

**Dealing with the  
Macroeconomic Impact of  
Scaling Up Aid**

## Executive Summary

In order to attain the Millennium Development Goals, it is widely acknowledged that a rapid and substantial increase in aid to developing countries is needed. However, the rapid scaling up of aid raises new concerns of the potential threat to macroeconomic stability in recipient countries. Potential adverse effects could include excessive appreciation of the real exchange rate resulting in loss of competitiveness, and high inflation. This paper reviews some of the major policy concerns emerging from the debate on the macroeconomic impact of increased aid flows. There are concerns with potential Dutch disease effects, ensuring macroeconomic stability in an environment of high aid flows, and coping with potential volatility of aid flows.

This paper discusses a range of policies and practices that should be addressed to minimize adverse macroeconomic effects of increased aid. For recipient countries, effective dialogue is needed between government authorities and central banks on the extent to which aid should be 'absorbed' as well as 'spent'. Dutch disease effects could be minimized if aid resources finance government spending with high import content, or are used in financing infrastructure investments which enhance domestic productivity of the private sector. Increased dialogue between governments and central bank authorities to discuss appropriate levels of macroeconomic indicators – such as inflation and interest rates – would also be needed. Central banks may also permit gradual absorption of aid by accumulating reserves, which can also serve as a precautionary buffer against volatile, future aid flows.

Donors can assist by disbursing aid in line with long-term commitments of resources, and in a predictable manner which supports planning in recipient countries. International financial institutions can also assist aid-recipient countries with periodic policy advice on how to increase aid effectiveness and manage potential adverse effects.

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## 1. Introduction

The call for increased aid, extended debt relief, and additional sources of development finance has increased following the United Nations Financing for Development Summit in Monterrey in 2002. A major result of these recent discussions on development finance has been the commitment by G8 countries to increase official development assistance (ODA) flows to developing countries, particularly those in Africa. Following commitments made at the G8 summit in Gleneagles in July 2005, aid flows to Africa are projected to increase by an additional US\$25 billion a year by 2010. This increase would mean a doubling of aid for Africa by 2010.

The Millennium Development Goals (MDGs) provide a clear set of objectives for mobilizing the international development community in the area of development finance. To achieve the MDGs, the UN Millennium Project estimates that high-income countries should increase ODA from 0.25 percent of their GDP in 2003 to 0.44 percent in 2006, and 0.54 percent in 2015 – a value still lower than Monterrey target of 0.7 percent (UN, 2005). Direct ODA contributions provide the most effective way of generating additional resources for MDG-based spending in developing countries. However, in recent discussions, alternative financing mechanisms – such as the International Finance Facility and global taxes – have been considered.

The scaling up of aid will present new challenges for macroeconomic management in aid-dependent countries. As discussed by Heller (2005), government officials in recipient countries are likely to face “a complex set of decisions and tough choices”, which will require appropriate fiscal and monetary policy responses in recipient countries. A major concern is the possibility that higher aid flows might cause an appreciation of the recipient’s currency, resulting in the loss of international competitiveness. Recipient countries also need to deal with the likelihood of increased inflation if aid flows finance domestic fiscal

programs. In addition, the impact of uncertainty and volatility in aid flows is likely to be exacerbated in a high aid environment. A sudden increase in aid flows therefore presents new challenges for macroeconomic management in recipient countries.<sup>1</sup>

The rest of this paper is structured as follows. Section 2 provides a brief discussion of the concepts of 'absorption' and 'spending', which are useful in understanding the short-term consequences of increased aid flows. Section 3 examines the main issues of potential concern, such as the likelihood of Dutch disease effects, macroeconomic management in an environment of high and uncertain aid flows, the implications of increased aid for public service delivery, aid fungibility, and aid and growth. Section 4 provides practical recommendations on macroeconomic management in an environment of increased aid flows, looking at the roles of policymakers in recipient countries, of donors, and of international financial institutions. Section 5 summarizes the discussion in this paper and provides issues for further debate.

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<sup>1</sup> See Gupta et al (2006:1-7) for further discussion on this issue

## 2. Distinguishing Between *Absorption* and *Spending* of Aid

It is useful to distinguish between the concepts of '*absorption*' and '*spending*' following IMF (2005). Aid transfers to a country are initially provided as foreign exchange to the recipient's central bank. These funds are subsequently monetized into domestic currency by the recipient government. 'Absorption' refers to the use of the foreign exchange transfer to finance imports, while 'spending' refers to the use of the domestic currency component of the aid transfer to finance the recipient government's fiscal activities. Aid absorption results in a widening of the current account deficit (excluding aid), while spending results in the increase of the fiscal deficit (excluding aid).

This conceptual distinction is helpful as it provides the various policy options available to governments and central banks in aid-recipient countries. Authorities in recipient countries may also choose various degrees of 'absorption' and 'spending', for a given aid transfer. A summary of four possible policy options available when aid is transferred is provided by Foster and Killick (2006) – see Box 1 below.

## **Box 1: Policy Options for Absorption and Spending**

### **SCENARIO I: Neither absorb the foreign exchange, nor spend the counterpart.**

The aid is saved, with the foreign exchange added to reserves. The counterpart is used by government to reduce its indebtedness but there is no change in the level of demand or the growth of the economy.

### **SCENARIO II: Spend the counterpart, without absorbing the foreign exchange.**

If the foreign exchange is added to reserves but government spends the counterpart on local goods and services, the aid increases the monetary base and raises domestic demand, which is inflationary unless there is spare capacity in the economy. If there is spare capacity, government could have loosened fiscal or monetary policy to bring it into use, and it can be argued that anything achieved by the aid could have been done equally well without it, by relaxing macroeconomic policy. Spending without absorbing is thus closely analogous to deficit financing, the macroeconomic effects of which are well known (see, for example, Roemer (1989)).

### **SCENARIO III: Absorb the foreign exchange, without spending the counterpart.**

If government saves the domestic currency counterpart but the foreign exchange is sold to finance increased net imports, the effect of the aid on the macro-economy will be deflationary, taking demand out of the economy as foreign exchange is sold for domestic currency and is then used to finance increased net imports. This can be a sound use of aid if the budget deficits and inflation need to be reduced. It may be an effective way of assisting the growth of the private sector, via reduced use of the inflation tax and less crowding-out in credit markets.

### **SCENARIO IV: Fully absorb the foreign exchange and spend the counterpart.**

If the aid is entirely spent on additional imports, then the foreign-exchange reserves and the government budget deficit are unchanged. The economy enjoys a boost through increased net imports, but the increased demand is matched by increased supply of net imports and there is no effect on the domestic supply-demand balance. Unless all the aid is used to finance government imports that would not otherwise have been purchased, absorbing all the foreign exchange in higher net imports may require an appreciation of the real exchange rate, to persuade purchasers to switch enough demand from domestic to foreign goods and services.

Source: Foster and Killick (2006) P.17

### **3. Challenges of Scaling Up Aid**

#### **3.1 The Dutch disease problem**

A major policy challenge for recipient governments faced with an increase in aid flows is the likelihood of Dutch disease effects. Aid inflows absorbed into the economy, result in an increase in domestic demand for both tradable and non-tradable goods. In the tradable sectors, an increased demand results in higher imports from international market. In the non-tradable sectors, an increased demand may not be directly met owing to various domestic supply constraints, resulting in an increase in prices in the non-tradable sector. The rise in prices in the non-tradable sector relative to prices in the tradable sector causes an appreciation of the real exchange rate. A higher real exchange rate consequently harms the international competitiveness of a country's tradable goods sector.

There are few empirical studies of the incidence of Dutch disease in aid-dependent countries, and in most instances the empirical evidence is mixed. Recent country studies have examined indicators for the presence or absence of Dutch disease symptoms, comparing the situation before and after the increase in aid flows to seven African countries (Foster and Killick, 2006). These studies provide mixed evidence on the likelihood of Dutch disease problems arising from a significant increase in aid flows.

**Table 1: Aid Utilization by Country**

	Not spent	Partly spent	Mostly spent	Fully spent
<b>Not absorbed</b>	Ghana (0, 7)			Tanzania (0, 91)
<b>Partly absorbed</b>	Ethiopia (20, 0)		Uganda (27, 74)	Mauritania (n.a., 100)
<b>Mostly absorbed</b>		Sierra Leone (n.a., n.a.)		Mozambique (66, 100)
<b>Fully absorbed</b>				

**Source:** Foster and Killick (2006); figures in parentheses refer respectively to percentages of aid absorbed and spent; n.a. indicates that the data are not available/clear.

Table 2 below presents correlation coefficients of net aid/GDP ratios with inflation rates and real exchange rates for 13 African countries, including nine countries that recently experienced a surge in HIV/AIDS related inflows. In eight countries, the association between net aid inflows and real exchange rates is positive, implying a real depreciation. In the remaining five countries, there is weak evidence of real appreciation. The correlation between net aid inflows and inflation rates is in most cases found to be positive (in contrast to the results for the larger sample just mentioned). Hence, because of the mixed evidence, it is not possible to say a priori whether a rise in net aid flows would lead to real appreciation or higher inflation (see Chowdhury and McKinley, 2006 for a fuller discussion).

**Table 2: Correlation coefficients between Net Aid/GDP ratios and selected Macroeconomic Indicators**

Countries	Real Exchange Rate	Inflation	Budget Deficit
Ghana ( 1970-1997)	0.79	-0.32	0.73
Chad( 1983-2002)	-0.84	-0.07	-0.23
Burundi( 1970-2003)	0.76	0.13	-0.46
Rwanda(1970-2003)	0.13	-0.01	0.04
Uganda(1980-2003)	0.69	-0.51	-0.32
Ethiopia( 1970-2002)	0.36	-0.13	-0.28
Kenya ( 1970-2003)	0.45	0.68	-0.27
Lesotho( 1973-2003)	-0.30	0.28	-0.30
Malawi( 1980-2003)	0.42	0.39	-
Mozambique ( 1986-2003)	-0.09	0.66	-
Swaziland( 1970-2003)	-0.48	0.55	-0.14
Tanzania( 1970-2003)	0.72	0.45	0.30
Zambia ( 1970-2003)	-0.08	-0.05	0.36

**Source** Chowdhury and Mckinley (2006) P.17

Indeed, studies of some African countries find that aid inflows appear to be associated with a real depreciation, reflecting either increased productivity or a very limited degree of aid absorption (see table 2). In Mauritania, Mozambique and Tanzania, there were small depreciations of the real effective exchange rate (REER), while in Sierra Leone, there was a significant depreciation of the REER. No changes in REER were noticed in Ethiopia and Uganda (IMF, 2005). The evidence suggests that Dutch disease effects may be either weak or unimportant. Even in countries that experienced surges in HIV/AIDS related inflows, the association between net aid inflows and real exchange rates was positive, implying a real depreciation (Chowdhury and Mckinley, 2006).

Aid recipient countries have a number of available options to minimize the risks of the effects of Dutch disease. If aid is fully absorbed, some appreciation of the real exchange rate is likely to occur. In such instances, the government must adopt appropriate policies to minimize the adverse effects of Dutch disease. There are two main suggestions.

First, aid resources can finance government spending with a high import content, for example, in the purchase of foreign medicines or capital equipment. In this regard, coordination between the Finance ministry and line ministries would be important to ensure that aid resources for sectoral programs are utilized in a way which minimize adverse macroeconomic effects.

Second, strategic planning can also ensure that aid flows are directed at public investments which improve long-term productivity in recipient countries. In particular, using aid resources to finance infrastructure investments can reduce supply constraints in developing countries, raise domestic productivity levels, and compensate the private sector for losses in competitiveness due to Dutch disease effects.

### **3.2 Macroeconomic management with increased aid flows**

Besides the concerns above relating to Dutch disease effects, macroeconomic management would generally be more challenging in an environment of high aid flows. In general, most countries employ macroeconomic tools (such as fiscal and monetary policies) to achieve specific policy goals on real growth rates, inflation, and the real exchange rate. In 'spending' aid, governments tend to increase domestic money supply, which in turn increases domestic liquidity and inflation. Central bank authorities can manage part of the increased money supply by sterilization typically by issuing government bonds.<sup>2</sup> However, such

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<sup>2</sup> Sterilization by the sale of foreign exchange would place upward pressures on the exchange rate, further worsening Dutch disease problems.

sterilization activities result in an increase in domestic interest rates, which tend to ‘crowd-out’ private sector borrowers from domestic financial markets (Heller, 2005).

A substantial scale up of aid would further exacerbate these challenges of macroeconomic management. Central banks can limit absorption of aid flows into their economies by careful management of their foreign exchange reserves. Aid inflows may enable central banks to increase existing reserves from an existing low stock; or to increase reserves for precautionary reasons and thereby enable smoothing of unpredictable, future aid flows.

Increased dialogue between governments and central bank authorities to discuss appropriate targets of macroeconomic indicators would also be needed. For example, if government spending of aid results in higher domestic liquidity, authorities must agree whether to accept higher rates of inflation, or higher domestic interest rates, if sterilization measures are adopted. Prudent management and coordination of monetary policy, fiscal policy and foreign reserves would therefore be very essential in a high-aid environment.

### **3.3 Coping with uncertainties in aid disbursements**

Aid flows tend to be volatile, and a rapid scaling up of aid may further exacerbate the effects of uncertainty in aid disbursements (Bevan, 2005; Celasun and Walliser, 2005). In an environment of increased aid flows, governments may be faced with situations in which a significant share of their budgets may be financed by external funds. The greater reliance on aid can expose a country’s budget to significant volatility when the country is faced with uncertain aid disbursements. Finance ministers in aid-dependent countries may be concerned about the impact of uncertainty in the volume and duration of aid flows on their national budgets. Moreover, various channels exist at present for the disbursement of aid flows – ranging from direct budget support for national

treasuries to tied aid projects administered by NGOs – which further complicate uncertainty in aid transfers.

Moreover, while increased aid flows may facilitate a substantial expansion in vital public services and increased investment, unpredictable aid flows can create significant challenges for those sectoral ministries charged with managing the scaling up and delivery of services. Consider for example a health ministry which has embarked on a significant expansion of services in rural areas but is faced with a sudden reduction in aid flows. Reversing the sectoral programs may be difficult as new employees must be laid off and various public services discontinued. A complete withdrawal of the public service program may be undesirable, and there may be an increased likelihood that government officials may seek alternative means of deficit financing to sustain their fiscal program. Donors can help countries by disbursing aid in line with long-term commitments of resources.

It is important for recipient governments to devise ways of offsetting the adverse effects on the different groups in the society, especially the poor, arising from volatilities in aid flows. As discussed earlier, precautionary savings by recipient governments – in the form of higher foreign exchange reserves – can enable authorities to smoothen the impact of volatile aid flows<sup>3</sup>. In the longer term, governments need to strengthen capacity for domestic resource mobilization, as a means of reducing aid dependency (Heller, 2005).

### **3.4 Managing the fiscal effects of aid**

There is a growing body of literature on how aid affects the fiscal behaviour of governments. Studies in this area have been classified into two groups. First, fungibility studies have sought to analyze the effects of aid on the composition of government spending. Aid is said to be fungible if it is given for one purpose (for

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<sup>3</sup> See Eifert and Gelb (2005) for further discussion of this issue.

example, investment) and used for another (for example, consumption). Also, if aid is used to finance a project that a recipient government would have undertaken anyway, the aid finances expenditure other than the intended projects. These studies tend to be critical, typically finding evidence of considerable fungibility (aid is not necessarily allocated to the spending headings intended by donors, but are subject to many shortcomings that undermine effectiveness (McGillivray and Morrissey, 2000)). The second approach using fiscal response models goes further and argues that aid has a complex impact on government fiscal behaviour – on tax efforts and borrowing in addition to effects on the allocation of expenditures (Osei et al 2005). Evidence that aid to Africa is partly fungible (Devarajan et al 1999) underscores the need to improve the quality of public spending in recipient countries.

The critical challenge for aid recipients is how to manage the fiscal effects of aid, given the fact that a lot of aid to developing countries is given to government. Studies that analyse how foreign aid inflows affect recipient government fiscal behaviour are important. Some results already show that aid to particular sectors influence the composition of public spending, hence sectoral aid programs and projects play important roles in development assistance (Devarajan et al, 1999). The fungibility debate needs further exploration and empirical evidence than is presently available in order to assist policymakers to make informed choices. Additional country studies are needed on the incidence and costs of fungibility, and ways to mitigate the fungibility prospects of scaling up aid. Also essential are country studies on the fungibility across donors, that is, whether increased aid from one donor increases or decreases aid from other donors.

### **3.5 Aid and Growth: Achieving Results**

In the long-term, the main objective of aid is to promote growth and reduce poverty in recipient countries. The cross-country evidence of whether aid has a positive impact on growth, however has been mixed. Burnside and Dollar (2000)

stimulated this recent literature. They find that when other determinants of growth are controlled for, especially indicators of economic policy, aid has no independent effect. Aid makes a positive contribution to growth only in those countries with strong policy environments: if domestic policy environment is poor, aid is largely ineffective.

However, Hansen and Tarp (2000) amongst others have questioned these conclusions on several grounds. They find that aid may have an impact on growth, which is not conditional on good policies. Researchers at the Center for Global Development (CGD) have also presented recent results which indicate a positive relationship between aid and growth. Clemens et al (2004) argue that if aid flows directed at political and humanitarian objectives are excluded, a positive effect emerges for the impact of aid on its economic objectives.

A survey of the recent country studies by the IMF and ODI to examine the impact of recent aid surges further illustrates this point. Both surveys indicate that the recent aid surge in a number of African countries was accompanied by an improvement in GDP growth in about four of the countries, while the aid surge was accompanied by higher investment in six countries (see Table 3 below).

**Table 3: Impact of aid on macroeconomic outcomes**

COUNTRY	INDICATOR	PRE-SURGE	AID-SURGE
<b>ODI case studies</b>			
<b>Mauritania</b>	<b>Period covered</b>	<b>1996-98</b>	<b>1999-02</b>
	Net ODA as % GDP	21.4	26.2
	GDP growth p.a. (%)	4.1	4.4
	Inflation p.a. (%)	6	4
	Investment (%GDP)	20.3	30
	Non-Govt investment (%GDP)	14.6	21.5
<b>Sierra Leone</b>	<b>Period covered</b>	<b>1997-99</b>	<b>2000-03</b>
	Gross ODA as % GDP	13.7	39.2
	GDP growth p.a. (%)	-8.9	5.5
	Inflation p.a. (%)	35	negative
	Investment (%GDP)	4.8	8.7
<b>IMF &amp; ODI cases</b>			
<b>Mozambique</b>	<b>Period covered</b>	<b>1998-99</b>	<b>2000-02</b>
	Net ODA as % GDP	11.5	17.4
	GDP growth p.a. (%)	9.7	7.3
	Inflation p.a. (%)	1.8	13
	Investment (%GDP)	30.5	41
<b>Tanzania</b>	<b>Period covered</b>	<b>1998-99</b>	<b>2000-03</b>
	Net ODA as % GDP	5.6	7.4
	GDP growth p.a. (%)	2.8	5.4
	Inflation p.a. (%)	10	4.9
	Investment (%GDP)	15.5	17.8
	Private investment (%GDP)	12.4	11.5
<b>IMF-only cases</b>			
<b>Ethiopia</b>	<b>Period covered</b>	<b>1999-00</b>	<b>2001-03</b>
	Net ODA as % GDP	5.3	13.3
	GDP growth p.a. (%)	5.7	1.8
	Inflation p.a. (%)	4.7	2.2
	Investment (%GDP)	16.4	19.6
	Private investment (%GDP)	9.8	9.4
<b>Ghana</b>	<b>Period covered</b>	<b>1998-00</b>	<b>2001-03</b>
	Net ODA as % GDP	1.3	6.8
	GDP growth p.a. (%)	4.1 (1999-00)	4.6
	Inflation p.a. (%)	85	20.5
	Investment (%GDP)	24	23
	Private investment (%GDP)	14	14
<b>Uganda</b>	<b>Period covered</b>	<b>1999-00</b>	<b>2001-03</b>
	Net ODA as % GDP	10.1	13.5
	GDP growth p.a. (%)	6.6	5.6
	Inflation p.a. (%)	3	2.7
	Investment (% GDP)	19.6	21
	Private investment (% GDP)	11.2	13.9

**Source:** Foster and Killick (2006)

Irrespective of whether policy is important for aid effectiveness, it must be emphasized that both groups of studies agree that aid works, in one way or another. It is generally agreed that in the absence of aid flows, growth would have been lower and, to the extent that growth supports poverty-reduction, absolute poverty levels would have increased. Donors and countries need to improve the effectiveness of aid, with donors aligning the assistance behind country led planning processes.

## **4. Managing a Doubling of Aid**

African countries working with development partners can manage the possible consequences of additional aid flows effectively. The main questions should center around how to create the conditions for a more effective use of additional aid resources. What can aid-recipient countries do to cope with the increased aid flows? And what can donors do to address these issues in a productive way? The ideas presented below represent initial attempts to identify the critical areas that need to be addressed.

### **4.1 Role of recipient countries**

#### **Integrating consistent macroeconomic frameworks into MDG-based PRSPs**

PRSPs serve as a useful framework for development planning in most recipient countries. In most instances, however, PRSPs do not address direct macroeconomic policy issues. To appreciate the macroeconomic implications of the PRSP it is necessary to consider the potential impact they would have on the indicators of macroeconomic stability such as real GDP, inflation, exchange rates, current account balance and budget deficits. To achieve these goals, the PRSP needs to incorporate an analysis of the macroeconomic impacts of aid under different scenarios.

There are three approaches to constructing such scenarios, each depending on the goals of a particular country and the data available for the design of the policy framework:<sup>4</sup>

- **Costing non-income-related MDGs:** The costing of the non-income MDGs will provide information about the resources needed in each sector.
- **Projecting the macroeconomic impact of different aid flow levels:** The assumption of different autonomous levels of foreign aid inflows enables planners to identify associated macroeconomic aggregates at the various levels.
- **Targeting a particular GDP growth rate:** This method begins with a set target growth rate which will achieve the income-poverty MDGs and then assumed increases in external resources introduced. Analysis will then indicate the kinds of improvements in productivity or policies that might be required to achieve the associated macroeconomic objectives of assumed increases in aid.

Whatever approach is used, countries need to ensure that the macroeconomic framework underpinning their development strategy is consistent with the overall objectives of poverty reduction and growth.

### **Strengthening Macroeconomic Management**

Available evidence shows that prudent macroeconomic management can help address the potentially adverse impact of increased aid flows. In countries with strong fiscal, monetary, and trade policies, aid has a positive impact on growth (Burnside and Dollar, 1997). Nonetheless, the aid recipient countries must take

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<sup>4</sup> Sanjeev Gupta, Rorbert Powell, and Yongzheng Yang (2006), *Macroeconomic Challenges of Scaling Up Aid to Africa, A Checklist for Practitioners*. IMF, Washington, DC U.S.A.

ownership of their development strategies, devise appropriate macroeconomic policies and fiscal management to respond to the scaling up of aid. As has been discussed earlier, there may be room for central banks to permit gradual absorption of aid (for example, by accumulating and decumulating reserves), and also using sterilization policies where possible to contain liquidity problems arising from government 'spending' of aid. In addition, aid-financed expenditures with high import content are likely to minimize the likelihood of Dutch disease effects. Countries need to design macroeconomic programs that are consistent with objectives of stability, poverty reduction and growth. The increased demands on macroeconomic management will require improvement in domestic capacity.

### **Mobilizing Additional Domestic Resources**

There is a moral hazard concern that increased ODA flows are likely to serve as a disincentive to mobilizing public revenues in recipient countries (Heller, 2005). A 2003 IMF study found a modest negative impact of aid on the mobilization of domestic revenues, especially if aid is provided through grants rather than loans (Gupta et al, 2005). There is also the concern that an aid surge will weaken efforts to raise domestic savings. In reality, however, this will depend on whether ODA boosts both public and private investment (Mckinley, 2005). Recipient governments can reduce future levels of aid dependency by improving domestic resource mobilization, enhancing tax administration systems, and adopting reforms that enhance management of public resources. Countries can use their PRSP and national budgets to identify ways to free up domestic resources. In the long run, countries need to have a clearly formulated and effective strategic plans to enable them to eventually exit from aid dependence.

### **Redesigning the Framework of Service Delivery**

Most PRSPs have a medium-term focus and tend to tailor policy content to expected aid resources (Heller, 2005). With the prospect of increased aid, it is important to consider longer term strategic issues, which include boosting service

delivery. There is a need to consider new and innovative delivery mechanisms that can reach poor people directly. PRSPs should also be designed to take account of sector-specific absorptive capacity constraints when strategies for scaling up aid are being formulated.

### **Strengthening Public Financial Management**

The effectiveness of aid in improving productivity, incomes and welfare will depend on how the respective governments manage their resources. A World Bank-IMF study (2005) highlighted the weaknesses of public financial management systems in a number of areas including the formulation of budgets, classification systems, commitment controls, cash management, budget reporting, audit and regulatory capacity (for semi-autonomous agencies and extra-budgetary funds).

Ironically, higher aid flows may serve to exacerbate these weaknesses, and thus intensify the need to strengthen the capacity of budget managers independent of whether services are to be directly provided by the government or contracted out to the private sector (Heller, 2005). It therefore requires that budget managers systematically develop plans and address weaknesses in public expenditure management systems and improve domestic capacity to formulate and execute budgets in an environment of increased aid flows.

## **4.2 Role of donors**

### **Ensuring predictability of aid flows**

Uncertainty in the magnitude and duration of aid flows poses a significant macroeconomic challenge for developing countries. The effects of aid volatility would be more pronounced in a scaled-up scenario in which a significant share of budget resources are derived from aid flows. Donors can assist macroeconomic planning in recipient countries by providing steady and predictable funding. A close working relationship between budget officials in

recipient countries and donors, can ensure a stable and smooth disbursement of aid resources.

### **Improving coordination and harmonization of donor programs**

Poor donor coordination and harmonization are obstacles to improved aid efficiency in developing countries (see High level forum on Aid Effectiveness, 2005). There is a need for greater coherence of donor aid, and the introduction of measures that align aid programming and donor priorities behind those of aid recipients using the Poverty Reduction Strategies (PRSs). Ensuring aid facilitates, rather than hinders, the development process requires various reforms such as, simplifying procedures, eliminating burdensome practices, and relying more on country strategies and systems (Heller, 2005). The shift in emphasis by donors on temporary policy changes to the development of institutions for growth, is important to reduce aid dependency (Adam and O'Connell, 1998). Some analyses, for example, Svensson (1998), have stressed the importance of commitment in foreign aid policy. It is argued that if donor governments can enter into a binding policy commitment, aid may mitigate rent-seeking behaviour and promote productive public spending in recipient countries.

### **Benefiting from economies of scale**

Unlocking efficiency gains may extend beyond merely using aid delivery instruments more efficiently. Further gains may be derived by identifying and exploiting economies of scale. A key finding by Birdsall (2006) is that regional or even global public goods are highly promising, but yet under-funded development opportunities. Donors should look for ways to provide more assistance to regional public goods that would benefit low income countries outside the normal aid channels.

### **Technical assistance and capacity building**

Development interventions should be designed taking into account absorptive capacity constraints, rather than assuming that more resources will immediately translate into improved outcomes. Measures to overcome short-term and long-term constraints, such as capacity building, should be incorporated into programs at the design phase. As the pressures to demonstrate aid results and achieve MDGs rise, aid recipients need to constantly prioritize sectors requiring expenditure. Where possible, rapid technical assessments (for example, using tools from cost benefit analysis) could be employed in prioritizing sectoral investments. Donors can improve the quality of project implementation in recipients countries, by strengthening capacity of local authorities to implement aid-financed expenditure programs.

### **4.3 Role of International Financial Institutions (IFIs)**

International financial institutions (IFIs), notably the IMF and World Bank, can help in providing policy advice and support to help aid recipients cope with the anticipated macroeconomic challenges of increased ODA flows. The IMF can help countries formulate and manage their long run external policy framework, calibrate fiscal and monetary policies and determine an appropriate foreign exchange reserve strategy. Fund officials can also assist authorities in recipient countries to ensure the consistency and sustainability of their fiscal policy (Heller, 2005).

The IFIs should intensify their assistance to countries in building sound institutions, which strengthen the capacity of the public sector in improved budgetary management. The IMF could usefully provide comparisons of the likely impact of different fiscal stances on the achievement of the MDGs. For instance, if health expenditure is scaled up by a specific percentage, what impact would this have on poverty? In an environment of increased aid flows, policy support from the IFIs would become increasingly important.

## 5. Issues for Discussion

This paper has discussed the challenges facing countries and donors in managing a doubling of aid. There are a number of challenges that aid recipient countries and donors should focus on:

- Managing potential loss of competitiveness (i.e. conventional Dutch disease concerns);
- Avoiding a decline in the quality of public expenditure (and hence concerns about public sector absorptive capacity);
- Dealing with the transmission of aid volatility to macroeconomic management; and
- Addressing political concerns on growing aid dependency, and the intrusion of conditionality and unwelcome political oversight.

Given the reality that African countries have different needs, have different policy capacities, and experience different degrees of absorptive capacity, it is essential that aid policy be sufficiently flexible to allow each country engage with the process at its own pace and conditions.

Some issues for discussion:

- What are the challenges of incorporating macroeconomic frameworks into country PRSPs?
- What steps can countries take to address Dutch disease problems where a large inflow of aid causes the exchange rate to appreciate in real terms, damaging exports and distorting the real economy?
- How can countries manage the tensions between fiscal, monetary and exchange rate policies as aid increases?
- How can donors and countries prevent the damage caused by uneven, temporary flows which distort spending patterns, and create inefficiencies in the economy?

- How can donors and countries prevent the damage caused by off-budget aid which erodes governance and accountability within recipient countries?
- What role should the IFIs play in helping countries to design macroeconomic frameworks that are consistent with achieving the MDGs?

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