odi Briefing Paper

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WHAT WOULD DOUBLING AID DO FOR MACROECONOMIC MANAGEMENT IN AFRICA?

The problem and the approach

Britain and other donor governments have committed to double aid to Africa by 2010. The prospect of such a 'scaling-up' sounds attractive to Ministers of Finance struggling to balance their budgets but the reality is more complex. Many African countries already receive large aid inflows relative to the scale of their economies and budgets. A doubling of aid could bring in extra foreign exchange, investible resources and government revenues on a scale equivalent, typically, to a fifth of national income, 100% of existing investment and a very large proportion of tax revenues. However, a 'macroeconomic shock' on this scale poses real challenges for balance of payments, monetary and fiscal management. There are also related questions about the ability of governments to spend the extra resources wisely. This Briefing Paper explores the consequences of aid scaling-up for macroeconomic management, reports on the results of recent research and makes policy recommendations.

Building on recent work from the International Monetary Fund (2005), ODI commissioned country studies examining the experience of four countries with recent past episodes of an aid surge: Mauritania (in 1999-2002), Mozambique (2000-02), Sierra Leone (2000-03) and Tanzania (2000-03). The IMF study additionally included analysis of Ethiopia (2001-03), Ghana (2003) and Uganda (2000-03). That work was based on a distinction between the absorption and spending of aid (see Box 1); ODI followed this approach, while going beyond it into longer-term and more qualitative matters. It also commissioned a paper on the macroeconomic effects of commodity price surges, to examine what inferences might be drawn from these experiences (see Box 2).

Box 1: The distinction between the absorption and spending of aid

When official aid is transferred to an economy the foreign exchange accrues in the first instance to central bank reserves, while the recipient government is credited with the counterpart value in domestic currency. We call the use of the foreign exchange 'absorption', while the utilisation of the domestic counterpart is labelled as 'spending' the aid.

- Absorption is defined as a widening of the current account deficit (excluding aid), with increased imports financed by more aid, or possibly reduced exports as a result of higher domestic demand. Absorption depends on both domestic demand management and exchange rate policy.
- Spending is defined as a widening of the fiscal deficit (excluding aid) due to additional aid, as a result of higher government expenditures or lowered taxation.

The importance of this distinction is that aid only enables an economy to invest and consume more by financing an increase in imports. If the aid is simply spent on domestically produced goods and services, it does nothing to increase their supply, at least in the short run. Unless there is spare capacity in the economy, the result is an increase in inflationary pressures.

How should developing country governments manage increased aid?

Concentrating on the short-term and ignoring time lags, there are four combinations of the absorption and spending defined in Box 1:

1. Neither absorb the foreign exchange nor spend the counterpart. The aid is saved, with the foreign exchange added to reserves. The counterpart is used by government to reduce its domestic indebtedness but macroeconomic balances are left largely unchanged.

2. Spend the counterpart, without absorbing the foreign exchange. This appears to be the most frequent outcome and is equivalent to deficit financing. If the foreign exchange is added to reserves, but government spends the counterpart on local goods and services, the aid raises the monetary base and domestic demand. This is inflationary unless there is spare capacity in the economy and is apt to disadvantage the private sector.

3. Absorb the foreign exchange, without spending the counterpart. If government saves the domestic currency counterpart but the foreign exchange is sold to finance increased imports, the effect of the aid will be to take demand out of the economy. More resources, and probably more credit, become available to the private sector but exporters may be adversely affected by an appreciated real effective exchange rate (REER).

4. Fully absorb the foreign exchange and spend the counterpart. If the aid is entirely spent on additional imports, the foreign exchange reserves and the budget deficit are unchanged. There is an increase in demand but this is matched by more imports. Absorbing all the aid may require an appreciation of the REER, to induce a sufficient switch in demand from domestic to imported goods and services - known as a Dutch Disease effect (see Box 3).

A key point here is that it is the absorption of the foreign exchange that is critical, since it is only in this case that aid has an impact on the level of production, consumption and investment.

So what policies should governments pursue? On the face of it, Option 4 seems the most desirable: fully absorb and fully spend. This is the combination which donors, concerned to justify their budgets, are most likely to favour. However, it all depends…

(a) On the quality of spending decisions and how these are affected by large increases in resources (see Box 2). If a surge can only be accommodated by lowering the productivity of spending, deferring spending and smoothing it over a longer period may be preferable.

(b) On how the money would be spent, e.g. the division between tradeable and non-tradeable sectors, between consumption and investment, and between developing the public or private sectors.

(c) On the initial state of the public finances. Where the government is operating without reserves to smooth cash flow imbalances, and/or is using the non-payment of bills to the private sector as a management tool, there is a strong prima facie case for not spending all the aid increase, instead devoting it to eliminating arrears in payments and/or building a cushion of reserves. Similarly, where the domestic public debt is large, and where servicing it is onerous, there is a strong prima facie case for using at least part of aid increases to retire public debt. To do so will encourage the growth of the private sector, by lowering interest rates and improving its access to credit.

(d) On the overall macroeconomic situation. For example, spending an aid surge in the midst of large initial inflationary pressures or a commodity boom could be a bad idea. Similarly, absorbing it all through increased imports might not be the best course when external debt servicing claims are large and/or foreign exchange reserves are low.

(e) On the authorities' expectations about whether the aid surge is temporary or will be sustained. This is a central lesson from experiences with commodity booms (Box 2).

Such a wide range of considerations indicates a case-by-case approach is needed. The nearest we can get to a general rule is that governments should avoid large excesses of spending over absorption, because such excesses threaten to generate an inflationary monetary expansion. The authorities may try to avoid this by cutting back on credit to the private sector or raising interest rates.

What is the evidence from country studies?

Table 1 summarises aid utilisation in Ethiopia, Ghana, Mauritania, Mozambique, Tanzania, Sierra Leone and Uganda. The most striking result is the absence of countries classified as having both fully absorbed and fully spent the aid increase – the donors' preferred outcome. A second clear result is that governments were better at spending aid increases through their budgets than they were at absorbing them through increased imports. There is a tension between these outcomes and the 'golden rule', that governments should avoid large excesses of spending over absorption.

The IMF found that Ethiopia and Ghana neither absorbed nor spent the increased aid, taking the opportunity to re-build foreign exchange reserves and reduce government debt. The history of volatile aid receipts (due to the war in Ethiopia and erratic economic management in Ghana) may have prompted both to choose to reduce their vulnerability to future fluctuations. Sierra Leone also needed to re-build reserves and reduce unsustainable deficit financing, but had additionally to finance post-war reconstruction. She therefore absorbed most of the aid, and significantly increased spending.

Mauritania, with high aid and foreign investment inflows, and the prospect of a big improvement in earnings from oil, was able to both increase net imports and add to foreign exchange reserves. This could be viewed as 'full absorption' of the aid if it was assumed that aid was financing the growth in net imports. In practice, a significant share of increased net imports was directly related to private capital inflows to finance oil development and we therefore classify Mauritania as a case of partial absorption.

Box 2: Lessons from commodity booms

The literature on commodity booms suggests a rather strong link between commodity price instability and fluctuations in economic performance, explaining as much as half of variations in country growth rates. This is noteworthy because it is likely that future aid shocks could often be even larger, in relation to the size of the economy, than past terms of trade shocks, with a greater potential for economic destabilisation.

An even more pertinent lesson, however, is that past gains to output and income from price surges have often been meagre and short-lived, while the costs resulting from price declines have been significant and more persistent. The causes of this asymmetry include:

1. Governments incorrectly assume that a temporary increase in revenues will be sustained. In this case, both governments and private actors are apt to increase consumption and incur long-term spending obligations that are costly to exit from. Malaysia, Nigeria and Jamaica all provide examples of this danger.

2. Deterioration in the quality of public expenditure in the boom years. It is difficult for a government to resist spending pressures when revenues increase. Nigeria during past oil boom years is the most notorious example of wasteful public expenditure, but there are other examples, from Malawi to Trinidad to Mexico to Cote d'Ivoire and on. However, this imprudence is not inevitable and, in Africa, Botswana has shown how a commodity bonanza can be harnessed for long-term development.

There are lessons to be drawn from these experiences for the management of aid surges:

- Additional revenues are often badly spent, and it is therefore vital to ensure that credible plans and budgets have been prepared setting out how the additional resources will be used. The strength of in-country institutions influencing the quality of fiscal management, including the underlying nature of their political systems will be specially important here, as also the extent to which donors are able to influence the quality of public finance management. Exchange rate policy is also likely to be important.
- It is sensible for governments to err on the side of caution in spending increased aid revenues because the difficulties of adjusting to future shortfalls can exceed the initial benefits from the aid.

Table 1: Aid Utilisation by Country

	Not Spent	Partly Spent	Mostly Spent	Fully Spent
Not Absorbed	Ghana (0,7)			Tanzania (0,91)
Partly Absorbed	Ethiopia (20,0)		Uganda (27,74)	Mauritania (??,100)
Mostly Absorbed		Sierra Leone*		Mozambique (66,100)
Fully Absorbed				

Figures in parentheses refer respectively to percentages of aid absorbed and spent.
* The data for Sierra Leone are not good enough to provide precise proportions.

Tanzania, Uganda and Mozambique spent all or most of the domestic counterpart but did not absorb the foreign exchange. The increased public expenditure was not truly financed by aid, which was largely saved in higher foreign exchange reserves, but from domestic sources. Essentially, the choice was between increased demand growth and the risk of inflation or tighter control on private sector credit to leave room for faster growth in public expenditure.

Tanzania exemplified the dilemma between risking inflation or frustrating private sector development. Aid to Tanzania increased by 8% of GDP between 1995 and 2004 and was ostensibly the major source of a large expansion of public expenditure. However, the increase in aid was not absorbed through increased net imports. With government revenue constant as a share of GDP, increased expenditure required tight credit controls to avoid an inflationary increase in domestic demand. By 1996, private sector credit as a share of GDP was less than one third of the level of the early 1990s. As a share of a growing GDP, such credit in 2003 was still below the level of the early 1990s. Although lending rates came down slightly, inflation came down far more quickly, resulting in real interest rates increasing from 1% to a peak of 17% in 2000, a rate at which few private investors could be confident of earning profits. Both public and private investment came down during the period of shrinking aid in 1993-96, but private investment continued to fall even in the late 1990s.

Concerns to avoid an erosion of the profitability of exporting may have been part of the reason why several central banks limited aid absorption by not selling all the additional foreign exchange. None of the countries allowed the REER to appreciate; most experienced depreciation during their aid surge periods. Ghana was the exception, where the REER recovered very slightly after a steep decline in the pre-aid period. The REER steadily depreciated in Mauritania from 1995. It also depreciated in Sierra Leone, partly reflecting the relief of supply shortages after the war.

The experience of Tanzania during the second half of the 1990s suggests that subsequent government fears of the consequences of REER appreciation may have been well placed. ,Then, a combination of rapid growth in foreign direct investment in mineral extraction and rising aid resulted in a 25% appreciation. This occurred despite a build-up of reserves, as increased foreign exchange receipts were not matched by increased imports in an economy that was growing only sluggishly. The Bank of Tanzania was only able to reverse the appreciation after 2000 by more aggressive reserve accumulation and slightly looser credit policies. Exports grew rapidly as the exchange rate depreciated. Although much of the increase represented gold exports coming on stream and could not be attributed to the exchange rate, non-traditional exports also took off after 2000.

Unfortunately, our studies threw little light on the quality of increased spending. In Sierra Leone there is evidence of huge leakages of monies for local level health and educational services. There were breakdowns in basic services in the capital city, Freetown, despite the aid surge, because of corruption and government apathy. It is difficult to judge the extent to which this record may be typical of other countries, bearing in mind Sierra Leone's traumatic recent history, but it would be rash to assume that similar weaknesses have not existed elsewhere.

Box 3: A clean bill of health on Dutch Disease?

One potential analogy between the commodity booms analysed in Box 2 and the issue of aid scaling-up is that they may share a tendency to cause 'Dutch Disease'. This refers to a situation in which a foreign exchange surge may shift relative prices – particularly the REER – in ways unfavourable to exporting and import-substituting sectors, in favour of services and other 'non-tradeables'.

This danger is underlined by the large size of prospective aid inflows relative to export and other macroeconomic aggregates. Some research indicates that Dutch Disease is a real problem, including a substantial recent IMF study suggesting that aid has a negative effect on export competitiveness, but other studies have found Dutch Disease effects to be either weak or unimportant.

The message from the countries studied here is generally reassuring. Thus, in Sierra Leone the REER depreciated during the aid surge period and the same was true in Mauritania and Tanzania. The Mozambique study also found no signs of a Dutch Disease problem. To these results may be added the conclusion of the IMF study, that there was no evidence of REER appreciation during the aid surge episodes studied there. One recurring line of explanation for the apparent immunity to this disease was that, in low-income economies, export supply is more likely to be determined by non-price constraints, such as poor transport and storage facilities. This draws attention to ways in which aid can be used so as to forestall the threat of Dutch Disease, by using it to reduce the costs of export production and distribution.

However, there are reasons why we should not reject the possibility that aid scaling-up may erode incentives to export:

- Remember that none of the countries fully absorbed and spent the aid in question (Table 1), so the actual 'aid surge' was limited and there was hence less reason for predicting symptoms of Dutch Disease. Moreover, fear of REER appreciation was precisely one of the reasons for holding back, as in Tanzania.
- The shift in recent years away from using aid for directly-productive development in favour of health, education and other social spending is another source of concern. In effect, non-tradeables have become favoured outputs, increasing the danger of Dutch Disease. Our country cases illustrate this trend, e.g. in Mozambique and Tanzania.
- That the REER did not appreciate is insufficient evidence that Dutch Disease was absent, for it may be that the aid inflows prevented the REER from depreciating to the full extent necessary to stimulate non-traditional exports.
- Relatedly, virtually no evidence was found of aid being used for promoting private sector development. The significance of this is that it is within the private sector that most exports and import-substitutes are produced, while non-tradeables come more from the public sector.

So there is logic and evidence pointing in both directions. It remains an open question whether a large increase in aid to African countries would induce symptoms of Dutch Disease.

Policy recommendations for developing country governments and donors

The work summarised here points towards a cautionary view of the desirability of a large scaling-up of aid to African governments. Four factors are likely to be particularly important in determining the balance of benefits and costs:

1. Co-ordination of fiscal and monetary policies within government. The importance of this dimension is a key finding of the IMF study and is reinforced by our own studies. There is too often a separation of decision-making between central bank and Ministry of Finance staff responsible for budget preparation and management.

2. The predictability of aid flows. Governments' willingness to absorb a future scaling-up of aid will, rightly, depend crucially on the extent to which they and their policy makers can be reasonably convinced that aid will become

more predictable as a source of long-term development finance.

3. The quality of public financial management and the degree of donor influence on this. Box 2 records examples where commodity booms resulted in large-scale waste of public resources in the face of sudden increases in state spending power. Through conditionality, policy dialogue and technical assistance donors seek to ensure that their monies will be well spent and reach intended beneficiaries, so a key issue here is the extent to which their efforts are likely to be successful. The past history of donor-driven fiscal reforms is not encouraging, nor is the wider evidence on the effectiveness of conditionality. Moreover, a large scaling-up would create additional strains: increased pressures to spend within donor agencies, reducing their ability to discriminate in favour of countries with good or improving standards of fiscal management, and a danger that the demands of the scaling-up itself may debilitate domestic efforts to strengthen local institutions.

4. The quality of aid data. If improved coordination of fiscal and monetary policies at the macroeconomic level is to be feasible, it has to be evidence-based – and the evidence has to be available. There are major problems here, including (a) the appalling past record of donor agencies in providing recipient authorities with comprehensive, reliable and up-to-date statistics on actual and intended levels of support and (b) the limited ability (and perhaps interest) of recipient governments to process data and feed it into policy decision processes. Evidently, there is little prospect for a sophisticated matching-up of fiscal and monetary responses if a lot of any increases in aid continues to be 'off budget' and not reported to government.

Policy recommendations for donors

1. Modest but dependable incremental increases in aid would be easier for recipients to manage than large, discontinuous jumps of uncertain sustainability. The current donor commitment to increase aid for the MDGs and sustain it for as long as necessary would, if implemented, represent a very sharp break from past experiences. It is essential to improve the reliability of aid as long-term finance and (more difficult) to convince governments that reliability has genuinely improved, e.g. by such means as the UK's proposal for an International Financing Facility, which would provide greater assurance of dependable long-term flows.

2. The increases in aid-financed public expenditure contemplated across Africa must be accompanied by increased absorption of the aid if it is not to risk crowding-out private sector growth. However, the necessary increased demand for foreign exchange may not be forthcoming without REER appreciation and this may reduce the profitability of exporting, jeopardising eventual reductions in aid dependence. Donors risk pressing ahead with plans for massive aid increases without sufficient prior analysis of the implications for private sector growth, and for the incentive to export.

3. Large rapid increases in aid stand a good chance of being wasted unless they are provided in the context of carefully prepared plans which are often not yet in place. Using aid to break infrastructural and other impediments to greater export success, reversing the excessive recent shift in favour of social spending, will be particularly important. Questions arise about the capacities of African governments to spend rapidly increasing budgets effectively and about the ability of donors to influence this. There is hence a risk that donor disillusion will develop, leading to broken promises and leaving African governments with the familiar problem of the short-run benefits of an aid increase being succeeded by destabilising difficulties, as they try to run expanded services and infrastructures with less than promised assistance.

This Briefing Paper is drawn from Mick Foster and Tony Killick, 'What would doubling aid do for macroeconomic management in Africa: a synthesis paper' (*ODI Working Paper 264*, April 2006).

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Principal Reference

Foster, M. and Killick, T. (2006) 'What would doubling aid do for macroeconomic management in Africa: a synthesis paper' *ODI Working Paper 264*, April.

Further Reading

IMF (2005) 'The macroeconomics of managing aid inflows: experiences of low-income countries and policy implications' IMF Policy Development and Review Department, August 2005, available from the Fund website,

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