IMF's Policy Support Instrument promotes close policy dialogue

A number of African countries are considering adopting a flexible new policy framework with the IMF that enables them to secure Fund support for, and endorsement of, their economic policies without a borrowing arrangement. Since the new Policy Support Instrument (PSI) was established by the IMF's Executive Board in October 2005, four countries in Africa—Nigeria, Uganda, Cape Verde, and most recently Tanzania—have adopted it.

The PSI was created to provide a support framework for low-income countries that no longer need IMF financial assistance but want Fund endorsement of their economic policies. The PSI, which is voluntary and demand driven, is well suited to countries graduating from Poverty Reduction and Growth Facility (PRGF) arrangements. These countries—the so-called "mature stabilizers"—have made significant progress toward macroeconomic stability and debt sustainability, are well advanced in structural reforms, and have built up adequate international reserves. Nevertheless, they may still want Fund advice and support as they continue to strengthen their growth prospects, together with their macroeconomic policy frameworks, institutions, and governance structures. An on-track PSI may also provide the basis for rapid access to the IMF's quick-disbursing Exogenous Shocks Facility in case emergency assistance is required.

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Underpinning stability

The PSI encourages countries to deepen and broaden their ownership of the policy agenda. As much as possible, policy strategies and objectives draw on domestically produced documents, including budget documentation and Poverty Reduction Strategy Papers. Nigeria's PSI, for example, is based on the National Economic Empowerment and Development Strategy, the country's homegrown poverty reduction strategy. The authorities chose to present their policies to the Fund in their own policy statement rather than in the format of a conventional letter of intent. Uganda's initial PSI and its new three-year PSI incorporate macroeconomic targets based on its existing medium-term expenditure framework and reflect the priorities and strategies set out in the country's Poverty Eradication and Alleviation Plan.

Similarly, the PSIs for Cape Verde and Tanzania have been developed in coordination with these countries' overall development and poverty reduction strategies. In support of domestic ownership, PSI countries typically pursue a range of measures to strengthen local skills and capacities. For example, measures to increase capacities in such areas as public sector financial management, delivery of public services, and resource mobilization are prominent in the current PSIs.

Tailored strategies

Under their PSIs, countries have the flexibility to specify policy objectives and design reform strategies that are tailored to their economic conditions. In general, policies aim to consolidate macroeconomic stability and push ahead with structural reforms, addressing, in particular, critical bottlenecks to private sector–led growth and poverty alleviation. The reform agenda often includes measures to improve public sector management, strengthen the financial sector, and move forward in other areas consistent with the IMF's medium-term strategy. Under some of the current PSI-supported programs, countries can borrow on less concessional terms for high-quality projects, broadening their financing options and helping them move away from aid dependency. Within each program, however, there is substantial flexibility as to the specific areas of emphasis:

- Uganda began with a 16-month PSI centered on preserving its long record of macroeconomic stability. The country then decided on a new three-year PSI that would both sustain this macroeconomic progress and give particular attention to financial market development—both longer-term financing for businesses and access to financial services in rural areas—together with energy security and transportation infrastructure as the keys to future prosperity. Uganda's PSI also makes special provisions for nonconcessional financing for hydroelectric dam construction, which is a critical part of solving the country's electricity crisis.
- The PSI for Cape Verde aims to support the country's strong economic performance and prospects—as reflected, for example, in high and rising inflows of foreign direct investment. Particular attention is given to reducing macroeconomic risks and providing a safety margin against exogenous shocks, including through the reduction in public debt and further buildup of official foreign reserves.
- In Nigeria, the PSI recognizes the large infrastructure gap that is a major obstacle to private sector development while emphasizing the need for continued efforts to safeguard the country's oil wealth and macroeconomic stability.
- The recently approved PSI for Tanzania seeks to support sustained growth and poverty reduction by enhancing


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On a recent mission, the IMF's Nils Maehle (front row, right) discusses macroeconomic issues with officials in Cape Verde.

public resource mobilization and the efficiency of spending, increasing the financial sector's contribution to growth and the effectiveness of monetary policy, and improving the business climate.

Signal to donors

The PSI also provides an important signal—to bilateral donors, multilateral development banks, and financial markets, among others—that a country's economic policies have been discussed with and endorsed by the IMF. Successful performance under the PSI has allowed Nigeria to implement an agreement with its Paris Club creditors, leading to a substantial reduction of its external debt. Such signals were also viewed as particularly important in Cape Verde, which continues to face significant needs for external assistance to support infrastructure development and other efforts to increase growth and reduce poverty. The signaling role of the PSI is reinforced by the regular, six-monthly review cycle of PSI-supported programs, coupled with the expectation that the country's staff report and other program documents will be published following each review.

In summary, the PSI offers low-income countries a flexible tool for articulating their policy priorities with the support of a continuing, close dialogue with the Fund and for signaling their policy commitments to the international community. Experience under the PSI to date has been positive, both among the countries and among their development partners. These favorable responses may well continue in the period ahead, with countries that graduate from PRGF arrangements finding that the PSI provides an appealing framework for focusing on the broader outcomes sought from their policy agendas and for exploring alternative approaches to reaching these goals. ■

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African banks need more lending nerve, says author

Banks in Africa have money, but "they don't lend very much. The biggest challenge is getting banks to lend more. It's not a question of liquidity. They have the money. . . . There's a lack of banking nerve," according to Patrick Honohan, who, with his World Bank colleague Thorsten Beck, is the author of a new World Bank book on African finance.

At a panel discussion at the World Bank on March 13 to discuss *Making Finance Work for Africa,* Honohan—Senior Advisor, Finance and Private Sector Development—said that there has been some progress in the past decade in deepening financial systems in sub-Saharan African countries. Private credit, bank deposits, and liquid liabilities have all turned up since 1996. And there has been some pickup in stock markets, too. Still, the financial systems in most sub-Saharan African countries are dominated by banks, and African banking systems are small, absolutely and relatively. They are also reluctant to lend to the private sector, and what little private lending they do is expensive.

Banking spreads are high, far higher than in most of the rest of the world, Honohan said in his presentation, perhaps because of what banks perceive as the riskiness of lending. Those banks lend only about 30 percent of their resources to the private sector. In most other regions, banks lend 60 percent or more of their resources to the private sector (in Latin America and high-income countries, banks lend 70 percent).

As a result, financial systems in sub-Saharan Africa are the most frequently cited barrier to growth, according to a survey of enterprises. Honohan and Beck, a Senior Financial Economist, Development Research, suggested a number of reforms to increase *finance for growth,* including making banks more comfortable with lending by working on information and legal infrastructures (including property rights), getting rid of unnecessary regulations, and finding other sources of finance, such as pension and social security funds.

In addition to making improvements to enhance economic growth, Honohan and Beck cite developments, such as the Internet and cell phone technology, that can overcome isolation and costly teller services to give households and small businesses better access to banking services—what they call *finance for all.* ■