AID AND REAL RESOURCE TRANSFERS

An Outline of Work in Progress

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Common Perceptions

- Aid is fully absorbed (i.e. foreign exchange is spent on imports)

- Aid is fully spent (i.e. used to finance govt. expenditures)

- These are misconceptions

Observations (1999-2005)

- On average about 40 percent of aid to SSA is not absorbed, but is added to reserves

- Only about 30 percent of aid was used to finance increased budgetary spending

Questions

- How can the relatively low use of reserves be explained?
- Can it be justified?

Macro Impact Of Aid

Aid absorption and spending have separate, but often mutually reinforcing impacts

Aid Absorption

- Sale of aid dollars by central banks puts upward pressure on the real exchange rate and downward pressure on interest rates
- Imports will probably rise, but exports may fall and capital flow out

Aid Spending

- If spending is directly on imports, then no impact on exchange or interest rates

- If spending is on nontraded goods, real exchange rate will appreciate (Dutch Disease) and interest rates rise.

Supply-Side Effects

- Adverse macro impact of aid may be offset by supply-induced response
- Supply response may be quick (infrastructure spending) or slow (education outlays)

So Back to the Question:

- Why Has Relatively Little Aid Been Used?

There Are a Number of Valid and Legitimate Reasons

- Concerns over real exchange rate appreciation

- Aid volatility. Aid is much more volatile and unpredictable than tax revenues in developing countries. Governments respond rationally by saving aid inflows

- Low reserves. This renders an economy vulnerable to shocks, currency instability and BoP crises. Problem may be addressed if aid is added to reserves and not absorbed

- Unsustainable fiscal dynamics. Countries may have unduly large domestic debt burden. Aid receipts can be used to pay down debt

In Short.....

There may therefore be acceptable reasons why aid is not absorbed or spent. However, the rationale diminishes over time:

- Positive supply-side impact will increase over time (assuming aid is spent “effectively”), thereby diminishing Dutch disease concerns

- Once adequate reserves have been built up or domestic debt reduced, there is less reason to save aid

Indeed there is evidence that, more recently, much larger proportions of aid are being absorbed and spent

Real Resource Transfers

- For commodity aid, the resource transfer is automatic and visible

- For cash aid (now more than one-half of all aid), the picture is murkier. It is far from clear whether the resource transfer occurs and, if it does, what form does it take

Aid inflows lead to one or a combination:

- Higher imports
- Lower exports
- Higher reserves
- Private capital outflows

We know that 40 percent of aid has gone to reserve accumulation, but the issue is what happened to the rest.

Preliminary evidence indicates that Dutch Disease (i.e. lower exports) does not appear to have been a problem, but it also appears that imports have not risen significantly. Rather, much of the aid received seems to have flowed back out through the capital account.

The magnitude of the impact on capital outflow in SSA will be the focus of empirical work

In Sum:

- The provision of aid may have resulted in relatively little transfer of real resources to SSA