

Fiscal Policy for Growth in Africa in Light of the Crisis

Paper to be presented at African Economic Conference 2010, Tunis

Setting the Agenda for Africa's Economic Recovery and Long-term Growth

Kathie Krumm and Chandana Kularatne

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Abstract

This paper assesses the fiscal response to the global crisis in low income countries in Sub-Saharan Africa (SSA), within the framework of fiscal policy for growth. In particular, it asks what has been the success of fiscal policy in protecting medium-term growth prospects in light of the crisis. When the global crisis hit in 2008, SSA countries were building on a base of fiscal performance improvement. Several of these countries planned to adjust little or only partially to the shock or institute fiscal stimulus packages, mainly countries with the necessary fiscal space and low risk of debt distress, as would be expected. In line with fiscal policy for growth, one spending area to protect or concentrate any increases if feasible is those likely to increase long-term growth. With this in mind, and building on recent expansion in their programs for expanding infrastructure, protection of this expansion has been a key objective in the fiscal response, for example. However, only a subset of countries were successful in this regard. Most governments' actual expenditures were lower than budgeted. As a result, several countries had more contractionary fiscal stances and lower levels of growth-oriented expenditures than intended when fiscal policy response for growth was designed in face of the crisis. The paper concludes that most of the challenges in actually implementing higher quality expansionary fiscal policy in light of the crisis are similar to the challenges facing fiscal policy in supporting growth within a medium-term context, notably, strengthening of public investment management.

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Context

1. This paper assesses the fiscal response to the global crisis in low income countries (LICs) in Sub-Saharan Africa (SSA). The particular focus is on the response in relation to Fiscal Policy for Growth. The objectives are to place fiscal response issues within a conceptual and comparable framework, to analyze experience to date within that framework, and to identify the key links with the growth agenda.

2. When the global crisis hit in 2008, SSA countries were building on a base of fiscal performance improvement. The overall fiscal stance had changed significantly during the 1990s, with positive primary fiscal balances in 72 percent of SSA by 2008 compared with 28 percent in the early 1990s.¹ Likewise, fiscal space for pro-growth expenditures also grew since the early 2000s. For example, spending on infrastructure in Africa has been higher than previously thought, amounting to \$45 billion a year when budget and off-budget spending (including state-owned enterprises and extra-budgetary funds) and external financiers are taken into the account. As much as two thirds of this overall spending has been domestically sourced by the African taxpayer and infrastructure user, including \$20 billion in O&M and \$15 billion in capital expenditures.²

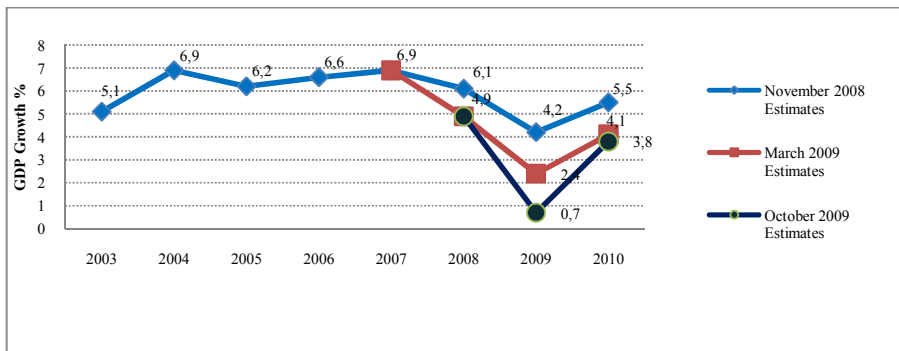
3. From this improved base, the global economic crisis threatened to undermine the gains in growth and poverty reduction in SSA. The Region already had been hit by the first wave of food and fuel price increases. A global financial crisis followed, affecting the region less directly. Then the third global economic crisis hit. To varying degrees, most of the impact of the global crisis on SSA countries was transmitted via the real economy. The crisis slowed economic growth in SSA economies through several interrelated channels by lowering demand for exports of goods and services, compounded by the slowdown or decline in capital inflows—foreign direct investment, portfolio inflows and remittances. Economic growth in Sub-Saharan Africa is estimated to have fallen to 1.6 percent in 2009—negative in per capita terms—from over 6 percent in 2007 and 5 percent in 2008. LICs grew by 3.9 percent in 2009 or 1.5 percentage points slower than the rate of growth recorded in the earlier period. While growth prospects overall for 2010 have strengthened slightly to 4.5 percent from the reduced levels projected at the peak of the crisis,³ growth prospects for the medium term are closely linked to the uncertain pace of global recovery.

¹ Regional Economic Outlook, IMF, October 2009.

² Africa's Infrastructure: A Time for Transformation, World Bank, 2009.

³ Global Economic Prospects, World Bank, 2010.

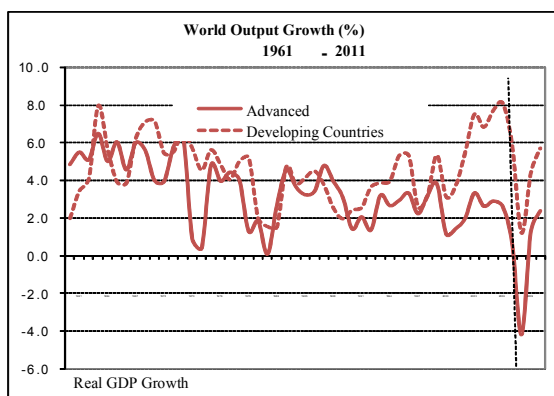
Graph 1. GDP Growth in Sub-Saharan Africa



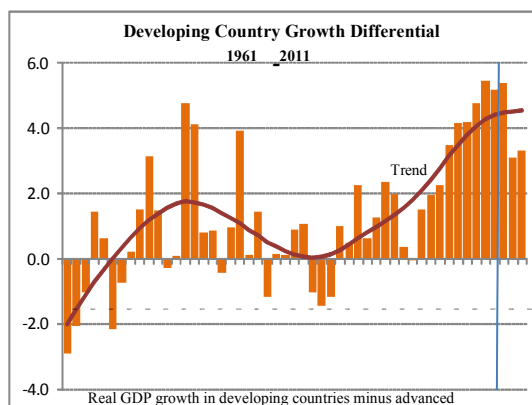
Source: Global Economic Prospects, World Bank.

4. This is compounded by an uncertain picture regarding global prospects post-crisis. First, economic cycles in developing countries remain closely correlated with those in developed countries, as noted for the impact on Africa. Second, while before the early 2000s the trend growth in developing countries was close to that in advanced countries, since then it has become substantially higher: there has arguably been a decoupling in underlying trend rates of growth. Developing country growth averaged only 0.8 percentage points higher than advanced countries in the 1990s, but this gap widened to 3.5 points in 2000-08, as the second panel of Graph 2 shows. Is the growth premium of the 2000s mainly a payoff for the better macro, structural and other policies adopted by developing countries including many African countries over the last couple of decades? In this case we should expect to see it persist in the medium term, despite the shock of the crisis. Or was it mostly temporary, due to favorable “bubble” conditions? One piece of evidence: developing countries *continued* to grow much faster than advanced countries in 2009 – the expected trough of the crisis – and all major forecasters expect the growth premium to continue in the next few years. So the question is whether Africa also can sustain this growth premium post-crisis?⁴

Graph 2. Trend Decoupling between Advanced and Developing Economies



Source: World Bank, World Development Indicators and staff estimates and forecast.



Source: World Bank, World Development Indicators and staff estimates and forecast. Hodrick – Prescott trend.

⁴ Speech of Otaviano Canuto, World Bank, 2010

How has fiscal policy in African countries responded to these shocks? How should it? In particular, what has been the success of fiscal policy in protecting medium-term growth prospects in light of the crisis? Many factors should enter into the decision making on fiscal policy response in addition to the disparate initial conditions. These include the pre-crisis fiscal and balance of payments positions, the availability and terms of official or private capital, the impact of the crisis on vulnerable segments of society, and the ability of governments to adjust fiscal policy expeditiously to effectively respond to the changing external environment, in particular, related to growth-oriented expenditure programs. The objective of this paper is to clarify the fiscal policy options facing African policy makers and their links to the growth agenda. Section I outlines a simple conceptual framework to evaluate policy options. Section II lays out a methodology for assessing across countries the planned fiscal responses aimed at mitigating negative impact of the crisis on growth, illustrating the diversity of pre-crisis conditions. Section III shares lessons of experience based on analysis of the implementation of those proposed fiscal policy responses. Section IV concludes with some thoughts on issues raised by the analysis of country experiences which will need more attention to ensure effective fiscal policy for growth.

I. Conceptual Framework

A. What is meant by Fiscal Adjustment or Stimulus?

1.1 The conceptual framework outlined in this section is constructed to facilitate evaluation and comparison of fiscal policy responses.⁵ Its assumptions are chosen to illustrate the common conditions prevailing in low income Africa notwithstanding the diversity in pre-crisis circumstance. Unlike in high income countries and many MICs, most African LICs do not maintain formal social insurance programs, for which spending automatically rises when output and employment fall. Indeed, employment in the formal sector is generally a small fraction of the labor force. Moreover, few countries have implemented changes in tax policy in response to the crisis. Hence the principal fiscal shock from the crisis is a loss in revenue from changes in the economic environment, and the principal potential discretionary fiscal response tool is an adjustment in discretionary government spending.⁶

1.2 Within this framework, assume that government revenue declines by 2 percent of GDP as a result of a combination of external shocks such as loss of export revenue, falling corporate profits, remittances, tourism, FDI, as well as terms of trade shocks that may be positive or negative. Table I.1 illustrates possible fiscal expenditure responses to the shock, which range from an increase in discretionary spending notwithstanding the revenue decline that widens the fiscal deficit beyond the revenue loss (defined as stimulus), to full adjustment to the revenue loss that avoids any increase in deficit (defined as full adjustment).

⁵ Based on Krumm et al (2009).

⁶ See Blanchard (2009) for distinction between changes in economic environment and changes in discretionary policy.

Table I.1. Fiscal Stance: Based on Expenditure Responses to a Revenue Shock (In Percent of GDP)

Options	1	2	3	4
Fiscal Stance	Stimulus	No adjustment	Partial adjustment	Full adjustment
Revenue shock (A) (Economic Environment)	- 2	-2	-2	-2
Expenditure response (B) (Discretionary)	+1	0	-1	-2
Deficit change (A+B)	-3	-2	-1	0

B. Financing versus Adjustment

1.3 What mix of financing versus adjustment should African LICs utilize? A number of factors pertinent to the current crisis are worth highlighting.

- Prior to the crisis, many African countries benefited from a sustained period of stronger growth, rising foreign investment and debt relief that together created greater fiscal space. Even commodity importers not benefiting from debt relief such as Kenya, were able to reduce public debt from over 70% of GDP in the mid 1990s to just above 40% prior to the crisis. However, the decline in debt was driven at least in part by higher economic growth and real exchange rate appreciation, trends that have been reversed in the short term.
- Aid flows may have remained stable immediately following the crisis, or even risen in part reflecting frontloading of multi-year aid programs as is the case with IDA. However, past financial crises among donor nations have resulted in lower aid, and aid flows over the medium term could therefore decline, constrained by persistent fiscal pressures in donor countries. Increased lending from the IMF may offset these declines in some countries.
- Net private capital flows diminished sharply in 2008-09 and are difficult to predict for 2010 and beyond. Incipient access to global capital markets was effectively cut off since the onset of the acute phase of the crisis by prohibitively high interest rate spreads. For example, Kenya had to forgo a \$500 million bond issue planned for its 2008/09 fiscal year.

1.4 A first approximation of the above trends is that there would be no net increase in external finance in response to the crisis, though country experiences undoubtedly vary. This has been used as an argument against anything but full adjustment to the external shock, Option 4 in the above table, on the grounds that an increase in the fiscal deficit must be matched by a parallel decline in the private investment-saving deficit given no change in external financing. If this is the case, allowing the fiscal deficit to increase would mean squeezing private spending, and no increase in aggregate demand would result. Moreover, government spending displacing private spending may be bad for growth in the long run.

1.5 But private investment, consumption and saving will also be impacted by the shock, *independent* of fiscal policy. For example, investment may fall because of weaker export prospects. Consumption may decline if output and employment decline. Saving could also increase because of the weaker prospects. So allowing the fiscal deficit to increase need not *cause* an increase in net private saving; the latter may rise as a result of the external shock—providing a rationale for a larger fiscal deficit to ease the shock. At the same time, it is worth emphasizing that for any fiscal stimulus to work, it must create domestic demand that will quickly trigger the employment of otherwise idle resources. The limited evidence on the impact multiplier from fiscal stimulus in low income SSA suggests it might be quite limited (Box 1).

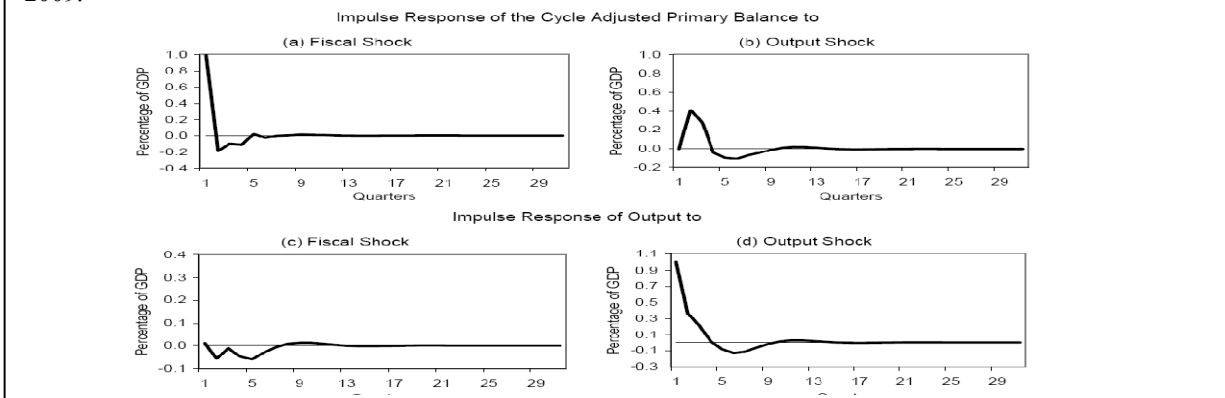
Box I.1. Accommodate vs stimulus? Limited impact of additional spending? Evidence from Fiscal multipliers—and Evidence from Kenya

The impact multiplier for high income countries has been estimated at about 0.24 and the cumulative long-term multiplier at 1.04. In other words, an additional dollar in government spending will deliver 24 cents of additional output in the quarter in which it is implemented; and after the full impact of a fiscal expansion is accounted for, output has essentially risen by only slightly more than the initial level of government consumption. For developing countries, the impact multiplier has been measured at close to zero with a cumulative multiplier of 0.79. In other words, in the long run, an additional dollar of government consumption crowds out some other components of GDP (investment, consumption, or net exports) by 21 cents. Source: Ilzetki, Mendoza and Vegh, 2009.

The impact on the output gap of expansionary fiscal policy may be limited in SSA. Given that a large share of GDP is accounted for by commodities, for fiscal policy to effectively reduce the output gap, increased demand for non-commodity sectors needs to rise. Given the structural constraints faced by non-commodity sector, increase in output may be marginal. Impact on fiscal expansion on the non-tradable sector may be limited, once again due to constraints. SSA has a relatively large informal economy facing structural constraints, and increased government expenditure may have fewer positive knock-on effects on the informal sector. However, this remains an empirical question worthy of further analysis.

In order to assess the effect of random discretionary fiscal policy (fiscal innovations that are purely unpredictable) on Kenya’s economy, a small VAR model was constructed and analyzed. Highlights of the analysis are that a discretionary fiscal response has a small impact on output: 0.1% for any 1% change in cyclically adjusted primary balance as shown in panel c. The impact persists for 9 quarters positively but then moves negative as shown in panel b. However, this finding needs to be interpreted with caution. There are two other fiscal policy components: (i) systemic discretionary policy which are routine responses to changing economic situations; and (ii) automatic policy, governed by rules and laws, such as the tax code. A full assessment of the impact of overall fiscal policy on GDP needs to take all three components into account and further research is needed in this area.

Source: Kenya Fiscal Policies and Institutions for Shared Growth: Lessons from the Global Crisis, World Bank, 2009.



Domestic Financing

1.6 To the extent that additional financing is needed (i.e., the country chooses not to adjust fully to the revenue loss, or to increase spending relative to pre-crisis plans), domestic financing would thus likely be the main, or at least an important source of financing.

1.7 What are the options for domestic financing? The country can borrow domestically, monetize part of the deficit or accumulate arrears. The latter two are not advisable or feasible for long, so the focus here is on domestic borrowing, assuming there is a market for government securities. For domestic borrowing, there are three sets of issues that should be considered:

- Crowding out
- Debt sustainability
- Balance of payments impact

1.8 **Crowding Out.** A perennial concern of government borrowing is that it diverts resources from the private sector where they may be used more productively. But it is again important not to take a static view. The external shock is likely to impact private demand for funds, as well as banks' perceptions of risks to lending to the government and private sector. Unless government credibility is low, or its debt high, bank risk perceptions are likely to shift in favor of lending to the government in a climate of greater risk and uncertainty. Private demand for bank borrowing from creditworthy borrowers could decline as investment plans become more conservative, opening the space for greater borrowing by the government, and in the process providing the banks a source of income when private loan demand may have declined.

1.9 At the same time, there is a risk that governments could abuse the temporary windfall from lower domestic borrowing costs by reinforcing the shift to risk aversion—and thereby diverting credit from worthy private borrowers—or jeopardizing longer term debt sustainability concerns (considered below). If there is recourse to more domestic borrowing when private demand is low, the government needs to remain alert to changing market trends, in particular the re-emergence of private sector demand. Thus the best guidance may be to pay close attention to market signals; i.e., consider additional domestic borrowing only if interest rates are more attractive than the pre-crisis situation, the yield curve is not unusually steep, and bank liquidity is not a systemic concern.

1.10 **Debt Sustainability.** The current crisis will adversely impact debt sustainability projections through several interrelated channels: (i) more borrowing, external and domestic, which leads to faster buildup of public debts; (ii) real GDP growth was slower; (iii) exports will be lower because demand for traditional exports fell; and (iv) revenue will be scale back because of slower GDP growth and the decline in trade. The advisability of assuming additional debt in this environment will depend on the country's existing debt burden, its medium-term debt sustainability outlook, and the effectiveness of the additional borrowing in generating incremental government revenue or foreign exchange. Risks to debt sustainability also relate to the strength of recovery and the ability of countries' transition back to a sustainable fiscal policy. To the extent that the additional borrowing finances investment that leads to higher growth, it

will be important to incorporate this into the DSA, in addition to the adverse impact of the increased borrowing on public debt and debt service.

1.11 **Balance of Payments Impact.** Even if debt sustainability and crowding out concerns do not constrain a widening of the fiscal deficit, the balance of payments position may pose a binding constraint, given slower exports, remittances and tourism, and a negative net trend for private capital flows. Declining import demand may offset these trends at least partially, but given low reserves and large current account deficits, a number of African countries cannot afford to ignore the impact of larger fiscal deficits on the balance of payments.

C. External Financing

1.12 Bilateral and multilateral official flows are the main source of external financing for African LICs even in the absence of a global crisis. But a few countries such as Ghana had already accessed global capital markets and a number of others had aspirations to do the same. While borrowing spreads widened during the crisis, they have already receded somewhat, and it is possible that access to the capital markets could again become a realistic prospect. African LICs should, however, resort to the global capital markets as a last resort, after bilateral and multilateral external flows have been fully utilized and domestic financing options explored, since the terms of borrowing from global capital markets will remain more onerous than external finance from official sources, and carry the added currency risk over borrowing in local markets.

D. Composition of Spending

1.13 Should the onset of the crisis impact the composition of spending? Historical experience suggests that expansionary discretionary spending has not been an especially effective stabilization tool for most developing countries, that mis-timed interventions can be counter-productive, and that spending increases, if feasible, should concentrate on areas that are either reversible or likely to increase long-term growth. This is made even more difficult when there are no safety nets (to cope with income support) and factor markets do not work very well (to cope with lower consumption in aggregate demand).

1.14 This suggests that if a country is able to increase spending to offset the effects of the crisis, the incremental spending may best be directed towards areas that tend to be chronically under-budgeted such as maintenance of existing infrastructure⁷. And financing of already pre-appraised projects will be preferable to embarking on untried projects that may be wasteful or result in unanticipated recurring costs and/or rents for the few suppliers available. Such maintenance and investment projects can represent an important element of maintaining fiscal policy for growth in response to the crisis.

1.15 There may also be reasons to direct incremental spending towards the non-tradable sector—for example, if export demand has fallen relative to domestic demand, or because balance of payments constraints are more acute than fiscal constraints. Such considerations

⁷ The recently published “Africa’s Infrastructure: A time for transformation” shows how inadequate spending on maintenance has contributed to sub-Saharan Africa’s infrastructure deficit and undermined the effectiveness of capital investment.

would reinforce the presumption to spend more for maintenance instead of import intensive capital goods, or for increasing the budget for health and education workers rather than spending to import more drugs. However, those relationships may be difficult to establish in practice.

1.16 Those most adversely impacted by the crisis are likely to be workers in exporting industries, particularly mining, farmers whose crop prices have fallen, workers in construction or tourism, and households relying on remittances. Most of these categories are unlikely to comprise the poorest segments of the population, although many farmers impacted by the crisis may be poor. Moreover, households relying unduly on remittances, who may also be poor, may not be easily identifiable and may be regionally dispersed. These factors suggest that creating new government programs to target groups impacted adversely by the crisis may not be a widely applicable strategy. However, scaling up existing programs that protect the vulnerable may be the most promising avenue for providing relief—and for attracting additional donor financing—and maintaining social stability also critical to sustained growth.

1.17 Amongst the programs worth considering are supporting household income via public transfers and self-targeted public works programs. Efforts to reduce transaction costs for remittance payments by exposing intermediaries to more competition can be effective in countering declining remittances and an important medium-term objective as well. Finally, reducing school or health care fees can help to keep children in school and support family health, mitigating the impact of declining household incomes. At the same time, the crisis may be an opportunity to trim wasteful or corrupt spending while scaling up programs that have proven capacity to deliver results.

II. Country Experiences—Fiscal Policy for Growth as Reflected in Budgets

2.1 As outlined in Section I, the principal fiscal shock from the crisis is a loss in revenue from lower than anticipated growth and trade, and the principal potential fiscal response tool is an adjustment in discretionary government spending. Another major impact is on sources of financing, with reduced access to international private capital among others. Finally, the crisis can call for adjustments in the composition of expenditure.

2.2 Overall trends in the impact of the crisis, however, hide important differences among low-income African economies, in terms of magnitude, channels and timing of the impact as well as the initial fiscal situations when the crisis hit. As noted in the first paper, many factors should enter into the decision making on fiscal response in addition to the disparate initial conditions. These include the pre-crisis fiscal and balance of payments positions, the availability and terms of official or private capital, the impact of the crisis on vulnerable segments of society, and the ability of governments to adjust fiscal policy expeditiously to effectively respond to the changing external environment.

A. Methodology

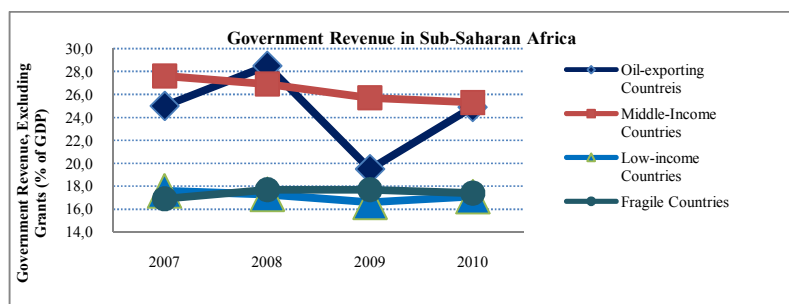
2.3 The methodology used to assess across countries the fiscal response to the crisis focuses on changes in expressions of policy intent before and after the crisis. The standard methodology is to assess changes in fiscal policy over time. The choice of the methodology for this paper was

motivated by the objective of assessing change in response within a more restricted timeframe. The approach also draws on the framework provided in the first section, assessing diversity of responses across countries relative to the differences the framework in the first section would suggest. As noted there, for comparability purposes, the revenue channel is used as the starting point.

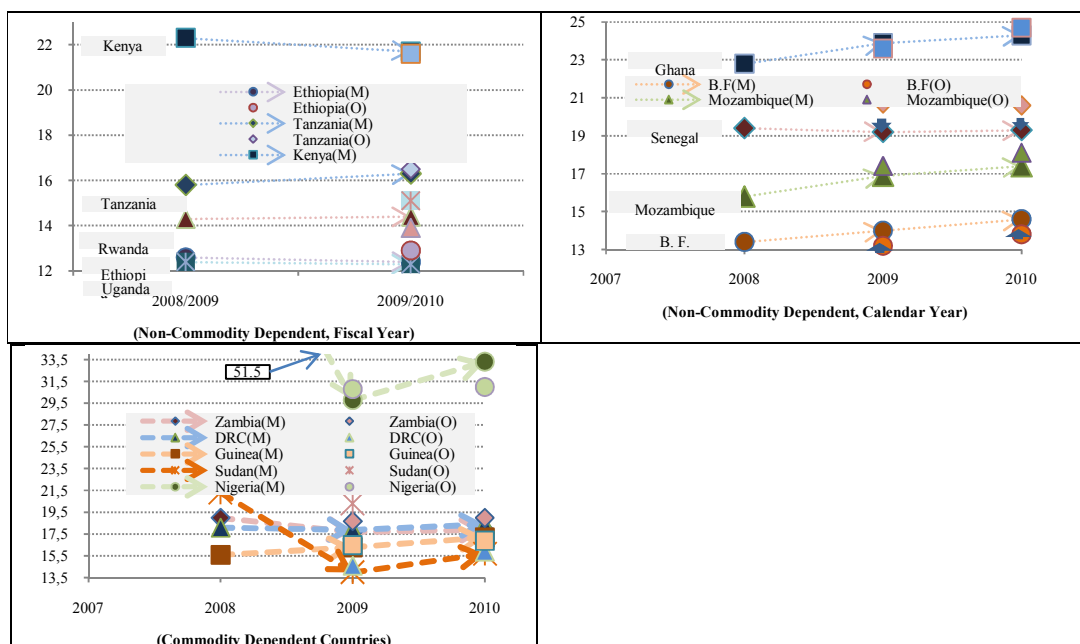
B. Impact of crisis: Revenue channel

2.4 As posited in the first section, declines in revenue projections are likely to be one of the major drivers for a fiscal response. Indeed they declined as shown in Graph II.1. Graph II.2 shows that while several countries hoped to improve their revenue performance relative to the previous year (such as Burkina Faso and Tanzania), almost all countries showed declines in revenues as a share of GDP in 2009 and/or 2009/10 budgets compared to earlier projections. In those cases of absolute declines in GDP, in particular, a measure of revenues as a ratio of GDP understates the significance of the revenue decline.

Graph II.1. How Large was the Revenue Channel?



Graph II.2. Change in Revenue/GDP in Budgets of Select Low-Income African Countries (arrow—change in projection; dotted line—change year-on-year)



2.5 The most pronounced declines have been in countries highly dependent on commodities such as oil and minerals (Graph I.2, lower box). For example, in Sudan, revised total revenues for the Government of National Unity were 27 percent less than 2009 budgeted levels in April 2009 reflecting lower oil inflows (57 percent less than budgeted levels), albeit steadily improved relative to the first three months of 2009. In Zambia, the sharp contraction of copper prices nullified any increase in revenues from new mining tax legislation implemented in April 2008. Revenue from oil in Nigeria was expected to decline from both lower global prices and declining output due to continued restiveness in the Niger Delta. At the same time, countries such as Guinea have benefitted from higher gold prices and new mining ventures coming on stream. Democratic Republic of Congo projected enhanced revenue mobilization effort enabled by progress on conflict resolution to more than offset the impact of the global crisis on its mineral revenues.

2.6 Nonetheless, it is notable that several countries continued to set ambitious revenue targets regardless of potential crisis impact. Simultaneously attempting to increase revenue collection, while increasing fiscal expenditure, was a feature common across many of the SSA countries that had fiscal space prior to the crisis. One rationale was that any lower targets would have the unintended consequence of reducing the administrative effort which had been the focus of much of the revenue strengthening in the last few years. Hence, using revenue declines as a proxy for crisis impact remains a highly imperfect feature of this conceptual approach.

C. Fiscal Response: Overall fiscal stance as reflected in budget

2.7 Many low-income African countries entered the global financial crisis on a record of sound macroeconomic management, helped in many cases by debt relief under the HIPC Initiative and the MDRI. Both resource-rich and aid-dependent countries were in this group, giving these countries scope to avoid full adjustment to the shock and, in some cases, engage in some form of fiscal stimulus.

2.8 Graph II.3 presents the fiscal stance changes of countries in mid 2009 *relative to plans a year ago* before the extent of the global crisis was anticipated. We use the change in plans rather than year-on-year changes, which distinguishes our analysis from others in the literature. For comparative purposes, the fiscal stance is described in terms of fiscal expenditure responses to the crisis, ranging from an increase in discretionary spending notwithstanding the revenue decline that widens the fiscal deficit beyond the revenue loss (defined as stimulus), to maintaining expenditure levels despite the revenue decline (defined as no adjustment), to full adjustment to the revenue loss that avoids any increase in deficit (defined as full adjustment). A similar story tends to emerge when describing the fiscal stance relative to the previous budget year, albeit less powerfully.

Graph II.3. Planned Fiscal Stance of Select Low Income African Countries (2009 fiscal year as of mid-2009 relative to projections mid-2008, percent of GDP)

Fiscal Stance	Country	Debt Distress Risk	Fiscal Projection Changes (2009)				Country	Debt Distress Risk	Fiscal Projection Changes (2009)				
			Revenue	Expenditure	Balance (Ex. Grant)	Balance (In. Grant)			Revenue	Expenditure	Balance (Ex. Grant)	Balance (In. Grant)	
Fiscal Tightening	Ethiopia	Moderate	-0,5	-4,1	3,6	2,3	Ghana	Moderate	-1,0	0,3	1,1	-0,8	1,3
	Rwanda	Moderate	0,5	-1,3	1,9	2,0							
Full Adjustment	Guinea	High	-0,2	-0,3	0,2	0,0							
Partial Adjustment	Mozambique	Low	-0,5	-0,1	-0,5	-0,3	Uganda	Low	5,0	-2,8	-3,1	0,2	-0,2
	Sudan	High	-6,3	-4,1	-2,8	-2,1							
No Adjustment	Senegal	Low	-1,5	0,4	-2	-1,9	Burkina Faso	High	2,0	-0,8	0,0	-1,0	0,4
Stimulus	D.R.C	High	3,3	8,5	-5,2	-4,0	Kenya	Low	5,0	0,1	1,8	-1,6	-1,6
	Nigeria	Low	-1,0	15,2	-16,1	-16,1			Tanzania	Low	-1,5	-0,2	0,9
	Zambia	Low	-1,0	0,8	-1,7	-0,9							

Note: Source: IMF, July 2008 and July 2009 or nearest equivalent.

2.9 A few countries instituted fiscal stimulus packages, with plans to increase discretionary expenditures beyond the revenue shortfall. As expected, these are mainly countries with the necessary fiscal *space*. The most recent joint Debt Sustainability Assessments (DSA) of the International Monetary Fund and World Bank had judged Kenya, Nigeria, Tanzania and Zambia as having low risk of debt distress.⁸ Resource rich countries such as Nigeria that had managed the commodity boom relatively well were able in principle to introduce fiscal stimulus packages despite the sharp commodity price decline.

2.10 Several countries planned to adjust little or only partially to the shock. That is, projected public expenditures were reduced, albeit to a lesser extent than the revenue shock. This includes countries which have the macroeconomic space for a more expansionary stance should they have wished, such as Mozambique and Uganda. Countries such as Burkina Faso already were at high risk of debt distress.

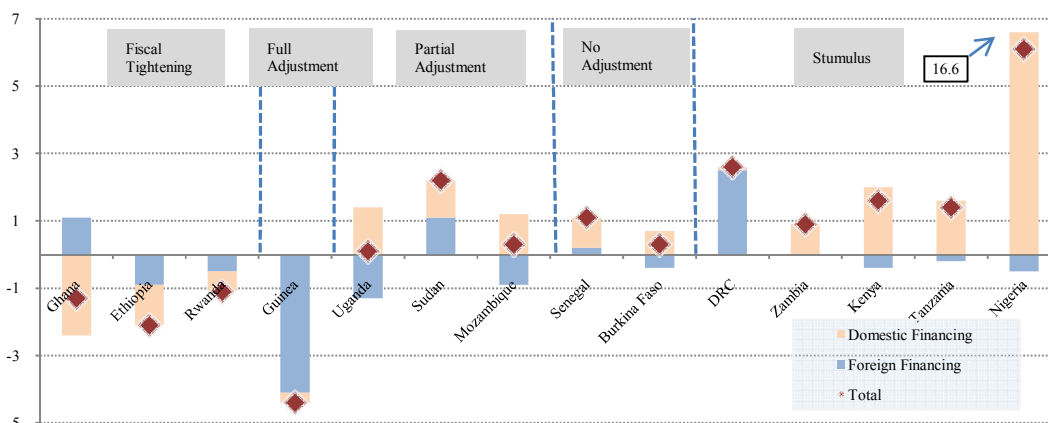
⁸ As noted above, DRC's stance relates more to conflict resolution than crisis response.

2.11 At the same time, a handful of countries planned to adjust fully to the shock or engage in fiscal tightening. This group includes countries such as Ghana and Ethiopia whose macroeconomic tensions and moderate risk of debt distress in 2008/09 pre-dated the crisis. Less affected by the crisis but sensitive to macroeconomic concerns from a recent expansionary fiscal stance, Rwanda took precautionary measures to rein in spending rather than use higher-than-anticipated revenues. The fully adjusting countries also include those with serious debt sustainability issues, as suggested by the relevant DSA ratings on fiscal sustainability. For example, Guinea has been assessed to have high risk of debt distress, compounded by weaker management of resources during the commodity boom period.

D. Domestic and external financing patterns in the budget

2.12 How had countries proposed to finance their fiscal stances, in particular, the majority which were not planning on adjusting fully or tightening? The evidence in Graph II.4 suggests that notably domestic borrowing was expected to play a major role, as was considered a likely response under the framework laid out in Section 1.

Graph II.4. Planned Changes in Public Financing Composition (percentage points of GDP)



Note: Change of projections for calendar year 2009 or fiscal year 2008/2009 (fiscal year countries: Ethiopia, Rwanda, Uganda, Kenya, and Tanzania). Source: IMF

2.13 By contrast, most countries did not intend to rely more heavily on external financing for their budgets (excluding grants). This is the case whether a country is heavily aid-dependent or not. Net private capital flows diminished sharply in 2008-09, and incipient access to global capital markets was effectively cut off since the onset of the acute phase of the crisis by prohibitively high interest rate spreads. Some countries, such as Nigeria, Kenya, and Zambia have postponed euro-bond offerings and are expected to rely more on domestic financing⁹. For aid-dependent countries, aid flows generally were maintained immediately following the crisis – or increased slightly, but generally did not exceed previously projected levels. The exception is countries such as DRC which were projected to tap into significant additional support based on improved performance unrelated to the crisis. However, past financial crises among donor

⁹ For example, Kenya had to forgo a \$500 million bond issue planned for its 2008/09 fiscal year.

nations have resulted in lower aid, and aid flows over the medium term could therefore decline, constrained by persistent fiscal pressures in donor countries.

2.14 Increased risk aversion on the part of commercial banks and slower economic growth hindered the growth of credit to the private sector. For instance, in Kenya the private sector's share of commercial bank lending of 2009 was below historical level of 80 percent and rate of credit growth to the private sector continued to slow down. Tanzania also experienced a slowdown in credit to the private sector from October 2008. There is scant evidence that increased budgetary reliance on domestic financing for those with fiscal space was the major factor in this slowdown.

E. Composition of Spending in the Budget

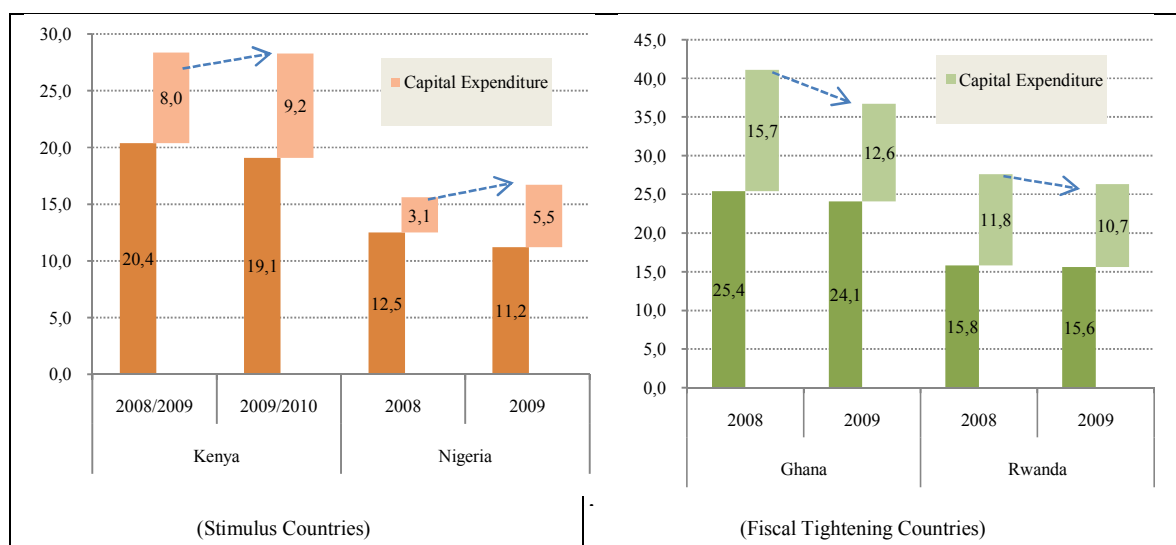
2.15 How did the onset of the crisis affect the budgeted composition of spending? What was its role in promoting fiscal policy for growth?

2.16 **Public capital investment.** In line with fiscal policy for growth, as laid out in the first section, one spending area to protect or concentrate any increases if feasible is those likely to increase long-term growth. Several African countries recently expanded their programs for expanding infrastructure with this in mind. Protection of this expansion has been a key objective in the fiscal response. For example, in Tanzania, the allocation to roads in the 2009/10 budget represents 3.5 percent of GDP compared to 3.3 percent in 2008/09 (although the rural roads program allocation declined); and 1.1 percent of GDP to water in 2009/10 compared to 0.9 percent in 2008/09. Resource-rich economies that managed resources well during the boom also are able to protect public investment. In Nigeria, the 2009 budget capped recurrent spending (expected to decline by 1.3 percentage points of non-oil GDP) while allocating higher amounts for capital spending in sectors which represent major growth bottlenecks. Capital expenditure was budgeted to increase by 2.5 percentage points of non-oil GDP in 2009, mostly in the area of works, housing, agriculture, transport and power¹⁰.

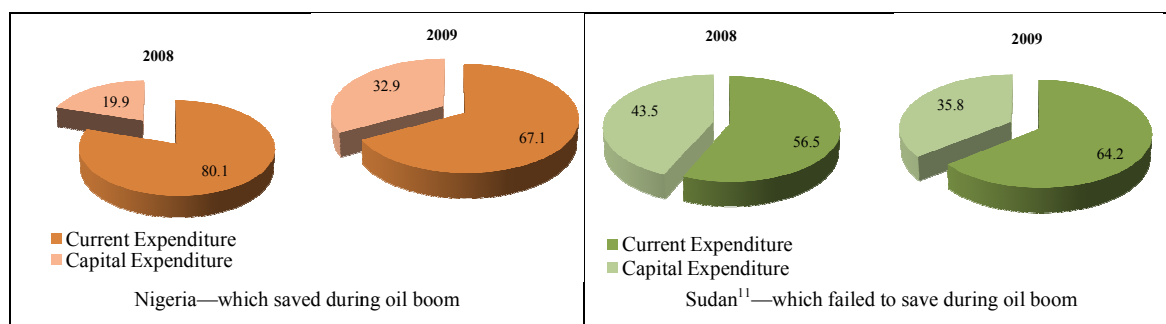
2.17 By contrast, countries that are experiencing serious contraction in expenditures usually targeted investment expenditures. In Sudan, development transfers from Federal to northern states was 88 percent less than budget in 2008 (with total transfers to northern states shares declining from 24 percent budget plan to 19 percent actual). Expenditure cuts in the initial 2009 budget for Senegal targeted mainly investment spending in sectors other than health and education. In Liberia, any further reduction in revenues from slower growth stemming from the global crisis may have forced the Government to eliminate its already anemic capital spending.

¹⁰ World Bank, Memorandum of the President, Financial Sector and Public Financial Management DPC, July 2009.

**Graph II.5. Changes in Budgeted Expenditure Composition
(select stimulus and fiscal tightening countries)**



**Graph II.6. Impact of Management of Natural Resource Revenue
(Shift in capital expenditure budget share of select oil exporting countries in response to shock)**



2.18 Another risk could have been that lower-than-anticipated demand for services would trigger calls on revenue guarantees under PPP (public-private partnerships) for public projects and concessions (such as ports and power generation). However, there is no evidence to date of such pressures.

2.19 **Protecting the vulnerable.** Scaling up existing programs that protect the vulnerable may be another important shift in spending in response to the crisis. The permanent losses associated with temporary household descent into poverty (eg, taking children out of school) might be prevented with an impact on growth in the longer term. For example, Ghana further extended its cash transfer program (Livelihood Empowerment Against Poverty, LEAP) to new beneficiaries. The Government also initiated a Public Works program in the Northern region of the country. In Tanzania, the Government increased its allocation to the Social Fund TASAF which supports

¹¹ Capital and current expenditures of Sudan are calculated based on the IMF's projections as of July 2009. Capital expenditure consists of (i) Capital transfers to Northern States, (ii) All transfers to South, and (iii) Net acquisition of NFA.

community based public works and has started pilot conditional cash transfers. In Kenya, the Government introduced a youth workfare program, Kazi kwa Vijana, with an initial allocation of KSh 3.4b in 08/09 (0.15 percent of GDP), with plans on expanding it in 2009/10. In addition, a targeted food security scheme was developed, building on existing targeted programs, with a preliminary allocation of KSh 1b (about \$13m) in the 2009/10 budget in light of expectations of heightened food security pressures in the coming year. A relatively large allocation was made to a conditional economic stimulus at district level—KSh22b (about \$280m or nearly 1 percent of GDP) in the 2009/10 budget, although this was aimed at public service delivery more broadly.

2.20 At the same time, there also have been pressures to support workers and farmers adversely impacted by the crisis. This includes support for marketing boards to cover the difference between falling commodity prices and producer prices at previous levels, as well as to protect parts of the domestic financial sectors heavily exposed to domestic commodity exporters. In Burkina Faso, the Government put together an emergency package to respond to the sharp decline in cotton prices, with a focus on immediate measures to save the coming crop campaign (2009/10); direct budgetary expenditures add up to \$23m (0.3 percent of GDP). In Mali, the 2009 budget included a transfer to CMDT (public cotton monopoly) of CFAF 3.7b (0.1 percent of GDP) to pay arrears to cotton coops and farmers. Likewise, in Tanzania, both cotton and coffee buyers have been seriously affected by the sharp drop in both prices and orders during the 2008-09 crop season, threatening farmers' access to crop finance in the coming season. In response, the authorities financed a banking package including a loss compensation facility, rescheduled loan guarantee facility and working capital financing facility; direct budgetary expenditures may add up to TSH 144b (0.5 percent of GDP) for the severely impacted sub-sectors. Evidence suggests that the majority of cotton farmers in these countries, for example, are poor. However, while features have been put in place to mitigate the risk of moral hazard and to promote farmers' access to crop financing, the benefit is likely to accrue partially to the intermediaries as well as to farmers that are not from the poorest or most vulnerable segment.

2.21 **Recurrent expenditures as budgeted.** There may also have been reasons to protect or direct incremental spending towards the non-tradable sector to increase the domestic demand impulse for a given amount of expenditures. In several countries there have been sizeable increases in road maintenance expenditures which are less import intensive, such as Senegal. Such expenditure shifts represent a potentially effective response to not only global demand slowdown but also pre-existing structural deficits in infrastructure or facility maintenance critical to growth. Increases in the public wage and salary bill could only serve a similar purpose in cases where the levels were previously inadequate. In Uganda, it is not clear that the across-the-board increases included in the FY2009/10 budget were consistent with enhanced service delivery and that there were not other expenditures which could have provided a similar impulse while making a greater contribution to growth.

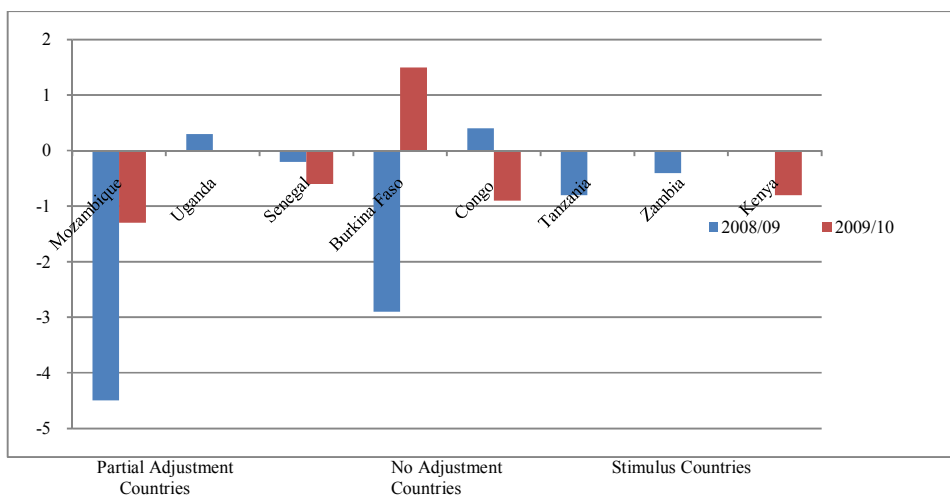
2.22 Finally, the crisis provided opportunities to trim wasteful or corrupt spending as well as implement complementary policies that ensure a higher supply response from existing public goods.

III. Country Experience—Implementation of Fiscal Response for Growth

3.1 The preceding section confirmed that many SSA LICs had the space for a fiscal response to the crisis consistent with growth. Namely, many fiscal stances laid out in the budget included maintaining public expenditure programs, notably, public investment consistent with growth, and in some cases discretionary increases. However, the impact has been muted due to the numerous challenges in the implementation of the proposed fiscal responses. Some of the policies to ensure sustained growth were not enforced and other policies were lacking. A key feature is that most of the challenges in actually implementing higher quality expansionary fiscal policy in light of the crisis are similar to the challenges facing fiscal policy in supporting growth within a medium-term context.

3.2 **Realized fiscal stance.** As noted in section II, most countries with the requisite fiscal space designed a fiscal policy response to protect, if not enhance, expenditures. Only a subset of countries were successful in this regard. As shown in Graph III. 1, most governments’ actual expenditures were lower than intended as reflected in budgets. As a result, several countries had more contractionary fiscal stances than intended when fiscal policy response for growth was designed in face of the crisis.¹²

**Graph III.1. Public Expenditures as Percent of GDP
(Difference between planned and actual or latest projection)**



Source: IMF (various Article IV documents)

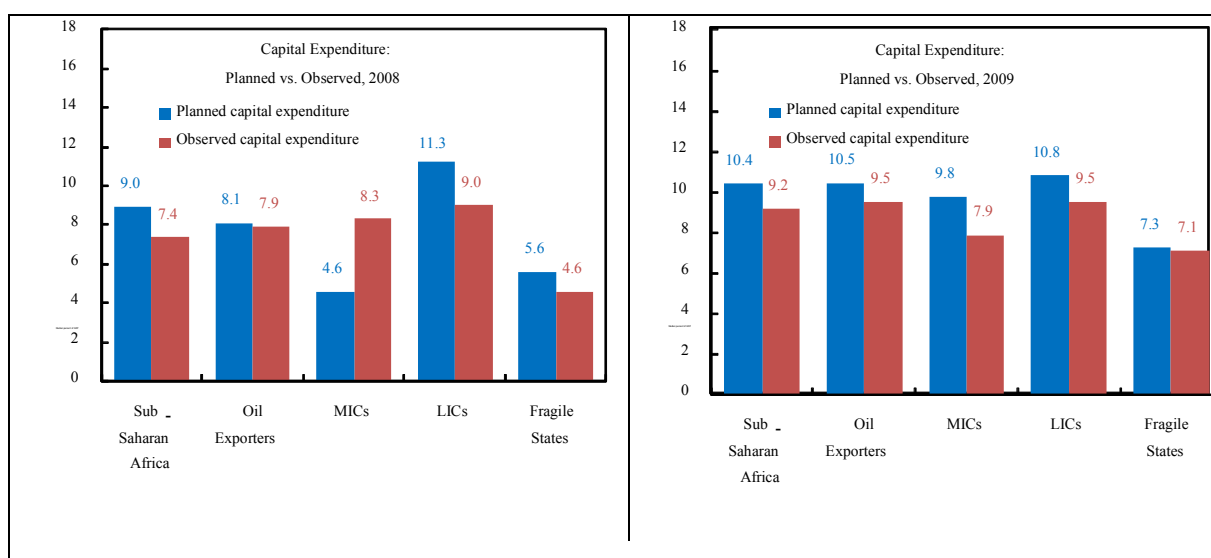
3.3 In addition, fiscal policy works with a variable lag effect due to structural factors, the type of instrument used, coordination of policy and complementarities of private sector decisions. Hence, the lag effect of fiscal policy likely delayed the impact of the stimulus as well. While evidence is limited, it is expected that most of the African countries, the multiplier appears to be relatively small, thus limiting the impact of any stimulus package that could be implemented. Smaller multipliers in SSA vis-à-vis advanced economies are indicative of

¹² See also Regional Economic Outlook April 2010, IMF.

crowding-out effects of fiscal policy due to less access to international capital markets, smaller domestic financial markets, or less accommodative monetary policy.

3.4 Execution of public investment budget. Limited state capacity to implement quality public investment programs is one of the main challenges. The evidence in reviewing the implementation in the crisis period suggests that many governments were unable to absorb the public investment budget allocations. As shown in Graph III.2, actual expenditures continued to lag planned capital expenditures. For example, Uganda and Zambia spent less than planned, although execution of the capital budget was higher than in 2008. For middle income amongst all other categories of countries in SSA, their observed capital expenditure was a full 2 percentage points lower than planned capital expenditure for the year.¹³

Graph III.2. Capital Expenditure: Planned versus Observed



Source: Regional Economic Outlook April 2010, IMF *Excludes Eritrea, Guinea, and Zimbabwe.

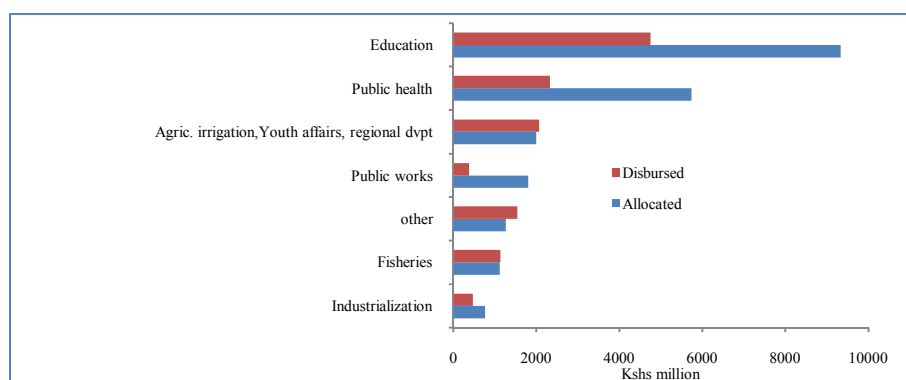
3.5 The lesson is to accelerate the institutional strengthening of public investment management. Limited state capacity for SSA economies arises from several factors including insufficient human capital; inadequate management of public investment programs without sufficient emphasis on results and downstream feedback loops to avoid old-style planning pitfalls; ineffective project management, especially in donor-financed projects; and inefficient and limited transparency in the tendering boards in some countries adversely affected public infrastructure investment. Moreover, insufficient coordination between government departments, such as the Ministry of Finance and the Planning agencies creates institutional overlap. In some instances, the proliferation of ministries exacerbates institutional impotence. Contestability in the budget across ministries is also lacking. There are domestic supply constraints as well. For example, an extensive public infrastructure expenditure may be unable to occur due to lack of skilled workers, domestic construction firms, inability of unemployed labor to move from the commodity exporting sector to work in infrastructure development, poor transport network to get

¹³ See Regional Economic Outlook April 2010, IMF.

materials and poor logistics to name a few.¹⁴ These factors dilute the effectiveness of SSA governments to design and implement effective public investment programs in normal times, let alone to ensure execution during crises when continued fiscal impulse is needed to sustain economic activity.

3.6 Execution of other stimulus programs. Other programs also showed problems related to implementation. For example, in Kenya, by end of third quarter FY2009/10, only 57 percent of the program aimed primarily at supplements to district level spending had been disbursed, and it is unlikely that the full stimulus will be implemented. Some of the problems can be attributed to addressing medium-term structural issues including delays while anti-corruption measures are being put in place, and hence, a delay was indeed appropriate (for example, education sector programs in Kenya, drugs and water investments in Uganda). This highlights the importance of accelerating governance improvements in public expenditure management so that programs can be implemented quickly without fears of corruption.

Graph III.3. Kenya Fiscal Stimulus FY2009/10: 57 percent implementation through Q3



Source: Kenya Economic Update, World Bank, June 2010; based on Ministry of Finance

3.7 Meeting revenue targets. Revenue targets were by and large lowered in anticipation of global crisis impacts, although for many countries this still implied an increase in revenue collection compared to previous years. In comparing actual revenues with targets, evidence is quite mixed. The revenue story would require more further analysis to better understand these disparate trends.

3.8 Domestic and External Financing. Financing patterns were by and large in line with fiscal policy plans. On domestic financing, the major concern is whether there will be enough depth in domestic markets –which was key to first round of fiscal stimulus--should a second round of fiscal stimulus be appropriate (in event of W or double-dip global scenario). Vulnerabilities related to foreigner holdings of domestic debt are also a concern amongst SSA countries. The issue of non-concessional external borrowing for viable projects remains a

¹⁴ Based on discussions at High-Level Workshop on Africa Fiscal Policy for Growth in Light of Global Crisis, World Bank, Maputo, December 2009.

complex topic as the appropriate institutional frameworks and capacity are generally still being put in place.¹⁵

IV. Links to Growth Agenda

4.1 This paper assesses the fiscal response to the global crisis in LICs in Sub-Saharan Africa in relation to Fiscal Policy for Growth, using a conceptual and comparable framework to analyze experience to date across countries. The comparative framework is constructed with the principal fiscal shock from the crisis a loss in revenue from changes in the economic environment, and the principal potential discretionary fiscal response tool an adjustment in discretionary government spending.

4.2 Most countries chose not to adjust fully to the shock and revenue declines stemming from changes in the economic situation but rather to finance an increased fiscal deficit. The bulk of the additional financing came from domestic borrowing but without threatening macroeconomic stability. It will be important to continue to assess whether this delicate balance can be maintained, how much of the stimulus that was intended as transitory indeed did not remain in the public finances more permanently, and whether the fiscal stance quickly reversed once the economic situation improves. These issues, in particular, require further attention and analysis: the use of aid and external finance in facilitating fiscal policy adjustments to shocks; the scope for additional domestic borrowing and its impact on private flows including the possibility of crowding out borrowing by the private sector; and the use of special instruments such as infrastructure bonds to facilitate the fiscal response. The impact of the global financial crisis on SSA may be prolonged. In this case, the ability of African economies to continue with expansionary fiscal policy may only be possible if the debt levels are sustainable. Furthermore, expectations matter! Many governments worked hard over the last decade to establish strong macroeconomic and fiscal policy credentials. With looser fiscal policies and rising debt levels, the risk premium attached to government paper may rise. The extent to which risk premium rises depends on the credibility of fiscal policy (and other macroeconomic policies) of the government which affects the ratings attached to the country's debt. Mirroring the global discussions, measures may now be needed to transition back to the long-run optimal trajectory.

4.3 The analysis demonstrates the considerable range of fiscal policy responses by SSA LICs to the global crisis. In large part, these responses are consistent with the framework laid out in Section I outlining how fiscal policy in African countries should have responded. Namely, for countries which have built up fiscal space through from a sustained period of stronger growth, rising foreign investment and debt relief, an appropriate response would be at a minimum to accommodate any loss in revenues, protect spending and increase the fiscal deficit temporarily. Even if no net increase in external financing, net private savings may rise as a result of the external shock, *independent* of fiscal policy, providing a rationale for a larger fiscal deficit to ease the shock. It also suggests that such accommodation could play a critical role in protecting

¹⁵ Based on discussions at High-Level Workshop on Africa Fiscal Policy for Growth in Light of Global Crisis, World Bank, Maputo, December 2009.

medium-term growth prospects, notably, through growth-oriented public investment programs and targeted programs that prevent irreversible damage to human capital.

4.4 The methodology employed focused on changes in expressions of policy intent before and after the crisis, as well as preliminary observations on budget execution relative to policy intent. Most countries' policy intent was not to adjust fully to the shock and revenue declines stemming from changes in the economic situation but rather to finance an increased fiscal deficit, with the bulk of the additional financing from domestic borrowing. A smaller set of countries tightened their fiscal stance, representing however not so much a response to the change in the global economic situation but rather a response to pre-existing macroeconomic tensions and risks of debt distress.

4.5 The most common fiscal response was to avoid a contraction in expenditures as reflected in budgets. Thus, by and large, growth-oriented public investment programs were protected. This was the response as well of select countries with fiscal space which could have been more ambitious in terms of increasing discretionary expenditures, in part due to legitimate concerns regarding the ability of additional discretionary expenditures to meet the intended objectives and the potential impact on credibility of their macroeconomic policies. Another set of countries instituted fiscal stimulus programs based on increases in discretionary expenditures. These range from public capital investment expansion (such as Nigeria) to programs aimed at affected populations (such as Tanzania and Kenya). This protection of expenditures including public investments programs oriented toward growth is a notable development compared with adjustment efforts in SSA LICs in previous decades.

4.6 Despite plans for fiscal policy stances that by and large protected growth expenditures, execution of those plans was another matter. Only a subset of countries were successful in actually spending as much as budgeted, in large part because of structural factors in public investment management. It will be important to assess features of managing public investment programs that increase the ability to maintain growth over time and in times of volatility avoid an irreversible disruption.

4.7 In addition, it will be important to assess how much of the stimulus that was intended as transitory indeed did not remain in the public finances more permanently, and whether any delays in discretionary spending results in lags. Ensuring that the fiscal stance is quickly reversed once the economic situation improves would be critical to sustainability. The impact of the global financial crisis on SSA may be prolonged. In this case, the ability of African economies to continue with expansionary fiscal policy may only be possible if the debt levels are sustainable. Furthermore, expectations matter! Many governments worked hard over the last decade to establish strong macroeconomic and fiscal policy credentials. With looser fiscal policies and rising debt levels, the risk premium attached to government paper may rise. The extent to which risk premium rises depends on the credibility of fiscal policy (and other macroeconomic policies) of the government which affects the ratings attached to the country's debt. Mirroring the global discussions, measures may now be needed to transition back to the long-run optimal trajectory.

4.8 In conclusion, most of the challenges in actually implementing higher quality expansionary fiscal policy in light of the crisis are similar to the challenges facing fiscal policy in supporting growth within a medium-term context. This should be a comfort to those focusing on quality expenditure programs for growth.

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