Annex 4

Assessing Macroeconomic Eligibility

A. Introduction

This Annex to the Budget Support Guide provides a template for setting out a structured assessment of the macroeconomic eligibility criterion that assess the relevance and credibility of the macroeconomic policies being pursued by the authorities. Additional background information is contained in a number of Appendices.

The assessment should:

- analyse the main macroeconomic aggregates and identify potential sources of instability that would endanger the strength and the persistence of growth, or the return to a stable macroeconomic frame and debt sustainability;
- assess macroeconomic and fiscal policies in place and their contribution to stabilize the macroeconomic framework over the short and medium term;
- assess efforts to strengthen domestic revenue mobilisation;
- assess vulnerability to external shocks and efforts to strengthen macroeconomic resilience.

The template below provides analytical tools and proposals for indicators on which to base the assessment of eligibility. The analysis should also underpin the risk assessment. The analysis should be based on national documents, on IMF analysis as well as on analysis from other international financial institutions. The assessment should take in consideration that there is no "single" stability-oriented macroeconomic policy in a given situation and that the authorities generally have to face conflicting objectives. The benchmarks are, however, that the Government's capacity to finance the fiscal and external deficits is not jeopardized in the short- and the medium term, and that inflationary pressures are brought under control. Furthermore, efforts to enhance domestic revenue mobilisation should be effective in order to strengthen the resilience of the economy. The country context, in particular in fragile or transition situations, including available financial resources, administrative capacities and short term social and economic priorities, shall be taken in account when assessing those medium term oriented efforts.

The assessment of the macroeconomic eligibility criterion during implementation follows the same logic as during the preparation phase, and the same template should therefore be used. However, the analysis at the time of decision on payment of a tranche should in particular include answers to the following questions: have the authorities respected their commitments towards a stability oriented macroeconomic policy? Have unexpected domestic or external events required a macroeconomic policy adjustment? If so, what has been the reaction of the authorities? And, is the new policy stance still stability oriented?

B. Template for the supplementary document to the action fiche and payment dossier

NB: No data and no analysis are required to fill in this template that are not easily available in national official documents, if any, and by default in documents by the IMF, the World Bank or other international organisations documents. The relation of the country with the IMF and the analysis of this institution of the macroeconomic policy orientation is key to assess the eligibility criterion. The economic analysis, in particular the assessment of the credibility of the policy stance, should also be strengthened by regular contact at technical and policy level between the Delegation and the national authorities, as well as with the IMF mission and the Resident Representative and other relevant stakeholders. The document should in general not exceed 6 pages plus tables and graphs. It should aim at a synthesis of the main issues while referring (positively or negatively) to the analysis provided in documents by other institutions.

1. Introduction

Context

Brief overview of key structural indicators of the economy: Income per capita (LIC/MIC?), past medium term growth performances, source of GDP (agriculture, natural resources) and diversification, poverty/inequality, qualities of institutions and business environment, openness. The delegation is encouraged to use its local knowledge and judgement to identify and briefly present on the base of few indicators **the few most pressing economic and social challenges and risks** faced by the government and that could jeopardise medium term growth and development prospects[8], recognising that economic transformation is never socially or environmentally neutral. Indicators of inclusiveness that can be provided include (i) absolute poverty and inequality (Gini coefficient, income lowest to highest quintile/decile, people under poverty line, ..) (ii) pattern of economic growth and social development: persistent contrast between main sectors (traditional agriculture vs. export oriented); (iii) rapid urbanisation with pressing deficit in public infrastructure and service provision; (iv) unemployment, in particular youth; land and water access as emerging issues as a result of the transformation of property rights. Cross references may be made where appropriate to the analysis of the assessment of public policy eligibility.

Source: National publications, World Bank and IMF on line data bank and data bank of other international financial institutions and bodies[9] (e.g. International Energy Agency, …), MDG and UN Human Development statistics.

Relation with the IMF

The mandate of the IMF is to *advise and help member countries in implementing macroeconomic and financial policies that promote stability, reduce vulnerability to exogenous shocks, and encourage sustained growth and high living standards as well as poverty reduction.* The quality of the relation of the country with IMF is therefore of first importance, while not necessarily decisive, for assessing the eligibility of the country to a

[8] There is, in particular, growing evidence that inequalities jeopardize growth prospects in the medium term. See for example: Inequalities and Unsustainable Growth: two sides of the same coin, IMF, 2011, http://www.imf.org/external/pubs/ft/sdn/2011/sdn1108.pdf

[9] For example: http://www.worldenergy.org/publications/energy_efficiency_policies_around_the_world_review_and_evaluation/1230.asp

budget support operation. The link to be established between the relation of the country with the IMF and this eligibility is described in the main part of the text.

The relationship with the IMF should be described[10], including: Current credit arrangement or Policy Support Instrument or Staff monitored programme: when available/relevant, date of conclusion of last review, planned date of next review or of IMF mission, expiry date, amounts; main conclusion of last staff report and of the last Board meeting; or, date of last Article 4 consultation and summary of staff appraisal and of commitments/announcements by the authorities in this context (diverging views, e.g. on forecasts or policy recommendations, shall be mentioned and as possible explained); expected date of next programme review or Article 4 consultation. As relevant, this description can be usefully complemented by a description of the relationship of the country with the World Bank and Regional Development Banks.

Source: IMF country webpage. World Bank or Regional Development Bank country webpage; see appendix 3

2. Key macroeconomic indicators and potential source of instability

Short term performance and outlook

This section focuses on the presentation of key imbalances to be addressed by the Government. The main indicators to be used should be presented in an analytical table (see template below) and complemented as necessary. Imbalances may for example relate:

- to a significant weakening of real GDP growth compared to long/medium term trend as a result of a sudden and unexpected weakening of internal or external demand or supply factors (including natural shocks or events like rain fall), and/or
- to pressures on prices and/or competitiveness that could jeopardise prospects for moderate inflation and currency stability; inflation rates need to be assessed in their historical dimension (persistently high, acceleration). Changes in prices induced by an exogenous price shock and the policy response to it shall be carefully assessed (see appendix 3) and/or
- to a deterioration of the external accounts, for example as a result of changes in terms of trade, weakening of external demand, reduced aid, or domestic demand pressure that jeopardizes the capacity to finance the balance of payments and/or keep the level of reserves at a sufficient level, or would result in an unsustainable evolution of debt levels (see appendix 1), and/or
- to an evolution of public expenditures, for example as a result of social pressures, food security crisis, political cycle, or of revenues (change of prices of natural resources, unexpected shortfall in tax revenues) that jeopardizes the capacity to finance in the short run the fiscal deficit or would result in an unsustainable evolution of public debt levels, and/or
- to weaknesses in the financial or banking sectors (accumulation of bad loans, difficulties to refinance). Indicators can in general be found in IMF Review documents (Table "Financial Soundness Indicators").

Source: National accounts, National Budget, Central Bank report, IMF last Program review or Article IV review, IMF country web page.

[10] For the various IMF lending instruments see: http://www.imf.org/external/np/exr/facts/howlend.htm

3. Assessment of macroeconomic policies and stabilisation of the macroeconomic framework

The relevance of macroeconomic policies shall be assessed in view of the macroeconomic imbalances identified in the previous section and of the debt sustainability analysis. The overall orientation of the macroeconomic policy stance in a short and medium term perspective is in general outlined in the letter of intent signed by the authorities in the context of credit arrangements with the IMF, in other national public documents (Budget, Central Bank announcements) or in IMF documents (Article IV review, Review of Credit arrangements). Appendix 4 provides examples of formulations for the diagnostic and the macroeconomic response as reflected in IMF Review documents.

The main quantitative indicators of the fiscal policy stance are included in the Analytical Table. They include the fiscal deficit, the primary deficit (overall deficit excluding interest payments), the level and change of public debt as a percentage of GDP. Based on these indicators, the fiscal policy stance shall be assessed taking account of the cyclical position of the economy, the desirability of a short term expansive stimulus or of a deceleration of demand, as well as of debt sustainability considerations (see appendix 2).

The credibility of expected tax revenues may be measured by verifying the coherence of the change in tax ratios with recent tax policy changes and efforts to strengthen administrative capacities (see below assessment of efforts for strengthening domestic revenue mobilisation). For natural resources, the underlying extraction volume and price hypothesis may be taken into consideration. For expenditures, underlying assumptions for salaries and staff and social expenditures (including the political impact), expected interest payments related to debt stock, as well as changes in public investment volume, are determinant for assessing the credibility.

The method of assessing the contribution of macroeconomic policies to price stability very much depends on the monetary policy instruments, the exchange rate, and the capital movement regime, which may differ widely from country to country. The Delegation will, in general, rely on the analysis of the IMF for this purpose. An explanation should also be provided of the quality of banking supervision, the path of financial sector reforms, because of the high relevance of these aspects for assessing risks.

Source: National Budget, multi-year programming documents (Medium-Term Fiscal and Expenditure Frameworks – MTFF, MTEF), Budget Execution reports, Balance sheet of the Central Bank, other Central Bank reports, National Accounts, the national statistics institute's financial statistics, the International Financial Statistics (from the IMF), IMF last Program review or Article IV review, IMF country web page

4. Domestic revenue mobilisation

Measuring domestic revenue mobilisation as a share of tax revenues to GDP shows two features. For developing countries, higher per capita revenue tends to go hand in hand with relative higher public revenues without saying anything on the nature and direction of causality. The variance of this ratio is high within each income group.

Table: Key Indicators on Domestic Revenue Mobilisation[11]

Year 2010	Size of the sample	Tax ratio (% of GDP)			Estimated effort (Effective tax revenue in % of estimated potential)		
		Median	Maximum	Minimum	Median	Maximum	Minimum
LICs	12	13,9	22,4	8,1	77,6	92,4	41,0
Lower MICs	24	16,5	36,6	9,5	63,2	87,1	38,1
Upper MICs	20	26,8	45,7	14,3	77,2	98,4	48,3

The table provides only a very broad indication for situating the efforts of a developing country for its domestic revenue mobilisation[12]. However, the assessment of efforts made to enhance domestic revenue mobilisation needs to be put in the country context. The annex on Domestic Revenue Mobilisation provides a detailed background to this end.

Many oil and resource-rich countries have relatively high revenue-to-GDP ratios. These countries, however, need to improve the efficiency of their tax systems to reduce reliance on natural resource revenues. In such countries, indicators to be analysed should include ratio of revenues from natural resources to GDP, and from tax revenues to GDP (excluding natural resource revenues).

Basically, efforts made to enhance revenues can be assessed on the base of the answers to following questions:

- Does the Medium Term Financial Framework foresee a progressive increase of coverage of public expenditures by tax revenues? An assessment would have to take in consideration the per capita income level of the country, its development needs and the existence of natural resources;
- Tax policy: Did the authorities take any significant tax policy measures in the period under consideration? What is the objective of these measures and the expected impact on tax revenues? A particular attention needs to be given to the transparency and consistency of tax incentives as well as to their coherence with well defined public policy objectives. A quantification of the overall costs of tax exemptions shall be sought.
- Tax administration: Did the authorities take any measure to build up an effective and efficient tax administration promoting tax compliance and strict enforcement of tax codes?
- How are the specific problems arising for taxing natural resource, especially in natural resource rich countries, addressed (transparency, commitment to EITI, …).
- Did the authorities take any measure to contribute to international tax cooperation?
- Can visible progresses be demonstrated in the collection of one or more specific taxes compared to the relevant tax base as result of policy or administrative measures? Compared to the average increase of tax revenues?

Dialogue with the authorities, with donors and agencies providing assistance to fiscal reforms, contact with the IMF and the PFM assessment provide in particular the base for answering

[11] Source: IMF, 2011, Revenue Mobilisation in developing countries, P. 60. The potential has been estimated by the IMF on the base of a simple regression retaining most pertinent determinants (tax base, level of development,..). Samples include natural resource rich and poor countries. LIC = Low Income Countries; MIC = Middle Income Countries

[12] These numbers need to be interpreted with caution, including because the quality of GDP estimates may vary strongly from one country to another.

these questions. The assessment shall be put in a medium term perspective recognising that tax reforms are difficult endeavours and that their successes is contingent to several factors. However, based on the answers to previous questions, a repeated and obvious lack of commitment by the authorities to take serious measures for enhancing domestic revenue mobilisation shall result in a negative assessment of the macroeconomic eligibility criterion.

Source: National documents, IMF reports; TA reports; NGOs reports

5. Assess vulnerability to external shocks and efforts to strengthen resilience

Developing countries are particularly vulnerable to exogenous shocks, e.g. a sharp decline in international, trade, a shift in terms of trade, volatile external flows, or climatic changes. In the face of an increasingly uncertain global environment, macroeconomic stability over the medium term therefore depends on building economic resilience to future shocks. The assessment of efforts made to strengthen economic resilience has to be brought in relation with the vulnerability of the economy to shocks (commodity prices, world demand of main export products). Evidence on vulnerability includes volatility of economic growth, of exports values as well as of fiscal and natural resource revenues as a result of external shocks. It is therefore strongly country dependent. Experience accumulated over the last decade, in particular in the wave of the 2007-08 food prices and financial crisis shows that economic resilience depends on three important factors: external and fiscal buffers, a well-targeted and efficient social safety net, and over the medium/long run capacity to diversify production. Efforts to strengthen economic resilience should be assessed alongside these three dimensions.

6. Conclusions of the analysis

This section should draw a basic conclusion on the relevance and credibility of the macroeconomic framework and hence eligibility for budget support. The assessment of eligibility may take the following form[13]:

At end of identification or formulation:

"Based on the analysis above [and the latest IMF review dated MM YY][with the following caveats…] it is concluded that the authorities pursue a credible and relevant stability oriented macroeconomic policy aiming at restoring fiscal or external stability and sustainability.

Implementation phase/Disbursement decision

Based on the analysis above it is concluded that there is a stability-oriented macroeconomic framework in the country or progress is made towards restoring key balances.

[13] For illustrative purposes

Appendix 1
Assessing external accounts

Two tables are central to assessing external accounts: the standard Balance of Payments table and the summary table "External financing requirements and sources" as calculated by the IMF from the Balance of Payments.

Assessing the balance of payments cannot be limited to the size of the trade balance or of the current account. Firstly, the vulnerability of the current account depends on structural factors, e.g. geographical and product diversification of exports, size and origin of remittances, vulnerability of import values to raw material prices. It also depends on changes in price competitiveness. Secondly, a current account deficit corresponds to national investment in excess of national saving. Such a deficit going for example hand in hand with a high investment ratio and rapid growth will be the consequence of a successful growth oriented development strategy as long it is financed on a sound basis; by contrast, a deficit in the context of low growth and low investment or low investment efficiency will tend to generate an unsustainable external debt. Thirdly, the source of financing matters. Indicators include reliance on official versus private flows, change and level of external reserves and the respective share of FDI, long term and short term capital flows in private capital flows.

The "external financing requirements" (requirement: -) as defined in the summary table include the current account balance (deficit : -), the increase or intended change of international reserves (increase: -) and the financing requirement stemming from debt amortization (debt repayment: -). There are two types of external financing : private flows (inflows: +), subdivided into forecast FDI minus reversible investment in productive capital and other private flows, representing investments in short, medium and long term financial assets; and the contribution of the IMF and other official flows. As EU budget support falls into of this latter category, it makes sense to compare yearly disbursements under EU budget support to the overall amount of official capital flows.

An agreed IMF programme always presents a "closed" overall balance of payment, i.e. equality of financing requirements and sources. Before an agreement is reached, the presentation of a "residual financing gap" by the Fund specifically raises the question of the contributions of official donors and multilaterals already included under "other official flows". If the Fund deems expected official flows insufficient to "close the gap", it will have to renegotiate the macroeconomic framework, with specific regard to the fiscal policy stance, with the Government. This will in general result in reduced public expenditures or a more restrictive monetary policy stance.

Appendix 2
Debt sustainability[14]

Debt sustainability relates to debt and debt service relative to measures of repayment capacity. A debt and related debt service obligation growing persistently faster than the revenue base underpinning repayment will unavoidably result in a liquidity or solvency crisis. A current deficit – either external or fiscal - shall therefore be in a first step be assessed in relation to the existing level of debt and the change of the debt it will mechanically induce compared to the expected growth rates in revenues (debt to revenue ratio). Debt sustainability put a constraint on the acceptable size and desirable evolution of the current deficit under consideration. For example, an increased of the fiscal deficit that may appear to be desirable for sustaining activities in the case of an adverse shock may have to be rejected because of debt sustainability concerns.

For most Low Income Countries the first indicator to be looked at is the sustainability of public external debt. However, as more and more countries have access to a domestic capital market, attention needs to be given to the overall public debt

The information to be provided in all cases should be based on the joint analysis by the IMF and the World Bank. These institutions undertake such analyses for most of the LICs on a regular basis (three year cycle with yearly update). They are published on the IMF website (http://www.imf.org/external/pubs/ft/dsa/lic.aspx). In some cases, a debt sustainability analysis is undertaken for middle income countries with access to capital markets, though using a somewhat different methodology.

Debt stock indicators provide a useful measure of the total future debt-service burden of existing debt. Debt-service indicators provide a measure of the immediate burden that debt imposes on a country by crowding out other uses of scarce resources. Repayment capacity is measured by GDP, exports of goods and services, or Government revenues. The most relevant measure of repayment capacity depends on the constraints that are most binding on an individual country. Present Value debt ratios are summary indicators of the burden represented by the future obligations of a country and thus reflect long-term risks to solvency, while the time path of debt-service ratios provides an indication of the likelihood and possible timing of liquidity problems[1].

IMF/World Bank debt sustainability analysis is based on "realistic" macroeconomic scenarios intended to "provide safeguards against excessive borrowing and return to debt distress, without constraining justified optimism about the effective use of external resources to promote growth, reduce poverty and achieve MDGs" (IMF, 2010). It includes base line, alternative and stress test scenarios. Increasingly, the attempt is made to take consideration of the efficiency of public investment.

It relates to Debt Burden Thresholds (Debt and debt burden as % of Exports, GDP and fiscal revenue) taking account of the institutional capacity of the country to manage debt on a sound basis (IMF, 2010, P. 9). It classifies countries in low, moderate, high risk of debt distress or in debt distress. Particular attention should also be given the accumulation of arrears.

[14] **Source:** Staff Guidance Note on the Application of the Joint Bank-Fund Debt Sustainability, IMF, 2010, http://www.imf.org/external/np/pp/eng/2010/012210.pdf ; see also the Framework for Low-Income Countries: http://www.imf.org/external/pubs/ft/dsa/index.htm

Appendix 3
External price shocks on food and energy, control of inflation and fiscal policy

In the absence of external price shocks, the objective of a moderate and stable inflation rate is generally pursued mixing interest rate policy, control of domestic credit and exchange rate stability. An external shock on food and/or energy prices may give rise to substantial challenges for the authorities of several developing countries, in particular of LDCs. The average share of food in the consumer basket of LDCs is around 45% and of fuel 6%. Price shocks affect mostly the poorest households, but the middle class may also be significantly affected. Capacity to partially absorb the price shock through reduced saving or depletion of savings is limited or inexistent. The poverty incidence is therefore high. Small enterprises with limited access to credit may be hit by an excessive volatility of energy prices, resulting in liquidity problems.

As a result, full passing through of food and energy price shocks to the final users in absence of an effective social safety net targeting the poorest and where credit market access is weak, is often not a sustainable solution. Price subsidy schemes appear as a second-best, but expensive solution, and need to be carefully designed to meet the needs of the poorest in a cost-effective manner, taking account of the fiscal space. Reversibility of such schemes is also a key issue.

Moreover, monetary policy is challenged. The “standard” advice is to accommodate first round effects on prices whilst opposing to further "second round" spill over effect on domestic prices that would trigger an inflationary dynamic. However, countries which had international reserve problems and/or inflationary pressures before the shock may have to pursue an even more restrictive stance to oppose immediate effects of the price shock.

This underlines the importance of strengthening resilience over the medium term through effective and well-targeted social safety nets as well as through international reserve and fiscal buffers for ensuring medium term macroeconomic stability.

Appendix 4

IMF lending instruments to Low Income Countries

The IMF has overhauled its instruments for low-income countries *since the beginning of the global economic crisis to address their* ***greater vulnerability and exposure to the ups and downs of the global economy*** *needs for short-term and emergency support. Lending instruments include:*

The Extended Credit Facility *(ECF), replacing the Poverty Reduction and Growth Facility, (PRGF)*

- Provides sustained engagement over the medium- to long-term, in case of medium-term balance of payments needs;
- Offers more flexibility than before on programme extensions, the timing of structural reforms, and formal poverty reduction strategy document requirements.

The Standby Credit Facility (SCF), which supersedes the Exogenous Shocks Facility's High Access Component, is similar to the Stand-By Arrangement for middle-income countries. It

- Provides flexible support to low-income countries with short-term financing and adjustment needs caused by domestic or external shocks, or policy slippages;
- Targets countries that do not face protracted balance of payments problems but may need help from time to time;
- Can also be used **on** a precautionary basis to provide insurance.

The Rapid Credit Facility (RCF),

- Provides rapid financial support in a single, up-front payout for low-income countries facing urgent financing needs, and offers successive drawings for countries in post-conflict or other fragile situations;
- Provides flexible assistance without programme-based conditionality when use of the other two facilities is either not necessary (limited nature of need) or not possible (institutional or capacity constraints).

All these facilities allow for significantly higher access to financing and offer more concessional terms than previously. Low-income countries will receive exceptional forgiveness through end-2011 on all interest payments due to the IMF under its concessional lending instruments. Thereafter, concessionality will be reviewed every two years.

Standard tables

The tables below include core information required to make a macroeconomic assessment. They come on top of the information to be provided as suggested in the text (notably development indicators, size of EU aid in relation to macroeconomic variables, tax policy parameters, medium term macroeconomic framework of the debt sustainability analysis ...). They may have to be adapted to take account of country specificities. The calendar years are exemplary provided for an elaboration in the second half of 2011 and first half of 2012.

Table 1: National accounts and prices

	2000-08	2009	2010	2011 (est.)	2012 (proj.)	2013 (proj.)
Real GDP (% change p.a.)						
Real (nonoil) GDP (% change p.a.)						
Real GDP per capita (% change p.a.)						
Population (size end of period)	-					
GDP (US $ or €)						
Gross investment (percent of GDP)						
• Private						
• Public						
Consumer price index (% change annual average)						
Nominal effective exchange rate (% change end of period)						
Real effective exchange rate (%change end of period)						

Table 2: Financial sector

Net domestic assets of the banking sector (% annual changes)						
Net foreign assets of the banking sector (% annual changes)						
Indicator(s) of capital adequacy (for details see IMF table "Financial soundness indicators".)						
Indicator(s) of asset quality (idem)						

Table 3: External accounts (in Mio $ or €)						
	2008	2009	2010	2011 (est.)	2012 (proj.)	2013 (proj.)
Current balance (including grants)						…
Trade balance						…
• Exports						
➢ Of which (indicate the export value of the first main export product(s)						
• Imports						
➢ Of which Oil						
Balance on services and income						…
• Of which interest payments						
Balance on transfers						
• Of which official transfers (net)						
Capital and financial account						
Capital account (net)						
Financial account (net)						
• Official financing (Long and medium term loans)						
• Private capital						
• Short term capital						
Errors and omissions						
Overall balance						
Memorandum items (% of GDP unless otherwise indicated)						
Net international reserves (-, incr.)						
Current balance, including official transfers						
Total donor support						
• Of which official transfers						
➢ Of which EU aid (disbursed)						
External debt						
External debts service paid						
Gross international reserves in US$						
Gross international reserves in months of prospective imports						
Export volume (% change p.a.)						
Import volume (% change p.a.)						
Terms of Trade (%change p.a.)						

Table 4: Fiscal policy indicators (% of GDP resp. % of non oil GDP)						
	2008	2009	2010	2011 (est.)	2012 (proj.)	2013 (proj.)
Total revenue and grants						
Revenue						
Oil revenue						
Nonoil revenue						
Tax revenue						
Direct taxes						
Indirect taxes						
Trade related taxes						
Nontax revenue						
Grants						
➢ Of which EU budget support (disbursement)						
Total expenditure						
Current expenditure						
Current Non-interest expenditure						
• Wages and salaries						
• Goods and services						
• Other						
Interest payments						
• domestic						
• foreign						
Capital expenditure (total)						
Domestic						
Foreign						
Arrears clearance (clearance -)						
Domestic primary balance						
						<
Overall balance (after arrears clearance)						
Memorandum items (% of GDP resp. % of non oil GDP)						
Total poverty spending (social protection, health, education)						
Tax exemptions						
Outstanding domestic payments arrears						
Total government debt						
Domestic debt						
External debt						