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Country Economic Report 2004:1

Aid and Growth in Rwanda

Foreword

This economic country study on Rwanda is part of a series of annual studies, undertaken by various Swedish universities and academic research institutes in collaboration with Sida. The main purpose of these studies is to enhance our knowledge and understanding of current economic development processes and challenges in Sweden's main partner countries for development co-operation. It is also hoped that they will have a broader academic interest and that the collaboration will serve to strengthen the Swedish academic resource base in the field of development economics.

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Content

1. Introduction[1]

After the genocide, Rwanda began to reform its economy in 1995. There has been considerable progress since then, but much of this has been a rebound from the disaster. In the longer term it will be harder to sustain recent growth rates. The current economic policy follows Rwanda's Poverty Reduction Strategy Paper (PRSP) of 2002. The reforms have focused on the exchange and trade regime, privatisation of state enterprises, reform of public administration, budget and financial management, and private sector development. The reforms that have been undertaken have relied on major donor support.

This paper is commissioned by Sida to provide background information on the Rwanda economy that will help it take decisions on the future of Swedish aid collaboration with the country. In the paper we do not look specifically at aid projects, but aim to provide a broad evaluation of some important and controversial aspects of economic development and policy in Rwanda. Still, we discuss briefly some aid implications.

One aim is to evaluate the prospects and constraints on growth in Rwanda. We start by listing the factors that international research has shown to be important growth determining factors. We keep these factors in mind throughout the review of various aspects of the economy and its economic policy and then conclude the paper with a summary evaluation of where Rwanda stands with regard to those indicators and thus prospects for future growth.

A second aim it to look at changes in poverty. There is a lack of reliable data for recent years, but we use what is available and try to piece together a picture using indirect evidence. The long-term evolution of poverty in Rwanda will largely depend on what happens to growth.

Thirdly, we provide an evaluation of the policies pursued by the government of Rwanda. In particular we relate to the heated debate between the government and the IMF on the size of government expenditures and the budget deficit.

[1] Thanks for comments on an earlier draft are due to James Donovan, Simon Stevens and Bo Göransson.

2. Development Determinants

The aim of Swedish development aid is to "contribute to the creation of prerequisites that enable poor people to improve their living conditions" (Ronnås, 2003, p.1). In this report we discuss Rwanda's achievements with regard to the creation of conditions for a poverty-reducing growth process. To help us structure our discussion of Rwanda's growth prospects we start by a listing of growth determinants that have been identified in the recent growth and development literature. We have identified 13 aspects, which we group into five groups.

Macroeconomic aspects
1. Macroeconomic stability. A sound fiscal and monetary policy is a necessary ingredient in a growth policy. This means that the budget deficit has to be kept within reasonable limits and that money supply must not be allowed to grow too fast. Often there is a close link between the budget deficit and monetary expansion, since governments often choose to solve their financing problems by borrowing in the central bank. A low rate of inflation helps to create a stable exchange rate and it makes it easier for the financial system to function effectively. A stable economic policy also builds trust with economic agents by extending their planning horizon and making it easier for them to invest in long-term projects. Such projects are likely to have more beneficial effects on growth than short-term, more speculative investments.

2. International competitiveness. To be able to increase exports, i.e. be more internationally competitive, a country needs a realistic exchange rate. An overvalued exchange rate protected by trade controls is a serious growth constraint. Of course, a country's competitiveness depends on a whole range of other factors related to openness. In general, openness itself tends to make the domestic enterprises more efficient. International competition will not only increase production efficiency, but it may also affect the demand for more market-friendly institutions.

Microeconomic aspects
3. Functioning and competitive domestic markets. A functioning market economy is necessary for efficient resource allocation, and this is in turn important for growth. An important aspect in this area is the free entry principle of new enterprises. Numerous, complex or costly regulations to enter a

market will decrease competition and hence the efficiency of a market. Another problem is the crowding out of private investments by public investments or enterprises, which are active in markets that could function without intervention.

4. A stable financial system. A stable economic environment requires that the financial system is transparent and efficient. This makes savers willing to save and investors willing to take risks, while the financial system channels resources to the most profitable sectors.

Human resources and infrastructure
5. Human capital. The importance of human capital for growth has been emphasized in modern growth theory. Investments in education and health care are therefore important ingredients in a policy aimed at long-term growth (apart from having direct welfare effects).

6. An efficient physical infrastructure. To make it possible for firms to function effectively you need a well-developed system of roads, telecommunication and energy. Also the geographical conditions might be crucial for the development strategy of a country.

Self-reliance
7. Limited aid dependence. To be able to achieve self-sustained growth, a country cannot be too dependent on foreign aid. This tends to make donors a more important group than domestic citizens, and that in turn may undermine the long-term sustainability of policies. The experience from the structural adjustment programmes is that the results have been limited by the fact that the programmes were not owned by the governments supposed to implement hem. Therefore they were not effectively implemented, and the expected results were not achieved. A large inflow of aid may also overburden the weak administrative machinery in the recipient country, although this will to some extent depend on the type of aid transfer. The control of government resources including aid should lie in the hands of the government, and this should also be held responsible when things go wrong. Increased emphasis on budget support and debt relief is a step in this direction.

8. Sustainable foreign debt. Many countries in Africa have built up debt that they cannot possibly service. This has been a consequence of failed economic policy. Debt reductions within the Heavily Indebted Poor Countries (HIPC) programme aim to reduce the budgetary burden to a sustainable level and to increase the scope for social or poverty oriented expenditures. In return for the debt reduction certain demands have to be met by the recipient government to avoid that failed strategies persist and that unsustainable debt stocks are built up again.

9. Domestic savings and foreign private direct investment should be the main sources in investment finance. Investment in production in less developed countries should to a large extent be financed by domestic private investors. The second best alternative is that they are financed by foreign firms, which take the risk if they fail. State firms have often worked poorly.

Good governance and politics

The previous sections have looked at results in terms of actually implemented policies and the effects of those. However, for sensible policies to be undertaken and to be successfully implemented the institutional structure in the economy must be supportive. We look at four different aspects:

10. Well-functioning public institutions. Growth requires that property rights are respected and that laws are upheld. They need to be supported by well functioning institutions such as courts. One also needs an efficient and fair system of taxation. The emphasis in development strategies in most countries today is on the need to develop an environment conducive for private investment, and well-functioning institutions are a crucial component of this.

11. Good governance. One has to have a clear demarcation line between the private and the public sector to reduce the risks of nepotism and corruption, which are detrimental to growth. This is particularly difficult in small economies, where virtually everybody in the elite knows everybody else in that elite.

12. Broad participation of citizens. A stable development is easier if there are no acute distributional conflicts. A society needs a certain amount of "social insurance" to cushion economic reforms, which invariably will have some losers in the short term. If the society cannot handle distributional conflicts, for example, when the economy is liberalized, growth supporting economic reforms cannot be effectively implemented. We have noted that poverty reduction is the most important development target. Broad popular participation is not only a means to the end of growth and development, but also a development target in itself.

13. Political maturity. The liberalization process that has been undertaken in virtually all countries in recent decades has increased the scope for competing political constellations also in countries that previous had one-party regimes. Which policy that will be implemented depends on how the political process evolves. If new political forces are denied access to the political process and if corruption is extensive it will be hard to establish a stable policy regime generate that can generate the growth that is necessary to reduce and eventually to eliminate poverty.

3. Economic Performance

3.1. Macroeconomic Development

The key achievements during 2002 were a GDP growth rate of 9.4%, an annual inflation rate of 2% and progress in tax collection beyond expectations (Table 3.1) The result are mainly driven by the exceptional harvest of subsistence crops due to favourable rain and increased construction activity, while the monetized economy did worse. There are very limited multiplier effects from subsistence production to the modern sector in Rwanda, but the latter seems to have revived during the first half of 2003. The electricity output, which is a good indicator of the economic activity, increased by 25.7% during the first four months of the year compared to the same period 2002.

Six out of nine quantitative performance criteria for 2002 agreed with the IMF were met, and the other three were missed due to unanticipated events that occurred late during the year, or administrative lapse. Progress was also made on the structural reform agenda.

Table 3.1: Rwanda Macroeconomic Indicators

	1995	1996	1997	1998	1999	2000	2001	2002	2002pred	*2003pred*
GDP, growth (%)	35.2	12.7	13.8	8.9	7.6	6.0	6.7	9.4	*7.3*	*3.2*
Inflation (%)	48.2	13.4	11.7	6.8	-2.4	3.9	3.4	2.0	*2.0*	*4.7*
Money (M2) growth (%)	73.7	8.2	47.5	4.8	6.8	14.5	8.8	17.4	*6.9*	*8.0*
Gross Investments (% of GDP)	13.4	14.4	13.8	14.8	17.2	17.5	18.4	18.8	*18.8*	*19.9*
Of which: Private Investment (% of GDP)	5.3	5.1	5.5	8.0	10.9	11.6	11.8	12.0	*17.0*	*12.2*
National Savings (% of GDP)	-5.7	-4.9	-3.7	-2.2	0.5	1.2	2.5	1.7	*1.8*	*1.2*

Of which: Private Nat. Savings (% of GDP)	-0.1	-1.0	-2.7	-0.8	3.9	4.2	5.4	5.8	*4.9*	*4.8*
Total Government Revenue (% of GDP)	6.8	9.3	10.4	10.6	9.9	9.7	11.4	12.2	*12.2*	*13.4*
Total Government Expenditure (% of GDP)	20.5	22.5	19.6	18.9	19.6	18.7	21.0	23.2	*22.1*	*24.7*
Overall Balance Before Grants (% of GDP)	-13.7	-13.2	-9.2	-8.3	-9.7	-8.9	-9.5	-11.0	*-9.9*	*-11.3*
Overall Balance After Grants (% of GDP)	-2.4	-5.8	-2.5	-3.0	-4.0	0.7	1.3	-2.4	*-1.1*	*0.9*

Note: Private investments and savings include public enterprises.
Source: IMF (2003a).

The monetary policy during 2002 was fairly stable with net foreign assets well above the agreed floor at the end of the year, a larger than predicted reduction of the public sector debt, and an average inflation rate of only 2%. However, inflation accelerated during the year and reached 6.2% in December. This was partly due to increased prices of petroleum on the world market, the increased value added tax (VAT) and poor rains which increases the food prices. The inflation rate remained high in June 2003 (7%), again partly due to increased food prices. Non-food inflation was in the 3 to 4% range, but also this was above target.

The main cause of inflation this year is still excessive money supply growth. Because of the shortfalls of foreign assistance the government chose to rely on the banking sector for credits. The problem of excessive money growth seems to continue during 2003. The projection of an inflation rate of 4.7% (well above the 3% target), will be exceeded if prices continue to increase at the same rate as at the beginning of the year.

National savings are practically non-existent. This is a serious threat to further development and an indication of a poor investment climate as well as an underdeveloped financial sector.

Government revenues are increasing as a percentage of GDP, but so are expenditures. This means that the overall deficit before grants is fairly constant around 10%. In 2002 there was an increase in the deficit from 9.5% to 11%, which was reduced but not covered by external grants. The predictions for 2003 suggest that aid inflows this year will more than cover the overall deficit before grants. The deficit issue is discussed more extensively in Section 6.2.

3.2. Sectoral Development

The overall structure of the economy has not changed much over the years (see Table 3.2). In 2002, the agricultural sector contributed 47% of GDP, industry 18% and the service sector 36%. Since 1998 growth has mainly been driven by agriculture and construction, which means that the shares of manufacturing and services in GDP have declined slightly. As far as one can judge from these aggregate figures there is no major process of economic transformation or structural transformation going on in Rwanda.

Table 3.2: Gross Domestic Product by Sector, 1995–2002,%

	1995	1996	1997	1998	1999	2000	2001	2002
GDP (Rwf million)	336,489	386,560	441,981	482,658	513,89	546,052	584,18	642,206
Agriculture	0.44	0.46	0.42	0.43	0.43	0.45	0.45	0.47
Food crops	0.37	0.38	0.35	0.35	0.36	0.37	0.38	0.40
Export crops	0.03	0.02	0.01	0.01	0.02	0.01	0.01	0.01
Industry	0.16	0.17	0.18	0.18	0.18	0.18	0.18	0.18
Manufacturing	0.10	0.10	0.11	0.10	0.09	0.08	0.08	0.08
Electricity, Gas and Water	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Construction and Public Work	0.05	0.06	0.07	0.07	0.08	0.09	0.09	0.09
Services	0.40	0.36	0.39	0.39	0.39	0.38	0.37	0.36
Wholesale & Retail trade	0.14	0.10	0.10	0.10	0.10	0.09	0.08	0.08
Transportation & Communication	0.04	0.04	0.05	0.06	0.07	0.07	0.07	0.07
Finance and Banking	0.02	0.02	0.02	0.02	0.03	0.03	0.03	0.03
Government Administration	0.07	0.08	0.09	0.08	0.08	0.08	0.08	0.07
Other Services	*0.11*	*0.11*	*0.11*	*0.11*	*0.11*	*0.12*	*0.11*	*0.10*

Source: Rwanda Revenue Authority (2003a), Republic of Rwanda (2002c)

Agriculture

The bulk of agricultural production is for subsistence production (food crops contributed about 40% of GDP in 2002), while exports crops only contributed 1%. The main strategy of the government is to promote some priority crops that are selected because of their high kilo caloric content, the fact that they are well known among the farmers and because they are responsive to increased use of inputs. About one third of the production today is bananas, which is a very extensive crop. By a more intensive agriculture the aim is to increase the area for export crops. The promotion of the priority crops is both through improved distribution of seeds and technical training and the resulting increase in the productivity of priority crops is clear from Table 3.3.

Table 3.3: Rwanda: Trends in the production of priority crops, tonnes per hectare, 1995–2002

	1995	1996	1997	1998	1999	2000	2001	2002
Rice	2,001	6,596	9,805	7,935	8,921	11,363	17,697	24,539
Maize	55,600	66,595	83,427	58,618	54,912	62,502	92,129	78,465
Soya	0	0	4,279	9,831	4,707	7,034	17,140	19,216
Potatoes	137,700	195,381	229,625	181,138	175,889	954,418	988,982	1,097,503
Coffee	21,952	15,285	14,830	14,268	18,817	16,098	18,268	
Dried Tea	5,414	9,057	13,239	14,874	12,669	14,481	17,817	

Source: Republic of Rwanda (2003b).

Another priority of the Ministry of Agriculture is to increase in the number of animals so that each farm has at least one animal. A large part of the livestock was killed during the genocide, which means there is very little use of organic fertilizers. Increasing the use of chemical fertilizers is therefore important. The chemical market has been liberalized in an attempt to increase the supply, but the use is still restricted. The amount of imported fertilizers doubled, however, during 2002. Increased fertilizer use is expected to contribute with 75% of the growth in the agricultural sector, compared to 16% from changed cultivation techniques and 8% from increased land use (Mackinnon et al, 2003). Other programmes of the Ministry of Agriculture, such as terracing, reforestation and agroforestry, are related to soil degradation. The government is also trying to encourage co-operation among farmers to facilitate specialization and commercialisation. People have been trained in forming associations, running and financing of small projects, and new production techniques.

Labour-intensive public works (HIMO) are also a central rural programme, which aims to create new income opportunities for the farmers (see also Section 4.2). The main sectors for public works in the rural area are road infrastructure, agricultural and environmental protection infrastructure, water supply, as wells as schools and health infrastructure.

Still, in spite of these new initiatives the rural sector remains very undifferentiated also by African standards. One stage in the process of income diversification is normally diversification within the rural sector or even within the individual rural households. The government obviously tries to pave the way for such a process of diversification, but so far the impact of the new initiatives has been limited.

Industry

The industry has problems not only when it comes to new investment but also with respect to existing activities. The important beer company, for example, saw production decrease by 16% in 2002, despite a reduction in the excise tax on beer. The construction sector has increased significantly since 1995, though.

Improvements in the economic infrastructure in 2002 includes reconstruction and rehabilitation of some roads, improvement of the Kanombe Airport terminal building, enlisting of two companies to exploit methane gas and the expansion of rural water supply, not least through private sector involvement.

However, there is still a large need for improved transportation and energy supply. The high energy and transport costs, to and from Rwanda and inside the country, are major constraints on economic development. By exploiting an alternative source of energy such as methane and privatising parts of the sector, there might be a downward pressure on energy prices. In spite of the high prices the state electricity company Electrogaz is making heavy losses (Republic of Rwanda, 2003c). Even though only 2% of the population has access to electricity, there is a production shortfall of over 50%. The gap is filled by imported electricity from the DRC and Uganda. Privatisation of Electrogaz is expected to increase the domestic supply.[2] The Ministry of infrastructure has also conducted a study for the feasibility of rural electrification through micro-centrals and geothermal energy.

The emphasis in the economic infrastructure development is put on:

1. Maintenance and rehabilitation of the rural road network to promote trade
2. Encourage greater competition in air transport
3. Reduction of the cost of electricity by increasing the domestic production
4. Rural electrification to promote economic activities
5. Encouraging competition in the area of telecommunication

The strategy is in many cases (especially with regard to points 3–5) to open up the market to competition, or at least letting a private company manages the company in question under more or less strict contracts (see Section 5.4). Rural road improvements are expected to be achieved with public works programmes.

Services

Education has been one of the major priorities in the PRSP process and 25% of total government expenditures go to this sector. All of the education targets from the PRSP for 2002 have been met. Table 3.4 shows some indicators for primary education. The target of 76% net enrolment rate in 2003 is expected to be exceeded, not least because the government will abolish the 300 RwF annual school fee from September 2003. There is still a shortage of teachers but a distance learning programme and other will improve the situation somewhat. The dropout rate of 17% in primary school is still high as is the repetition rate. Another problem is the lack of school materials, since the main part of the government spending on education goes to salaries (Fofack et al, 2003).

[2] The expected costs after the privatisation should be compared to the cost of continued import of electricity. However, it is also important to have some degree of independence for security reasons.

Table 3.4: Major changes in primary education

	2001	2002	*2003 proj*
Gross enrolment rate (%)	99.9	103.7	*108.9*
Net enrolment rate (%)	73.3	74.5	*81.7*
Transition to secondary (%)	–	37	*40*
Drop out rate (%)	14.2	16.6	–
No and% of qualified teachers	17,995(63%)	21.123(81%)	*22.997*
No of student per teacher (qualified or non-qualified)	51.0	58.9	*59.9*

Source: Republic of Rwanda (2003b)

The transition rate from primary to secondary school is 37%. Tertiary education is still very small, and research at the university is practically non-existent. The government is trying to promote education in science and technology, not least in information and communication technology (ICT).

Also in the health sector there has been progress. In 2002 malaria prevalence dropped, the immunization rate increased to above 80% (one of the highest in Sub-Saharan Africa), and 70% of the population is aware of the AIDS/HIV risk. The rate of health service utilisation increased slightly from 0.24 to 0.28 consultations per person per year. However, health services are still poor, and the health situation is precarious. In 2002 was for example 13.7% of the adult population HIV positive.

The health sector receives about 4.4% of total government expenditures. The four priority programmes in the health sector are:

1. Provision of basic health care
2. Specialized interventions into major health problems
3. Development of health infrastructure and financing mechanisms
4. Improvement in management of the health system

Like in the political system there is an emphasis on decentralization in the health system, and *mutuelles de santé* are improving the access to health. When it comes to external financing there is a problem that HIV/AIDS gets almost all the attention, restricting the development of the general health care.

3.3. The External Sector and Foreign Debt

We noted in Section 2 that international competitiveness is a precondition for self-sustained economic growth. This is even more clearly the case for a small country like Rwanda, which will be unable to exploit scale economies if it produces only for the tiny domestic market. To achieve self-sustained growth the country thus has to expand exports.

The recent export experience is dismal. In 2002 the already low merchandise export revenue declined by a staggering 28% (see Table 3.5), and this decline continued during the first quarter of 2003. Three quarters of Rwanda's export is made up of coffee, tea and coltan, and there were dramatic price declines on both coffee (-32%) and coltan (-52%) during 2002. Terms of trade fell by 12% in 2002 following a drop of 22% in 2001 (IMF, 2003a, p. 7). In 2002 there were also large drops in quantities exported. On the import side there was a reduction of food imports due to the bumper harvest of 2002, which meant that the trade balance deterioration was contained. Still, capital goods exports were increasing fast as a consequence of investments, particularly in construction. The invisibles account deteriorated, largely due to higher costs of transport services.

Table 3.5: Balance of Payments

	1995	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	***2003proj***
International reserves (months of imports)	3.3	2.7	4.0	4.6	4.7	5.4	5.8	6.3	*7.4*
Exports, f.o.b. ($US millions)	50.4	62.0	93.0	64.1	62.0	89.8	93.4	67.3	*71.8*
Of which: – Coffee	38.8	43.2	45.3	28.1	26.5	22.5	19.4	14.6	*16.8*
– Tea	3.8	9.3	20.6	22.8	17.5	24.3	22.7	22.0	*24.6*
Exports f.o.b. (% change)	56.8	22.9	50.0	-31	-3.3	44.7	4.2	-28.1	*6.6*
Imports, f.o.b. ($US millions)	194.1	213.3	277.4	255.7	248.8	239.8	237.9	233.7	*253.6*
Imports (% change) f.o.b.	-47.7	9.9	30.1	-7.8	-2.7	3.6	-0.8	-1.8	*8.5*
Current acc. (% GDP) – without official transfers	19.1	-19.3	17.5	-17.0	-16.7	-16.3	-15.9	-17.2	*-18.7*
– with official transfers	-3.1	-6.7	-9.5	-9.6	-7.6	-5.0	-5.9	-7.3	*-11.3*
Real Exchange Rate Change (%)	-39.7	8.6	26.5	-18.2	5.1	-9.7	-3.4	-12	…
Terms of Trade Change (%)	22.6	-15.9	40.7	-14.2	16.1	7.7	-21.7	-11.9	*0.4*

Source: IMF (2003a)

The country thus has a very weak trade balance. The current account balance is also negative at -7.3% of GDP, although official transfers reduced the deficit with about 10% of GDP in 2002. In the longer term the country has to diversify into new export products if it is ever to get to a stage were the current account is to be sustained without massive aid inflows. [3]

[3] The PSIA (p. 69) points to the need to remove non-price restrictions, and list critical actions as follows: Privatisation of tea factories, encouragement of private investment in coffee-washing stations, investment in new coffee trees, support for extension and fertilizer distribution, better marketing of Rwanda as a tourist destination, and restoration of Rwanda as a re-export base.

Table 3.6 shows how the external deficit has been financed over the last decade. The bulk has come from grants, which has been at a very stable level since the genocide. Donors do obviously feel committed to the recovery and development process of Rwanda, and this suggests that the country can expect sizeable aid inflows for an extended period of time.

Table 3.6: Foreign Debt, External Financing Requirements and Sources (million US$)

	1995	1996	1997	1998	1999	2000	2001	2002	2003 proj
Foreign Debt (US$ mn)	1063	1112	1178	1159	1256	1300	1336	1410	*1471*
Debt stock/ GDP (%)	82.2	80.4	61.6	58.3	65.1	71.8	78.5	81.2	*86.1*
NPV of external debt (% exports)	628.6	658.2	691.5	636.6	148.1	173.8	179.3	197.4	*222.2*
Foreign financing requirements	-365.0	-317.4	-347.0	-406.0	-372.3	-357.3	-371.4	-335.5	-425.0
– Grants	300.7	263.5	262.6	243.8	246.4	278.4	233.5	236.6	194.6
– Loans	50.7	53.8	64.0	58.9	86.9	47.3	78.4	92.3	42.8
– Purchases from IMF	13.5	0	20.5	16.1	29.3	25.1	12.1	5.9	8.3
Other	0	0	0	77.2	9.7	6.4	38.6	0	6.7

Source: IMF (2003a), p. 29.

The debt stock of Rwanda increased significantly during 2002. There was new borrowing of $92 million, albeit on concessional terms. Of the 92 million, 51 was budget support from the International Development Association (IDA). This meant that the net present value (NPV) of debt to export at the end of 2002 was still only 197%, which was in line with what was required for the country to be able to reach the completion point in the HIPC process. Negotiations with other creditors, particularly the Paris Club, continue. Rwanda accumulated some arrears with foreign creditors during 2002, breaking one of the Poverty Reduction and Growth Facility (PRGF) conditions (see section 5.1). This was not considered a serious breach, though, and it has been dealt with.

In HIPC agreements it is normally assumed that a country is to reach a debt sustainability ratio of NPV of debt to export of 150% at the completion point. In the case of Rwanda the IFIs have, however, acknowledged that the countries external position is weak and that domestic needs are large. They will therefore accept a higher rate, with the 150% level reached only in 2008. During 2003 the government has been borrowing somewhat more ($18 million) than planned within the PRGF. The government feels this is advantageous, not least since it can borrow more on very favourable IDA terms than was originally envisaged. As shown in Table 3.6 the predicted debt to GDP ratio is higher in 2003 than at any time since 1995. This has raised concerns within the IMF, since the export prospects are not good. The country will be vulnerable to external shocks. Without new aid the ratio will be 222% after debt relief has been obtained at the completion point (IMF, 2003a, p 8). The new projected date for reaching 150% is changed to 2016, mainly due to a more pessimistic view on export prospects. We will return to the debate on the appropriate debt strategy in Section 6.

3.4. Government Revenues and Expenditures

Revenues

At the end of the 90s Rwanda had problems collecting taxes, but tax collection has improved because of a more efficient system through Rwanda Revenue Authority (RRA) and because of a larger tax base. Moreover, a value added tax was introduced in January 2001. Revenues increased from 11.4% of GDP in 2001 to 12.2% in 2002 (see Table 3.7), exceeding the agreed PRGF floor slightly. The increase was mainly due to an increase in the VAT from 15% to 18% and a continued improvement in the collection of taxes, especially the import taxes. This more than compensated for the reduction in corporate income tax from 40% to 35%.

The revenues are projected to increase to 13.4% during 2003, not at least through the introduction of a tax on professional remuneration, extension of the product range covered by the excise tax and increase of the excise tax on beer. Moreover, there was 2365 VAT registered companies in 2002, while the projection for the end of 2003 is 3000 companies (Republic of Rwanda, 2003a). So far during 2003 tariff revenue has more than doubled.

Domestic revenues are, however, small, also compared to other African countries (Kenya's, one of the most successful countries in this respect, revenues are for example around 25% of GDP). There are also limits to the expansion of tax collections until the GDP level of the country has increased and the rural sector has become monetised. A large part of the revenue growth has been due to increases in the number of taxes and the tax rates. However, a continued growth must increasingly come from growth in the tax base. Moreover, although domestic tax revenues are increasing, a large part of government revenues still come from external grants (see Table 3.7). This may be acceptable in the short run, since an increase in tax revenues, which is not based on an expansion of the tax base, may be detrimental to the growth. Some of these are direct budget support to the government while others are capital grants that go into the so-called development budget. The budget support is a general grant, while the capital grants in the development budget are sector or project specific.

Table 3.7: Government Revenue by Source (% of total revenue)

	1995	1996	1997	1998	1999	2000	2001	2002	*2002 proj*	*2003 proj*
Tax Revenue	35.3	51.1	57.3	63.2	72	50	79	95	*93*	*112*
Non-tax Revenue	2.2	4.5	3.2	3.2	4.5	2	6.7	6.6	*7.8*	*7.0*
Grants	62.4	44.4	39.5	33	23.5	48	61.9	70.8	*72.7*	*103*
Of which:										
Budget support	19.5	1.5	2.9	3.5	–	–	33.9	39.3	40.6	73.6
Capital grants	42.9	42.9	36.5	29.8	–	–	28.1	31.5	32.1	35.4

Source: IMF (2003a)

Table 3.8 lists the providers of budget support. Apart from temporary support for the demobilization process, Sweden and the UK (Department for International Development, DFID) are the only bilateral donors giving budget support. The main contributors are the World Bank, the UK, and the EU. The HIPC initiative has also brought some extra revenues and these are projected to increase even more

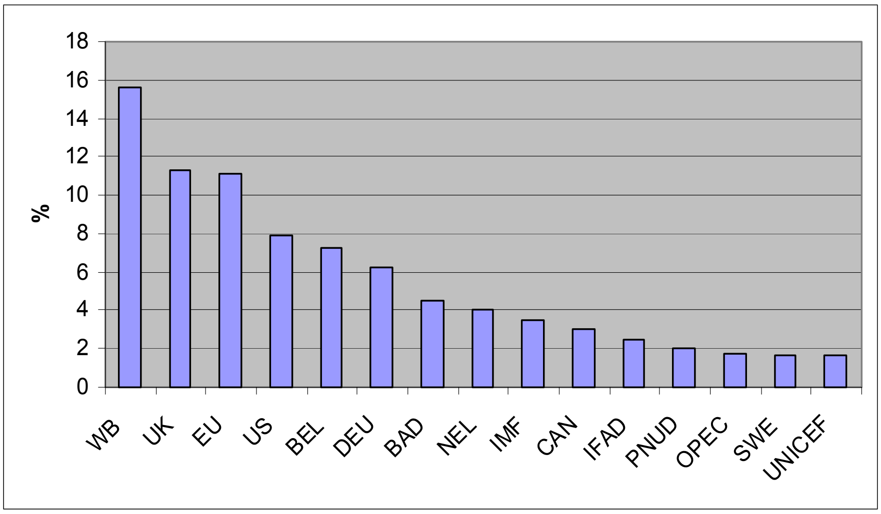
Table 3.8: Recurrent Budget Grants and Loans (million $US)

	2002	2003 proj	2004 proj
Grants			
DFID	12.98	13.87	10.22
EU	12.21	12.50	12.50
Sweden	1.03		
Bilaterals (demobil)	3.81	5.78	0.95
HIPC Initiative	10.70	14.57	18.34
Loans			
World Bank	13.98	10.00	10.00
World Bank (demobil)	1.69	5.70	4.00

Source: Republic of Rwanda (2003b)

As much as 88% of the development budget is financed by donor funds. Of the donor funds 40% are multilateral, 49% are bilateral, and 11% are from non-governmental organizations (NGOs). Figure 1 shows that quite a large number of bilaterals give capital grants, but the main supporters are again the World Bank, the UK and the EU

Figure 1: Main Donors of Grants and Loans for the Development Budget, 2001–2002



Note: Contributions of less than 1% are not presented.
Source: CEPEX (2002).

Expenditures
The development of government expenditure composition is to a large extent influenced by the PRSP process and its priority sectors, which most clearly is reflected in the increase of expenditures on education and health (see Table 3.9). The agricultural sector is also a priority sector, since nearly 90% of the population are dependent on that sector. Expenditures on military activities have been significant throughout the period due to internal conflicts and the military involvement in the Democratic Republic of Congo (DRC). These expenditure are however predicted to decline along with increased security in the country and the withdrawal of troops from the DCR.

Table 3.9: Functional Classification of Central Government Recurrent Expenditures, 1995–2001 (RwF billion)

	1995	1996	1997	1998	1999	2000	2001
Military	14.8	22.6	23.3	27.2	27.0	25.8	28.6
Administrative services	…	18.7	23.8	27.5	31.5	35.7	53.7
Economic services	4.1	2.0	1.3	2.5	2.6	2.1	4.9
Education	…	6.6	9.8	11.1	17.2	24.0	29.8
Health	1.6	1.4	1.5	2.6	3.3	3.8	5.1
Other Services	1.5	0.5	0.5	1.0	1.4	2.7	1.3
Debt Services	3.8	4.0	3.8	3.4	4.0	1.8	2.8
Memorandum items:							
Total Current Expenditure	42.1	55.9	64.0	75.3	87.1	95.9	126.2
Capital Expenditure	27.4	39.4	46.1	42.3	40.8	42.0	50.0

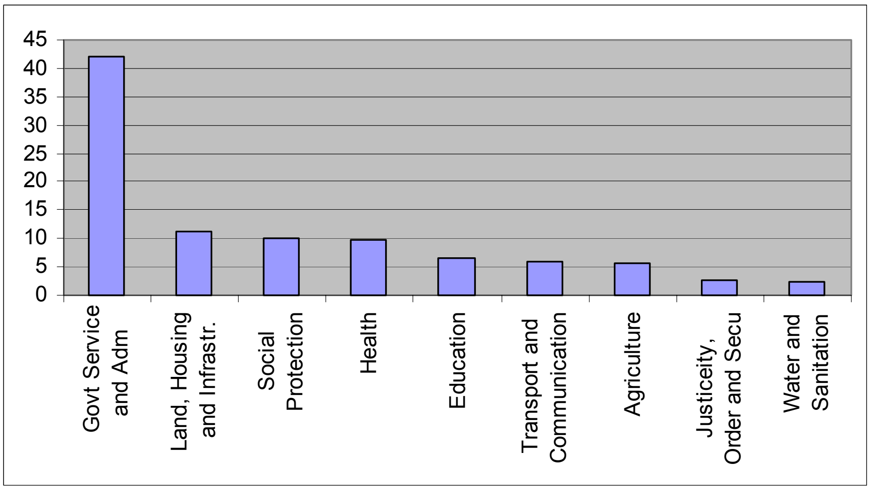
Source: IMF (2002)

The so-called exceptional expenditures, which are connected to the special needs to deal with the unique post-conflict situation, peaks in 2003 and are then projected to decline steadily. Expenditures identified as exceptional expenditures in 2003 were:

- Demobilization and reintegration (33% of total excep. exp)
- Supplies for prisoners and Gacaca (8% of total excep. exp)
- Victim of Genocide Fund (14% of total excep. exp)
- Orphans assistance, support to orphanages and ENA, reinsertion of street children
- Assistance to and reinsertion of vulnerable groups and reinsertion of displaced groups from Gishwati
- Support to local initiatives (education)
- CFIM operations
- Good governance commissions, including for example the Electoral commission (17% of total excep. exp), the Human rights national commission and the Constitutional commission.
- National commission for the fight against HIV/AIDS
- Educational institutes (9% of total excep. exp)
- Special exceptional road works
- Special exceptional health expenditures (7% of total excep. exp)

Central Projects and External Financing Bureau (CEPEX) is set up to co-ordinate and oversee all public investments, aid financed as well as domestically financed. By June 2003 CEPEX had produced a report that covered 92% of the projects for 2002. The timely delivery of this report was a benchmark required by the IMF. Figure 2 presents the composition of main expenditures in the development budget according to this report. Government services and administration is by far the largest expenditure category. It includes legal institutions, finance and budget, transactions on the public debt, general public services etc. Other important sectors are Land, housing and community infrastructure, Social protection and Health.

Figure 2: Composition of Expenditure – Development Budget (%)



Note: Expenditures less than 2% are not presented
Source: CEPEX (2002).

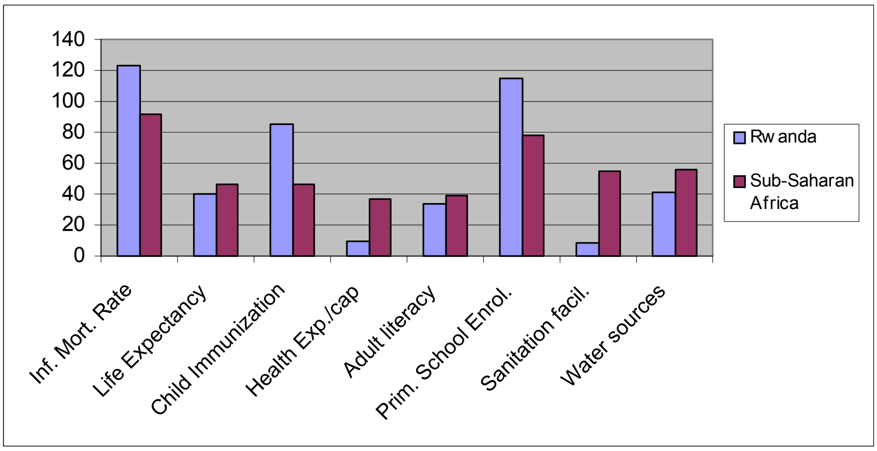
An important issue in the evaluation of government performance is the degree to which it manages to execute its programmes. The possibilities of following actual project implementation are, however, still poorly developed (see Section 5.4). Another problem with the development budget is the lack of integration with the recurrent budget. This may cause large inefficiencies where some investments never pay off and government expenditures are paying of less then if investments where directed to the same area. However, the problem of integration is recognized by the government in the PRSP (Republic of Rwanda, 2003b)

4. Poverty in Rwanda

4.1. Distribution of Wealth and Income

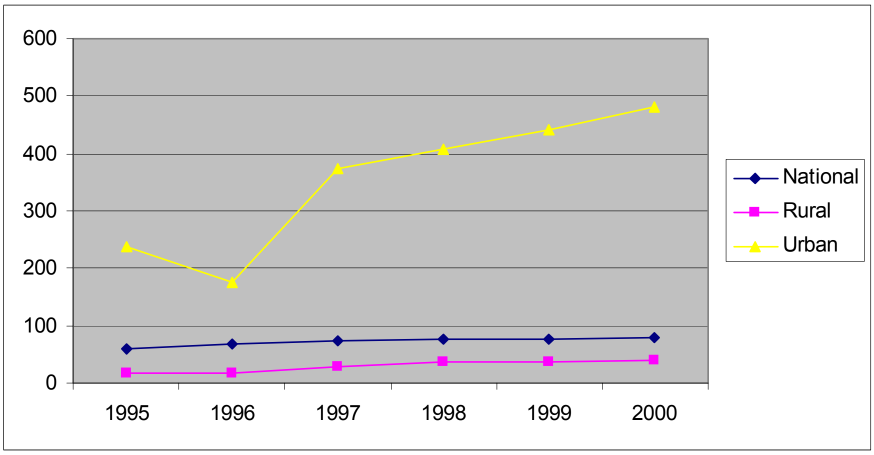
Rwanda is still very poorly developed compared to the SSA average (see Figure 3), with the exception of gross primary school enrolment rate and child immunisation. GDP per capita has increased remarkably since the genocide, but there are significant differences between the developments of income per capita in the urban areas compared to the rural areas (see Figure 4). This suggests that income inequality has increased. In 2001 the Gini coefficient for income in Rwanda was 0.45 compared to an estimate of 0.27 for 1985. The latter figure looks incredibly low, so the change may in reality have been less that what it suggests. This increase in income inequality may reflect a relative neglect of the rural area in the post-conflict reconstruction process. The external funding mainly created development and employment opportunities in the urban area, while the rural area primarily got humanitarian relief (World Bank, 2002a). It has, however, been common in post-conflict economies that it is the transaction intensive activities in the modern sector that rebound most strongly. This is because they depend on a functioning infrastructure and suffer relatively more from conflicts than subsistence activities, and when peace is restored they benefit relatively more from the recreation of a stable business environment.

Figure 3: Quality of Life Indicators in Rwanda and SSA



Source: World Bank (2002b)

Figure 4: GDP per capita, urban and rural, 1990–2002



Source: World Bank (2002b)

It is clear that poverty has decreased since immediately after the genocide, both in rural and urban areas, but poverty has still not come down to the 1985-year level. Poverty is more severe in the rural areas (68% identified as poor) than in the urban areas (23%) (Table 4.1). In 2001 the average consumption level in the urban areas was more than three times higher than in the rural areas. Thus, in 2001, 97.5% of the poor lived in rural areas (Republic of Rwanda, 2002).

Table 4.1: Changes in poverty in Rwanda since 1985

Year	Percentage below poverty line		
	Rural	Urban	Total
1985	48.4	16.1	45.7
1990	50.3	16.8	47.5
1994	82.4	27.5	77.8
1995	76.6	25.5	72.4
1996	75.3	25.1	71.1
1997	74.1	24.7	70.0
1998	70.7	23.6	66.8
1999	69.3	23.1	65.4
2000 est.	67.9	22.6	64.1

Source: Republic of Rwanda (2001d, p. 19)

According to the World Bank (2002) the reasons why *rural* households are poor are the following:

– Low agricultural productivity, declining soil fertility and environmental degradation
– Lack of access to land, land fragmentation and insecurity of land tenure

– Social and economic isolation due to high transportation costs and insecurity
– Poor health services and health standards and rise in HIV/AIDS incidence, impacting negatively on productivity
– Loss of capital stock (livestock and other animals) in the genocide
– Poor agricultural extension services, lack of access to and knowledge of the use of improved inputs

The reasons why *urban* households are poor are:
– Rapid increase in the urban population
– No employment opportunities particularly among poorly educated people
– Poor basic social services and infrastructure, lack of housing
– High food prices due to low agricultural productivity, high transport costs and restrictions on petty trade

To give an idea of the depth of poverty by area, Table 4.2 shows the extent to which different groups have experienced difficulties in satisfying food needs. It is clear that the severity of poverty is higher in the rural areas. For example, among the rural poor 37% are often or always experiencing food shortages, while the number is 14% for the urban poor.

Table 4.2: Percent distribution of households by the difficulty experienced in satisfying food needs during the year before the survey

	Difficulty experienced					
	Never	**Seldom**	**Sometimes**	**Often**	**Always**	**Total**
Total	21.0	18.5	31.9	26.7	1.8	100.0
Place of residence						
Rural	19.4	18.4	32.3	27.9	1.9	100.0
Rural poor	12.4	17.6	32.8	33.3	3.9	100.0
Urban	47.0	20.2	26.0	6.8	0.0	100.0
Urban poor	33.2	25.6	27.5	13.7	0.0	100.0

Source: Republic of Rwanda (2001), p. 21.

Another strong pattern is the correlation between poverty and household activity. Poverty is high for those working in agriculture, especially as wage labour (73% poor) but also for those farming their own land (67% poor). Table 4.3 gives an overview of the economic activity by consumption quintile. Overall, 90% of the population is working in the agricultural sector. Most farmers work on their own account, especially the poor. The production is largely for subsistence, since there are small opportunities to commercialise a surplus. For example, only 15% of the cells have a weekly or daily market and the average distance to market is 4.6 km.

Table 4.3: Main Household Economic Activity by Consumption Quintile

Consumption Quintile	Lowest	Second	Third	Fourth	Highest	Total
Public Sector Employee	0.1	0.5	0.5	2.1	6.3	1.9
Parapublic Sector Employee	0.3	…	0.2	0.5	1.7	0.5
Private formal sector employee	0.3	1.0	0.7	1.5	6.7	2.0
Informal Agricultural Employee	6.4	3.1	3.1	2.5	2.1	3.4
Informal Non-Agricultural Employee	1.7	1.5	2.2	5.3	17.4	5.6
Own Account Agriculture	89.2	91.1	90.7	83.0	50.0	80.8
Non-farm Self Employed	1.5	2.2	2.3	4.6	14.6	5.1
Non-working	0.5	0.4	0.3	0.5	1.2	0.6
Total	100	100	100	100	100	100

Source: Republic of Rwanda (2002a)

Moreover, the incidence of poverty in 2001 was 7.3 percentage points higher in female-headed households than male-headed households. An unusually large fraction of households are female-headed, which is a consequence of the genocide, where many men were killed or arrested.

The health status is still very poor in Rwanda, but it has improved since the genocide. Apart from directly increasing the well-being of the people, health improvements are important for increases of production and income. Maternal mortality in Rwanda is one of the highest in the world, the prevalence of HIV/AIDS is 13.7% among adults, and life expectancy at birth is only 40 years. There are at least two primary health care centres per commune, but this implies an average distance to a health centre of 5.8 km. As many as 70% of the operational costs are covered by individuals, which may explain why 40% of those who are ill among the richest consult a doctor, while only 11% among the poorest do so. Instead 26% among the poorest consult a traditional healer, while only 8% among the richest do so. In a recent study Fofack et al (2003) found that 95% of the respondents who needed the see a health provider but did not do so cited the high costs as the reason.

Education in Rwanda has developed faster than expected, and in 2001 the net enrolment rate for primary school was 73%. However, the net enrolment rate for secondary school is only 8% and there is a high dropout rate for both primary and secondary school, especially among the poor. As much as 90.5% of financing to attend school comes from the children's families, while the state only provides 4.5% and organisations 4% (Republic of Rwanda, 2002a, p.16).[4] The result is that many poor children do not have the means to attain school. Only 15% of the poorest have completed primary school compared to 53% of the richest (Republic of Rwanda, 2002a, p. 17).

Another indicator of wealth is housing conditions. The government is still dealing with the problem of families that have not yet found an appropriate resettlement, but also with the families whose dwellings were destroyed during the genocide. The most common source of water is

[4] However, many schools provided fee exemption for pupils from very poor households (Fofack et al, 2003).

public hydrants, but a large proportion of the population relies on water from rivers and lakes. Electrogaz only supplies electricity to 2.4% of the population; 0.3% in the lowest quintile and 13.5% in the highest. Electricity is only 1% of total energy use in Rwanda, but it is still crucial for the development of the formal sector. There are potentially high returns to the electrification of rural areas, since it is densely populated and it will sooner or later be forced into developing off-farm economic activities, such as the processing of agricultural products and other small-scale industries.

Poverty in the rural areas of Rwanda is mainly associated with underemployment. People work few hours and would be able two have an alternative employment, if any were available. However, 97% of the members of households with own account agriculture (80% of the households) work on the farm only, i.e. there is practically no diversification. The number of hours worked increases by quintile, indicating that underemployment is more severe among the poorer household.

Poverty is also related to farm size as is clear from Table 4.4. Overall, land size is small with only 12.2% of the household having land of 1.5 hectare or more. Even among the rich there are few large-sized farms, but there is still a substantial land ownership inequality in Rwanda with a Gini coefficient of 0.59. About 41% in the lowest income quintile have less then 0.2 hectare, compared to 14.9% in the highest.

Only 7% of the households use purchased inputs on their land, and again there is a big difference among the rich and poor. The proportion of households using purchased inputs on any of their plots is only 2.1% in the lowest quintile compared to 14.3% in the highest.

Table 4.4: Main Household Economic Activity by Consumption Quintile

Consumption Quintile: **Land size:**	**Lowest**	**Second**	**Third**	**Fourth**	**Highest**	**Total**
No Land	5.3	4.3	5.1	8.7	34.1	11.5
0 – 0.2 ha	40.5	34.5	30.9	23.4	14.9	28.9
0.2 – 0.5 ha	21.1	24.4	19.5	17.1	11.9	18.8
0.5 – 1 ha	15.4	19.1	23.6	21.0	13.6	18.6
1 – 1.5 ha	9.5	8.7	10.7	12.5	9.1	10.1
1.5 – 2 ha	4.1	5.1	4.8	8.0	6.2	5.7
2 – 3 ha	2.7	2.5	2.6	5.5	4.7	3.6
3 – 4 ha	0.5	0.4	1.5	1.7	2.3	1.3
4 – 5 ha	0.4	0.6	0.7	0.5	1.1	0.7
> 5 ha	0.4	0.3	0.6	1.5	2.0	0.9
Total	100	100	100	100	100	100

Source: Republic of Rwanda (2002a)

4.2. Trends and Prospects of Poverty Reduction

Poverty reduction is one of the government's national priorities, and this is reflected in the strategies of the PRSP. The priority programmes are concentrated to sectors such as health, education and agriculture that are especially important for the poor. Hence, most of the growth-promoting strategies presented above are simultaneously poverty reducing strategies. The poverty report of Mackinnon (1999) has been an important input into the PRSP process. Mackinnon identifies five, still valid, major challenges that Rwanda faces in its attempts at generating poverty-reducing growth:

1. Increase agricultural productivity by new technologies, improved provision of fertilizers and rural public works to generate both infrastructure and incomes for the poor.
2. Commercialise the agricultural production by reducing transport costs and by develop marketing and credit channels for farmers.
3. Export-orientation of the economy with policy reforms from the macro-level and downwards.
4. Expansion of non-agricultural sectors. Higher incomes in agriculture will stimulate demand and supply in other sectors.
5. Stimulate internal and external migration so that Rwandans could benefit from working in other countries and also from skilled labour immigration.

When it comes to the general macroeconomic stabilization programmes, it is difficult to draw any straightforward conclusions about the effects on the poor (see e.g. Garuda, 2000, and Bigsten, 2003, for a discussion). Still, some remarks can be made. Basically the programmes tend to have two components, namely contraction of public expenditures and changes in relative prices. The aim of the programmes is to create a stable macroeconomic environment, which encourages investment and growth, and if one starts from an unbalanced situation one may have to cut back public expenditures, and this is likely to hurt the poor in the short-term. In the longer term it is the possibilities for the poor to benefit from increased economic activity that matter. This is particularly pertinent for a country like Rwanda, where much of the growth is expected to come from the agricultural sector (see the further discussion in Section 6.2).

The second effect comes via relative price changes. To the extent that the programme includes a currency devaluation, the producers of export goods will gain, while the users of imports will lose. The former would be for example coffee- and tea-producers, while the latter would be for example industries based on imported inputs. One important question for the poor is what happens to food prices, but that is not clear. It depends on the market characteristics for the individual crops, whether they use imported inputs etc. The impacts will certainly vary across categories of poor people. Those that produce for the export market should be the major winners. Those farmers that are net sellers of food would benefit from higher food prices (if that is the outcome), while the net buyers would lose. The urban poor are obviously almost always net buyers, and would be the most likely losers. Rural households that are essentially subsistence producers would not be that much affected. So the overall picture may be quite mixed, but generally devaluations in Africa tend to benefit the rural economy at the expense of the urban economy.

The farm size per household is usually too small to sustain the whole family at a reasonable consumption level, but alternative employments are almost non-existent. The prevailing underemployment is an argument for public work programmes. If it had been the case that members of a household usually worked too many hours, the government would have had to take into account that public jobs would compete for scarce labour (Subbarao, 1997). However, given underemployment, the opportunity cost of a worker is close to zero and the government needs only to consider, a part from the usual project trade-off due to the budget restriction, whether the positive income effects for the workers and the investment benefits for the public are large enough to cover the operational costs of the project. Because of the high density in the rural areas of Rwanda, the returns to these public work programmes are probably relatively high.

The picture given in Table 4.4 is important. Especially among the poor, but also as a national average, the farm size is very small, which is natural in a densely populated agriculturally based country. However, in combination with very low inputs in terms of fertilizers this creates restrictions on growth. One partial explanation for the low input use are the low returns due to the lack of a commercial infrastructure in the agricultural sector. Moreover, with the small plots there is little scope for economies of scale, i.e. the farmers cannot get sufficient returns on agricultural investments.

A land reform is discussed in Rwanda, but given the sensitive nature of this issue (particularly in Rwanda) it has been hard to come to a final conclusion. Still, it seems necessary to reach some decision and give people title deeds, which can be used as collateral for example. A land reform will, however, not have any significant effect on growth or poverty if there is no functioning financial system in the rural area. There is evidence that benefits of a credit system is relatively larger in densely populated countries such as Rwanda (World Bank, 2002c). The financial institutions set up should not be too small, since they have to have a sufficiently diversified portfolio to manage risks. It is also important to have a functioning saving system, making it possible for farmers to insure themselves against the risks that the climate implies for their production. This is especially important for the poor that are living on the edge.

5. Review of Government Policies

5.1. The PRSP and the PRGF

The policy agenda of Rwanda is set out in its PRSP, which was completed in June 2002 (Republic of Rwanda, 2002b). The PRSP was developed in an extensive participatory process and it provided broad guidelines or priorities for the policy makers. The more specific expenditures are presented in a Medium Term Expenditure Framework (MTEF), which is a three-year moving expenditure framework. The MTEF is the starting point for the annual budget. IMF approves and other donors adopt the PRGF which present a macroeconomic framework. The PRGF is incorporated in several stages of the budget process. The basic budget process idea is described in Box 1, although the implementation in some areas still leaves a lot to be desired.

Box 1: The Budget Process

Stage 1: The MTEF process derives from the Vision 2020 document. However, as a "vision" document, the Vision 2020 lacks operative concreteness.

Stage 2: From the Vision 2020 derives the national plan of action, in this case Rwanda's Poverty Reduction Strategy Paper (PRSP), which identifies needs and lays down priorities.

Stage 3: On the basis of the PRSP, sector plans will be drawn up.

Stage 4: This is the actual MTEF stage where a medium term (3-years) expenditure framework is drawn up. This is annually revised.

Stage 5: After the MTEF has been worked out, the actual annual budget is produced and subsequently approved by the Parliament.

Stage 6: Money is transferred to executing ministries to enable the supply of goods and services to the public.

Stage 7: Results of financial, physical and participatory monitoring are then reported back. The current monitoring system is developing but still lacks a wholly functioning reporting system.

More specifically the PRSP has identified six broad priority areas (*Stage 2*):

1. rural development and agricultural transformation
2. human development
3. economic infrastructure

4. good governance
5. private sector development
6. institutional capacity building, and there is supposed to be a specific policy action plan and budget priority programme in each of these areas (*Stage 3*). The specific action plans are still being developed. Plans that are presently developed are at the ministerial level and not in terms of PRSP priority areas.

The government aims to pursue its policies within the PRGF-framework agreed with the donors. Rwanda managed to meet most of the targets in the PRGF for December 2002. It failed, however, on three counts. It missed the goal on net reduction in domestic arrears by 0.5% of GDP. It accumulated some external arrears to the African Development Fund. Finally, the domestic fiscal balance, which was RwF –34.8 billion or 4.2% of GDP, was slightly above target. However, this was due to unexpected expenditures due to the withdrawal of troops from the DRC, and this cost overrun was considered acceptable by the IMF. The first review of the PRGF programme was successfully completed and accepted at the IMF Board Meeting of the 13th of June, 2003.

The medium term macroeconomic targets for Rwanda are a growth rate of 6%, an inflation rate of 3%, and foreign reserves corresponding to 6 months of imports. Against this background the government has formulated its programme for 2003. This programme lies within the resource envelope set out in the PRGF. The government is, however, unhappy about the expenditure limitations imposed by this, and we will return to this issue in Section 6. The GDP growth target for 2003 is set as low as 3.2%, because of an expected return to normalcy in agriculture after last year's bumper harvest. The annual average inflation target is 4.7% and the goal for import coverage is 7.4%. The latter target is above the long run target of 6 months of coverage and is due to the requirement by the IMF that part of the large projected aid inflow be sterilized in the central bank. The IMF believes that the inflow this year represents a spike, and that it is unsound to expand expenditures so that all of the inflow is used up.

The agreed overall deficit on "core" activities is 9.6% of GDP in 2003. This deficit is planned to be increased by 1.1% of GDP to cover certain "non-core" or exceptional expenditures. The domestic revenue is expected to increase from 12.2% of GDP to 13.4%. Foreign financed capital expenditures are programmed to increase by 10.5%. Total spending authorized under the 2003 budget is 0.3% of GDP above the level consistent with the deficit target set out above. Any revenue shortfall is to be offset by reductions in non-priority expenditures.

The Technical Memorandum of May 9, 2003 spells out the details and definitions that are agreed between the government of Rwanda and the IMF. The government agrees that if a programme is over-financed by external budgetary support, the excess is going to be saved. It is also agreed that any shortfall in expenditures in the World Bank led demobilization and reintegration programme will be used to reduce the deficit target. The deficit ceiling will be reduced by the RwF equivalent of any shortfall in earmarked external budgetary support. The ceiling will also be reduced by privatisation revenue and deviation between planned spending to add to the petroleum reserve and what is actually spent.

During the first five months of 2003 monetary financing of the deficit, as a consequence of low foreign aid disbursements, was not offset by a decline in other sources of monetary growth. We see here a very close link between the government deficit and Central bank borrowing and increasing money supply growth (12.3% in the 12 months up to end of May 2003). This in turn has fuelled inflation.

Conditionalities related to Phase 2 of the PRGF

The economic programme for 2003 is spelled out in the "Memorandum of Economic and Financial Policies of the Government of Rwanda for 2003". It covers both macroeconomic and structural policies. It lies within the framework of the PRGF and has received the approval of the International Financial Institutions (IFIs). For the second PRGF review, the programme includes two structural performance criteria and seven structural benchmarks (IMF, 2003b).

The performance criteria and benchmarks in the macro sphere covered by the IMF are as follows:

- A floor on Net Foreign Assets. It is notable here that larger than expected inflows of external budget support is to be saved as reserves. The floor will thus be increased if this happens. This sterilization of the inflow is done to avoid excessive credit expansion. If, on the other hand, there is a smaller than expected inflow the floor will be reduced.
- A ceiling on Net Credit to the Government (NCG) from the banking system (= the difference between credit to the government from the banking system and total government deposits with the banking system). If more than expected budget support flows in, this is to be saved as government deposits. The NCG will then be reduced by the same amount. And again the ceiling can be increased if the inflow is less than predicted.
- A ceiling on Reserve Money. This is the narrow definition of money that is most easily controlled by the monetary authorities. The concept of broad money, which includes bank deposits is an indicative criterion, which is followed, but it is not a performance criterion.
- A ceiling on Contracting of new non-concessional external debt with original maturity of more than one year.
- A ceiling on changes in outstanding stock of external debt, with original maturity of up to and including one year.
- A ceiling on the Domestic Fiscal Balance. This is discussed elsewhere.
- A floor on Recurrent Priority Expenditures. This is to guarantee that the poverty focussed programme says on course.
- A ceiling on Net Accumulation of Domestic Arrears. This is negative which means that domestic arrears are to be reduced.
- A continuous performance criterion on the non-accumulation of non-reschedulable external arrears. This means that the government is to make sure that it does not accumulate arrears to the IFIs.

The World Bank also has a set of conditionalities for tranche releases. They include "the preparation of a financial accountability review and reform action plan, agreement on a plan for the continued implementation of the MTEF, and on the composition and budget allocation to the PRSP priority programs. Conditionalities in the private sector area include progress in the privatisation of Rwandatel and the tea factories, the establishment of a Multi-sector Regulatory Agency and of the coffee and tea boards, the installation of private management at Electrogaz, and restructuring/privatisation of BCR[5]"(IMF 2003a, p. 71). The listing of structural measures in IMF and World Bank Programmes for 2003 (p. 73 – p. 77) includes 75 items. This suggests that there is a very strong IFI-control, which puts a considerable burden on the government in terms of reporting requirements etc.

5.2. Macroeconomic Policy

The current PRGF defines a structural fiscal (base) deficit. This includes exceptional expenditures other than the one-time outlays for the constitutional referendum, presidential and parliamentary elections, one time health operations, additions to the strategic oil reserves and demobilization payments deferred to 2003 from 2002. Much of the exceptional spending is expected to have been concluded by 2005, although some, like assistance to victims of the genocide, are expected to continue beyond that data.

This structural deficit is expected to fall in 2003 from 2.9% to 2.6%. Before grants the targeted deficit is 9.6%. The projected inflows are expected to more than cover this, which means that some of the money is sterilized in the central bank. Tax revenue is expected to reach 13.4% of GDP after some taxes have been increased and measures of implementation improved. Priority expenditures are planned to increase by 17%. External grants and loans to the government were 14.1% of GDP in 2002 and are expected to reach 16.6% of GDP in 2003. Firm commitments for 2004–5 are only around 11% of GDP, though. Against this background the agreement is that some of the aid inflow is to be saved, and the government's domestic indebtedness thereby being reduced somewhat. At the end of 2002 there were three PRGF conditions that were not met, but the situation seems to have improved in the beginning of 2003. In the Statement by the IMF Staff Representative of June 13, 2003 it is noted that "the benchmarks for end-March 2003 for the domestic fiscal deficit, recurrent priority spending, and the net accumulation of domestic arrears appear to have been met."

The aim of monetary policy is to bring inflation back down to 3% at the end of 2003. The target for broad money growth for 2003 is 8%, compared to 12.1% in 2002. Allowing for a range of factors such as the increased monetization of the economy this is estimated to be compatible with a 7.1% increase in reserve money. The latter is thus the target agreed between the IMF and the government for end-2003.

The country pursues a policy of managed float of the currency. The government only intervenes lightly in the foreign exchange market. It supplies predetermined amounts of foreign exchange to a weekly auction

5 Banque Commercial du Rwanda (BCR) is a large commercial bank.

and tries to smooth out market fluctuations. There is a parallel or informal market in foreign exchange, but the spread between the two markets does not exceed 2.5% and is said to be a reflection of higher costs in the official market. The country is planning to open up further towards foreign trade by joining Common Market for Eastern and Southern Africa (COMESA) free trade area on the 1st of January 2004.

Restrictions on government spending may reduce investments, but on the other hand macro stability is good for growth. It is therefore essential for a country to try to establish an appropriate degree of budgetary tightness. The attempts to bring about budgetary discipline in Rwanda are therefore motivated, but the question then is how to define the budget balance. The IMF focuses a lot on budgetary targets excluding aid, with the intention of making the country increasingly self-reliant, financing its own foreign exchange expenditures. It forces the country to pursue a policy that is tighter than what is possible in the short run. Is this desirable?

One purpose of aid is, of course, to make it possible for the recipient government to have larger public expenditures than what the domestic tax base alone would allow. It is therefore natural that it runs a deficit excluding aid. If aid inflows are not used fully in the budget, it will be used to build up foreign reserves or to reduce public debt. This may also be desirable, but one needs to find a reasonable trade-off. If aid flows are expected to be sustained over a long period of time, one should not force the government to do away with the budget deficit excluding aid over that time horizon. If aid is presumed to be temporary this is the appropriate strategy, though. In the case of Rwanda it seems reasonable to assume that there will substantial aid inflows for an extended period of time, provided the government pursues good policies.

There is also a long-term aim to move the core operations to long-term sustainability or balance (IMF, 2003a, p. 11). This is an issue that one could discuss. If core activities are balanced, than donor inflows will have to be used for exceptional expenditures. What is exceptional is, of course, not self-evident, but given the current definitions, there will not be room for much aid within the constrained budget in the future. Given our pessimistic views about the prospects of self-sustained growth in Rwanda and the so far supportive view of donors, it seems reasonable to plan for larger aid inflows over a longer period of time than just what is required to fund exceptional expenditures.

Does Rwanda want to remain one of the most aid dependent countries in the world? After following the debates in the country and interviewing government officials it seems to us that they are. There is some concern about aid dependency, but the general view seems to be that as long as donors provide resources mainly as budget support there is no dependency problem. This is, of course, not quite true since no donors are going to let go of taxpayer's money without having some kind of control over what it is used for. Given that it goes to finance the whole budget, the donors will obviously have to evaluate the whole programme. The government thus has to be willing to take a discussion with donors on the whole strategy. This is, of course, already done within the PRSP process. However, continued strong aid dependence may be a risky strategy, since donors will find it much easier to withdraw budget support than to sacrifice a project that is underway. Should the government feel that it has to do something that annoys donors, the drop in budget funding can be dramatic. Much of the debate on what the appropriate targets are on a range of variables such as expenditures, hinge on what one predicts about the future and how risky a strategy the government is willing to pursue.

5.3. Institutional Reforms and Governance

The focus of the democratisation process that started 1999 has been to decentralize the strongly hierarchical state from before the genocide. The promotion of trust, or social capital, through transparency and grass-root participation in both the design and implementation of programmes, is considered to be a precondition for political stability and economic growth led by the private sector. Hence, the aim of many efforts connected to governance and institution-building is to create a credible political and financial system that will give economic agents faith in the development of the country and hence create an entrepreneurial atmosphere.

Decentralization and Participation

The decentralization of the units of government started in 2000 with the aim of increasing broad-based participation in the design, implementation and monitoring of projects. Elections at the lowest levels, the sector and the cell, were held for the second time in 2002. An important institution in the decentralization efforts is the Community Development Fund (CDF), which was established to oversee and coordinate the administration of the districts. It is also a channel for distribution of the part of the budget (the goal is 10%) that is earmarked for projects or programs at the district levels, and the grants directly allocated to the district level. The priorities of the CDF are education projects, health projects and minor infrastructure projects. Table 5.1 gives a picture of the fiscal decentralisation budget's dynamics.

Table 5.1: Fiscal Decentralization through the recurrent budget and the CDF

	2001	2002	2003	2004proj
Total Budget of Ministries	96.8	96.6	117.5	100.5
Total Budget of Provinces		22.0	25.6	26.6
Total Budget of Districts		3.4	5.5	7.3
– Recurrent*		1.4	1.5	1.8
– CDF**		2.0	4.0	5.5

Note: * 1.5% of last year's domestic revenue, ** gradually moving towards the target of 10% of the budget
Source: Republic of Rwanda (2003b)

The decentralized political system will give the central government a new role. The idea is that the centre will have more of a monitoring role then a controlling role, or a role of giving advice instead of directions (FARAP, 2003). However, the capacity, both in terms of human capital and facilities, is still very limited at the district level, and the decentralization process must go hand in hand with the improvement of the capacity.

The decentralization idea is not only shown in the structure of the government's organization but also in the design of its policies. The PRSP progress document notes that "Rwanda's Poverty Reduction Strategy Paper (PRSP) was produced in November 2001 following extensive consultation with all stakeholders and based on participatory assessment and quantitative surveys on households living conditions". Moreover, there is an expressed goal that the representation and participation of the private sector in policy formulation and financial sector reform should increase.

Transparency

Corruption exists in Rwanda, but it is deemed to be low relative to other African countries. The level is kept low by the decentralization of decisions and by the relative transparency in the budget process. Rwanda has made impressive progress when it comes to the latter. This has been a condition for international support but is also a part of the process of rebuilding social capital.

Data on government financial operations are timely published and a comprehensive reporting system is developing. From 2001 all ministries have an internal auditing service and are supposed to deliver quarterly reports from the beginning of 2003. The Ministry of Economic Planning and Finance will post data on government operations with a one month lag. Another well-functioning institution that is making progress is the Auditor General. In 2003 the Auditor General will conduct 41 audits of public sector entities. It is also approaching a functioning system of annual auditing of all line ministries.

Because of the limited liquidity and in an attempt to increase fiscal control, a cash budget system with quarterly ceilings has been implemented. All expenses must be approved by the Ministry of Finance and can be traced in a computerized payment system. This prevents the separate ministries from incurring excessive expenses, and it limits the possibilities for corruption. However, since the expenses may fluctuate significantly during the year it may create inefficiencies. Hence, in the longer run it may be enough that all expenses are approved by the Ministry of Finance, without quarterly ceilings.

For 2003 the government has established an action plan to further strengthen its capacity to administer public finances and to increase the financial accountability. These include:

- Incorporation of extra budgetary activities in the budget
- Improved management of government bank accounts
- Focus on public debt management improvements
- Continued improvement of the reporting system of district government finances
- Strengthening of the legal system by reforming the system of tax exonerations and by preparing financial instructions guiding the administration of public financing
- Auditing of nine new ministries

An important issue in the evaluation of government performance is the degree to which it manages to execute its programmes. The overall numbers for the execution rate were for 2002 102% for priority programmes (Republic of Rwanda, 2003b). The number is an average over sectors, where the executing rate in some instances was well above 100%. The most prominent of those were the ministries of health, education and infrastructure. Some other ministries under-performed instead. When it comes to the non-priority areas performance is considerably poorer, with 77% for education, 60% for health and 71% for infrastructure. The system is unfortunately still not satisfactory. At present it is possible to track how much money is delivered to each ministry, but there are limited possibilities to follow up how the money was actually used. CEPEX is in charge of the monitoring of the development budget. CEPEX is mainly doing financial monitoring, while control of actual physical implementation of the projects is underdeveloped. The institution argues that it lacks resources to do proper follow ups.[6] A relevant question is, however, why the development budget should be the semi-autonomous body partly outside the government budgetary framework, instead of being incorporated into the Budget Department, which is responsible for the MTEF.

Financial Sector

The financial sector in Rwanda has indeed some serious problems. Non-performing loans as a percentage of gross loans was in 2001 about 30% and there is a lack of diversity of financial products. Loans to the private sector are typically given with a 15–16% interest rate and should be repaid within 5 years or less. On top of this it is not unusual with a collateral requirement of 115–120% of the loan, making it impossible for some groups to get any credit. This is especially true in the agricultural sector, since farmers do not own their land which otherwise could have been used as collateral. Apart from the general high-risk situation in an emerging economy, the restricted conditions on loans are a consequence of the banks' costs of non-performing loans, but also because of the lack of an accounting system, as well as accountants, in the private sector. There are considerable difficulties for the banks to evaluate the prospect of an investment without a proper accounting system.

As a benchmark from the IMF, three banks was audited by the National Bank of Rwanda (NBR), and so was the NBR itself. The large commercial bank BCR got its reconstruction plan approved and was to be sold in the end of 2003. Since then the sale has been postponed to March 2004.. However, since the government needs to recapitalize the banks due to the high share of non-performing loans, they are not expecting a large profit. Nevertheless, there are huge future benefits from having a sound financial system. The IMF and the World Bank will jointly undertake an assessment of the financial sector (FSAP) that

[6] It is only the major projects by the IFIs, African Development Bank (ADB) and the Belgians that are monitored. The agency thinks that the World Bank portfolio is easiest to manage since it has well developed procedures and regular consultations. The European Union funds on the other hand is hard to handle. The bilaterals feel free to implement their projects without caring about reporting and co-ordination procedures and the information on those projects is therefore often poor. Moreover, the contributions of the NGOs are not in the development budget.

together with the governments financial sector study will provide the inputs to an action plan in the end of 2003. An enforcement unit at the NBR will be created in March 2004.

Even though the Union des Banques Populaires du Rwanda (UBPR) was created to promote investments in the rural area, agriculture only attracted 2% of bank credits in 2002. The UBPR has an impressive network and they are successful in collecting the revenues from loans, but some argue that there is lack of training to see new investment opportunities. However, there have been some improvements in credit availability in the rural area via the NBR that are promoting micro-financing, the idea of *Ubudehe*, and the investment possibilities through the Rural Sector Support Project (RSSP) supported by the World Bank and run by the Ministry of Agriculture. *Ubudehe* is supposed to be decentralized budget support, which is supported by the EC but is also an opportunity for some donors that are reluctant to only give budget support to the central government. RSSP has three main objectives: rural infrastructure facilitation, rural technological facilitation and rural investment facilitation. The investment facilitation is mainly through soft loans, i.e. subsidized loans.

Privatisation

The government of Rwanda have been planning to sell 77 companies and by June 2003 37 had been sold. Rwandatel was expected to be sold before the end of 2003 (now postponed to 2004), as are two tea companies. In the end the whole tea sector is expected to be privatised. Moreover, a management contract for Electrogaz for five years has been signed with a private operator.

The main idea behind the privatisation process is that it will make it possible for the government to focus on public goods such as education, health and social infrastructure. This means that the government aims to sell firms of a private character (such as tea companies) or semi-public character (such as energy companies). However, there is a concern that poor areas will be worse off after privatisation, but the risk might be less severe than many believe. First, private companies exposed to competition are expected to be more efficient and lower costs make it profitable to expand production. Secondly, Rwanda had in 2000 a population density of 345 per km^2, which means that a unit of investment in traditional public goods such as roads, telecommunication and energy, will reach a lot of people. This creates possibilities for high returns making it more attractive for a private investor to supply also rural areas. Finally, when needed the government may sign agreements with private firms about production and delivery for specific purposes.

There are five categories of state commitment in the companies in question (Republic of Rwanda, 2003e): (i) Companies that will be withheld by the state, but which have to be restructured to improve their functioning; (ii) Companies in which the state will keep a majority or a minority of the shares; (iii) Companies from which the government will withdraw as a shareholder; (iv) Mixed companies from which the state will sell all of its shares; and (v) companies that are not viable and that have to be liquidated. The goal is that the state should gradually pull out of the commercial activities, and its remaining task will be to strengthen the environment favourable for economic growth and development of the private sector.

Land Reform

The government is planning a land reform in Rwanda. The government is now the owner of all land and the farmers have only user rights. This creates problems not only with regard to the farmers' willingness to invest but also for their possibilities to invest. The main objective of the land reform is to make people willing to make long-term investments, which is only possible if people can be sure of keeping their land, and hence the profits from the investment. Moreover, to provide credit banks will demand security. Without any owned capital the farmers would not be considered as possible borrowers.

One problem is if people are myopic, as in the case of extreme poverty, and sell their land without having any alternative income. This must be considered by the government. Moreover, nearly 3.5 million people returned to Rwanda after the genocide. Some had fled the country in 1959 and others in connection with the genocide. The government made a firm decision that the refugees and repatriated were not allowed to claim their old lands, since it would have created unbearable conflicts. Instead new villages, so called *imidugudu*, were created in the national parks for resettlement. By the *imidugudu* the aim is to promote security and social bonds, but also to facilitate the provision of public services, which will encourage non-agricultural activities and the commercialisation of agricultural products. This has been an accepted solution so far, but might of course be a potential problem when the land reform is on the political agenda.

5.4. Industrial Policy

In the short to medium term, the growth of Rwanda's economy is expected to come from the agricultural sector. However, in "Vision 2020" the government expects the share of the population that is involved in agriculture to drop from 90% to 50%, and the subsistence economy is expected to be transformed into a market-economy. GDP is projected to increase from about $US 260 per person and year today, to $US 900 in year 2020.

A general question is how and to what extent the government should be involved in the promotion of the new sectors. The political and legal insecurity in Rwanda is still considerable, transport costs are extremely high due to the country's poor infrastructure, the capital stock is old, and there is a lack of skilled people. Hence, the government does have a role to play in creating a general favourable investment climate, by for example create physical and financial infrastructure and a stable legal system. Given that the government is able to do this, the investments in production activities should as much as possible come from entrepreneurs.

The Rwanda National Innovation and Competitiveness Program (RNICP) is supporting the goals of Vision 2020. The private sector is seen as the engine of growth, and the general growth strategy of the government is to create an economic structure that encourages private investments and creates a class of entrepreneurs.[7] There is a long way to go since private investments are very low (see Table 3.1). The Rwanda Investment Promotion Agency (RIPA), together with the Private Sector

[7] One example is act that foreign investments over $100,000 are exempted from import and sales tax when importing plants, machinery and equipment (Country Watch, 2003).

Federation (PSF), are promoting Rwanda internationally and coordinates the paper work needed for investments, to attract foreign as well as domestic investors. A necessary (but not sufficient) condition for investments to occur at all is a stable political system, which is also in focus of the government and spelled out in the PRSP.

These types of general government interventions are obviously called for. But to what extent should the government intervene to develop specific sectors? The results of selective industrial policy in Africa have not been good. Direct public ownership is generally not the way to go. To the extent that private returns to certain investments are lower than social returns, government interventions or subsidies may be called for. Such interventions are not easily handled by governments with limited resources, though. Still, there are many activities that the public sector should undertake that can be tailored to fit the needs of the sectors that are predicted to be the growth sectors over the next decades. In that respect it can be of interest to try to think about where the growth potential lies.

So what markets or sectors have the potential to grow? The consultancy firm ontheFRONTIER has been hired by the government to analyse the production possibilities and the market for some sectors, to work out investment plans, as well as creating the needed domestic institutional setting. Certain sectors have been identified both when it comes to "ease of development" and "impact on the economy" (ontheFRONTIER, 2003). Coffee, tea, tourism, fruits and vegetables, are assumed to be easily developed and have a large economic impact. Pyrethrum and horticulture are also assumed to be easily developed but will have a lower impact on economic growth. Financial services and ICT products and services are identified as difficult to develop, but their impact on the economy would be large, not at least as an input in the other sectors.

Coffee and Tea

Coffee and tea are the primary hopes for increased growth according to the consultants. A problem is the already scarce agricultural land for food production, but with the intensification strategies of the Ministry of Agriculture (see Section 3.2), the land area for cash crops can be increased. Another problem is the low prices of especially coffee, but also tea, on the international market. However, the strategy of Rwanda is to cultivate high quality coffee and tea, for which the country has the perfect climatic conditions. The price of high quality coffee is about three times higher then the price of normal coffee and the contracts are not on a day-to day basis but rather on several years (sometimes up to 20 years).

In 1972 the share of Rwanda's coffee production that constituted ordinary coffee was 7%, standard coffee 80%, and superior coffee (i.e. fully washed coffee) 13%. In 2000 the shares are 83% for ordinary, 17% for standard and 0% for superior. The goal is to reverse this trend and in 2010 produce 12% ordinary, 25% standard and 63% superior. When it comes to tea the production is expected to grow from about 17,000 tons per year to 36,000 tons per year in 2010. This requires an increase in productivity from 1,431 kg tea per ha to 2,400 kg per ha.

A first step towards a productive coffee industry is to install washing stations. This has already started, but it is hard to find enough credit. The main sources of credits will probably be soft loans from the RSSP and loans from the CDF. CDF is developed to support public goods, but there are arguments for why washing stations can be seen as public goods, as long as they are open (maybe for a charge) to the whole community. Another important process is the privatisation of tea companies that hopefully will increase the effectiveness and investment rate in the sector.

Tourism

The tourism sector is another expected growth engine. In the mid-80s there were about 35,000 visitors to Rwanda each year, but the rate dropped to zero during the genocide and in 2000 it was only 8,000. The goal for 2015 is 70,000 per year. Rwanda can offer attractions such as gorillas and chimps, national parks, Lake Kivi, etc. A problem with this kind of tourism is that it allows only a limited number of visitors per year. In the case of the gorillas the authorities only allow a maximum of 32 persons per day. However, Rwanda can offer high quality tourism, for which it can charge high fees. Another idea is cultural tourism, probably in cooperation with neighbouring countries. Round-trips of museums and other sites that tell the story of the Great Lake countries' history, could be made possible.

A first step is to build attractive hotels. Many visitors only spend a day in Rwanda and then go back to one of the neighbouring countries. A problem is the past experience of hotel investments. Following the genocide there were many workers in international organizations in the country demanding accommodation, and this led to high returns for hotel construction. However, when they left the country the returns collapsed and the banking sector was left with many non-performing loans. Another major problem for the tourism industry is the infrastructure. Without acceptable roads and electricity supply it is not possible to attract luxury tourists.

ICT

Because of the limited land area of Rwanda, which puts natural restrictions on both agricultural development and tourism, there is hope for success in the more service-oriented sectors. One of these is the ICT sector. An obvious problem is the lack of both human capacity and physical equipment. Even among the large businesses more than 80% do not use computers or are only using basic computer technology. The situation at the local government level looks even worse (even though 80% of the districts in 2003 are, in one way or another, computerized) and there is a need to expand the rural electricity and telecommunication networks, as well as training programmes in basic applications. However, in the longer run and with emphasize on the sector as a supporting sector for the other emerging sectors, it might be a catalysing factor for growth.

Training is mainly given at tertiary institutions such as the KIE, the KIST and the NUR. The first goal is to identify the critical adopters at each stage of the ICT engagement, and develop the infrastructure and training according to them. The adopters that, according to ontheFRONTIER, have both a high ability to buy and use ICTs and a large economic impact are the government, large businesses and maybe small and medium enterprises to some extent. The universities would also have a high ability to buy and use ICTs but the economic impact is expected to be lower. Homes and NGOs are not expected to be early adopters, but internet centres can be set up in towns. Individuals can get access to those for a small fee.

Concluding Remarks

The service sector in Rwanda is still poorly developed, but the government has ambitious plans to try to develop this, particularly the ICT-sector. Given the resource constraints of the country this certainly makes sense. The attempt to improve the level of education is one necessary ingredient of such a strategy. However, the inland location of the country and the poor infrastructure remain tremendous obstacles. To attract investors into the sector, the government must be able to develop an economic environment that is conducive to service activities, or really one that is better than in competing countries. The country has a long way to go before it is there.

5.5. Evaluation of the New PRSP/PRGF Process

Rwanda has entered the PRSP/PRGF process. Has much changed? It seems that there was initially quite extensive consultations with stakeholder, although some of them may well feel that it was hard to influence the contents of the final programme. It is easy to come up with lists of things that are desirable, but the resource constraints do put limits on what can be done. Still, the final PRSP seems quite appropriate for Rwanda. There is still a lack of concrete sectoral policies, but such policies are supposed to be available before the end of the year.

It is not to be expected that old problems will go away quickly. The old administrative system largely remains, and the ways that the administration works cannot be changed that quickly. It is relatively easy to produce a good document (a few experts can do that), but it is much harder to get a heavy administrative apparatus to implement the policies in a systematic fashion. A PRSP does not change the incentive structures within the bureaucracy in any major way, and that is what needs to be done if day-to-day implementation of policies and programmes is to be efficient.

On the positive side the authorities note that there has been an improvement in so far as the IFI staff now is more open to the views of the government, but when it comes to macroeconomic conditionalities there is a discrepancy between what the government wants and what the IMF is willing to accept.

The idea with the new process is that the PRGF shall be embedded in the overall strategy for growth and poverty reduction derived from the PRSP. To do this well one needs a good macroeconomic model framework, and Rwanda is in the process of developing a new macro model that may help in this regard.

There is need for flexibility to accommodate higher levels of spending, and flexibility to accommodate income shortfalls. There is some flexibility in the form of contingency arrangements in the current deal with the IMF, which is good. It is useful that those contingencies are spelled out in the memorandum of understanding. Of course, it is impossible to specify all possible outcomes, so there must also be some room for discussions during the period if there are unexpected shocks.

There does not seem to have been and significant reduction in the number of conditions imposed by the IFIs in the case of Rwanda. When there is a credible government in power, which we believe the Rwandan one to be, it would probably make sense to scale down conditions. For that to be possible there must be new forms of follow up or evaluation, which actually do have credible consequences if the government misbehave. Until such procedures are in place it will be hard to make substantial progress with regard to reductions in standard conditionality.

Rwanda has a fairly good track record of implementation. There has been a considerable shift of resources towards priority sectors, but sustained progress requires a reformed administrative structure with proper incentives and political will. These are the core problems of development in Africa. These governments do not need new initiatives or new administrative structures on top of what they already have. What they need to do is to reform the regular structures so that they can accommodate the ongoing programmes. Structures should not be made more complicated. It is hard to get them to work as it is!

Donor coordination has improved somewhat in Rwanda, but it still leaves a lot to be desired and close to half of the aid does not go though the budget at all. The government tries to draw in as much as it can in the regular system, and feels (probably rightly so) that there are considerable efficiency gains to be had from this. There are examples of duplication and NGOs producing comparable services at much higher cost than the government.

What is required for monitoring are indicators, access to relevant data, publication of monitoring information, and use of this for continuous update and development of the PRSP. There had been some progress here, but the system remains weak when it comes to monitoring what is actually happening on the ground after the money has been distributed.

How much should the donors, notably the IMF, be involved in the domestic policy debate and decision making? It seems reasonable to argue that they should help the government to see to it that key assumptions are realistic, critical tradeoffs are acknowledged, arrangements for dealing with unanticipated shocks are made and several policy alternatives to read goals are considered. IMF should have clear and transparent criteria when it assesses macroeconomic stability and to be open about trade-offs. Still, country ownership needs to be enhanced. This would be possible in a case such as Rwanda, where there seems to be a clear political will to undertake reforms.

To get the administrative structures to work effectively is the key problem. There is a worrying tendency in evaluations to come up with suggestions about new structures. We think one has to be careful not to go too far here. The main thing we think is to make a simple structure work well, and that has to do with training and incentives. To give very weak administrative structure new tasks without eliminating old ones can be counterproductive. A key question is how one can implement new policies without overburdening the weak administrative structures. Either the task given to the administration should be made easier, or the administrative structures should be developed. In the short term the administration and its behaviour are essentially given, so one has to start from there.

6. Should the Public Expenditures and Deficit be Allowed to Increase?

6.1. The Budget Deficit Debate

Over the last few years there has been an intensive debate between the government and the IMF about the appropriate size of the fiscal deficit in Rwanda. This is spelled out in the recent PRSP (Republic of Rwanda 2003b, p.13–14):

> ”The discussion on the optimal fiscal deficit, critical for a post-conflict country like Rwanda, is ongoing with the International Financial Institutions. In this regard, the PSIA (Poverty and Social Impact Analysis) presents a convincing case for increased front-loading of essential fiscal expenditures. The government of Rwanda strongly believes that current public expenditure must be increased in order to set a substantial base for poverty reduction and social stability and to deliver its commitments to Rwandan citizens.”

Since this is the focal point of the current discussion between the government and the donors, we will discuss this issue at some length, while devoting less time to other policy issues that are less controversial.

The government fiscal deficit can be defined in different ways, and in the case of Rwanda there is a proliferation of definitions. The two definitions that are used by the government and the IMF are the domestic fiscal balance and the overall budget deficit. They are defined as follows (with the numbers in RwF billion according to the 2003 budget):

Domestic fiscal balance =	*-43.52*
domestic revenue	117.90
– current expenditures (excluding external interest)	145.01
– domestic capital	10.41
– net lending	6.00
Overall Budget Deficit (excluding grants) =	*-104.30*
domestic revenue	117.90
– total expenditure (excluding debt and arrears)	222.21

The deficit measure used should capture future macroeconomic vulnerability. The primary deficit treats inflows of support differently according to whether they finance recurrent or capital expenditures, since recurrent expenditures are assumed to be harder to change. However, most capital expenditures lead to recurrent expenditures, and the use of this category as a target is an incentive for the government to transfer expenditures from the recurrent to the capital budget. A special problem is that there is a lot of off-budget donor spending that makes it harder for the government to plan and this makes the deficit measures less useful. The PRGF still chooses to set a ceiling on the domestic fiscal deficit as a performance indicator. One argument for using this provided by the IMF is that the overall budget deficit is less precisely measured. Data on the development budget are weak, partly due to problems in CEPEX reporting.

Still, the PSIA-report argues that one should use the overall budget deficit rather than the primary deficit or the domestic fiscal balance. Here overall deficit excluding grants is not the best choice provided donors can provide resources on predictable and flexible terms. The PRGF now stipulates that unexpected grant inflows are to be saved, although some flexibility so far is allowed within the framework of the category exceptional spending. This will soon be phased out, though. The PSIA-report argues that this deficit indicator should not be used as a programme target, because there is need for flexibility to use grants as they become available. Instead they recommend the use of the overall budget including grants. We support this view.

6.2. Evaluation of the PSIA Critique of the Macroeconomic Constraints in the PRGF

The issues

The PSIA provides an ambitious analysis of the appropriateness of the macroeconomic framework. The IMF and others who support the application of the framework are concerned about the possibility of boosting expenditures to levels that cannot be sustained if donor financing is reduced. There is also a concern about the risk of increased indebtedness if funding comes from loans, the disincentive effects of debt for private investments, and the Dutch disease effects of foreign currency inflows on the real exchange rate and thus trade competitiveness. There are further concerns about lack of absorptive capacity within the government and the risk that other expenditures are really financed since there is fungibility. The PSIA discusses these arguments systematically and comes up with the conclusion that in the case of Rwanda there are good reasons for allowing higher expenditures.

As we have already noted, Rwanda has a very weak export base, a small revenue base, low levels of private investment, and exceptional investment needs in the aftermath of the genocide. The PSIA starts by putting the case for higher expenditures in Rwanda. This is not hard to do since there is a very long list of obvious needs. The PSIA (p. 79) lists the following areas: Post-conflict needs, AIDS, declines in soil fertility, high temporary unemployment, and a need to recapitalise the rural sector. There are also warranted temporary expenditures.

The growth strategy of Rwanda is rural based, and increased fertilizer use is seen as a key input increasing agricultural output. The increased output that can emerge from the sector also has to be marketed effectively domestically and internationally, and here the system still leaves very much to be desired. There is an export diversification strategy, which has identified six areas of potential, namely agro-processing, garment exports, ICT services, and tourism, mining and regional exports of skills. There is further a strong emphasis of rural public works to generate rural employment and to help rural development. This strategy still has to be translated into sectoral strategies, and this work is ongoing. The aim is to have drafts out before the end of 2003. This then has to be incorporated in the MTEF within the overall resource envelope. The PSIA notes that it will be hard to cut back on non-priority sectors, so further expansions of priority sectors need to be based on expanded resources.

The increases in real expenditure in the public sector during the first year in the new scenarios that are simulated in the PSIA are as high as 55% and 86% respectively (PSIA, 2003, p. 17).[8] Activities that are envisaged are labour intensive public works, road maintenance and rehabilitation, emergency roofing and water harvesting kits, and additional resources to education, health and agricultural services. These are expenditures that were identified as appropriate by the PRSP should more resources become available, and they all seem to be useful. It is hard to believe, though, that the government could effectively absorb such a large and rapid expansion, even if the kind of uses is carefully chosen not to overburden it.

The PSIA (p.23) argues that the fundamental point at issue in the debate with the IMF is whether "Rwanda needs more resources to address the needs of poverty reduction". We don't think that this is what is at issue, but whether the macroeconomic stance can be more expansionary without undermining prospects for future growth and poverty reduction. There has been a debate about how the government should handle extra external resources, and the PRSP document notes that if expenditures with no macroeconomic impact can be identified, then the programme may be revised upwards. A key issue in the PSIA report is the size of the resource envelope itself, and in particular how the government should handle extra foreign resources that are on offer and which have to be spent when offered.

Debt-sustainability

The PSIA-report argues that a country that borrows on concessional rates under certainty should borrow as much as it can as long as the interest rate is smaller than the country's growth rate. Such a country can borrow any amount without ever having to make net repayments and

[8] The PSIA uses a macroeconomic consistency model to do simulations of policy outcomes. It has some special features. It has for example an equation in which output in all sectors depend on accumulated government expenditures of all sorts. Public expenditures – both recurrent and development – are treated as a capital stock that produces a permanent increase in productivity. The impact of accumulated private investment versus government expenditures varies by sector according to chosen assumptions. Those are not based on data nor are the assumed impacts on output. So the model estimates of public expenditure is a guesstimate (admittedly done by well-informed people, but still very uncertain). The PSIA group (p. 116) has "modelled a sharp spike in expenditure". It is noted, though, that "given wage pressure in a growing economy, this may be unrealistic". We do think that the simulated expenditure increases are beyond the absorptive capacity of the country.

without the debt-service ratio exploding, although the country may eventually run into a quantitative constraint on borrowing and grants. (Mackinnon et al, 2003, p. 27).

When if comes to grants there may be good reasons not to spend the money immediately. If there is no use-it-or-lose-it-constraint, it is often rational to save part of the money rather than use it all at once. Alternatively there may be a use it or lose it constraint, but that the macroeconomic damage is so large that it still makes sense not to use the money.

When it comes to concessionary loans the PSIA identifies three possible reasons for resisting extra expenditures. The first one is that the quantity constraint binds in future periods, so that borrowing now leads to higher net repayments in the future, when discount rates may be higher. The second one is that there is no use-it-or-lose-it constraint, which means that it may make more sense to borrow the money later. The third argument is that the expected returns are less than the concessionary borrowing rate, partly due to negative macroeconomic side-effects.

Increased borrowing will lead to an increase in the debt to export ratio, which could be damaging in the long term. There are four arguments for limiting this ratio. First, a reduced NPV ratio implies that resources can be released for government expenditures other than debt service. Secondly, increased debt leads to higher outflows in the future. Third, a high debt tends to reduce foreign investment and growth. Fourth, a high debt reduces the government's freedom and creates dependency, which may have negative implications.

There are also implications for the HIPC process, if the country departs from the agreed path. Rwanda has a foreign debt of about $1.4 billion, most of which is due to the IFIs. More than half is due to IDA, which offers a 10-year grace-period, 40 years maturity and zero interest plus a service charge of 0.75%. The net present value (NPV) of debt to export ratio was about 600% in 2000, but since then it has come down to a bit above 200%. The aim of the enhanced HIPC agreement is to bring this ratio down to 150%, which is the definition used in this context for a sustainable debt.

The PSIA-report argues that the NPV ratio is not the appropriate target for Rwanda. The IMF uses the need to reach the agreed ratio as an argument for not incurring further debt. It certainly has a point here, since the pay-off if the completion point is reached is high. Still, the PSIA goes on to discuss whether the HIPC way of defining sustainability is appropriate, and this is a larger issue. The PSIA lists five arguments against using the NPV/exports as an indicator. First, it is essentially a proxy for future flows. One should therefore look at flow projections. This will in turn depend on growth projections and debt conditions. There is, however, the argument that foreign investors look at the ratio when deciding whether to invest or not. Second, using this ratio means that debt per capita will be particularly low for relatively closed economies like Rwanda. Thirdly, Rwanda's export is likely to be understated, since there is a lot of trade with neighbouring countries not accounted for. Fourthly, the use of three-year backward looking averages for exports further restricts the NPV ratio, because the country is still recovering from the genocide. Fifthly, the use of NPV means that the sustainability will be affected by changes in interest rates.

The first argument is clearly plausible. It would be preferable to look at flow projections. The second argument is less convincing. If the country is not exporting much, it needs to be cautious with foreign borrowing. The third argument is also rather weak. The question here is to what extent the unrecorded exports bring in money that can be taxed and used to pay foreign debt service. The fourth argument is also weak right now, since exports are stagnating. The fifth argument is a technical one and it does have some validity, but it is not a major point. So the main argument as we see it is that it would be better to look at flow implications rather than stock ratios.

The punch line in the PSIA argument is that as long as the real growth rate of the economy is larger than the borrowing rate one should borrow the money. The PSIA (p. 47–48) presents a simple theoretical exercise, which ends with the expression $(g-r)D$, where g is the real growth rate of GDP, r is the real interest rate and D is the initial real debt stock. When $g>r$ "the net inflows consistent with a stable level of the debt/GDP-ratio is positive and increasing in the level of the debt." As long as $g>r$, the debt ratio can be held constant without the country ever making net repayments. However, there may be future borrowing constraints (the IMF position), which justifies borrowing less than the maximum possible in the short run. If this is the case there will be a trade-off between expenditure in the current period and expenditures in the future. There is also the concern that a debt-overhang may negatively affect private investments in the country. There is some evidence for other countries that this is the case. The PSIA argues, however, that this should only happen when the debt creates a risk of policy reversals or default, which would be less likely if the debt is on concessionary terms.

The PSIA argues that the IMF is too cautious, and the downside risks would better be handled by state-contingent contracts. The PSIA accepts that there are some level at which further borrowings would be imprudent. In that case one would need to go for increased grants or increased debt relief. The conclusion drawn from the analysis is that debt-sustainability post-HIPC is less of a problem than thought, particularly when loans can be got on very concessional terms. We think that this is a reasonable point of view, although we think that the report may underestimate the risks of foreign borrowing somewhat, given the very weak external situation of Rwanda. Some of the proposed ways of increasing export revenue proposed in the PSIA seem too optimistic. It does not seem very likely that there is going to be room for a rapid increase in food staples export to the neighbours, who also have their comparative advantages in agriculture. [9]

Inflation

Excess spending may lead to inflation. High rates of inflation are bad for growth, while it has been hard to show that low rates have significantly negative effects on growth. There is not much evidence indicating that one-digit inflation damages growth, so the target of 3 per cent in Rwanda may be overly cautious. Still, increased public sector deficits will

[9] The predicted growth in potato exports (PSIA, p. 84), for example, seems very optimistic.

lead to inflation if it leads to excessive money creation.[10] Even if it does not lead to monetary expansion, it may lead to inflation. Expenditures in the current period create pressures for expenditure in the future, and this will in all likelihood at least to some extent be financed by monetary expansion. There may also be an effect via expectations, if agents anticipating inflation in the future choose to increase prices now.

Still, PSIA believes that inflation should not be a major concern for increases in public expenditures as long as they are financed out of revenue and external resources. This is a reasonable conclusion.

Types of expenditures

One should distinguish between different types of expenditures. First, some expenditure may be neutral in so far as not having future expenditure implications. Demobilization is a case in point. Secondly, they could be expenditure augmenting, e.g. by leading to staff recruitments that are hard to reverse. Thirdly, expenditures could in principle also be expenditure reducing but for example reducing the future needed for health expenditures. A temporary expenditure push should obviously try to avoid category two as much as possible.

This is clearly a sensible and important point. Still, most expenditures lead to some costs in the future, so the PSIA-report argues that priority should be given to those expenditures that actually reduce recurrent costs. There are such expenditures as suggested above, but they do not make up the major part of the expenditure programmes discussed. So there is a real concern here.

Dutch Disease

Increased government demand has at least three demand-side effects. The first is the Dutch-Disease effect. The PSIA does not consider this a serious problem in the case of Rwanda, but we believe that one may need to worry about this in the longer term if the Rwandan export strategy is to work. If expenditures have short-term effects on demand, while having long-term effects on supply, the prospects are more positive. The PSIA (p. 62) argues that the low level of exports mainly reflect non-price effects. The report also argues that an appreciation leads to cheaper imports and thus makes it easier for e. g. farmers to afford imported fertilizers and investors to afford imported investment goods. Still, the export producers will lose, and smallholder producing coffee and tea are certainly among them. The soft conclusion is that "Dutch Disease effects on exports are not likely to be serious enough to warrant the rejection of grants". A certain effect of aid inflows on the exchange rate is inevitable, but we agree that this is not reason enough to reject grants. Still, we would not dismiss the concern for the real appreciation of the exchange rate. The price effects are surely important in the long run for the prospect of the export strategy.

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[10] Seignorage is the increase in government resources due to an expansion of the liabilities of the monetary authorities. This can be used to finance government expenditures. The PSIA does not find that the use of an inflationary tax is a good idea to finance the deficit in Rwanda.

Costs of public services
The second demand-side impact to worry about is increased prices for the goods and services bought by the government. Public sector wages may well increase if aid-sponsored projects start to compete for skilled people, and doing so offers higher wages than the public sector. This does already happen. On the positive side we have the third effect, which is employment expansion due to government programmes.

The PSIA is concerned about the effect of expenditures on the prices of goods and services bought by the government. They hope that cooperation between the government and donors not to push up wages may help here, but realistically this will probably not work out. So this is a significant concern.

Absorptive capacity
There is also the concern about absorptive capacity (p. 67), which is a major one. Implementation of development projects is of uneven quality, but it could of course be argued that implementation could be improved if more resources were available The report argues for increased efforts to deal with the problem. It provides the somewhat reckless recommendation that "it may be best to ascertain these by planning ambitiously and then seeing what is accomplished." There is also a concern about the lack of sectoral strategies. These are on their way, though, although they will probably not be very sophisticated in their first versions due this year.

The most important part of the agricultural strategy is the increased used of fertilizers (PSIA, p. 87). These are supposed to have higher returns in the Rwandan environment, but still they will have to be imported. And then the increased output has to be marketed. There seems to be limited work ongoing to increased market access and market infrastructure in the rural areas. The development of Rwanda will be very dependent on its ability to develop its economic infrastructure.

Still, administrative capacity is certainly a huge problem throughout Africa, and due to its history it is extra severe in the case of Rwanda. There is a thin layer of skilled people, but the ability to implement programmes at lower levels is much weaker. To get to a stage of self-sustained growth, the development of an efficient administrative structure is a key concern or possibly even *the* key concern. This problem remains even if resources come in the form of grants, and its implications need to be considered carefully before new expenditure programmes are put in place.

So how large is the optimal deficit?
The PSIA group was asked by the government to try to define an optimal deficit for Rwanda (p.119). It does not come up with a specific number, but sets out to show how one could discuss the issue. Their first conclusion is that none of the macroeconomic arguments seem to be strong enough for the government to turn down free money. Hence the macro programme needs to be flexible enough to allow for this. It is noted that it is possible to find good uses for grants (medical drugs, for example) that do very little macroeconomic damage. This suggests that one should not

cap the overall level of expenditures, although certain forms of expenditures might need to be capped. This is a reasonable argument, and it also seems that the IMF is fairly willing to go along with it.

The government says that free money is sitting with the donors waiting to come in, although it may be too optimistic. There is also the issue if the money that comes in must be spent immediately or otherwise be lost. Then there may be good reason to spend it quickly on non-damaging expenditures. However, if the money can be smoothed over time it makes more sense to spread its use in an optimal fashion.

When it comes to loans, the judgement will depend on among other things the likely availability of loans in the future. The PSIA argues that one should choose a borrowing strategy with a higher NPV/export ratio than 150%, and that it does not make sense for a fast-growing economy to turn down IDA-loans. One question here is whether Rwanda really will be fast-growing in the future. Growth is at present highly dependent on the aid inflow.

The PSIA says that there is a strong case for a temporary spike in expenditures, provided that the administrative capacity is there. This seems to us to be a big if! The kind of increases that are simulated seem too large to be feasible. This naturally leads on to the question of managing the composition of expenditures. One wants primarily to avoid bidding up the cost of government's own activities. Therefore it is suggested that one should cap expenditures own wages and salaries, excluding casual work in public works programmes.

The team has the sensible suggestion that both donors and government should be cautious about the proliferation of initiatives. It is better to focus on core activities and to make those work. Uncertain resource flows is a major problem in Rwanda and could be reduced if donors provided longer contracts ay three years rather than one. More concessionary loans are of course better. The use-or-lose-it constraint should be eliminated and the government should be able to shift expenditures across years.

The PSIA group wants more stakeholders to be involved in the negotiations, presumably to soften up the stance of the IMF. The IMF is at present the lead agency when it comes to macroeconomic conditionality, and the other donors essentially have to accept the rulings of the IMF. So how should the stakeholders be involved? This is not obvious. There has long been a realization that donors need to coordinate and that the government should not be provided with contradictory conditionalities. Since the IMF essentially is an organisation controlled by the donors, the appropriate way for the donors to influence conditionalities is to work within the organization and to change its behaviour if it is needed.

IMF's decisions and plans certainly need to be discussed. As part of the PRGF profess there are attempts to make the IMF more flexible, and it seems to us that the IMF in Rwanda has over the years shown considerable flexibility. The question is whether it should cease to be an agent of restraint when it comes to the recourse envelope. There will always be pressures from within the government to spend more, and it might be particularly attractive to increase budget deficits if there is a presumption that somebody else ill pick up the tab if things do not work out. In Europe the EU membership as well as the need to qualify for one has served a very useful role by tightening up fiscal behaviour of European governments. This would not have been so effective if the EU had not been there. So as long as Rwanda cannot join the EU, we feel that the IMF fills this role of an external agent of restraint. This, however, it can do more or less skilfully, and this is what should be discussed.

6.3. Concluding Remarks on the Budget Deficit

With regard to the debate about the size of the resource envelope, which is a bone of contention between the IMF and the government, our evaluation can be summarized as follows: The size of the optimal resource envelope depends on predictions about the future. These are related to what one can reasonably believe about the growth prospects of Rwanda, and to some extent a strategic decision as to how aid dependent the country should be, or for that matter a prediction about how much aid it may receive from the donors in the future. The IMF here takes a fairly cautious stance and argues for a strategy that will let the country finance an increasing share of its budgetary expenditures from its own resources, while the aid share gradually is reduced. On this point we believe that the IMF is pushing too hard for a reduction in aid dependency. Given the situation in Rwanda it both makes sense and seems possible to plan for continued substantial aid inflows in the medium term. It seems premature to move towards a low aid strategy already now.

We think that it is preferable to cast the budget deficit issue in terms of fiscal sustainability, and that it is more appropriate to use the overall deficit definition. It is probably not too risky to expect continued high aid inflows in the medium term.

The IMF also wants the government to limit its indebtedness, to avoid creating problems or risk in the longer term. Because of this the PRGF, which has been accepted by the government with some grumbling, contains constraints on total government expenditures. The budget deficit is defined in a way that makes it possible to use it to reduced external funding of the budget, as well as limits (in relation to the HIPC) process on foreign debt. It should be noted, though, that the IMF has accepted that there are exceptional expenditures due to the special circumstances in the country, which implies that there is a certain frontloading of expenditures that will not be there long-term. It has also accepted that the government borrows money on IDA-terms to such an extent that it will not be able to reach the generally agreed target of 150% of NPV of debt to exports at the time it is supposed to reach the completion point. So to some extent the IMF has been flexible and taken the special conditions of Rwanda into account.

However, the government wants to push ahead with its expenditure programmes at a higher speed that what these constraints allow. There arguments have been put forward most systematically in the PSIA-report. The argument there is that the needs are very large, and because of this there has to be very strong macroeconomic arguments against a more expansionary stance. We have considered the arguments and do feel that the PSIA paper reviews the arguments in a comprehensive fashion and weighs the arguments for or against. This is well done, but as we have noted above we feel that the report may underestimate some of the constraints. There is a risk that this may lead to a stance that is too expansion-friendly. There are real macroeconomic concerns and absorption constraints that have to be considered.

With regard to the issue of the optimal size of the budget deficit, and thus expenditure levels, we do feel that one could argue for a larger deficit if one is convinced that donors will continue to support the country on a large scale, since the growth prospects are still very insecure. This would be easier to recommend if donors were willing to commit resources more long-term. Otherwise one would have to take the risk or possibly try to insure against it in some fashion. At present donors seem quite positive.

With regard to the kind of debt ratio one could live with, there are several factors that one needs to take into account. First, if one can borrow money on very generous terms and invest them in highly productive activities, than there need not be a problem. But to pay back the money there has to be sustained growth and there has also to be export revenues that can be used to pay foreign debt. So far the country has not been able to achieve any significant export growth, and as we have argued above, there are several reasons to assume that the growth prospects are not as impressive as some would have it. We therefore feel that there are reasons to be cautious with regard to foreign indebtedness, unless of course one wants to gamble on their being a HIPC2 eventually if things go wrong.

We do think that there needs to be macroeconomic restrictions imposed on Rwanda, and that the IMF or someone else acts as an agent of restraint is probably sensible. That there has to be macroeconomic constraints is of course beyond question. Economics is about choosing among alternative *within* resource constraints. It is very easy for politicians to be carried away by their ambitions to deal with all problems at once. This is not possible to do.

There is also a serious concern about absorptive capacity. There is a general agreement that the top layer of the administration is of good quality and non-corrupt. But further down the line there is an enormous lack of skills, and therefore there is not an abundance of free resources that can be put to use without overburdening the economy.

There is also an issue of what type of expenditures that one could choose. This also has an effect on how large a deficit one can go for. For example, expenditures that do not require much of scarce domestic resources are easier to handle than projects that do. Distribution of imported medicine may be a case in point. The employment of free labour in the rural areas to build feeder roads is also easier to handle than projects that require more extensive sue of the government machinery. Demobilization expenditures are also an excellent type of activity, since the expenditures cease by definition once people have been demobilized.

So we believe that one may argue for somewhat larger expenditures in the short term, provided expenditure categories are chosen in a reasonable fashion. The finance of this expenditure increase should only be on concessionary terms. We are not ready to come up with a concrete number of the appropriate deficit level on the basis of our brief review. That should be decided in the future debate between the government and donors.

7. Conclusions

7.1. Growth Conclusions

In this report we have looked at several aspects of the Rwandan economy. We started by presenting a list of development determinants that have been identified in the literature as important, and it is now time to revert to them to see what we conclude for the case of Rwanda.

1. Macroeconomic stability. Rwanda has managed to control its macroeconomic situation quite well, and it is indeed moving in a direction that would create a more stable economic environment for investors. The expenditure constraints can probably be relaxed somewhat, provided that concessionary finance is available and the extra resources are used for the right type of expenditures. That means expenditures that do not impose too high short-term costs and that do not generate too much long-term expenditure pressures.

2. International competitiveness. There is a need for increased imports not at least into the agricultural sector, where the growth acceleration is expected to come from fertilizer imports. However, so far there has not been any significant progress on exports, although the government has high expectations with regard to high quality coffee and tea as well as tourism. There are still problems of high transaction costs, due to the poor external and internal transportation systems and high energy prices. Joining regional trade agreements such as COMESA is a step in the right direction.

3. Functioning and competitive domestic markets. This is still a huge problem but one that is recognized by the government. We have in the paper described the challenges and the progress in areas such as privatisation and the establishment of systems protecting property rights.

4. A stable financial system. Most stakeholders in Rwanda mention the problems with the financial system as a major obstacle for investments and growth. The ongoing financial sector reconstruction is important, but also very difficult given the high shares of non-performing loans. The cost to the society of recapitalizing the sector is huge. This has created limited possibilities to provide new loans, as well as a reluctance to give new loans due to the mistrust of investors in general. The reform must be accompanied by the introduction of a standardized accounting system for all companies, public and private, as well as training of accountants.

5. Human capital. The largest part of the expenditures on priority areas already goes to human capital investments, especially in education but also in health. Further expansion of expenditures on these needs would probably have to come from new resources, since it is getting harder and harder to reallocate resources from non-priority activities.

6. An efficient physical infrastructure. The physical infrastructure is a crucial problem for Rwanda. There has so far been limited progress, although various programmes that could help are in place. This area should be prioritised, since it is vital for promoting exports.

7. Limited aid dependence. The government of Rwanda is one of the most aid dependent in the world. This may be a growth problem in the longer term as discussed above. Still, we do not argue that Rwanda in the short to medium term should aim for a low aid strategy. The country cannot as yet achieve self-sustained growth.

8. Sustainable foreign debt. The country is on its way to the HIPC completion point, which is assumed to mean that the country has reached a sustainable debt level. The government is, however, keen to borrow more, and if exports do not take off the country may run into problems in the future due to its debt.

9. Domestic savings and foreign private direct investment should be the main sources in investment finance. Domestic investment and savings, as well as FDI, are very low. This problem is well recognized by the government and measures are taken to increase investments. Many of the policies that we have discussed such as macroeconomic stability, financial monetary reforms, export promotion initiatives, privatisation, and improved property rights, all encourage investments. The most important factor is probably to convince (by good governance) foreign, but also domestic, investors that Rwanda and the region around Rwanda is stable. There are several sectors identified as "growth-sectors", such as high quality coffee and tea, tourism and ICT, which will get special attention from the government. However, the government should not get too much involved in micro-management or crowd out private incentives, which in the end must be the driving force. The government should concentrate on investment promoting public goods, including a stable legal and ownership system.

10. Well-functioning public institutions. The public sector is improving, but there is a lack of both financial capital and human capital, especially at the more decentralized levels. The legal system is overloaded due to the genocide, which creates problems for commercial cases. If courts are not able to deal properly with such cases, the market system will function poorly because of lack of trust and security of contracts.

11. Good governance. Governance is very good in Rwanda compared to many developing countries. The low level of corruption is indeed a comparative advantage for the country in the competition of foreign investors. The accounting system and the transparency of the budget are improving, and an increasing number of financial flows are computerized and possible to follow. The evaluation of the physical execution of projects is, however, still weak.

12. Broad participation of citizens. The PRSP process is well accepted at lower levels, as well as within the private sector and external financiers. The far-reaching decentralization plans are ambitious and aim to build trust throughout the economy. This is an important development but requires capacity building at the local level. Moreover, given the history of the country this seems like a sensible strategy.

13. Political maturity. Rwanda got its constitution accepted through a referendum in March 2003 and held elections for President in August. Elections at district level have been going on since 2001. It is still not a full democracy because of the problems that opposition parties have faced, but the country is at least moving in the right direction.

Concluding, we can only say that the growth prospects of Rwanda are uncertain. Much of the growth we have seen for has been a rebound after the conflict, and it may be hard to sustain current growth rates The economic aspects discussed are interrelated. For example, an open economy will not give growth if there is unstable governance, and a market economy will not function without well-functioning public institutions. Hence, the government of Rwanda has to work on several fronts as discussed through the paper to create a stable growth-promoting environment. There is movement in the right direction in Rwanda, but the country is still far from a situation where it could achieve significant growth without massive aid inflows. The country is thus far from achieving self-sustained growth.

7.2. Aid Implications

What are the implications for Swedish aid to Rwanda? Should Sweden give a larger amount of aid? It seems possible that more aid could be absorbed, but this has to be checked in collaboration with other donors. There is an absorption constraint, and how much that can be swallowed depends on the forms of aid.

It seems desirable to shift resources towards budget support, since this reduces the administrative burden. It also makes it an integral part of the system, and as we argued in the report of last year this is an appropriate way of channelling aid (Bigsten et al, 2002). This will alleviate the burden on a weak, if ambitious, bureaucracy.

The debate in Rwanda mainly has been concerned with the overall resource envelope and the limitations that the PRGF puts on this. Such a constraint is also part of the HIPC process and it seems hard to try to change that specifically for Rwanda. It is important for the country to reach the completion point and to get a substantial debt write-off.

Should Sweden accept that the IMF is the agent that determines whether the country is on or off track? We believe that it would not be appropriate to go for an alternative approach, since donors need to be coordinated. This does not mean, however, that Sweden should not join in the discussion and possibly try to change IMF policies in certain areas. An external agent of restraint is probably a good thing, although it is important to make the policy domestically owned. This has turned out to be necessary if the problems are going to be effectively implemented. Therefore one should aim for a small number of conditions, and those should be on an aggregate level.

Interviewed persons

Mr Vincent Karega, Director of Strategic Planning and Poverty Reduction Monitoring, Minecofin

Ms Consolate Rusagara, First Deputy Governor of the Central Bank.

Mr Ben Karenzi, Permanent Secretary, Minecofin.

Mr Camille Karamaga, Director of Budget, Minecofin.

Mr Musafiri Prosper, Director of Macroeconomic Policy, Minecofin.

Mr Sam Kanyarukiga, Director General, Central Public Investments and External Finance Secretariat (CEPEX).

Mr Jean Jacques Nyirubutama, Director, Disbursements and Portfolio Performance, CEPEX.

Mr Manassé Twahirwa, Deputy Commissioner General, Rwanda Revenue Authority.

Mr Elias Baingana, Executive Assistant to Commissioner General, Rwanda Revenue Authority.

Mr Guido Rurangwa, World Bank Economist in Rwanda

Mr Abdikarim M. Farah, Resident Representative of the IMF in Rwanda

Mr Simon Stevens, Economic Adviser, DFID in Rwanda

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Annex
Country Economic Reports

Halving poverty by 2015 is one of the greatest challenges of our time, requiring cooperation and sustainability. The partner countries are responsible for their own development. Sida provides resources and develops knowledge and expertise, making the world a richer place.

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