reserves are compared, to help determine adequacy. And gauging adequacy against these variables typically offers scope for judgment. Turning to the BoP position itself, this is a flow concept and, given statistical lags and the time needed to prepare a program, in practice, actual need in the form of a BoP deficit is assessed within a broad time horizon of one year backwards and forward around the date of the purchase request.

- Prospective need is one that is expected to arise in the future, including through implementation of the Fund-supported program.

- A potential need is one that may, but is not expected to, arise during the arrangement.

Note that while actual use of Fund resources (i.e., purchases) cannot be greater than the member's actual need, access under an arrangement is determined based on an assessment of the member's prospective and/or potential needs. In fact, an arrangement may be approved on the basis of a purely prospective or potential need, that is even if an actual need has not yet materialized.

Moreover, access under an arrangement is generally phased (with the FCL being a notable exception) so that incremental financing is linked to conditions under the program. The aim here is to:

- Ensure progress in program implementation in a manner that is not destructive of national or international prosperity

- Provide safeguards to the Fund.

If it were not for the broad scope for judgment on assessing BoP needs, ex ante decisions on access levels and phasing could lead to tensions with the (ex post) assessment of an actual BoP need at the time of each purchase.

Representation of Need and Use by Member

Where a member requests a purchase under an arrangement, it needs to represent that a BoP need actually exists. In practice, members make such representation by stating in the purchase (SWIFT or telex) request that it is making the purchase in accordance with Article V, Sections 3 and 4 (governing the use of Fund resources) and with the specific terms of its financial arrangement with the Fund; it further "represents that the purchase is needed in accordance with the provisions of the Fund's Article of Agreements." The Fund may take remedial action after the purchase is made if it determines that a need did not exist at the time of the purchase, although this has never happened.

The Articles also require that the resources purchased from the Fund be "used" to address a BoP problem.[13] To be clear, the Fund does not attempt to track its disbursements (to gauge, for example, whether Fund resources are used for international payments). In fact, the member is *not* required to specify how it intends to use the resources and the fungibility of money would make it difficult, if not impossible, to actually monitor what happens to foreign exchange once it has been purchased from the Fund. Thus, assurances that Fund resources are used to address the BoP problem are obtained by the way of (i) adequate policies and, where relevant, program design and (ii) the member's representation that it will use Fund resources in accordance with the Articles and with its financing arrangement from the Fund.

Safeguards

Use of Fund resources is also subject to the existence of adequate safeguards about the member's capacity to repay. This is ultimately an issue related to the strength of policies and program design. If a program is well designed and properly executed, supported by conditionality and other targets to assure that the use of resources is consistent with achieving the arrangement's objectives, this provides the strongest safeguard that the Fund will ultimately be repaid. In the case of the FCL, where there is no Fund-supported program, safeguards are provided by the strict qualification requirements that aim to provide assurances that policies will remain strong during the life of the arrangement.

Summing up

To sum up, as discussed with Executive Directors in the August 2009 informal briefing, Fund resources may be used to finance the budget, provided the following conditions are met:

> (i) the member has an actual BoP need when making a purchase, as represented by the member,
>
> (ii) the member has committed to implement policies, including in the contest of a program, that will assist in resolving its BoP problem and ensure repayment.
>
> (iii) the member's program is designed, in broad terms, in a manner that envisages that the amount equivalent to the foreign exchange purchased from the Fund will be used to meet a BoP deficit or to strengthen reserves.

Within these broad parameters, a Fund arrangement can allow the member using Fund resources within the member's domestic economy to finance the budget deficit of the

[13] In Decision No. 71-2, adopted September 26, 1946, the Executive Board decided as follows: "The Executive Directors of the International Monetary Fund interpret the Articles of Agreement to mean that authority to use the resources of the Fund is limited to use in accordance with its purposes to give temporary assistance in financing balance of payments deficits on current account for monetary stabilization operations." Later, in Decision No. 1238-(61/43), adopted July 28, 1961, clarified that the earlier decision did not preclude use of Fund resources for capital account cases.

government. The use of the domestic currency counterpart of a Fund purchase in this fashion may create an appearance that Fund resources are not being used to meet a BoP need but to finance the budget deficit of the government. While such cases may raise problems of perception, they will be consistent with the Fund's legal framework as long as the BoP-related conditions listed above are met.

B. PRGT Framework

While the general principles are similar to those under the GRA, the legal basis and framework set out in the recently adopted PRGT Instrument are different.

Under the PRGT- Instrument, the purpose of PRGT financing looks not only to the BoP of eligible members but also to the achievement or maintenance of stable and sustainable macroeconomic positions consistent with strong and durable growth and poverty reduction (Section I, Paragraph 1(a)).

- For the new Standby Credit Facility (SCF) and Rapid Credit Facility (RCF) the test for BoP need will be similar to the analysis under GRA financing described above[14].

- For the new Extended Credit Facility (ECF), which has succeeded the PRGF, as discussed below, the test for BoP need will be similar to the one undertaken under the PRGF (a "protracted BoP problem")

- Regarding the ECF, members may receive financial assistance under this facility if they have a "protracted balance of payments problem" at the time of approval of the arrangement (Section II, Paragraph 1(b)(2) of the PRGT Instrument). In determining whether a "protracted BoP problem" exists, the Fund examines the components of BoP rather than the overall BoP position and also a variety of indicators. The analysis is flexible.

- A member can have a protracted BoP problem even if it does not have a BoP need as defined under the Articles. While a determination of whether a member has a "protracted BoP problem" is not dependent on the criteria of need applicable under the GRA, the GRA need criteria are relevant for the purposes of determining the amount of access to be granted under an ECF arrangement (Section II, Paragraph 2(f))[15]. Specifically, the amount of a commitment under an ECF (or under other PRGT facilities) may not exceed the present need of the member based on the three

[14]The test to be employed under the Exogenous Shocks Facility is also the test used under the GRA and not the "protracted BoP problem" (see Section I, para. 1(a)(iv) of the PRGT Instrument). New arrangements under the ESF can only be approved for a transitional period to expire on April 7, 2010.

[15] The same provision of the PRGT Instrument applies to the determination of access under the SCF, RCF, and ESF.

criteria set out in the Articles, and any prospective need that is expected to arise during the period of the relevant arrangement.

- Accordingly, while the PRGT Instrument does not require the Fund to examine whether the member requesting financial assistance under an ECF arrangement has a protracted BoP problem or a BoP need (as defined in the Articles) at the time of each disbursement that is subsequent to the approval of the arrangement, the provision governing the approval of such arrangements and the setting of access effectively assume that, normally, both a protracted BoP problem and a BoP need will exist throughout the period of the ECF arrangement.[16]

As is the case under the GRA, the PRGT Instrument prescribes the manner in which PRGT resources may be used.

- With regard to the ECF, the PRGT Instrument specifically requires that the resources provided by the Fund support a program that will enable members with a protracted BoP problem to make significant progress toward stable and sustainable macroeconomic positions consistent with strong and durable poverty reduction and growth (see PRGT Instrument, Section I, Paragraph 1(a)(i)).

- With regard to the SCF, the PRGT Instrument requires that the resources provided by the Fund support a program that enables members with actual or potential short-term balance of payments needs to achieve, maintain or restore stable and sustainable macroeconomic positions consistent with strong and durable poverty reduction and growth (see PRGT Instrument, Section I, Paragraph 1(a)(ii)).

- With regard to the RCF, the PRGT Instrument requires that the resources provided by the Fund support policies of members facing urgent BoP needs so at to enable them to make progress towards achieving or restoring stable and sustainable macroeconomic positions consistent with strong and durable poverty reduction and growth (see PRGT Instrument, Section I, Paragraph 1(a)(iii)).

- Moreover, given that the level of access specified under a PRGT-supported arrangement assumes that the Fund's resources are needed, presently or prospectively, to meet a BoP deficit or to build up gross reserves, the Fund has sought to ensure that, in broad terms, the member's PRGT- supported program is designed in a manner that envisages that disbursements are used for one of these two purposes.

[16] In limited circumstances, the amount of a commitment under the ECF may be reduced during the period of the arrangement. Specifically, Section II, paragraph 3 (provides that "The amount committed to a member under an ECF arrangement shall not be reduced because of developments in its balance of payments, unless such developments are substantially more favorable than envisaged at the time of approval of the arrangement and the improvement for the member derives in particular from improvements in the external environment."

Provided the above conditions are met, as under the GRA, it is legally possible for a member's PRGT-supported program or policies (in the case of outright disbursements) to provide for the use of a disbursement in the domestic economy, in particular, to finance the budget deficit of the government.

ANNEX II. ANALYTICAL UNDERPINNINGS[17]

The member's macroeconomic program defines how the liquidity provided by the Fund is used. A few stylized possibilities are described below. In practice it is difficult to categorize countries neatly according to the typologies described, given the absence of a non-Fund financing counterfactual.

a. **Don't absorb, Don't Spend[18]**

- *Objective:* Liquidity used to bolster reserves.
- *BoP need:* Applies to members whose reserve levels are too low or who expect future pressure on reserves that would not be met by the current level of reserves.
- *Conventional lending mechanism:* The Fund provides credit to the central bank, which saves the foreign exchange as international reserves. The domestic currency counterpart is not spent by the government.

b. **Absorb, Don't Spend**

- *Objective:* Liquidity used to meet private sector foreign currency demands. In countries with well-functioning domestic capital markets, liquidity provision by the central bank (monetary loosening) would help ease financing constraints on the private sector, thus avoiding an undue adjustment on the private sector's saving-investment (S-I) balance.
- *BoP need:* Increased private sector foreign exchange needs make it difficult to maintain reserves at a given level. Fund support helps avoid excessive real exchange rate depreciation and import contraction. Some examples include sudden stops in capital inflows and terms of trade changes resulting in high private sector import demand.
- *Conventional lending mechanism:* The Fund provides credit to the central bank, which sells the foreign exchange to the private or public sector. The domestic currency counterpart is onlent by the central bank to commercial banks (supporting higher lending to the private sector). The domestic currency counterpart is not spent by the government.

c. **Absorb, Spend**

- *Objective:* Liquidity is used to finance higher net imports and net capital outflows resulting directly and indirectly from a fiscal stimulus plan. For example, increased government spending may entail increased government imports, or may

[17] Draws on Berg et al., 2007, *The Macroeconomics of Scaling Up Aid: Lessons from Recent Experience*, Occasional Paper 253 (Washington: International Monetary Fund).

[18] Broadly speaking, "absorbing" refers to using external reserves, while "spending" refers to using the domestic counterpart of these reserves.

result in portfolio outflows. In the absence of BoP support, to accommodate higher (net) national expenditure, this loosening may lead to an offsetting adjustment in the private sector S-I balance (crowding out), which would defeat the purpose of relaxing the fiscal position.

- *BoP need:* Increased public (and private) sector foreign exchange needs, including through a more accommodative fiscal stance, make it difficult to maintain reserves at a given level.
- *Conventional lending mechanism:* The Fund provides credit to the central bank, which sells the foreign exchange to the private or public sector. An amount equivalent to the domestic currency counterpart of Fund disbursements is onlent by the central bank to the government for spending.

d. **Don't Absorb, Spend**

- *Objective:* Liquidity used to stimulate domestic economy
- *BoP need:* Increased reserves provide a cover against the uncertain import demand, which may be spurred by increased government spending. This helps prevent a possible sudden decline in reserves.
- *Conventional lending mechanism:* The Fund provides credit to the central bank, which saves the foreign exchange as international reserves. An amount equivalent to the domestic currency counterpart of Fund disbursements is onlent by the central bank to the government, which spends it.

ANNEX III. SOME RECENT CASES OF DIRECT BUDGET SUPPORT

Country	Central bank independence	BoP need justification	Rationale for direct budget support
Hungary (November 2008)	Yes, direct central bank lending to the government not allowed.	Multiple needs, including financing of the current account deficit, financial sector support, and increasing gross reserves.	The first two purchases under the SBA were disbursed to the government through its agent, the Hungarian Debt Management Office. Part of the resources was set aside for the bank support package and some were lent to domestic banks to help with immediate funding needs. The government also used the domestic currency counterpart of part of the Fund purchase to meet the government's financing need, partly due to nonresidents reducing their holdings of domestic currency government bonds. The associated increase in domestic liquidity was sterilized through the issuance of central bank bills.
Latvia (November 2008)	Yes, quasi currency board arrangement.	Loss of international reserves, need to bolster the banking system and to re-establish confidence.	The government faced acute liquidity constraints because of the increasing fiscal deficit and the need to provide liquidity assistance to a systemically important bank (and potentially others) that could not be channeled through the Bank of Latvia.
Ukraine (November 2008)	Yes. Its preservation is a key program objective.	Rebuild gross international reserves.	Sharp revenue shortfalls, the lack of access to international capital markets, and an underdeveloped domestic bond market meant that there were no realistic alternatives but to finance the programmed budget deficit target using Fund resources. Direct budgetary support from the Fund was seen as preferable to (indirect) central bank financing of the deficit as it helped preserve the independence of the central bank and prevented the entrenchment of monetization mechanisms that would burden the institutional set up in Ukraine going forward.
Armenia (March 2009)	Direct central bank lending to the government not allowed.	Increase gross reserves and address the current account deficit.	Fiscal policy was eased in response to the crisis, which led to pressure on the balance of payments, and resources from the augmentation were therefore transferred directly to the government to address the resultant balance of payments needs. In the absence of additional financing for fiscal purposes, Armenia would have been forced into a more severe external and domestic adjustment that would further worsen growth and require sizeable cuts in social spending.
Georgia (August 2009 Augmentation)	Direct central bank lending to the government not allowed.	Increase gross reserves, address current account deficit in the face of a more prolonged global crisis than originally envisaged.	Part of the support provided by the Fund in 2009 and all the support for 2010 is to be used to finance directly a higher fiscal deficit stemming from a sharper-than-expected economic slowdown. Given Georgia's under-developed domestic financial markets, Fund financing would allow a less restrictive fiscal policy while avoiding funding pressures and maintaining adequate reserve coverage.
Pakistan (August 2009 Augmentation)	Limits on direct central bank lending to the government.	Allow for a further strengthening of gross reserves to deal with increased risks to the external outlook.	The augmentation was also designed and to pave the way for a donor-supported relaxation of the fiscal deficit target in 2009/10. The program envisages that a portion of Fund credit (92 percent of quota) be used to finance the social spending element of the expanded budget as a bridge loan in advance of pledged donor support so as to reduce pressure from associated budgetary imports as a result of backloaded donor inflows.
Romania **(May 2009)**	Yes. Direct central bank lending to the government not allowed.	To rebuild gross reserves, while smoothing the current account adjustment in the face of large capital outflows.	Half of purchases related to the 1st, 2nd and 3rd reviews, totaling SDR 1.9 billion (or 17 percent of total access under the exceptional SBA program), were disbursed directly to the Ministry of Finance to finance the general government deficit. Financing these amounts in the domestic market would have strained the relatively shallow domestic market, and access to foreign private financing was limited. No further disbursements under the program are expected to go to the Ministry of Finance.

ANNEX IV. SAFEGUARDS CONSIDERATIONS

The use of the domestic counterpart of Fund resources for budgetary purposes raises at least three concerns from the perspective of adequacy of safeguards to ensure repayment to the Fund.

- First, the making of the repurchase may become subject to the budgetary appropriation process.

- Second, within the time period for repurchase, the government will either have to generate a budgetary surplus in order to be able to purchase the foreign exchange necessary to repay the Fund or borrow it from another source.

- Third, absent a clear exit strategy, there is a risk that fiscal policy will become unduly reliant on Fund resources to finance what may be permanent expenditures.

Safeguards assessments are one element in the Fund's package of safeguards aimed at ensuring the temporary and appropriate use of Fund resources.[19] In the context of a traditional Fund-supported program, program design is the ultimate safeguard. If a program is well designed and properly executed, supported by quantitative performance criteria to assure that the use of resources is consistent with achieving the arrangement's objectives, this provides the strongest safeguard that the Fund will ultimately be repaid. Where a Fund-supported program is not envisaged, as in the case of the FCL, safeguards are provided by the strict qualification requirements that aim to provide assurances that policies will remain strong during the life of the arrangement.

Safeguards assessments are conducted at central banks because Fund disbursements are almost always channeled to central banks in their capacity as reserves managers, regardless of whether the money is channeled directly to Treasury.[20] In practice, safeguards assessments have taken account of program design.

- For cases involving direct budgetary support, safeguards assessments have looked for a clear framework between central bank and government for the servicing of Fund lending so that their respective roles and obligations are transparent and understood. In all such cases, the authorities have also agreed that Fund purchases be deposited with the central bank. The objective has been to replicate as far as possible the situation where Fund purchases are on-lent to the government by the central bank.

[19] Safeguards assessments review the adequacy of key aspects of the financial safeguards in place at the central banks of borrowing countries, in particular the external and internal audit mechanisms, internal controls, financial reporting, and operational independence from government. The objective of safeguards assessments is to determine whether these safeguards are sufficiently strong to deter (i) the provision of incorrect information in order to gain access to Fund resources, and (ii) misuse of resources after their disbursement.

[20] To facilitate presentation, the term central bank is used to capture different institutional arrangements, including currency boards.

- Sometimes components of NIR and NDA performance criteria are sourced outside the central bank and safeguards assessments have sought external assurances of the integrity of these sources, where warranted. In the absence of well-defined government balance sheets, safeguards assessments have also called for the transparent disclosure of Fund transactions in the notes to the central bank's financial statements. In some cases, members' SDR accounts have been used as quasi escrow accounts.[21]

- Moving beyond formal safeguard assessments, the current risk assessment framework for exceptional access cases includes an assessment of the main risks to the member's capacity to repay the Fund targeted to each case. In cases where Fund resources are provided for budgetary purposes, the assessment would pay particular attention to risks to repayment relating to fiscal sustainability such as the public sector debt burden and the ability of the government to mobilize resources, drawing on the analysis in the staff report. In terms of the indicators used in the assessment, a ratio of debt service to the GRA to government revenues has been included in risk assessments to help to capture the budgetary risks to repayment of the Fund.

To date, the board has supported the focus of safeguards assessments on central banks.

- At the time of adoption of the safeguards assessments policy in 2000, it was recognized that members could, in principle, direct Fund disbursements to official accounts of the Treasury or the Ministry of Finance with commercial banks, and consideration was given to whether the scope of safeguards assessments should be extended to government agencies. However, such an approach was deemed impractical.

- At the 2002 evaluation of the safeguards policy, an external panel of experts suggested that the safeguards framework be adapted to include fiscal issues and other public agencies, but this was not taken up by staff and the Board.

- The 2005 policy review reaffirmed the scope of safeguards assessments, noting improvements in the quality of fiscal data and the practical difficulties in expanding the scope to include government agencies.

- The next policy review is planned for 2010.

[21] For example, the safeguards assessment for the Bank of Central African States encouraged the member states to establish a mechanism to prevent overdue payments to the Fund and facilitate timely payments through advance acquisition of SDRs and an authorization to debit the SDR account of the member.

Despite the additional assurances sought in cases of direct budget support, safeguards assessments are limited in scope because the main focus of safeguards assessments remains on central banks. In cases where Fund resources are provided directly to the government, the safeguards assessment aims to replicate as far as possible indirect budget support, i.e., when Fund resources or borrowings are made by the central bank and onlent to the government, although this may not necessarily provide the same level of assurance about minimizing the risk for misuse of Fund resources. Should direct budgetary support become increasingly prominent as a form of Fund disbursements, then alternative safeguards would need to be considered, building on existing platforms to strengthen fiscal transparency and accountability, including fiscal ROSCs. In this context, the forthcoming review of the safeguard policy will examine the pros and cons of possibly modifying the safeguards mandate, including potential innovations under the existing mandate.

ANNEX V. RECIPIENT OF FUND FINANCING: CENTRAL BANK OR TREASURY?

As a legal matter, when a purchase or disbursement is made, the member (i.e., the state under international law as represented by its government) is the sole obligor and is liable to make the necessary repurchase or repayment. Accordingly, from the Fund's perspective, Fund resources are made available to the member. Whether they are channeled to the central bank or the government is, from a legal perspective, irrelevant.

Financial transactions with the Fund must take place through a member's designated fiscal agent and it is the fiscal agent that provides instruction to the Fund regarding to whom the resources should be transferred. For most members, the central bank is the fiscal agent, but a member could designate the Treasury or similar agent. This is a matter of domestic institutional arrangements. The fiscal agent, is an agent of the member and acts as its intermediary to represent the member in its financial dealings with the Fund. As an agent, the fiscal agent is not legally liable for repaying the Fund. Currently, some three quarters of IMF members have designated central banks as fiscal agents.

As instructed by the fiscal agent, the Fund can either make Fund purchases available to the central bank, or it can transfer the resources to an account of the treasury or other designated entity in the central bank (or indeed a commercial bank). If Fund resources are made available to the central bank, the central bank may then directly or indirectly onlend to the Treasury, when the (program) policies envision the government spending some of the borrowing.

In an increasing number of cases, the economic situation and domestic institutional arrangements dictate that it would be more appropriate to channel Fund purchases directly to the Treasury.

- **Legal restrictions**. When restrictions on central bank lending to the government combined with either underdeveloped or frozen government access to domestic or international capital markets prevents the financing of a desirable deficit level, channeling Fund resources for budget support through the Treasury is warranted. (Even if the central bank is able to inject liquidity into the domestic economy through open market operations, there is no assurance that, in a crisis, economic agents will choose to maintain or increase their exposure to the government through the purchase of bonds.)

- **In monetary unions**, reserves obtained by individual countries are often required to be held at the common central bank and may not be available for the financing of national balance of payments problems—as opposed to the balance of payments

position of the currency block as a whole.[22] Moreover, some monetary unions have strict prohibitions against the extension of direct credit to individual member states (e.g., EMU. In those cases where there are restrictions on on-lending, it would be appropriate to channel Fund resources to the national Treasury.[23]

- **Currency boards and fully dollarized economies.** Under these exchange rate regimes, the central bank cannot adjust interest rates or extend credit, which may complicate the use of BoP financing from the Fund to address the FX needs of different sectors of the economy. Consequently, the central bank cannot lend to the government or to commercial banks. Given this constraint Fund resources are typically channeled to the Treasury.

[22] There are currently 46 Fund members that are part of a monetary union (the Eastern Caribbean Currency Union, the West African Economic and Monetary Union, the Central African Monetary and Economic Union or the Euro Area).

[23] This would not apply to, for example, the WAEMU and the CEMAC, which do allow on-lending.