

# COUNTERPART FUNDS IN THE DESIGN OF MACROECONOMIC AND STRUCTURAL ADJUSTMENT PROGRAMMES

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## 1 INTRODUCTION

The potential macroeconomic impact of the creation, accumulation, and use of counterpart funds can be significant. To ensure consistency between objectives and instruments, the impact of counterpart funds<sup>2</sup> should be taken into account in the design of macroeconomic and structural adjustment programmes, including those supported by financing from the International Monetary Fund (Fund). One conclusion of this article is that the time factor is important, as the creation or accumulation and the use of counterpart funds can have opposite effects on the money supply and on the overall government budget deficit. The creation or accumulation of counterpart funds contributes to a reduction in the money supply and therefore is consistent with the restrictive demand management policies that are often needed to achieve a viable balance of payments position and a sustainable rate of growth with price stability. In contrast, the use of counterpart funds has the opposite effect and is, in most instances, inflationary. Therefore, a great deal of confusion exists with respect to the macroeconomic impact of these funds, which often renders the exchange of views difficult and leads to wrong policy recommendations. Another conclusion is that the earmarking of counterpart funds for specific uses by donors is not efficient because money is fungible. Instead, donors should attempt to ensure that their policy advice is adequately reflected in the overall design of the recipient government's public expenditure programmes and budgetary policies.

Section 2 describes the Fund's approach to its financial assistance and provides an overview of the main elements of macroeconomic and structural adjustment programmes supported by the use of Fund resources; Section 3 describes the donors' approaches to counterpart funds; Section 4 analyzes the macroeconomic impact of counterpart funds; and Section 5 summarizes the conclusion of the paper.<sup>3</sup>

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<sup>2</sup> Although the notion of counterpart funds is well known to economists and officials from foreign aid donor and recipient countries, the definition of these funds varies widely. In this paper, counterpart funds are defined as the local currency proceeds of the sales of commodities and of foreign exchange provided by foreign aid in the forms of grants or loans to the recipient government. For further details on definition of counterpart funds, see Bruton and Hill 1990; Maxwell 1991; and Clément 1989.

## 2 FINANCIAL ASSISTANCE BY THE FUND AND ADJUSTMENT PROGRAMMES

The Fund's financial assistance is provided to member countries for balance of payments — rather than budgetary — support, except in countries belonging to monetary unions (such as some countries in West and Central Africa) where Fund resources can be used directly as budgetary support. The Fund disburses its financial assistance through arrangements under a number of facilities.<sup>4</sup> Under all these arrangements, the transaction entails an exchange of one asset for another — the recipient country acquires other currencies (usually those of the major industrial countries) in exchange for its domestic currency. These transactions take place between the Fund and the country's monetary authorities, usually the Central Bank. Fund disbursements are treated as a financing item — that is, they are below the line in the balance of payments and are shown as part of the net foreign assets of the monetary authorities. To the extent that these funds are subsequently used by the government for financing the budget, they are regarded as domestic financing from the banking system. Countries may adopt different internal accounting practices. The use of Fund resources does not result in the creation of counterpart funds by recipient governments.<sup>5</sup>

The main objectives of a programme with the Fund are to attain or safeguard a viable balance of payments, while achieving a sustainable rate of growth with price stability. The achievement of these objectives generally requires policies that restrain aggregate demand and improve economic efficiency. While the mix of policies depends on the specific circumstances of the country, fund-supported programmes emphasize two main instruments for controlling aggregate demand: monetary (or domestic credit) policy, and government tax and expenditure policy.<sup>6</sup> As the creation or accumulation, and the use of counterpart funds,

<sup>3</sup> For details on the macroeconomic impact of counterpart funds, notably on the balance of payments, money and the government budget, see J. A. P. Clément, 1989, *op. cit.*

<sup>4</sup> The IMF financial resources are made available to its members through a variety of facilities and policies, which differ mainly in the type of balance of payments needs and with the degree of conditionality attached to them (IMF 1991).

<sup>5</sup> More details on the treatment of Fund accounts in money and banking statistics are provided in IMF 1958; and IMF 1984, paragraphs 527-559.

<sup>6</sup> On the design of Fund's programmes and conditionality, see Guitián 1981; Khan and Knight 1985; and IMF 1987.

depending on the magnitude, can have important effects on monetary policy as well as on budgetary policy, they have to be duly taken into account to ensure consistency between macroeconomic objectives and instruments.

Because of the links between monetary flow, public sector spending, and aggregate demand, monetary policy is an essential demand management tool. The importance of domestic credit in influencing domestic and external balance provides the basis for the formulation of monetary policy in terms of domestic expansion either by the Central Bank or the banking system as a whole. In this context, the impact of counterpart funds on total domestic credit and net credit to government should be taken into account in order to ensure consistency with the programmed monetary expansion.

Fiscal imbalances stemming from expenditure levels that exceed the public sector's revenue are often the primary cause of an unsustainable expansion in aggregate demand and the consequent weaknesses in the balance of payments. In Fund-supported programmes, the correction of fiscal imbalances normally entails measures to restrain public expenditure while improving the expenditure structure. Therefore, total government expenditure — including that financed through the use of counterpart funds — is a key variable to be monitored. In this context, to strengthen the monitoring of public expenditure, the adjustment package very often includes a comprehensive and coherent public expenditure programme as well as a public investment programme. However, the earmarking of counterpart funds for certain expenditures, which leads very often to the creation of special accounts outside the budgetary process, renders the monitoring of public expenditure difficult. The earmarking of counterpart funds can also result in a structure of public expenditure that is not necessarily the most appropriate at the macroeconomic level, nor is it necessarily consistent with the objectives that are typically included in any public expenditure programme designed with the help of the Fund and the World Bank. Even though each earmarking at a microeconomic level or at a particular donor level might appear appropriate, the sum of all the donors' requests could very well be inappropriate at the macroeconomic level and work against the best allocation of resources in the light of a country's particular needs. In addition, the more stringent the conditions imposed by donors, the

more likely that the time lapse between the creation and the use of counterpart funds would exceed one or more fiscal years. If such a lapse between the creation and the use of counterpart funds does extend beyond a single fiscal year, this lack of simultaneity could have important macroeconomic effects. These effects would vary with the magnitude of the counterpart funds accumulated<sup>7</sup> in a given country as described in Section 4.

### 3 DONORS' APPROACHES RELATING TO COUNTERPART FUNDS

Counterpart funds are generated in various ways: donors differ in the ways counterpart funds are created and in the conditions attached to their use (Figure 1). It is essential to understand the features of these funds, especially if they are sizable, in order to assess their macroeconomic impact and to ensure consistency in macroeconomic programming:

**a** Sources of counterpart funds, i.e., grants vs. loans. The accrual of counterpart funds from grants is permanent, whereas loans will have to be repaid in the future, requiring the recipient government to raise a corresponding amount of local currency.

**b** Forms of initial donor assistance, i.e. in cash or in kind. When aid is provided in the form of cash, the foreign exchange can be sold by the recipient government to the Central Bank, other entities in the public sector, and the commercial banks, as well as to the nonfinancial private sector. When aid is provided in the form of commodities, counterpart funds are created only after the commodities have been sold to the nonfinancial private and public sectors.

**c** Ownership of funds, i.e. donors versus recipients. Donors may require that part of all the counterpart funds be owned either by the recipient government or by the donor government or, sometimes, jointly.

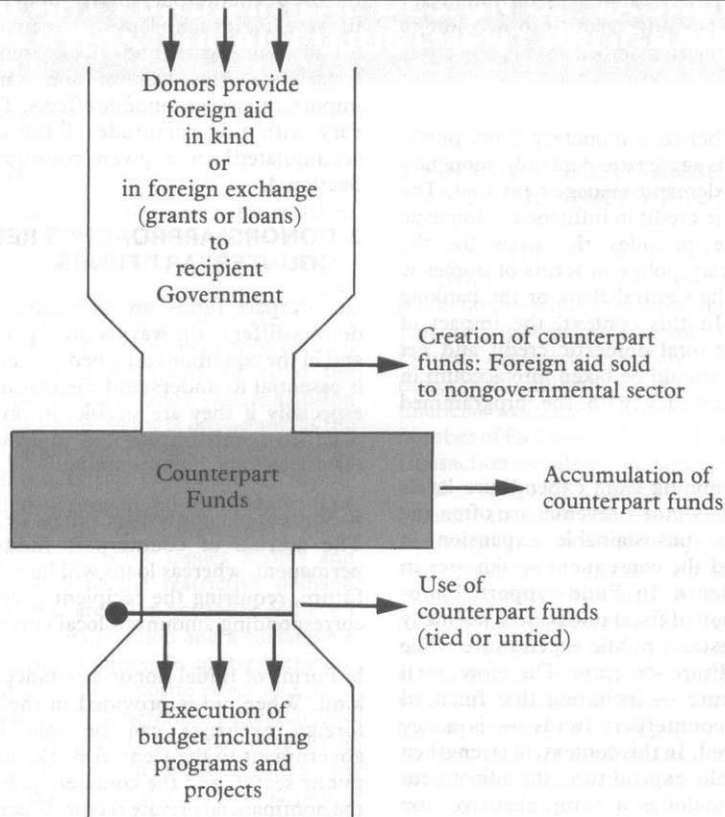
**d** Freedom to use counterpart funds by the recipient government, i.e. whether uses are 'tied' to the financing of predetermined expenditure. In many cases, the recipient government is required to open a separate account for the funds, and the use of these funds is often determined outside the budgetary process. In other cases, 'untied' counterpart funds cannot be distinguished from other unearmarked budgetary resources, as the recipient government can use them at its own discretion.<sup>8</sup>

<sup>7</sup> Obviously, the speed of accumulation of counterpart funds would vary depending on the type and design of projects, the programming and implementation capacity of the recipient country, and the complexity of procedures attached by the donors to the use of counterpart funds, as well as the rate of increase of foreign aid.

<sup>8</sup> In the monetary survey, foreign-owned counterpart funds are usually included in foreign liabilities as 'foreign lending funds'

whereas country-owned counterpart funds are usually included in 'government deposits', although in some instances, particularly for purposes of historical analysis, they are distinguished from the usable government deposits by being classified as 'government lending funds'. For more details, see IMF 1984, op. cit., paragraphs 481-84. Also, for details on the accounting treatment of foreign aid in the balance of payments, see IMF 1977.

Figure 1: Creation, Accumulation, and Uses of Counterpart Funds\*



**Definition of counterpart funds:** Local currency proceeds of the sales of commodities and of foreign aid in the form of grants or loans to the recipient government.

\* The impact of the creation, accumulation and uses of counterpart funds on the money supply and the government budget are described, respectively in Tables 1 and 2.

#### 4 MACROECONOMIC IMPACTS OF COUNTERPART FUNDS

The macroeconomic impacts of counterpart funds differ, depending on the specific features noted above, but typically the accumulation of such funds is deflationary. In most cases, the creation and accumulation of counterpart funds are deflationary, as they entail a shift of money from the private sector to the government sector, together with a decrease in net credit to the government, assuming that financial policies are not modified to offset the deflationary effect (Table 1). The accumulation of counterpart funds would therefore generally reinforce those policies aimed at reducing inflationary pressures and narrowing the balance of payments deficit.

The macroeconomic impact of the uses of counterpart funds is the reverse of that of the accumulation of funds and therefore tends to be inflationary.<sup>9</sup> The government may use these funds to repay debt to the Central Bank; to repay its debt to the public, which would free budgetary resources for other expenditure already planned; or to provide direct financing of expenditure that may otherwise not be undertaken (Table 2). The precise macroeconomic effect depends on the timing of such uses, following the initial provision of foreign assistance. If the creation and the use of counterpart funds take place simultaneously, the macroeconomic impact is neutralized. However, if the use of these funds takes place long after the goods obtained through the foreign aid have been consumed by the private sector, or after the foreign exchange untied to private

<sup>9</sup> A drawdown of such funds with the Central Bank and the commercial banks will increase net public sector borrowing from the banking system. The extent of the drawdown will therefore need to be set within the overall fiscal and monetary framework and may have

to be offset by lower government borrowing elsewhere. The use of counterpart funds has to be properly designed, and only then would it not be inflationary.

**Table 1: Creation or Accumulation and Use of Counterpart Funds — Their Impacts on Net Credit to Government and Money Supply**

Sources of creation of counterpart funds										
	Foreign aid in commodity grants				Foreign aid in grants or loans in foreign exchange					
	Bought by the private sector using				Bought by the private sector to finance imports using			Bought by the central bank		
	Cash balances		Deposits in commercial banks		Cash balances		Deposits in commercial banks			
	commer- cial banks	central bank	commer- cial banks	central bank	commer- cial banks	central bank	commer- cial banks	central bank	commer- cial banks	central bank
<b>Recipient government deposits counterpart funds in</b>										
Direct effects on:										
Net foreign reserves	0	0	0	0	0	0	0	0	+	+
Money supply	- <sup>1</sup>	-	-	-	-	-	-	-	0 <sup>1</sup>	0
Net credit to the government	-	-	-	-	-	-	-	-	-	-
<b>Use of counterpart funds<sup>2</sup></b>										
Money supply										
a. Repay debt to central bank	0 <sup>1</sup>	0	0 <sup>1</sup>	0	0 <sup>1</sup>	0	0 <sup>1</sup>	0	0 <sup>1</sup>	0
b. Repay debt to public	+	+	+	+	+	+	+	+	+	+
c. Finance budgetary expenditure	+	+	+	+	+	+	+	+	+	+
Net credit to the government										
a. Repay debt to central bank	0	0	0	0	0	0	0	0	0	0
b. Repay debt to public	+	+	+	+	+	+	+	+	+	+
c. Finance budgetary expenditure	+	+	+	+	+	+	+	+	+	+
<b>Simultaneous creation and use of counterpart funds<sup>2</sup></b>										
Money supply										
a. Repay debt to central bank	- <sup>1</sup>	-	- <sup>1</sup>	-	- <sup>1</sup>	-	- <sup>1</sup>	-	0 <sup>1</sup>	0
b. Repay debt to public	0	0	0	0	0	0	0	0	+	+
c. Finance budgetary expenditure	0	0	0	0	0	0	0	0	+	+
Net credit to the government										
a. Repay debt to central bank	-	-	-	-	-	-	-	-	-	-
b. Repay debt to public	0	0	0	0	0	0	0	0	0	0
c. Finance budgetary expenditure	0	0	0	0	0	0	0	0	0	0

Note: - effect is a decrease, + effect is an increase, and 0 effect is neutral.

<sup>1</sup> The commercial banks' potential to expand credit is higher.

<sup>2</sup> Use of counterpart funds owned by recipient governments.

Source: J. A. P. Clément 1989.

Table 2: Creation or Accumulation and Use of Counterpart Funds —  
Their Impacts on the Budget

	Sources of creation or accumulation of counterpart funds							
	Grants		Loans					
<b>Direct effects on:</b>								
Overall budget balance	surplus		0					
Total net financing	-		0					
Domestic	-		-					
Net credit to the government	-		-					
Domestic debt <sup>1</sup>	0		0					
Foreign	0		+					
		Use of counterpart funds to						
	Finance expenditure	Repay debt to central bank	Repay debt to public <sup>1</sup>	Repay foreign debt				
Overall budget balance	deficit	0	0	0				
Total net financing	+	0	0	0				
Domestic	+	0	0	+				
Net credit to the government	+	0	+	+				
Domestic debt	0	0	-	0				
Foreign	0	0	0	-				
	Simultaneous creation and use of counterpart funds							
	For which the sources are grants				For which the sources are loans			
	Finance expenditure	Repay debt to central bank	Repay debt to public	Repay foreign debt	Finance expenditure	Repay debt to central bank	Repay debt to public	Repay foreign debt
Overall budget balance	0	surplus	surplus	surplus	deficit	0	0	0
Total net financing	0	-	-	-	+	0	0	0
Domestic debt	0	-	-	0	+	-	-	0
Net credit to the government	0	-	0	0	0	-	0	0
Domestic debt	0	0	-	0	0	0	-	0
Foreign	0	0	0	-	+	+	+	0

Note: 0 effect is neutral, + effect is an increase, - effect is a decrease.

<sup>1</sup> Held by nonfinancial and nongovernmental sector.

Source: J. A. P. Clément 1989.

imports has been sold to the central bank by the recipient government, such use is inflationary as it is equivalent to domestic credit creation. Furthermore, in those cases where counterpart funds have been accumulated over several years, the backlog of such funds could be very large in relation to the money supply, which could potentially undermine the programme's stabilization objectives.

In the context of Fund-supported adjustment programmes, uses of counterpart funds can give rise to inconsistency with the fiscal or credit targets, or with the desired composition of expenditures, where use was restricted to certain purposes. Indeed, for a given target of net credit to the government, the greater the use of restricted counterpart funds, the less the government's degree of freedom in resource allocation. Additional projects 'requested' by different donors may divert scarce resources from a better use. An important issue is therefore the ranking of development projects according to their economic rate of return rather than to donors' particular sectoral interests. In countries with nonexistent or poor project evaluation capacity, this ranking is very difficult. This does not imply, however, that counterpart funds financing additional projects requested by donors is a better solution; i.e. that donors know better how to allocate the recipient country's resources remains to be demonstrated.

Given the above, a better solution would appear to be for donors to renounce both the accumulated counterpart funds and the creation of new ones. In other words, the donors should be encouraged to untie the use of existing and new counterpart funds. However, for political reasons, donors have to justify to their taxpayers the use of their foreign aid. Therefore, in exchange for 'untying' counterpart funds, the donors should be assured that these funds would be fully integrated in the design of adjustment programmes supported by the Fund and the World Bank. At the same time, advance consultations between major donors and the international institutions would have to take place to enhance aid coordination. The timely coordination of aid should ensure a better integration of donors' programmes and projects within a coherent macroeconomic framework that would include the sectoral priorities of public expenditure, including investment. Better aid coordination would also remove the pressure on the recipient government to earmark

resources for particular investment expenditure and therefore, inter alia, enable recurrent costs to be adequately financed; for example, maintenance of existing infrastructure is often more economically efficient than starting new investment projects which could suffer afterwards from lack of maintenance.

## 5 CONCLUSIONS

Some donors have monitored their aid through the designation of a special account for counterpart funds. This allows the recipient government to take into account the donors' views regarding the use of such funds and more generally, budgetary and sectoral policies. However, as money is fungible, directing counterpart funds toward narrowly defined expenditures can be offset by adjustments elsewhere in the budget. The financial resources provided can thus end up being used for other purposes through credit creation, while counterpart funds accumulate. The more stringent the conditions attached by donors to the use of counterpart funds, the more likely that counterpart funds will accumulate over time, thus increasing the possibility of inflationary pressures later. In addition, proliferation of these accounts complicates their monitoring and could potentially undermine the budgetary process.

Thus, from a macroeconomic stabilization perspective, 'untied' rather than 'tied' counterpart funds appear to be more appropriate, including when the recipient countries are implementing an adjustment programme with the support of the Fund and the World Bank. Care needs to be taken to ensure that the use of the funds is sufficiently integrated in the design of macroeconomic adjustment and structural reform programmes. Where counterpart funds are relatively large, advance consultation between the major donors and the international institutions could be useful to ensure consistency in approach. In addition to such consultation, modifications in the donors' approaches could also be helpful. For example, it would be desirable to keep the timing of the use of counterpart funds as close as possible to the provision of financial real resources from abroad, provided this would be consistent with the programme, and to avoid large accumulations of unused funds over time. To achieve this, conditions attached by donors to the use of funds may have to be eased.

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