THE MACROECONOMIC MANAGEMENT OF FOREIGN AID

Opportunities and Pitfalls

Editors PETER ISARD, LESLIE LIPSCHITZ,
ALEXANDROS MOURMOURAS, BORIANA YONTCHEVA

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Production: IMF MultiMedia Services Division
Cover design: Noel Albizo
Cover photo: Stephen Jaffe

Cataloging-in-Publication Data

The macroeconomic management of foreign aid : opportunities and pitfalls / editors, Peter Isard . . . [et al.] — [Washington, D.C. : International Monetary Fund, 2006].
p. cm.

ISBN 1-58906-520-4
"Presents the papers prepared for the seminar, which was hosted in Maputo by the Government of Mozambique during March 2005" — Pref.
Includes bibliographical references.

1. Economic assistance — Congresses. 2. Poverty — Congresses. 3. Fiscal policy — Congresses. 4. Foreign exchange rates — Congresses. I. Isard, Peter. II. International Monetary Fund.
HC60.M34 2006

Price: $28.00

Please send orders to:
International Monetary Fund, Publications Services
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Telephone: (202) 623-7430 Telefax: (202) 623-7201
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Contents

SESSION III

Dutch Disease
Where Do We Stand?

SESSION IV

Aid, Volatility, and Stabilization Policy. Does Aid Smooth Absorption or Exacerbate Shocks?
Reliability and Countercyclicality

SESSION V

Aid, Debt, and Fiscal Policy

SESSION VI

The Roles of Aid, Governance, and the Political Economy

The following symbols have been used in this book:
. . . to indicate that data are not available;
– between years or months (e.g., 1995–1996 or January–June) to indicate the years or months covered, including the beginning and ending years or months; and
/ between years (e.g., 1996/1997) to indicate a fiscal (financial) year.
"Billion" means a thousand million.
Dollars are U.S. dollars.
Minor discrepancies between constituent figures and totals are due to rounding.

Foreword

I am pleased to introduce this volume on *The Macroeconomic Management of Foreign Aid: Opportunities and Pitfalls*. As I indicated at the United Nations in September 2005, the IMF is a strong supporter of the Monterrey Consensus and is committed to helping countries meet the Millennium Development Goals. The IMF welcomes the recent pledges by the development community to support debt relief and provide a substantial increase in aid flows to low-income countries. Aid provides opportunities, but it also presents pitfalls. We need much more aid, but we also need smarter aid and smarter management of aid.

The IMF is centrally engaged in promoting policies that help countries achieve macroeconomic stability and high-quality growth—the surest and fastest route for reducing poverty. In support of these objectives, the IMF Institute took the lead in organizing a high-level seminar to raise awareness of the macroeconomic pitfalls and trade-offs that can arise in the wake of large new aid inflows. The seminar brought together senior African policymakers, experts from universities and development think tanks, and representatives of the IMF, World Bank, and aid-donor community. This volume presents the papers prepared for the seminar, which was hosted in Maputo by the Government of Mozambique during March 2005, and was cofinanced by the United Kingdom's Department for International Development (DFID) and Germany's Internationale Weiterbildung und Entwicklung gGmbH (InWEnt).

The Maputo seminar recognized the importance of taking maximum advantage of the exceptional opportunity that a significant increase in aid will provide. This will require careful macroeconomic management by aid recipients and supportive efforts by donors.

The papers in this volume address a range of relevant issues:

- The relationship between aid, growth, and poverty reduction.
- The potential for sizable increases in aid to adversely affect competitiveness, and how to avoid this.
- Concerns that aid flows that are volatile, unpredictable, and sometimes procyclical exacerbate macroeconomic stabilization difficulties.
- The impact of higher aid flows on the debt sustainability of recipients.

- The effect of aid on institutions and the political economy in recipient countries.

Ultimately, increased aid presents an opportunity to make major strides in reducing poverty. Improvement will require action by both aid donors and recipients. The IMF will play its part in helping countries manage increased aid flows so as to maintain macroeconomic stability, expand productive capacity, and seize the opportunity to raise standards of living.

I hope that the papers in this volume help in the process of resolving these critical issues. Certainly they open up for debate a number of profound questions that will continue to demand serious attention in the years ahead as we work toward meeting the Millennium Development Goals.

Rodrigo de Rato
Managing Director
International Monetary Fund

Preface

As part of its mandate to enhance the economic policymaking capacity of the Fund's member countries, the IMF Institute periodically organizes seminars at which high-level officials can discuss key policy issues with leading researchers and thinkers from academia and elsewhere. When well designed, the interactive nature of such events benefits both the policymakers and the subsequent research and thinking of the IMF and of outside experts.

Planning for the seminar on "Foreign Aid and Macroeconomic Management" began during the spring of 2004. With the international policy community strongly focused on the need for a large scaling-up of foreign aid and particularly concerned to address the plight of sub-Saharan Africa, the IMF Institute saw scope for a constructive discussion of issues relevant to ensuring that substantially more aid results in substantially more growth and less poverty. Although hardly anyone questions the formidable opportunity that a large increase in aid can provide in helping Africa accelerate growth and poverty reduction, it is critical for policymakers and donors to be well aware of the macroeconomic hazards that must be avoided to ensure that aid is used effectively.

By fall, the African Department of the IMF had agreed to lend its support to the organizing effort; the Government of Mozambique had graciously agreed to host the event and provide logistical support; the United Kingdom's Department for International Development (DFID) and Germany's Internationale Weiterbildung und Entwicklung gGmbH (InWEnt) had expressed strong interests in cofinancing; and an impressive group of experts had accepted invitations to give keynote addresses, present papers, or participate as session chairs or panelists.

In the event, the presentations and general interactions among ministers, central bank governors, and other high-level policymakers, aid donors, and outside experts succeeded remarkably in contributing to a deeper understanding of the key macroeconomic policy challenges associated with foreign aid. The decision to publish this volume reflected both the high quality of the papers prepared for the seminar and the numerous insightful perspectives that were provided during the presentations and general discussions. We have tried to capture many of the valuable perspectives in the overview chapter.

The organization of the seminar required substantial inputs from many people. Valuable contributions to the seminar program, including suggestions for paper presenters and session chairs, were received from Christopher Adam, Catherine Pattillo, and Arvind Subramanian. The African Department of the IMF provided suggestions for keynote speakers and high-level participants, and Mark Lewis did heavy duty in channeling an ongoing stream of logistical questions to appropriate staff in both the African Department and the offices of the IMF's resident representatives in Africa. Perry Perone, the IMF's resident representative in Mozambique, played a key role in liaising with the Mozambican authorities and making the initial arrangements for hotels and other facilities; and two members of his staff in Maputo—Emmy Bosten and Massiquina Calu—put in exhausting efforts over many weeks to ensure that the logistical arrangements worked smoothly. Many Mozambican government officials also devoted considerable time and energy to the organizational efforts. Antonio Laice supervised the government's team, which included Anabela Chambuca, Felix Massangai, Angelo Nhalidede, Manuel Paulo, Otilia Santos, Amilcar de Sousa, and Isabel Sumar.

We are also extremely grateful for the support received from others at the IMF Institute. Prior to the seminar, Eugenia Leonard and Olga Penova were extensively involved for several months—with valuable guidance from Nathalie Kerby-Lachnani and significant help from Jennifer Cook, Thomas Bonaker, Marie Therese Culp, and Deanna Kaufmann—in organizing materials, handling the communications with and administrative arrangements for participants, and dealing with the many frustrations of soliciting responses at long-distance from busy high-level officials. Following the seminar, we relied heavily on the careful and dedicated work of Martha Bonilla, who took charge of the editing and production of the book and recruited David Cheney to help with the editing. And Caryl McNeilly provided a very helpful set of reactions to a draft of the overview chapter.

The views expressed in these papers are those of the authors and do not necessarily represent those of any other institution.

—Peter Isard, Leslie Lipschitz, Alexandros Mourmouras,
Boriana Yontcheva

1

Foreign Aid and Macroeconomic Management

Overview and Synopsis of Key Lessons

PETER ISARD, LESLIE LIPSCHITZ, ALEXANDROS MOURMOURAS, AND BORIANA YONTCHEVA*

I. Introduction

Since the adoption of the Millennium Development Goals (MDGs) in 2000, the challenge of reducing poverty around the world has been more prominent on the agenda of the international community.[1] Relatively slow progress toward meeting the MDGs by the 2015 target date has added to the urgency of this effort. Two influential reports—the United Nations Millennium Project Report (the "Sachs Report") and the Commission for Africa Report (the "Blair Report")—envisage substantial increases in aid flows to poor countries, especially to countries in sub-Saharan Africa. The international community sees increases in aid, along with improvements in recipient policies and freer global trade, as necessary for global prosperity and poverty reduction.

While it seems clear that the MDGs cannot be met without a substantial scaling-up of foreign aid, historical experience provides reason to question whether

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[1] These goals, announced at the United Nations Millennium Summit in September 2000, set targets (in most cases for the period through 2015) for reducing poverty; achieving universal primary education; promoting gender equality and empowering women; reducing child mortality; improving maternal health; combating HIV/AIDS, malaria, and other diseases; ensuring environmental sustainability; and developing a global partnership for development. For details on the MDGs and the definitions of the concepts used, see United Nations (2003).

large increases in aid will translate into large strides toward the MDGs. Aid has indeed facilitated some remarkable successes in helping countries reconstruct or develop rapidly. Major beneficiaries have included the European recipients of Marshall Plan aid following the Second World War, Taiwan Province of China in the 1950s, Botswana and Korea in the 1960s, Indonesia in the 1970s, Bolivia and Ghana in the late 1980s, and Uganda and Vietnam in the 1990s. Aid has also been instrumental in eradicating certain diseases (e.g., river blindness) and clearly has the potential to facilitate large advances toward the MDGs for health and education. But the idea that countries can be lifted out of poverty simply by giving them more foreign aid belies half a century of experience.[2] To maximize the benefits of aid, policymakers and aid donors need to be aware of the important complementarities between aid, policies, and institutions, and to be cognizant of potential macroeconomic hazards to avoid.

The papers in this volume were prepared for a high-level seminar on "Foreign Aid and Macroeconomic Management," which was organized by the IMF Institute and the IMF's African Department, with cofinancing from the United Kingdom's Department for International Development (DFID) and Germany's Internationale Weiterbildung und Entwicklung gGmbH (InWEnt). The seminar was hosted in Maputo by the Government of Mozambique in March 2005. In opening the seminar, Prime Minister Luisa Dias Diogo emphasized that issues of macroeconomic management were complex and not conducive to simple solutions, that these issues were likely to become more challenging with a substantial scaling-up of aid, and that high-level seminars and other efforts aimed at strengthening the capacity for macroeconomic management were very important. Abdoulaye Bio-Tchané (IMF African Department) expressed similar views in his opening remarks, stressing the importance of strengthening not only the specific institutions of macroeconomic management but also the basic institutions and governance processes that support the rule of law.

The seminar brought together high-level African officials, experts from the academic community, and policymakers from the aid-donor community. While many issues relating to the efficient and effective management of aid were discussed in passing—for example, the scale of financial flows needed to meet the MDGs, and the short-run trade-offs between growth-enhancing infrastructure spending and social spending on health and education—the main focus of the seminar was on how to identify and forestall any adverse macroeconomic effects from a large-scale increase in aid flows. Do aid-receiving countries have the capacity to absorb a substantial scaling-up of aid flows? Does donor specification of the timing of spending and the precise sectoral allocation exacerbate the absorption problem? Could a substantial increase in aid shift relative prices in a way that would be detrimental to export competitiveness and longer-term growth prospects? What microeconomic constraints underlie the potential

[2] Easterly (2001).

macroeconomic hazards from scaling up aid? Will the scaling-up of aid exacerbate its volatility and unpredictability? What about the impact of higher aid flows on the debt sustainability of low-income recipients? And what is the effect of aid on institutions and the political economy in recipient countries?

This chapter provides a summary and synthesis of the perspectives that emerged from the papers and discussions in Maputo. Section II places the discussion of the macroeconomic hazards of aid in a broader context. It examines the nexus between aid, growth, and poverty reduction, which was the topic of the first session of the seminar. Section III of this chapter considers the issue of aid-induced Dutch disease—that is, the possible link between aid inflows and a deterioration of the recipient country's competitiveness in global markets—and the associated challenge of mitigating absorptive capacity constraints. It also addresses the trade-offs between different categories of aid-financed spending and the case for frontloading development assistance. This is followed by discussions of the volatility and unpredictability of aid in Section IV, and of debt sustainability and the choice between loans and grants in Section V. Section VI turns to the connection between aid and institutional quality along with the themes that rang through the three keynote speeches. Section VII summarizes the perspectives provided by the panelists in the final session of the seminar, and Section VIII pulls together the main policy messages that emerged from the discussions. The Appendix contains comments on some technical issues raised by the papers presented in Maputo.

II. Aid, Growth, and Poverty Reduction

Aid and Growth

The literature on the effectiveness of aid in promoting growth and poverty reduction is large and inconclusive: thus far, empirical studies have not found strong evidence of a robust and positive aid-growth relationship. The econometric work presented in Maputo provided new perspectives but did not lead to consensus on the effectiveness of aid in promoting growth. Some of the new evidence indicated that the relationship between certain types of aid and growth was more favorable than earlier literature had suggested; other empirical work painted a more pessimistic picture. The discussion was lively, and the debate remained unresolved.

The paper presented by Steven Radelet (Center for Global Development)[3] challenged the disappointing results of most aid effectiveness studies by questioning the appropriateness of basing analysis on an aggregate of all types of aid, which is the standard approach used in the literature. The authors (Radelet, Clemens, and Bhavnani) stress that many types of aid either are given for worthy

[3] Chapter 2 of this volume.

causes that have little to do with economic growth (e.g., humanitarian relief after floods, earthquakes, or other natural disasters; and aid to help democracy) or contribute to growth with long lags that short-run data cannot capture (e.g., spending on education and health). By contrast, aid to fund basic infrastructure or to support agriculture and industry ought to elicit higher growth after fairly short time lags. The absence of a strong link between aid and growth in the findings of many studies may reflect the failure to distinguish between these different types of aid.

Radelet and his coauthors therefore disaggregate aid into three types: humanitarian assistance; early-impact aid to finance infrastructure and direct investments in agriculture and other sectors; and late-impact aid to finance investments in human and social capital. Worldwide, early-impact aid averaged about 2 ½ percent of recipient country GDP between 1973 and 2001, and about 5 percent of GDP in Africa. Drawing on previous work,[4] Radelet's paper reported strong and robust evidence that early-impact aid exerts a powerful effect on growth. For the typical recipient, a 1 percentage point of GDP increase in this type of aid produces an additional 0.31 percentage point of annual growth over a four-year period. This is two to three times higher than previously estimated. By contrast, Radelet and coauthors find no clear influence of long-impact aid on growth and a negative relationship between humanitarian relief and growth, as the latter category of aid is often triggered by adverse growth shocks. They also find that the effect of aid on growth is more pronounced in countries with stronger institutions and longer life expectancy.

Radelet argued that high aid-to-GDP ratios in Africa ought not to alarm us: they reflect low incomes rather than generous aid.[5] Crucially, however, the effect of aid on growth is subject to diminishing returns, so that raising aid beyond some point does not add appreciably to growth. He estimated that, for the typical country, the aid saturation point is 8–9 percent of GDP for early-impact aid; this corresponds approximately to 16–18 percent of GDP for total aid. For some countries, these results may be good news: they suggest that there is substantial room to scale up aid from present levels without bumping into severe capacity constraints. However, the influence of each additional dollar of aid will be lower than that of the previous dollar.

In discussing Radelet's paper, Arvind Subramanian (IMF Research Department) emphasized the need for caution in assessing the growth effects of large aid packages and challenged Radelet's findings based on evidence from Rajan and Subramanian (2005). The latter paper examines whether labor-intensive industries (those in which a poor, developing country should have a compara-

[4] Clemens, Radelet, and Bhavnani (2004).

[5] As Radelet noted, per capita aid in Africa is about $30 per person, or one-third of what Korea received during 1955–75 and about one-fourth of aid to Botswana during the last quarter century.

tive advantage) grow relatively more slowly than other industries in countries that receive more aid. It employs an empirical methodology that exploits variation both within countries and across countries, and finds that aid inflows systematically undermine the competitiveness of labor-intensive export sectors, as reflected in a decline in the share of labor-intensive and tradable goods industries in the manufacturing sector. This result is not surprising at the theoretical level; it is consistent with most conventional models and with recent independent work by Arellano and others (2005) based on a calibrated real business cycle general equilibrium model. But the Rajan and Subramanian paper is remarkable for the robustness of the detrimental allocative effects of aid and the finding that these may occur without appreciable changes in the real exchange rate. Any link between aid and reduced export competitiveness is extremely important, Subramanian argued, because export-led growth has been so central to most successful development strategies.

Several participants raised a separate challenge to Radelet's conclusions based on the notion that aid is *fungible*. If aid is fungible—that is, if recipient governments can reallocate domestic resources in response to aid inflows—attempts to channel it to specific projects or sectors will be frustrated, the composition of public spending will remain that favored by the government, and the intended growth effects of aid might not be realized. Fungibility would not be an issue if the government's objective were to maximize social welfare and if donors and recipients had completely coincident views on how to do so. But in many developing countries the composition of public spending is biased against the poor and against growth. One explanation (Olson, 1965) recognizes the political pressure incumbents face—even in democratic regimes—from organized interest groups. These groups have power to influence the allocation of public resources in their favor, which is welfare-reducing as far as the general public is concerned (Dixit, Grossman, and Helpman, 1997).

Radelet argued that his results amounted to evidence that aid was not fully fungible, since the estimated effects of different categories of aid on growth are very different, implying that aid intended for different purposes has dramatically different relationships with growth. Goodall Gondwe (Ministry of Finance, Malawi) and others voiced support for Radelet's finding, noting that finance ministers cannot completely circumvent the allocative conditions attached to aid.

Radelet's paper also provoked questions about methodology. T.N. Srinivasan (Yale University) wondered whether the use of cross-section regression analysis was the right approach for analyzing the effects of aid on growth. Most developing countries had done very well until the oil shock of the early 1970s. One could argue that the global environment changed around that time, and that the change has had an impact on the development process. In Srinivasan's view, changes in donors' objectives and recipients' capacities and interests in receiving aid can affect the relationship between aid and growth but are not captured in cross-section regressions.

Among others who commented on methodology, Tertius Zongo (Ambassador to the United States, Burkina Faso) noted that a careful appraisal of the growth effects of aid required evaluation of the effectiveness of public spending, and Nancy Birdsall (Center for Global Development) emphasized the importance of looking at the impacts on productivity in assessing whether the growth effects were sustainable. Aart Kraay (Development Research Group, World Bank) added the perspective that cross-country regressions assessed the effects of aid, both directly and through its interaction with policies, after controlling for a host of factors, including institutions; but they did not shed light on the effects of aid on institutions and policies. The channels through which aid matters for institutions and policies are not well understood, but are an important agenda for research.

Aid and Poverty Reduction

Along with analyzing the effectiveness of aid in promoting growth, economists have sought a better understanding of the link between aid and poverty alleviation. Aid can make a direct contribution to poverty reduction. It can also have an indirect effect through its impact on investment, employment, market opportunities, and institutions. Kraay's paper (Chapter 3) addresses the effects of aid on poverty using household survey data from a large sample of developing countries.[6] A key result, which is corroborated by other studies, is that growth is the overwhelmingly predominant force behind poverty reduction: 97 percent of the cross-country variation in changes in poverty can be attributed to cross-country differences in growth, and virtually none of the variation to changes in relative incomes. More controversial, perhaps, is the finding that the impact on poverty of pro-poor growth strategies that explicitly seek to speedily improve the quality of life for the poor is not much different from that of other growth strategies. The latter finding provoked David Bevan (Centre for the Study of African Economies, Oxford) to point out that different countries have very different income distributions. Bevan regarded the view that almost all poverty reduction comes from economic growth—and that the only way to reduce poverty is through the growth process—as a form of extreme pessimism about the feasibility of altering a country's income distribution. He acknowledged that income distributions may be heavily influenced by culture and institutions, but he was somewhat more sanguine about the possibility of change.

A second key result is that the contribution of aid to poverty reduction—both directly and through its effect on growth—is quantitatively small. In a ver-

[6] Kraay first calculates changes in an index of poverty (the headcount measure) and changes in income or consumption. He then decomposes changes in poverty into "growth" and "income distribution" components, and employs variance decompositions to ascertain the relative importance of these two components.

sion of Burnside and Dollar's (2000) cross-country regression, Kraay finds that only 4 percent of the variance in growth is explained by aid, either directly or through its interaction with the quality of policies. By contrast, policies by themselves account for 10 percent of the variation in growth and institutions account for another 7 percent, while more than 60 percent cannot be explained by the specified regression. This underscores the need to better understand the nonaid drivers of growth, including institutions and policies, and how aid can support them.

Along with many other economists, Kraay views governance problems as a significant constraint on growth and poverty reduction in Africa, noting the poor performance of sub-Saharan Africa on measures of governance and the lack of improvement in recent years. He advocates tackling these problems as part of the effort to scale up aid to the continent. He takes issue with the suggestion (e.g., by Sachs and others, 2004) that governance is not an important concern in thinking about scaling up aid to Africa. He also recommends more research on how aid effectiveness can be enhanced by linking aid allocations to measurable improvements in governance. And while the direct poverty-reducing effect of aid through income redistribution appears small, Kraay argues that aid can be successful in addressing *nonincome* poverty—including through public health and other social spending for which long-term growth effects are hard to quantify.

Poverty Traps

Underdevelopment and poverty tend to be persistent. Countries often stay in a vicious circle of poverty for a long time. This might be taken to suggest that poverty is an equilibrium state and that there are forces at work that keep a poor country from developing (Basu, 2000, p. 17). A variety of technological, economic, and political mechanisms can generate such poverty traps. Endogenous growth theory suggests several such channels, which are surveyed by Kraay. For example, financial market imperfections could combine with lumpy investment needs to keep a country's capital stock (broadly defined to include human and physical capital) inefficiently low. This could rob a country of the ability to exploit economies of scale, causing sub-par growth and persistent poverty (Galor and Zeira, 1993). A scaling-up of aid could help a country break free from a low-income equilibrium if the problem involves threshold expenditure needs combined with a lack of resources.

Kraay cites a number of econometric studies that have used a variety of methods and data to look for evidence that poverty traps arise from the existence of investment or savings thresholds that must be overcome. These studies cast doubt on the notion that financial imperfections in combination with lumpy investment needs are responsible for persistent poverty, or that poverty can generally be attributed to low saving by poor countries. As Radelet argued, however, the anecdotal evidence of poverty traps seems particularly strong for the landlocked countries of the Sahara desert, which have been among the poorest countries of the world for centuries and lack opportunities to produce agricultural goods or labor-intensive manufactures. Moreover, Kraay is sympathetic toward the idea that poverty traps could arise from governance problems or from internal or external conflicts. If the problems are conflicts, corruption, or rent seeking facilitated by weak institutions, the success of a "big push" for development would require that these challenges be addressed together with resource needs.

The presentations by Radelet, Kraay, and Subramanian provoked Leslie Lipschitz (IMF Institute) to pose a number of questions. What did Radelet's finding of diminishing returns imply about the aid levels envisaged in the United Nations Millennium Project Report and the Commission for Africa Report? Was the case for a large scaling-up of aid undermined by Kraay's finding that aid explains only a small part of economic growth? Could a big scaling-up of aid be justified if one accepted Kraay's evidence that growth failures could not be blamed on poverty traps caused by threshold expenditure needs? Did the adverse effects of aid on competitiveness, as reported by Subramanian, offset the positive short-run effects of aid found by Radelet?

The discussion of these questions helped generate clarity on several important points. Participants agreed that the urgency of scaling up aid to Africa does not depend on whether poverty traps are relevant or not. However, the absence of poverty traps combined with diminishing returns to aid suggests that substantially scaled-up aid is unlikely to have proportionately much larger growth benefits than small increases in aid; moreover, the detrimental competitiveness considerations raised by Subramanian were particularly relevant to large increases.[7] Also, as emphasized throughout the seminar, the effectiveness of aid depends on much more than its scale. Thus, while the available evidence does not imply that a large scaling-up of aid is a bad idea, it does suggest a need to question unfounded optimism based on the notion of favorable discontinuities in the aid-growth relationship, and to be aware of, and guard against, the various factors that could reduce the effectiveness of aid. While Africa needs and can use more aid, it is not likely that aid will deliver a growth miracle unless other enabling conditions are also in place.

[7] Some participants took issue with this assessment. They thought that saving and technological traps were important in Africa. Situmbeko Musokotwame (Ministry of Finance and National Planning, Zambia) suggested that a large scaling-up of aid for Africa could have effects analogous to those of the Marshall Plan for Europe after World War II. Others countered that Europe in 1945 was a very different place than Africa is today. In particular, although much of its hard infrastructure had been destroyed during the war, Europe still had in place all of the knowledge and much of the human capital and other soft infrastructure needed to make aid effective. Many African countries may have less capacity to absorb large quantities of aid.

III. Aid Hazards Part I: Dutch Disease

Sessions II and III of the seminar focused on the macroeconomic challenge of avoiding the potential hazard of Dutch disease. Participants also addressed the related challenge of expanding absorptive capacity to address the microeconomic underpinnings of Dutch disease, the trade-offs between different types of aid-financed spending, and the implications of frontloading development assistance.

Dutch Disease: Conceptual Frameworks and Evidence

The debate about aid-induced Dutch disease centers on concerns that large inflows of aid could act like natural resource discoveries, inducing a real appreciation of the currency—either through inflation or nominal exchange rate changes—and reducing the competitiveness of exports.[8] To the extent that aid is used to purchase nontradable goods and services that are in short supply, the aid-induced increase in demand drives up the prices of these nontradables and shifts resources out of traded goods sectors. This could hurt development: for many countries successful development strategies have relied on exports to global markets as an engine of diversification and growth. Export production has also been an important source of productivity gains through learning by doing and other positive external effects.

In theory, the effects of aid on the allocation of domestic resources will depend on how the aid is used. It is useful to consider a few stylized cases.

First, suppose aid is used to buy traded goods that would not otherwise have been purchased (owing, presumably, to a dearth of foreign currency). In this case the real resource transfer intended by the provision of aid is effected immediately, the available supply of traded goods is increased, and this should enhance consumption in the recipient country and production to the extent that the imported goods are complementary to domestic goods in the production process.[9] There is no inflationary effect or loss of competitiveness.

Second, suppose that the aid prompts an increase in government spending on nontraded goods, but that the supply of these goods is infinitely elastic over the relevant range of demand because of unemployed resources. Again, there will be no inflation or real appreciation, and the effects of the spending will be wholly

[8] Dutch disease refers to the adverse effects of booming natural resource sectors on manufacturing production and exports. See Corden (1984), Gelb (1988), and Agénor and Montiel (2000). Bulíř and Lane (2002) draw attention to the possibility of aid-induced Dutch disease in their discussion of the macroeconomic and fiscal implications of aid.

[9] Of course, to the extent that domestic goods compete with imports there may be some secondary detrimental impact, but this can be ignored here.

positive. A question arises in this case, however, as to whether the positive effects are related to aid *qua* aid, or simply to increased government spending. There has been no transfer of resources from abroad—that is, net imports have not increased (except perhaps as a secondary effect)—and the same positive effect on economic activity could have been achieved by simply monetizing an increase in government expenditure that succeeded in eliciting a real supply response.

Third, suppose the aid leads to spending on nontraded goods and a consequent increase in the relative price of these goods—that is, a real appreciation—along with a shift of productive resources from the traded-goods sector to firms producing nontraded goods. Again, to the extent that aid is spent on nontraded goods, it does not elicit any real resource transfer from abroad. The inflationary consequences depend on the stance of monetary policy. If the additional spending is supported by a monetization of the increased foreign exchange received as aid (thereby giving the central bank more reserves as a cushion against future balance of payments needs), the increase in the relative price of nontraded goods will come about through inflation. Alternatively, if the monetary effects of the additional government spending are sterilized by selling the foreign exchange, there will be no inflationary impact from money creation but the nominal value of domestic currency will appreciate. In either case there will be a loss of competitiveness.

Clearly, it is this third case that commands much of the attention in the debate about aid-induced Dutch disease. The papers of Bevan and Christopher Adam (Centre for the Study of African Economies, Oxford)[10] draw on earlier joint work with a dynamic general equilibrium model of the effects of aid-financed investment in infrastructure on the real exchange rate and competitiveness.[11] The simulations reported by Adam assume—in contrast to the work of Rajan and Subramanian (2005) and Arellano and others (2005)—that aid-induced spending enhances the productivity of private factors of production. Under this assumption, an aid-induced expansion of public investment can increase long-term welfare and growth in the export sector of the economy even if it is associated with some initial real appreciation. The effect of aid-financed public infrastructure on resource allocation and competitiveness depends on the nature of the associated productivity boost. If the productivity boost favors nontradables, it could offset the appreciation of the exchange rate and explain why Dutch disease is not observed. If, on the other hand, aid raises productivity in the production of nontraditional exports more than that in tra-

[10] Chapters 4 and 7.

[11] This model (Adam and Bevan, 2004) is calibrated to Ugandan data and features several production sectors, several factors of production, and learning-by-doing externalities à la Arrow (1962) and Matsuyama (1992). The economy is closed to capital flows other than aid, so that domestic saving plus the aid-financed current account deficit equals domestic investment in each period.

ditional exports and nontradables, it will likely boost the profitability of producing nontraditional exports and attract domestic resources into their production. In these circumstances, any adverse short-term effect on traditional exports will be offset over time by the growth of the nontraditional export sector, and the overall effect on growth will generally be positive.

In commenting on these results, a question was raised as to whether aid per se is relevant to the growth effects of government spending on nontraded infrastructure. As there is no net transfer of resources from abroad at the time of the spending increase, the spending and the subsequent productivity gains could as well be financed simply by domestic means—borrowing or monetization—without any difference in macroeconomic effects in that period. The only case in which a critical distinction arises between aid-financed and domestically financed infrastructure investment is when the level of foreign exchange reserves is so low as to constitute a threat to confidence and a disincentive to any bold policy action by the government.

Monetary and Fiscal Policy Responses to Aid Inflows and the Case of Ghana

The analysis of Dutch disease, and of the macroeconomic effects of aid more generally, is clarified by considering how monetary and fiscal policies respond to the aid. The paper presented by Andrew Berg (IMF Policy Development and Review Department)[12] uses a case study of Ghana to examine the macroeconomic policy responses to scaled-up aid inflows in 2001–03. The authors (Aiyar, Berg, Hussain, Mahone, and Roache) note that aid inflows rose during this period but were volatile and unpredictable, fluctuating by several percentage points of GDP from year to year. Aid exceeded predictions in 2001, followed by a sharp drop the next year and a greater-than-predicted resurgence in 2003. Ghana went into the three-year episode with relatively weak macroeconomic conditions, including high inflation and public debt, very low international reserves, and a large domestic financing requirement for the budget.

The government of Ghana adjusted its monetary and fiscal policies in response to the variability of aid, and the central bank accumulated substantial quantities of foreign exchange reserves. In 2001, the top priority was the achievement of macroeconomic stabilization. To this end, the authorities limited the budgetary spending of the aid surprise and sought to lower inflation by selling some of the foreign exchange in the market to strengthen the domestic currency and help reduce money growth. With reserves still fairly low at end–2001, the collapse of aid during 2002 led to an easing of monetary policy and a renewal of government borrowing from the central bank, as the fiscal position contracted by less than the aid decline. Following the consequent

[12] Chapter 5.

acceleration of currency depreciation and inflation, the authorities again confronted a need to stabilize. Having been stung by the sharp drop in aid during 2002, the authorities chose to build up their foreign exchange reserves by more than the aid surprise during 2003 and to mop up liquidity through sales of Treasury bills and an increase in reserve requirements for domestic banks. While the accumulation of a foreign exchange cushion was understandable in light of the volatility and unpredictability of aid, Ghana's macroeconomic policy might have been more successful during 2003—including in meeting the objective of bringing the domestic debt ratio down substantially—had the authorities been less aggressive in accumulating reserves.

Relaxing Absorptive Capacity Constraints

In considering the operational implications of the prospect of Dutch disease, it is critical to recognize that the macroeconomic problem of limited absorptive capacity is rooted in microeconomic frictions. Government spending programs should take into account the presence of these constraints, which requires sector- and even firm-specific information. As Bevan stresses, before additional resources are poured into priority sectors, judgments are needed as to whether existing resources are being used effectively; if they are not, the problems must be diagnosed and solved or else there is little point in scaling up aid to these sectors.

This raises the difficult question of how to recognize capacity constraints. Sometimes, constraints can be easily identified. A simple headcount might be adequate in assessing whether there are enough trained personnel to expand social services. In most cases, however, such assessments are more difficult: the existence of capacity constraints may only become clear after outcomes deteriorate, projects fail to deliver planned results, and resources are thus wasted. Bevan is pessimistic about the feasibility of forward-looking diagnoses. Ideally, inputs could be monitored closely, and capacity constraints identified ex ante through activity-based budgeting and other means. But in practice, these approaches are informationally demanding and are probably not easy to implement, especially in countries with limited capacity. The good news, according to Bevan, is that this is recognized in recent public expenditure management strategies that aim at satisficing rather than achieving best practice. And, as others noted, because aid is a process—with expenditures in any sector typically occurring in tranches over time—it is sometimes both feasible and desirable to make early and mid-course corrections in spending plans, based both on current results and a forward-looking assessment. This process of periodic forward-looking evaluation is similar to that used by monetary authorities in operating inflation targeting regimes.

One of the factors that contributes to absorptive capacity constraints is the lack of coordination in many aid-related activities, particularly in social services. The government, bilateral and multilateral donors, and international and domestic nongovernment organizations (NGOs) all deliver services in aid-recipient countries and compete for skilled personnel and other scarce human resources. This competition sometimes leads to either bottlenecks or inefficient allocations. A key challenge is to find ways in which aid can be used to remove bottlenecks while simultaneously allowing better utilization of spare capacity. An aid-financed program for building some critical roads, for example, can eliminate a bottleneck to marketing agricultural produce and allow more complete utilization of arable land and rural labor. Very large competing road projects, however, could result in excess demand for certain types of skills, suck resources out of the agricultural and export sectors, increase wages, and reduce international competitiveness. Clearly, finding an appropriate balance between these outcomes is essential to success.

Allocative Trade-Offs and the Frontloading of Aid

Estimates of the amount of aid required to achieve the MDGs must be regarded as highly tentative, given the deficiencies in our knowledge and the various factors that can influence the effectiveness of aid. Such estimates can nevertheless be informative, particularly to the extent that they shed light on the trade-offs among different types of aid-financed public spending and the implications of frontloading assistance to low-income countries. The paper presented by Mark Sundberg (Development Economics, World Bank)[13] explores these issues using an approach that is similar to that of Adam. The authors (Sundberg, Lofgren, and Bourguignon) calibrate a World Bank dynamic general equilibrium model to Ethiopian data and use it to assess alternative approaches to meeting the MDGs.[14] Meeting the MDGs requires both basic infrastructure and social services (health, education, and water sanitation). Spending on infrastructure helps achieve the objective of cutting in half (between 1990 and 2015) the proportion of people whose income is less than $1 a day. Social spending helps achieve the other MDGs. The paper considers the trade-offs between infrastructure and social spending as well as the implications of alternative time profiles for the various components of expenditure.

According to the simulations generated by Sundberg and his coauthors, the cost-minimizing strategy for achieving the MDGs turns out to combine a

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[13] Chapter 6.

[14] Sundberg and others limit attention to the requirements for achieving the MDGs for poverty alleviation, education, mortality rates, and access to safe water and basic sanitation. Their model includes a considerable amount of sectoral detail and assumes that aid "works" in the sense of being channeled fully into spending on specified goods and services. Aid has supply and demand effects, including on productivity, real wages, relative prices, and competitiveness.

front-loaded expansion in infrastructure spending with constantly growing social spending. It also involves accelerating spending on education to increase skilled labor quickly, as human capital investments take a long time to mature. Implementing this strategy would require raising aid to $60 per capita or 40 percent of Ethiopia's GDP, roughly twice the level of aid per capita to sub-Saharan Africa in the early 1990s.

Seminar participants agreed on the need for careful analysis of the microeconomic and sectoral effects of aid to ensure that it helps the economy get on a path to higher productivity and, ultimately, self-sustaining growth out of aid dependence. It was also recognized that the difficulties of growing out of aid dependence in part reflected factors that discouraged private entrepreneurship. Alan Gelb (Development Policy, World Bank) noted that a multitude of factors raise the costs of private activity in Africa to high levels, including regulatory red tape and a range of indirect costs, such as lack of reliable power and logistics, inadequate port facilities, and security failures. He emphasized that there is considerable scope for African countries to reduce these regulatory and indirect business costs and raise the productivity of the nontradables sectors that provide services to export sectors. Some crude verification was provided by Sundberg's simulations of the implications of improving the productivity of public services at a rate of 2 percent annually: there was a huge benefit from the advance in public efficiency, because it improved the use of all resources, not just the effectiveness of aid. Gelb argued that if indirect business costs came down to levels seen in other countries, African firms could offset the effects on exports of any aid-induced real appreciation and raise wages by as much as 50 percent. What is worrying, in Gelb's view, is that we have seen so little progress in reducing these indirect costs over the past decade.

Seminar participants also agreed on the need to give policymakers more flexibility in allocating aid, and to guard against excessive aid-financed spending on "flavor-of-the-day" projects or sectors. Sundberg's study makes the point that there may be technical, microeconomic reasons why aid-financed infrastructure spending should be more frontloaded than social spending. Raising productivity in social sectors may be difficult, both because of the nature of the goods and services that these sectors produce and because of governance issues. In addition, a massive increase in social-sector spending would pose the risk of repressing nontraditional exports. The donor community must avoid putting all its aid money into sectors that cannot absorb it. Donors should coordinate and consult with each other and with policymakers in recipient countries to identify those areas where aid-financed spending can be used productively.

IV. Aid Hazards Part II: Volatility and Unpredictability

Absorptive capacity constraints and the prospect of Dutch disease raise the prospect that aid can be detrimental to macroeconomic performance unless its use is carefully planned and monitored. Efforts to plan the effective use of aid may be largely for naught, however, when aid flows are highly volatile and unpredictable. As emphasized by Goodall Gondwe, Manuel Chang (Ministry of Finance, Mozambique), Kassoum Karamoune (Ministry of Economics and Finance, Niger), and several other seminar participants, volatile and unpredictable aid flows cause major problems for budget management and macroeconomic stabilization in many countries. Unanticipated declines in aid confront policymakers with a choice between two unattractive options. They can adjust the scale of budget expenditures to the resources available. This is economically and politically costly as its forces policymakers to scale down, postpone, or abandon projects that are typically important for promoting growth and maintaining macroeconomic stability. Alternatively, they can continue financing essential spending through money creation or domestic borrowing, thereby putting macroeconomic stability at risk.

In addressing the hazards of volatile and unpredictable aid, the seminar focused on the empirical evidence, the causes of erratic flows, and various suggestions and initiatives for mitigating and dealing with the problems.

The Evidence

The volatility and unpredictability in aid disbursements is documented in the paper presented by Aleš Bulíř (IMF Policy Development and Review Department),[15] which takes a fresh look at the variability of aid relative to that of domestic fiscal revenues using annual data from a large number of developing countries.[16] The authors (Bulíř and Hamann) examine whether the statistical properties of aid have changed since the late 1990s, when several initiatives were introduced aimed at improving program design and implementation.[17] In addition to asking whether aid flows have become less variable and more predictable, they examine both the general cyclical properties of aid and the question of whether or not aid acts as a shock absorber or implicit insurance mechanism—in particular, whether it rises when countries are buffeted by negative shocks to GDP.

Bulíř and Hamann's findings may be summarized as follows.

First, aid has continued to be more volatile than domestic revenue: the aid-to-GDP ratio in the median aid-recipient country is significantly more

[15] Chapter 8.

[16] Relative variability is the ratio of the variance of aid to the variance of revenues, where aid and revenues are logs of detrended ratios to GDP.

[17] These included the enhanced Heavily Indebted Poor Countries (HIPC) Initiative; the sharpening diagnoses of poverty, broader participatory processes, and enhanced focus on macroeconomic policy design (all part of programs under the Poverty Reduction and Growth Facility); and ostensibly improvements in cooperation among donors.

volatile than the ratio of revenues to GDP.[18] Second, compared with the 1970s and 1980s, aid became more volatile in the 1990s and has remained so during the first half of the present decade. It thus appears that the delivery of aid has not been smoothed by the initiatives of the late 1990s.

A third finding is that aid unpredictability—as measured by the ratio of aid commitments to aid disbursements—has risen since the late 1990s. Actual aid delivery falls short of promises by more than 40 percent. Moreover, aid is more unpredictable the less developed is the recipient country. The finding that aid-recipient countries with higher incomes receive a larger share of promised aid than countries with lower incomes is disturbing: the poorest countries, which need aid the most, can least depend on aid actually arriving.

Bulíř and Hamann also ask whether aid has contributed to economic stability by smoothing out adverse income shocks in low-income countries. In fact, they find that aid is as likely to decrease as it is to increase in the wake of a negative GDP shock.

Several participants posed questions about the measurement of aid volatility. Bevan noted that relative aid volatility could increase because aid became more volatile or because domestic revenues became less volatile. A number of countries had shifted from extensive reliance on volatile trade tax revenues—which were affected by the terms of trade, weather, and other shocks—to broad-based sources of revenues such as value-added taxes, which were more stable. He was interested in how much of the increase in relative aid volatility reflected a reduction in revenue volatility rather than increase in aid volatility. Bulíř responded that about 75 percent of the increase in relative aid volatility was due to an increase in aid volatility and 25 percent due to a decline in revenue volatility.

Some participants took issue with Bulíř's choice of the aid-to-revenue ratio as the metric of aid volatility. Adam argued that there was no single appropriate measure of aid instability—several alternative measures could be useful depending on one's perspective. From the point of view of donors, aid volatility could be measured in terms of donor currency units, in relation to donor budgetary expenditure, or relative to donor GDP. From the point of view of recipients, aid volatility needed to be measured in relation to the overall volatility of the recipient's economy, which depends on trade and other shocks. From the recipient's side, the dominant question was whether adding aid to budgetary resources increased or decreased the smoothing problem faced by governments. Adam wondered whether focusing on the aid-to-domestic revenue ratio led analysts to miss any important covariance effects. Data measurement issues were also relevant. He asked whether the arrival of HIPC

[18] The extent to which aid volatility increases with the degree of aid dependency (as measured by the aid-to-GDP ratio) is, however, ambiguous and sensitive to the particular statistical techniques used.

completion points or other debt forgiveness or restructuring contributed to measured volatility.

Causes and Consequences

A number of factors can contribute to the volatility and unpredictability of aid disbursements in the short run—that is, within the budget year or the normal short-run cycle. The instability of donor commitments, or of donor disbursements relative to commitments, can reflect changes in technical evaluations or political priorities, the workings of donor budget mechanisms, or administrative bottlenecks. Short-run volatility can also arise from the failure of recipients to comply with the conditions specified in IMF-supported or other donor-supported programs.[19] IMF conditions are especially important as many donors base their disbursement decisions on whether or not the IMF signals that macroeconomic policies are on track. From that perspective, Gondwe argued that the quarterly frequency of signals from the IMF under some lending facilities was excessive and part of the volatility problem.

Delays in the arrival of budgeted aid cause mismatches between government receipts and planned expenditures. In many poor countries with shallow financial markets, such mismatches are difficult to manage. Short-run aid volatility then translates either into expenditure volatility—especially for those categories of spending that are relatively easy to postpone (e.g., repairs, maintenance, and investment)—or into additional money creation or debt issuance. As Gelb noted, postponement of spending is costly not only in a direct sense, but also because it weakens the general discipline of government operations, since spending units cannot be held responsible for meeting targets unless they have sufficient resources to carry out their tasks. And as Adam and several other participants emphasized, money creation and debt issuance can cause aid volatility to spill over into volatility in inflation, interest rates, and exchange rates.

As one way to gauge the welfare costs of the volatility, unpredictability, and procyclicality of aid, Arellano and others (2005) use a calibrated real business cycle model to estimate that households would be willing to forgo ¾ of 1 percent of their aid receipts if the remaining aid was provided in a constant stream. For countries where aid receipts are roughly one-fourth as large as GDP, this estimate is comparable in magnitude (as a percent of GDP) to estimates of the welfare cost of business cycle variability in the United States (see for comparison Lucas, 1987; and İmrohoroğlu, 1989). Households would be willing to sacrifice considerably more in exchange for a countercyclical aid stream that offsets the effects of productivity shocks.

[19] About one-half of aid volatility seems attributable to recipients' failure to meet policy conditions (Gelb and Eifert, 2005).

Longer-Term Aid Inconstancy

Careful planning to maximize the effectiveness of aid would be difficult even in the absence of short-run volatility and unpredictability. Bevan's overview paper focuses, inter alia, on longer-term aid inconstancy and provides perspectives on the policy issues it poses for aid-recipient countries. To provide a baseline for discussion, Bevan notes that in an ideal world, donors would precommit to reducing aid flows gradually over time as recipient countries developed, and recipients would have the flexibility to spend the aid when they saw fit. Decisions about whether to spend or save a particular aid flow would depend on whether the flow was permanent or transitory. In the long-run, the aid relationship would end.

The real world is different. Donors are not always able to deliver aid according to predetermined timetables, while recipients have limited flexibility to decide when to spend aid receipts. Donors are now challenged to raise transfers to help poor countries achieve the MDGs, which implies that there must ultimately be a correspondingly larger exit from aid. Bevan emphasizes that managing this particular type of aid inconstancy would be difficult even in the absence of short-run volatility. The reasons are familiar from the experiences that developing countries have had in managing surges of income from natural resources. Many countries have experienced resource-related income surges, have understood the transitory nature of these revenues, and have faced no external constraints on using them. Despite this, they have not always had the expertise to manage such flows effectively. Managing large aid inflows could give rise to similar or more pronounced challenges. Recipients have even less control over aid than over resource income and are sometimes forced to react to aid surges by reducing domestic taxes or raising expenditures, which can be problematic in the longer run.

Mitigating Aid Volatility Problems

Seminar participants discussed several types of measures that could mitigate the difficulties posed by the short-run volatility and unpredictability of aid. Donors could try harder to disburse aid according to agreed timetables and to improve coordination, while recipient countries could try harder to meet the conditions upon which disbursements often depend. In addition, aid recipients could be given more flexibility to decide whether to spend or save aid flows on the basis of judgments about the time profile of future aid flows and the capacity of the economy to absorb an increase in spending in the short run. Such judgments must be made on a case-by-case basis, taking into account country-specific information—including, inter alia, the historical relationship between aid commitments and disbursements.

Several participants reflected on Ghana's strategy during 2001–03—discussed in the paper presented by Berg—in responding to unanticipated fluctuations in aid. Ghana had chosen to avoid spending positive aid surprises in order to build reserves and help bring down inflation. Gelb wondered whether it made sense, as a general response to aid that is volatile and interferes with government operations, to always pursue a conservative fiscal policy, as Ghana had done. In his view, the case for treating positive aid surprises as temporary and negative aid surprises as permanent depended on many factors, including the level of a country's international reserves. Countries facing large and volatile aid inflows ought to build foreign exchange reserves and to strengthen fiscal accounts so as to provide cushions for governments to buffer transitory aid shocks and avoid major disruptions of spending plans.

Catherine Pattillo (IMF African Department) argued that more needed to be done to improve our understanding of the causes of aid instability and its consequences. She favored developing a body of case studies to ascertain the sources of aid volatility. Pinpointing the root causes of aid volatility—whether its was due to shifts in donors' political priorities, the failure of recipients to meet specific conditions, or administrative procedures—would matter a great deal for identifying solutions to the problem.

That said, Pattillo offered some thoughts on how donors and recipients could reduce aid volatility and its effects. On the donor side, she proposed dealing with breaches of conditionality by reducing future aid commitments rather than by imposing immediate aid cutbacks. This suggestion would reduce endogenous aid volatility but needed to be examined more thoroughly, and with consideration to the possibility of time inconsistency problems. A second suggestion was for donors to link their aid forecasts more closely to historical experience and to be more transparent with governments. Donors could also do more to coordinate their aid processes, for example, by agreeing to let one donor take the lead in providing aid to a particular sector and by pooling donor funds. And changes in the global aid architecture—for example, the International Financing Facility (IFF) where donors could create some type of endowment instrument by securitizing future aid commitments—also had the potential to make aid financing more predictable over the longer term.

Several participants stressed that the international community was taking steps to reduce the volatility and increase the predictability of aid. Peter Grant (DFID, United Kingdom) noted that bilateral donors have been moving toward long-term commitments of aid, which provide the basis for more predictable flows. For example, DFID is willing to go to a 10-year commitment period for aid to Rwanda. It will continue to attach conditions in certain areas critical to achieving poverty reduction and the MDGs, maintaining human rights and international treaty obligations, and ensuring the fiduciary responsibilities of donors. So in the new environment of long-term aid commitments, there will still be some residual volatility in aid disbursements ex post. But the reasons for which aid might be turned on and off will be clear and agreed upon ex ante. Finance ministers will know the conditions for disbursements and the implications of their policy decisions.

Speaking for the broader international community, Paul Isenman (Policy Coordination Division, Organisation for Economic Co-operation and Development (OECD)) reported on a ministerial level forum in Paris on aid effectiveness. Bilateral and multilateral donors, recipient countries, and civil society organizations had agreed on a Declaration that focuses on issues similar to those that seminar participants had raised.[20] The Declaration starts from government ownership; addresses the need for aid to be aligned with country priorities and systems, including budgetary systems; focuses on the need for harmonization and simplification of aid; emphasizes managing for development results; and also addresses the important need for mutual accountability. This represents a major effort by donors and recipient countries to move ahead in the spirit of mutual commitment and accountability to speed up implementation of what everyone agrees is needed to make aid more effective.

V. Debt Sustainability and the Issue of Loans Versus Grants

Discussions of the international aid architecture during recent years have revealed growing sentiment for providing less development assistance through concessional lending and more in the form of grants. This shift in sentiment has been motivated in large part by the failure of poor countries receiving concessional loans to achieve debt sustainability. Session V of the seminar addressed issues relevant to the loans versus grants debate. How can we better understand why recipients of highly concessional loans have run into debt sustainability problems? And what considerations should govern the choice between loans and grants?

Conceptual and Empirical Perspectives on Debt Sustainability

The paper presented by Bikas Joshi (IMF Policy Development and Review Department)[21] sheds considerable light on the debt sustainability problems of low-income countries since the early 1990s. The authors (Daseking and Joshi) show that whether the ratio of debt to exports becomes smaller or larger over time depends on whether the interest rate on external debt is less than or greater than the growth rate of exports. It also depends on the size of the non-interest current account deficit relative to exports, the extent to which the

[20] "Paris Declaration on Aid Effectiveness," by the OECD Working Party on Aid Effectiveness and Donor Practices (OECD, 2005). The Party comprises ministers, heads of aid agencies, and other senior officials from 60 donor and recipient countries and more than 50 donor organizations. The text of the Declaration and related information can be found at www.aidharmonization.org.

[21] Chapter 9.

noninterest current account deficit is financed by new debt, and the degree of concessionality of the new debt.[22]

Daseking and Joshi examine debt dynamics for 72 low-income countries during 1992–2003. With the average export growth rate of 8.1 percent a year far exceeding the average interest rate of 2.7 percent, the debt-to-exports ratio declined for the "average country" over the period even without accounting for debt relief. This "average" result, based on mean values, was, however, misleading, as the variance among countries was high. Indeed, application of the debt dynamics equation using the median values of relevant variables indicates that, in the absence of debt relief, the ratio of debt to exports for the "median country" could have remained stable only at a relatively high level, and the ratio of debt to GDP would have risen. For many countries, debt sustainability problems worsened, even though loans were highly concessional.

Loans Versus Grants: Basic Considerations

In light of these findings, Daseking and Joshi examine the various considerations in the loans versus grants debate and what needs to be done to achieve the MDGs without undermining debt sustainability. Grants have the obvious advantage of not contributing to the debt distress and forgiveness pressures historically associated with loans. Grants may be particularly appropriate for financing spending on basic social services and human capital investments that have returns with long gestation periods, or that borrowing governments cannot easily capture either directly or through additional tax revenue.

A key advantage of loans is that, *for a given net present value of assistance*, they allow a larger gross flow of resources than grants, which can be important for countries without access to private capital. A second attraction is that reflows from concessional loans can be used to help poor countries in the future. It has also been contended that loans force countries to determine that their projects are worth financing; this assists them in eventually overcoming informational barriers to accessing capital markets. Also, the need to service loans makes recipients more cautious about the use of these resources and gives them incentives to build debt management capacity.

Daseking and Joshi point out that the availability of larger gross resource flows can conceivably justify loans even if some projects fail ex post and require

[22] To develop a conceptual framework, Daseking and Joshi use a country's balance of payments accounting identity to decompose the sources of growth in its external debt. They separate the current account deficit into interest payments on external debt and the noninterest current account deficit; they divide the sources of financing of the current account deficit into debt-creating flows (such as bank loans or sovereign bonds) and non-debt-creating flows (such as foreign direct investment); and they manipulate these definitional identities to derive a "debt dynamics equation" for the net present value of debt as a ratio to exports.

debt forgiveness. This assumes, however, that the volume of lending makes it possible to raise poor countries' investment relative to what would be feasible with the amount of assistance available under a grants-only approach, and that in making decisions about debt relief, it is possible to distinguish between project failures that can be blamed on bad luck and those that are attributable to recipient country behavior. If there is moral hazard, a lend-and-forgive policy would be a problem.

Choosing the appropriate mix of loans and grants involves weighing the benefits of the larger gross flows that loans allow against the risks of future debt problems. Daseking and Joshi favor an approach that tailors the form of assistance to the characteristics of the projects and/or the recipient countries. Under a projects-based approach, grants might be relied upon to fund investments with high social returns but uncertain or delayed financial returns—such as spending on education and health. Loans might be used to fund projects that generate high and timely returns to the budget, such as infrastructure. But the rationale for such a projects-based approach is weakened to the extent that grants and loans are fungible. Moreover, a projects-based approach that tried to limit fungibility could be difficult to implement effectively and would risk compromising domestic ownership.

An alternative approach would base the mix of loans and grants on country characteristics. Donors would tailor the blend of aid to the needs and absorptive ability of the particular country. Under an algorithm proposed by Radelet and Chiang (2003), need would be based on economic and social indicators, while ability would be assessed in terms of growth prospects. Poorer countries would receive more grants, while faster-growing countries, and those with sounder policies and institutions, would receive more loans.[23] The country's debt sustainability and exposure to volatility would also be considered in the loans versus grants decision. An approach based on country characteristics is operationalized in the IMF's new debt sustainability framework for poor countries (IMF and IDA, 2004, 2005).[24]

[23] In comments during the seminar, Radelet suggested that the World Bank and regional development banks should switch to a grants-only approach in assisting extremely poor countries—those with per capita incomes below a threshold of about $400. These are countries that have been unable to sustain growth over the past several hundred years and that would have difficulty repaying loans. An IDA-type window should be used for countries with per capita incomes between, say, $400 and $1,000, and countries with higher incomes should receive regular IBRD loans. Radelet would treat China and India as special cases—they would be considered for IDA or IBRD loans, not grants.

[24] As detailed by Daseking and Joshi, this framework consists of (i) indicative debt-burden thresholds that are linked to the quality of a country's policies and institutions; and (ii) standardized, forward-looking analysis of a country's external debt and debt-service dynamics, including sensitivity tests to examine the implications for debt sustainability given plausible shocks. On the basis of these assessments, the framework tailors the loan versus grant decision to a country's risk of debt distress.

Loans Versus Grants: Additional Considerations

In commenting on the loans versus grants issue, Srinivasan thought that the analytical framework of the Daseking-Joshi paper was incomplete. In particular, as Charles Soludo (Central Bank of Nigeria) had emphasized in his keynote address (see Section VI of this chapter), the effectiveness of aid depended on deeper political economy issues that had to do with commitment to future actions on the parts of donors and recipients, along with the capacity to design and implement policies that delivered development. Loans established an extended relationship in which recipients made decisions about whether or not to default and donors decided what to do with loan repayments. Whether grants had a different effect than loans depended on whether or not there was an expectation that grants would be given repeatedly to create an intertemporal resource flow comparable to that of loans. In Srinivasan's view, if a country had leadership committed to development and a team of experts who could design and deliver it, and if the donor and recipient agreed on the objectives of development, the choice between grants and loans was irrelevant.

Gelb offered a different perspective on the loans versus grants issue. In providing loans to a country, donors were taking a bet on the recipient's long-term growth. This made development lending a form of quasi-equity investment, even though the loan contract did not formally recognize that. Within the International Development Association (IDA), the compact was that countries that succeed in growing and moving up to middle-income status would pay back, thereby providing an enhanced volume of resources and easing the burden on donors. By contrast, the type of algorithm proposed by Radelet and Chiang (2003) might have led to grant aid for China had it been implemented several decades ago, when Africa was richer than Asia. Gelb saw the IDA framework as a pragmatic way of dealing with the difficulty of predicting how well countries would perform ex ante and keeping debt service low for countries that remained poor.

Peter Heller (IMF Fiscal Affairs Department), Famara Jatta (Central Bank of The Gambia), and Radelet raised the issue of the recurring costs associated with aid. Projects financed with either loans or grants often involve ongoing operations and maintenance outlays that need to be incorporated into the analysis. Heller also emphasized that whether or not donors get more leverage out of loans depends on whether the loans are repaid. Subramanian argued that the arithmetic of debt distress suggested, on average, a very low rate of return on loan-financed projects.

Peter Grant noted that bilateral donors had already shifted from loans to grants, and that the current loan/grant shift in World Bank policy meant that many of the poorest countries were on a grants-only basis in IDA.[25] The

[25] While eligibility for IDA assistance is based on income, the decision between loans and grants is based on a country's risk of debt distress (not income), with countries assessed as having high risks of distress receiving only grants and those at moderate risk of distress receiving 50 percent loans and 50 percent grants.

remaining question was whether concessional loans should survive. He agreed with Radelet that it was critical for donors to give the same rigor to grants as they do to loans, and to make grants go through the budget just as much as loans. Grant also thought that the key consideration in the grants versus loans decision ought to be debt sustainability rather than recipient countries' income levels.

Berg noted that unlike IDA and other multilateral and bilateral donors, the IMF had not—and would not—switch to grants, partly because of the nature of its funding. The IMF's role was to point out cases where countries had an increasing need for grants rather than loans. He took issue with Srinivasan's argument that the form of financing was irrelevant for countries that had ownership and a commitment to the right development agenda, since a country's development agenda might not work out for a number of reasons beyond its control. Berg agreed that it was important to consider both domestic debt and external debt when assessing debt sustainability and considering the grants versus loans question. In the new debt sustainability framework, domestic debt was integrated into the country analysis and influenced assessments of whether a country was at high, moderate, or low risk of debt distress. But domestic debt should not be a major consideration in financing decisions by IDA, as there were incentive issues that would be problematic if countries received grants when they had higher domestic debt. External debt from IDA was cheaper than domestic debt, and there were situations in which countries might find it attractive to borrow from IDA and use the funds to retire their domestic debts.

In concluding the session, Birdsall agreed that a country-specific approach made a lot of sense. She also sided with Bevan in arguing that there were grounds for doubting whether a larger volume of aid would be forthcoming under loans than under grants. The loans versus grants question related mainly to IDA resources, not to funding from the IMF, where grants were not feasible, or from bilaterals, which had already moved almost completely to grants. In the case of IDA, with a 10-year grace period and a 40-year repayment period, Birdsall was inclined to view cash flow as almost equally constraining for loans and for grants.

Birdsall stressed that, regardless of whether the resource transfers were loans or grants, it was important to consider whether the transfers were effective, whether they were adding to volatility or not, and whether they implied recurring costs for the budget. She also felt that recipient countries should focus on increasing the accountability of the donors, more than anything else, in considering choices between grants and loans. Did grants invite more or less accountability, emphasis on benchmarks, and openness to evaluation? Finally, Birdsall proposed that the IMF, the World Bank, and bilateral donors devise creative financing approaches for reducing the vulnerability of countries that were extremely poor, small, and subject to exchange rate risks. Reflecting Gelb's analysis, she favored a more flexible pricing of loans—offering recipients financial instruments that would amount effectively to grants under some contingencies but include repayment provisions if countries became able to afford repayments. Similarly, contingent forms of debt relief arrangements could be designed for countries that have graduated from HIPC, whereby adverse exogenous shocks (such as tsunamis) could trigger automatic suspension of debt service.

VI. Aid, Institutions, and Growth

The vital need for good governance and strong economic institutions has become a prominent theme in discussions of the determinants of economic growth and development. Issues relevant to this theme were explored in Session VI of the seminar, which asked: What do we know about the links between institutions and growth and about the determinants of institutional change? Does aid have a tendency to weaken institutions that are important for growth? And could aid be used effectively to strengthen institutions? In addition, each of the seminar's three keynote speakers, in addressing the challenges of economic development, focused on important directions for strengthening institutions or institutional approaches.

Institutions and Growth

Following the stimulus provided by Douglass North,[26] economists have devoted considerable efforts over the past decade to expanding our knowledge about the relationships between institutions and growth. There are many types of economic and political institutions, broadly defined to include the formal and informal constraints (rules, laws, constitutions, conventions) that shape the incentive structure for economic, political, and social behavior. The growing availability, often at high frequencies, of data on economic and political institutions in recent years has made it possible to begin characterizing the nature and strength of institutions in quantitative terms. Theoretical and empirical studies have yielded important insights into the importance of institutions for growth. It is generally agreed, for example, that while rapid growth over periods of several years may be achievable without strong institutions, sustained growth over decades requires effective institutions to protect property rights and provide incentives for saving, investment, and entrepreneurship. As stressed in the paper by Simon Johnson (IMF Research Department) and Subramanian,[27] "broad economic institutions"—defined as institutions that protect against expropriation by the state or powerful elites, and that ensure that contracts between private parties are enforced—are essential if people are to entrust their savings to financial intermediaries and invest in human and physical capital.

[26] North (1990).

[27] Chapter 10.

Johnson and Subramanian distinguish between economic and political institutions and examine their interactions. Political institutions—defined as the laws, rules, and other practices that determine how people acquire and utilize political power—can help explain why economic institutions are more or less effective. Good economic institutions are more likely to emerge when rents from natural resources or other sources are limited and when political institutions are representative, allowing broad sharing of political power, including with people who own capital. But we know less about the sequencing of political and economic institutional development. In some countries, economic institutions improve first, followed by political institutions. In other cases, strong political institutions lead to effective economic institutions. Overall, Johnson and Subramanian find little correlation between economic and political institutions. In Africa, democratic institutions have strengthened recently, but it is not clear whether this will translate into better economic institutions.

As a crude quantitative perspective, Johnson and Subramanian report that estimates based on existing measures of institutional development suggest that raising the quality of institutions in sub-Saharan Africa to that of developing countries in Asia would increase per capita income by 80 percent. They also note that institutional weaknesses help explain macroeconomic instability and crises. Weak political institutions hurt the economy by exacerbating distributional conflicts and aggravating instability. Strong political institutions allow the burdens of adjustment to be distributed broadly, which is conducive to political and economic stability and prosperity.

Determinants of Institutional Change

Given that institutions are a key determinant of growth, it is important to improve our understanding of how they can be changed for the better. Johnson and Subramanian argue that institutions tend to evolve slowly but are not predetermined. Institutional change depends on decisions made by those holding political power, which depends, in turn, on their self-interest, concern for the general welfare, or other motivations. The ease with which institutions evolve also depends on economic conditions. Higher growth facilitates institutional adaptation by permitting, for example, more compensation to be paid to those who lose from various reforms. Moreover, economic stagnation can lead to change in political institutions, through both the voting process and other political actions, such as strikes and uprisings.

From the perspective of aid donors and the international community, it is relevant to consider the extent to which outside forces, including conditions attached to foreign assistance, can help strengthen economic and political institutions. Johnson and Subramanian are skeptical of the efficacy of external interventions in facilitating institutional change. External mechanisms are effective in that regard only if they are compatible with domestic political and economic cost-benefit considerations (see also Dixit, 2003). The European Union's (EU) accession process is an example of such a mechanism because the benefits of integration into an economic union provide powerful incentives for candidate countries to undertake comprehensive political and economic reforms. By contrast, as Johnson and Subramanian argue, the ability of outsiders to influence institutions in Africa and Latin America is likely to be more limited, since an anchor similar to the EU is missing.

Aid and Institutions

While Johnson and Subramanian are pessimistic about the scope for outside interventions to effect institutional change, other seminar participants pointed to channels through which aid might have significant effects on institutions, both for worse and for better. Bevan's overview paper focuses on potential detrimental effects of aid on institutions, noting that large aid inflows could (i) adversely affect a government's domestic revenue effort, which could reduce the incentives of citizens to monitor its activities and weaken democratic accountability;[28] (ii) intensify rent seeking, just as rents from resource discoveries do; and (iii) create challenges for governments in managing good projects and ensuring that budgetary processes are not fragmented or impaired.

Seminar participants also focused on the possibility of using aid to reward countries that took measures to strengthen institutions and governance in addition to implementing sound macroeconomic policies. Radelet pointed out that there were many examples of performance-based aid, such as the U.S. Millennium Challenge Account, which links aid, among other things, to the quality of governance, as characterized by a list of indicators.

Given the importance of institutions for growth and development, donors can play an important role in helping low-income countries assess the quality of their institutions. Donors can help poor countries recognize and monitor how they compare with others in terms of the growing list of available institutional indicators. They can also encourage aid-recipient governments to be more open and more transparent in their policies, especially their public finances. These activities can be an important component of the international community's surveillance efforts aimed at helping low-income countries achieve and maintain macroeconomic stability and promote growth.

Bilateral and multilateral donors should be mindful of ways in which their policies may have adverse effects on institutional development. Radelet thought that the continuing financial relationships between the IMF and well-performing African countries hindered the development of these countries' institutional strengths. In his view there were about a dozen African countries

[28] Some authors (e.g., Clements and others, 2004) have argued that a switch to grant financing may have the effect of weakening governments' efforts to raise revenue.

that no longer needed IMF-supported programs and were using the IMF as an institutional crutch. Radelet sided with Soludo in arguing that the IMF needed to formulate better exit strategies and allow countries much more latitude in developing their own economic programs and moving forward. He appreciated that countries would encounter difficulties along the way, but considered that an acceptable price for institutional growth.

Radelet was also concerned that donor practices undermined recipient countries' budgetary processes, in part by hiring away the best people and by setting up project management units outside the budget. Moreover, he thought that there was inadequate attention to addressing structural matters related to the budget, such as transparency in accounting, publishing the budget on a regular basis, and hiring and training staff.

Radelet's concerns echoed a theme that others had voiced. In opening the seminar, Bio-Tchané had stressed the specific need to strengthen public expenditure management systems, noting that the Paris Declaration on Aid Effectiveness called for greater use of countries' national systems to disburse and monitor aid projects, as opposed to the parallel systems that many donors have set up.[29] Bio-Tchané understood that donors were worried about weak national systems and corruption on the side of recipient governments related to their receipt or use of aid revenues. But the real solution to these problems, in his view, lay in encouraging good governance; the practice of bypassing government institutions undermined domestic governance. The challenge for donors is to determine how they can avoid corruption when they come up against weak institutions without taking actions that further weaken those institutions.

A number of participants raised issues about the role of IMF conditionality. Jatta argued that sometimes conditionality did not adequately take into account local circumstances. He referred to safeguard missions that pressured the government to adopt international accounting standards, which was problematic because the accounting firms in his country had not yet moved to international standards. Other participants came to the defense of conditionality. Gondwe argued that without IMF and World Bank conditions, Africa would not have changed from what it was in the 1980s. Conditionality had been helpful to Mozambique and a number of other countries. While he was critical of cases in which there were too many conditions or in which the imposition of participatory procedures did not take into account the political realities in the countries, he disagreed with those who said that the role of the IMF should be revisited. In a world of integrated economies it was important that countries share experiences, and the IMF and World Bank are institutions that know about country experiences and should continue to sit with African policymakers to discuss sound macroeconomic management.

[29] Heller (2005) provides a detailed discussion of the challenges of managing the budget and the responsibilities of donors and recipients in an environment of scaled-up aid.

Birdsall agreed that in some respects the dialogue between the international financial institutions and African countries had worked quite well over a long period of time. But she also thought that creditors frequently weakened programs and undermined pressures to strengthen institutions by their unwillingness to enforce conditions. By not walking away from programs that were not working, creditors never really provided the incentives that might have mattered in subsequent rounds.

Gudrun Kochendörfer-Lucius (InWEnt, Germany) noted that a twofold strategy for promoting institutional change in Africa had been formulated a decade ago in discussions of technical assistance by the OECD Development Assistance Committee. Donors would provide training and technical assistance to build institutional capacity. But those discussions also arrived at the view that the quality of institutions was affected by the quality of the users of the institutions. This needed to be taken into account, as it naturally led to a focus on democratization and governance issues.

Strengthening the Institutional Capacity for Macroeconomic Management

The luncheon speech by Kochendörfer-Lucius addressed the central issue that Prime Minister Diogo had raised in her opening remarks: the challenge of strengthening the institutional capacity for macroeconomic policymaking. Kochendörfer-Lucius stressed that strong domestic institutions are critical for development, and that for many African countries, the effectiveness of scaled-up aid flows in support of the MDGs will depend on efforts to strengthen the human and institutional capacity to formulate and implement sound policies. Aid donors should consider the implications for technical assistance and training, especially training in the area of macroeconomic policymaking. Their efforts could benefit significantly from improving donor coordination and making better use of different donors' comparative advantages.

Kochendörfer-Lucius also argued that policy frameworks are unlikely to be successful if they are not home-grown and internalized. Accordingly, it is important not only that scaled-up aid flows be complemented with strong and systematic capacity-building efforts, but also that Africans play a central role in ensuring that training is tailored to individual country needs and draws as much as possible on local knowledge and expertise.

Development from Within

The interplay between the domestic political economy and outside forces in African institutional development was taken up in Soludo's speech. Soludo focused on the need for African countries to develop genuine ownership of good policies and for donors and creditors to provide more policy space to African countries. In addressing the challenges of home-grown development, he stressed that reforms were not sustainable in the absence of genuine ownership, and that donor-driven approaches emphasizing process and participation had not been effective in creating genuine ownership. Especially in heavily aid-dependent African countries, these approaches were used merely to promote Washington-driven economic policies. Africa needed ownership to be embedded in the domestic political process of each country and to bring donor programs into better alignment with country priorities. A strong political leadership and a cohesive core economic team were the most important ingredients in the success of recent reforms in Nigeria. A key challenge was to institutionalize change in the judiciary, the legislative branch, and other areas. Constitutional reform, an aggressive legislative agenda, and continuity of the economic team were needed to ensure that reforms were not reversed or slowed in the face of political change. Soludo also thought that donors needed to have strategies for exiting from aid; that technical assistance needed to be aligned better with domestic priorities; and that trade ought to be on the agenda. Countries' home-grown strategies needed to make tough choices and take into account the growing interdependence of the world economy, which made it impossible for African countries to isolate themselves from the global system.

The International Approach to Development

Donald Kaberuka (then Minister of Finance and Planning, Rwanda) focused his address on what we know about development. One of his themes was the need for a paradigm shift in the international community's approach to development. Poverty and underdevelopment did not have single causes; development was not simply a matter of resources or good governance, but rather involved complex, nonlinear, and country-specific processes. Countries grew and developed along different paths that depended on initial conditions, geography, history, and their political economies. A new approach is needed because poverty does not always respond to growth and because globalization has left part of humanity behind, in sub-Saharan Africa and in other parts of the developing world—even in countries that have been growing successfully.

A second theme in Kaberuka's address, echoing Soludo's earlier remarks, was the need for the IMF and other creditors and donors to provide more policy space to African countries. The IMF's Independent Evaluation Office (IEO) had issued a report on the prolonged use of IMF resources,[30] noting that lack of political commitment and poor governance were key factors in prolonging financial associations with the IMF, and highlighting the importance of ownership. To promote ownership, IMF-supported programs needed to provide more fiscal

[30] See IEO (2002). The IEO was constituted in 2001 to provide objective and independent evaluation on IMF performance. The IEO operates independently of IMF management and at arm's length from the IMF's Executive Board.

space and scope for alternative strategies.[31] Since 2002, when the international community reached the Monterrey Consensus on a new global approach to financing development, IMF and World Bank conditions had been streamlined, but political conditions imposed by bilateral donors had increased in complexity. The IMF also needed to become less timid in its surveillance in Africa and to provide more effective signaling on members' policies.

Kaberuka emphasized that there was progress on creating a new paradigm. The Washington Consensus had been replaced by the Monterrey Consensus, the essence of which was development from within, emphasizing country ownership, partnership, and mutual accountability as the basis for solving development problems. The new paradigm sought to replace conditions imposed by donors with home-grown policies for development, and sought to make Africans responsible for their own progress and prosperity. Kaberuka cautioned, however, that ownership needed to be complemented with improvements in the capacity to design and implement policies. In this regard, he made a special plea for giving greater emphasis to higher education and science in Africa. This would be good for development and also help reverse the brain drain from the continent. Besides human capital, capacity building also required addressing deficiencies in infrastructure, promoting common markets, and considering various trade and investment initiatives.

VII. Roundtable Discussion

The final session of the seminar featured four panelists who offered a range of views on how to improve the international financial architecture in general and the effectiveness of aid in particular. Srinivasan focused his remarks on the roles of global institutions. Most of the existing major intergovernmental organizations had been created in the aftermath of World War II. One of their important characteristics was universality of membership, regardless of the nature of country governments. National sovereignty was valued, and there was an implicit commitment not to use international economic organizations to interfere with the domestic political processes of any member state. A second important characteristic was institutional specialization. Each intergovernmental organization was given a clear mandate and the tools to pursue its mandate efficiently.

All that had changed over the past half century. International economic organizations had developed overlapping mandates without changing their tools, and the global institutional architecture was no longer functioning well. There was a need to sharply narrow and separate the mandates of the international financial institutions (IFIs) based on a clear statement of objectives. In Srinivasan's

[31] The IMF's 2005 review of PRGF program design addresses the issue of fiscal space; see IMF (2005).

view, the objectives boiled down to ensuring the stability of the international monetary and financial system, promoting economic development, and generating macroeconomic stability at the country level. The World Bank should provide financial assistance to developing countries that do not have access to international financial markets, but the design of development programs is largely a domestic issue, not an issue for the World Bank or the IMF. The Bank should support domestically grown and owned development programs, with resources committed for the longer term when there is mutual agreement on the programs. The IFIs should not be involved in financing those emerging market countries that can easily obtain resources from world capital markets. The IMF should focus exclusively on promoting global financial stability and providing advice on domestic macroeconomic stabilization through the Article IV consultation process; its role in low-income countries should not extend to structural adjustment issues. IMF financial assistance should be provided to countries facing temporary, exogenous shocks, but not to countries facing domestic, policy-induced shocks. In addition, the World Trade Organization should ensure that all countries have access to international trade on a level basis.

Srinivasan also expressed concerns about discussions that characterized the MDGs as a compact. In his view, the commitments involved were not clear and certainly not very firm, and there was no indication of what the penalties would be for failing to live up to commitments. There was too much rhetoric and not enough attention to the reality that power and income disparities would exist for many years to come, and that donors' objectives were unlikely to change suddenly.

Gondwe stressed the timely nature of the seminar in light of African countries' desire to accelerate economic growth, catch up with other regions, and participate more fully in the global economy. To meet these objectives, African countries needed to use aid effectively. More than a transfer of resources, aid was a package that also included transfers of technology and technical assistance and training. The real issue was not whether aid was useful, but how to maximize its effectiveness and accelerate growth. He agreed with the view that aid is subject to diminishing returns, but noted that aid to Africa was still well below the levels that various countries had benefited from in the past and encouraged more studies of the threshold levels at which the returns to aid become negative.

Gondwe hoped that the next high-level seminar would invite papers by ministries of finance in aid-recipient countries to complement the presentations by outside experts and representatives of aid donors. He noted that African countries are in the "enviable position" of no longer administering their economies alone. With frequent missions from the IMF and the World Bank, there is much expert advice and monitoring available to ensure that the problems of policies, institutions, and governance are being tackled. This puts

African countries in a position where aid can be used effectively if it arrives on time. The main challenge is that aid disbursements have been unpredictable and always less than the levels pledged, which creates major difficulties for ministers of finance. Gondwe hoped that the Paris Declaration on Aid Effectiveness would make a difference, but he was not very optimistic.

Soludo used his panel presentation to "dream dreams" and to predict that the international aid architecture as we know it today is on the way out. He criticized most of the Maputo discussions for focusing on "tinkering at the margins" of an aid system that was not working. This system had led to numerous declarations and statements of good intentions that were not being implemented. He predicted that donors and recipients would abandon the present aid relationship in the wake of the growing inequalities caused by globalization and the mounting of associated pressures from international crime (e.g., terrorism and traffic in arms and drugs) and immigration. Soludo favored replacing voluntary aid with mandatory international transfers funded by international taxes, such as the tax on air travel that the French and German governments had recently proposed.

Soludo also criticized discussions that viewed development as the only objective of aid. Such a characterization ignored the political dimensions of aid as an instrument of foreign policy and control. The nature of the current aid system created problems for recipient countries analogous to the recognized problems created by national welfare systems. Aid ought to be a temporary phase for developing countries rather than a way of life. Proceeds from mandatory globalization taxes should ensure that transfers from rich to poor countries are sufficient to provide the resources Africa needed to exit from poverty traps and its continued dependence on aid. There was also a need to rethink the role of trade in the exit strategy from the existing aid system. Together with greater economic integration would come closer political integration of African countries. Soludo felt that this was important, as many African states were not viable politically or economically. Africa needed to have its own debate on these issues.

Grant's observations on aid effectiveness struck a pragmatic middle ground between the views of aid optimists and aid pessimists. External aid could be useful in achieving its objectives of growth, poverty reduction, and humanitarian relief, but the macroeconomic risks were real. The potential hazards were not insurmountable, but it was not clear whether the Millennium Project had given them sufficient attention.

In looking ahead, Grant saw two key issues: the scale of resource transfers needed and the volatility and unpredictability of these transfers. On the former, DFID supported the scaling-up of aid to Africa and encouraged detailed, sector-by-sector studies to identify absorptive capacity constraints and consider where they can be relaxed. On volatility and unpredictability, the answer was improvements in mutual accountability. The aid relationship needed to become a genuine partnership among recipients and donors. DFID had revised its approach to conditions with the interests of recipients in mind. It wanted to support countries that were signing up to achieve the MDGs while holding them accountable for the pattern of spending to which they had committed. DFID also needed to retain the ability to meet fiduciary responsibilities and to insist that recipients comply with broader political commitments to international human rights and other conventions. The IMF and the World Bank had a responsibility to set appropriate program conditions and to provide practical advice on how to manage aid.[32]

During 2005, the United Kingdom was in the central role of having the presidencies of the Group of Eight and the European Union in the second half of the year, and the Commission for Africa Report had been generated in that context. The Report stressed the themes of capacity building and accountability as well as the need for a scaling-up of resources. In addition, the United Kingdom had made specific proposals for multilateral debt relief and for an International Finance Facility that would allow donors to frontload aid by borrowing in the international capital market against future aid commitments.

VIII. Concluding Policy Messages

The Maputo seminar revealed a widely shared consensus that downplaying the macroeconomic complications that can potentially arise from scaling up aid can be extremely dangerous for recipients and for the international aid system. While participants expressed different levels of concern about the macroeconomic hazards, the following broadly shared perspectives and policy conclusions emerged.

- Aid has produced some striking successes, but there are reasons to be concerned that a substantial scaling-up of aid may fail to elicit correspond-

[32] Musokotwame was concerned about the potential implications of the shifting composition of aid. In the past, project aid had allowed recipients to cushion important initiatives against volatility in program and budget support. The shift toward budget aid meant that such cushioning would become less feasible if donors suspended aid following negative IMF assessments of a country's macroeconomic policies. This raised the question of whether donors would totally align themselves with the indicators that the IMF used to assess macroeconomic performance, or whether they would be willing to differentiate their views from those of the IMF. In response, Grant noted that while DFID was moving in the direction of more budget support—in Africa, its target for budget support was 70 percent of aid allocations—the aim was to step back and put countries much more in the driver's seat in designing poverty reduction strategies. He did not expect the IMF to move away from the performance criteria that were set for arrangements with upper credit tranche conditionality. But there were differences between what DFID and the IMF were trying to deliver and corresponding differences in performance risks, so DFID was moving in the direction of setting its own performance standards; see DFID (2005).

ingly large increases in growth and reductions in poverty. One reason is that aid appears to be subject to diminishing returns, which makes it extremely important to increase absorptive capacity. Another is the prospect that Dutch disease may hurt export competitiveness, which has been the one proven channel of growth.

- Policymakers should watch very carefully for early signs of absorptive capacity constraints, such as upward pressures on wages and the relative prices of nontraded goods and declines in the profitability of traded-goods sectors. These shifts should prompt a reevaluation of government spending, whether aid-financed or not, and perhaps also a reevaluation of monetary policy.
- The volatility, unpredictability, and procyclicality of aid pose major difficulties for recipient countries. Donors should allow recipients more flexibility in the timing of aid-financed expenditures. Recipients should build foreign exchange reserves and fiscal cushions to deal with aid volatility. They should be free to draw upon these resources when expenditure plans would otherwise be disrupted by aid shortfalls.
- Policymakers should adopt sensible and realistic spending plans consistent with their knowledge of absorptive capacity. They should be cognizant of the need to strike a balance between infrastructure development and spending on health and education, and they should not allow donor activity to be crowded into "flavor-of-the-day" sectors or to become inconsistent with an appropriate balance of overall spending.
- There is considerable scope for enhancing the competitiveness of Africa's exports through infrastructure investments and various initiatives to improve the delivery of services to business. Key issues in many African countries are reducing conflicts and improving governance and the attitude of governments toward business.

Good institutions and the sustained implementation of strong macroeconomic and structural policies are critical determinants of economic success. Well-designed policies are those that provide incentives for entrepreneurship and strengthen the supply responses of low-income economies to market signals. Countries that are able to exploit global markets will probably be the most successful in pursuing rapid sustainable growth and a lasting reduction of poverty.

Appendix. Sessions II and III: Comments on Technical Issues

This Appendix summarizes comments on a number of technical issues that were raised by participants during Sessions II and III.

Srinivasan made some general observations aimed at clarifying the nature of the evidence from cross-country regressions and simulation models. He noted that only a small proportion of firms in tradable-goods sectors are typically engaged in export activities, probably because of the fixed costs in entering export markets. If exporters have already incurred sunk costs, their short-run responses to unexpected shocks will be dampened. These considerations call into question empirical evidence based on sectoral averages or cross-country regression models and call for evidence based on firm-level responses. Regarding calibrated general equilibrium models, such as those presented by Adam and Sundberg, it is important to acknowledge that they rely less on data and more on modeling assumptions: while simulations produce clearer results, they are not necessarily more believable because they are less closely linked to data.

Srinivasan also thought it desirable to distinguish conceptually between concerning aid levels and those concerning volatility. Bevan, by contrast, did not think that the two could be cleanly separated. To him, a substantial scaling-up of the level of aid would also lead to a comparable increase in volatility. Srinivasan added that policy analyses relying on nonmonetary models alone were incomplete. Models that distinguish between tradable and nontradable goods yield important insights, but they may miss important responses of nominal variables under government control, which could be dangerous. One clear reference here is to the short-run phenomenon of exchange rate overshooting, as in Dornbusch (1976).

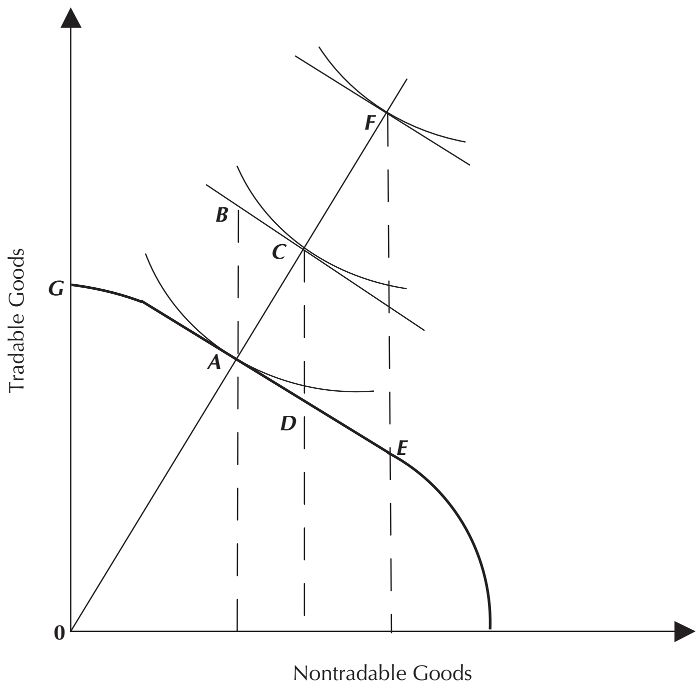
Seminar participants sought to reconcile concerns about aid-induced Dutch disease with the lack of clear evidence of aid-induced real appreciation.[33]

One possible explanation is the Adam-Bevan mechanism whereby aid enhances productivity and ameliorates short-term adverse effects of aid on competitiveness. Another is that macroeconomic policies could respond to aid inflows in a way that preempts a real appreciation of the currency. As illustrated by the Ghana case, aid inflows have no effects if they are saved. A third possibility, emphasized by Lamine Loum (former Prime Minister, Senegal) and Adam, is that historically, aid has often been part of a broader package that also includes policy reforms, such as devaluations and the removal of trade and other economic distortions. These considerations led to the question of whether analysis ought to ignore relative price effects and focus instead on the composition of production. Adam thought that was a sensible approach and that more effort should be devoted to developing appropriate measures of the relevant concepts of the structure of production.

Srinivasan provided another perspective on the issue, arguing that the lack of real exchange rate appreciation should not be surprising; it was easy to build pure trade models in which aid reduced the size of the tradable goods sector without any price (i.e., real exchange rate) effects. This is illustrated in Figure 1.1, which Srinivasan provided after the seminar. Production and consumption are initially

[33] It may be noted that Rajan and Subramanian (2005), in revising their paper since the seminar, report a new set of results that appears to be evidence of aid-induced real appreciation.

Figure 1.1. The Effects of Aid in a Trade Model



at point *A* on the linear segment of the production possibilities frontier, where the tradables and nontradables sectors are both subject to constant returns to scale at the margin. If consumer preferences are homothetic, the provision of an amount of aid sufficient to purchase the segment *AB* of additional tradable goods will lead to consumption at point C and production at point *D,* with no change in the relative price of tradables and nontradables (i.e., the real exchange rate, which is the constant slope of line segment *AE*). The maximum quantity of aid that can be absorbed by production changes without a change in the real exchange rate is *EF*, where *E* is the kink point in the production possibilities frontier.

Adam was asked about the empirical validity of the transfer paradox. He responded that evidence to support the classical transfer paradox was weak and that it was more relevant to focus on the income distribution effects of big relative price changes triggered by public expenditure decisions. Such changes may have important paradoxical effects for certain groups. Adam's paper alludes to an example from Uganda in which poor rural households that are net sellers of basic foods suffered real income losses in the aftermath of big supply-side boosts to output and associated relative price declines induced by aid-funded investments in roads.

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