The New Aid Approach

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Seminar trainees ‘attachés internationale samenwerking’
Brussels
Day 2
25 May 2007, Brussel

DAY 2 : Thematic Issues

I. The macroeconomics of aid
II. The role of the IMF, WB and other IFI
III. Cracks in the aid paradigm
IV. Lessons for Belgium

I. The macroeconomics of aid[1]

I.1 The basics

I.2 The effect of traditional projects

I.3 The effect of new aid modalities

I.4 Problem n°1: inflation

I.5 Problem n°2: fiscal instability

I.6 Problem n°3: Dutch disease

1: My colleague Danny Cassimon kindly allowed me to borrow and adapt several slides from a recent powerpoint presentation of his on the same topic

I.1 The basics

- Aid provides additional international purchasing power
- Aid thus has an effect on the **balance of payments**, and on the **exchange rate**
- Aid to the government also has an effect on the **budget**, and may provoke a fiscal response
- When aid is used for local spending, it has an effect on the money supply, and possibly on **inflation**
- When aid leads to an increase in production there are second round effects

Some exercises

(trace the effect on the balance of payments, the budget, and inflation)

1. The European Commission provides a €50 million grant to an African country to buy on the world market spare parts for the state railway company
2. Migrant worker remittances in a Central American country increase by $2 million; they are mainly used to construct houses using local labour and local construction materials
3. In the 1980s Belgium provided €4 million balance of payments support to a Central African country on the condition that the forex be sold to private sector operators, and that the receipts in local currency be kept in a counterpart fund (CPF) with double signature. Years later Belgium insists that ‘its’ CPF be used to increase social spending

- Mostly these macroeconomic effects are benign, but misalignment of fiscal, monetary and exchange rate policy may cause negative effects, such as inflationary pressure, Dutch Disease and economic instability
- With increasing but unpredictable levels of aid through the budget, the risks of macroeconomic mismanagement are magnified

Aid absorption

- Effect of aid on the non-aid current account of the balance of payments

$$absorption = \frac{\Delta(non - aid \text{ current account deficit})}{\Delta\, aid}$$

- To what degree is aid used to buy additional imports ?

Aid spending

- Effect of aid on the non-aid budget deficit

$$spending = \frac{\Delta(Total\ \mathrm{expenditure - Total\ Domestic\ Revenue})}{\Delta\ \mathrm{aid}}$$

- To what degree is aid used to finance additional public spending or to reduce taxes ?

I.2 The effect of traditional projects

- In traditional projects aid is mostly used to buy imports from the donor country (tying)
- Aid thus is by design ‘absorbed’
- On the other hand, such traditional projects bypass the government budget (not ‘through’, not even ‘on’ budget), and therefore there is no direct fiscal incidence
- But fungibility of aid: the government may well reduce its own spending in reaction to the project
- The ensuing saving may be spent on some other items (salaries, military spending, another development project,…) or used to reduce taxes

I.3 The effect of new aid modalities

- Aid increasingly ‘on’ and ‘through’ budget
  - this may be considered intentional fungibility
- Aid is less tied
- More spending on non-traded items
  - recurrent spending (mostly salaries)
  - increased social spending (MDGs)

Aid need not be absorbed or spent

- Illustration: aid is not **absorbed** because the Central Bank, in an effort to boost reserves, decides not to sell off the foreign currency
- Illustration: aid is not **spent** because the government prefers not to increase public spending or to reduce revenue mobilisation, but instead to reduce its domestic debt

This gives rise to 4 possibilities

Absorbed and spent	Absorbed and not spent
• fiscal deficit increased • Central Banks sells forex • current account deficit widens • no inflation effect	• fiscal deficit unaffected • Central Banks sells the forex • current account deficit widens • inflation goes down
Not absorbed but spent	**Neither absorbed nor spent**
• fiscal deficit increased • forex reserves go up • inflation goes up	• fiscal deficit unaffected • forex reserves go up • no inflation effect

I.4 Problem n°1: inflation

- In general aid is not inflationary, except
  - when aid is spent but not absorbed (see slide 12)
  - when spending follows absorption with a considerable time lag (see slide 12 and exercise 3 on slide 5)
- What causes such inflationary pressure?
  - increased public spending on non-traded items not compensated by diversion of private sector spending into imports (absorption) and corresponding decrease in money supply
- What is the solution?
  - when inflation is low, this need not be a problem
  - when inflation is high, the additional pressure may have to be countered by domestic borrowing or by restrictive monetary policies
  - in each case there is ‘crowding-out’ of the private sector

I.5 Problem n°2: Fiscal Instability

- In LICs, fiscal revenue is already subject to more instability than in HICs because of dependence on trade taxes and importance of agricultural sector (world prices and weather-related supply volatility)
- Such instability is greatly amplified if budget support by unreliable donors becomes a major source of revenue
- This is problematic because spending needs do not follow same boom and bust pattern, but instead creep up steadily

Solutions

- One solution is for donors to provide more predictable budget support over longer periods of time
  - but if budget aid is subject to policy dialogue and conditionalities, instances of unilateral withholding of budget aid are bound to arise
  - also, donor aid policies change over time, and such changes are often driven by domestic considerations
- Another solution is for donors to allow recipients to smooth out aid spending
  - but the idea that a share of aid is stored away for some later use may be unpalatable to donors
- Any remaining instability must be handled by fiscal and monetary instruments such as
  - short-term borrowing by the public sector (including through the market for Treasury bonds)
  - short-term upward and downward revisions of the budget

I.6 Problem n°3: Dutch Disease

- Article in The Economist (1977) on the decline in Dutch manufacturing after the discovery, exploitation and export of natural gas
- But: may be caused by other circumstances that boost foreign exchange such as
  - Foreign investment, improved terms of trade, surge in remittances,…
- IMF is warning donors and recipients about such an effect of the increase of ‘new aid’

What is Dutch Disease?

- Welfare of the country increases
  - Additional international purchasing power
  - Consumption of both traded and nontraded items increases

- Not everybody enjoys equally
  - The non-traded sector becomes more profitable
  - Workers may see an increase in their real wages
  - The traded sector however suffers
    - exports and import substitutes
    - agriculture is often major export sector
    - thus poor farmers may suffer

- But the major problem is the revaluation of the real exchange rate
  - revaluation of exchange rate

  and/or
  - higher domestic inflation
- This makes the traded sector less competitive
- Yet this is considered the most dynamic sector of the economy in terms of technology and effect on growth

How to temper effect of Dutch Disease?

- An active exchange rate , monetary policy and fiscal policy can lessen the effect
- Much will depend on how the supply side reacts
  - Is there spare capacity in the non-traded sector?
  - Is aid used to remove supply constraints of the non-traded sector?
  - Is aid being used to boost productivity and competitiveness of the traded sector?

II. The role of the IMF, WB and other IFI

II.1 The World Bank

II.2 The IMF

II.3 The regional development banks

II.1 World Bank

- Selectivity
  - not in choice of recipients, due to mandate
  - yes on aid volume and modalities
  - lacks a clear and consistent approach to fragile states
- Alignment
  - much budget support, especially Poverty Reduction Support Credit (PRSC)
  - has difficulty aligning its projects
- Harmonisation
  - variable, depends on personalities
  - country delegation is a strong point
  - ‘harmonises’ rather than ‘gets harmonised’
- Policy dialogue and conditionality
  - increasingly together with other donors
  - but often dominant position

World Bank and aid selectivity

- CPIA: Country Policy and Institutional Assessment
- CPIA mesures degree to which political and institutional environment is conducive to poverty reduction and sustainable development, and thus leads to effective use of WB aid
- 16 criteria with equal weight
- An ordinal scale from 1 (low) to 6 (high)
- Assessment by staff, with checks and balances
- Timing: assessment of past performance. Scores published in June 2006 concern performance in 2005

Rank	Country	A. Economic Management			
		1	2	3	
		Macro. Mgt.	Fiscal Policy	Debt Policy	Ave.
1	ARMENIA	5.5	5.0	5.5	5.3
5	TANZANIA	5.0	4.5	4.0	4.5
15	BURKINA FASO	4.5	4.5	4.5	4.5
16	SENEGAL	4.5	4.0	4.0	4.2
17	VIETNAM	5.0	4.0	4.0	4.3
19	BOLIVIA	4.0	4.0	4.0	4.0
20	MALI	4.5	4.0	4.5	4.3
35	RWANDA	4.0	3.5	3.0	3.5
47	NIGER	3.5	3.0	3.5	3.3
61	BURUNDI	3.5	3.5	3.0	3.3
64	CONGO, DEM. REP.	3.5	3.5	2.5	3.2
76	ZIMBABWE	1.0	1.0	1.0	1.0

Rank	Country	B. Structural Policies			
		4	5	6	
		Trade	Financial Sector	Business Regulatory Environ.	Ave.
1	ARMENIA	4.5	3.5	4.0	4.0
5	TANZANIA	4.0	3.5	3.5	3.7
15	BURKINA FASO	4.0	3.0	3.0	3.3
16	SENEGAL	4.5	3.5	3.5	3.8
17	VIETNAM	3.5	3.0	3.5	3.3
19	BOLIVIA	5.0	3.5	3.0	3.8
20	MALI	4.0	3.0	3.5	3.5
35	RWANDA	3.5	3.5	3.5	3.5
47	NIGER	4.0	3.0	3.5	3.5
61	BURUNDI	3.0	3.0	2.5	2.8
64	CONGO, DEM. REP.	4.0	2.0	3.0	3.0
76	ZIMBABWE	2.0	2.5	2.0	2.2

Rank	Country	C. Policies for Social Inclusion/Equity					
		7	8	9	10	11	
		Gender Equality	Equity of Public Resource Use	Building Human Resour.	Social Protection & Labor	Pol. & Instit. for Environ. Sustain.	Ave.
1	ARMENIA	4.5	4.5	4.0	4.5	3.5	4.2
5	TANZANIA	4.0	4.0	4.0	3.5	3.5	3.8
15	BURKINA FASO	3.5	4.0	3.5	3.5	3.5	3.6
16	SENEGAL	3.5	3.5	3.5	3.0	3.5	3.4
17	VIETNAM	4.5	4.0	4.0	3.0	3.5	3.8
19	BOLIVIA	3.5	4.0	4.0	3.5	3.5	3.7
20	MALI	3.5	3.5	3.5	3.5	3.0	3.4
35	RWANDA	3.5	4.0	4.0	3.5	3.0	3.6
47	NIGER	2.5	3.5	3.0	3.0	3.0	3.0
61	BURUNDI	3.5	3.0	3.0	3.0	2.5	3.0
64	DR CONGO	3.0	3.0	3.0	3.0	2.5	2.9
76	ZIMBABWE	2.5	1.5	2.0	1.5	2.5	2.0

Rank	Country	D. Public Sector Management and Institutions						IDA Resource Allocation Index (IRAI)
		12	13	14	15	16		
		Property Rights & Rule-based Govern.	Quality of Budget. & Finan. Mgt.	Effic.of Revenue Mobil.	Quality of Public Admin.	Transpar., Account. & Corrup.in Pub. Sec.	Ave.	
1	ARMENIA	3.5	4.0	4.0	4.0	3.5	3.8	4.3
5	TANZANIA	3.5	4.5	4.0	3.5	3.5	3.8	3.9
15	BURKINA FASO	3.5	4.0	3.5	3.5	3.5	3.6	3.8
16	SENEGAL	3.5	3.5	4.5	3.5	3.0	3.6	3.8
17	VIETNAM	3.5	4.0	3.5	3.5	3.0	3.5	3.7
19	BOLIVIA	2.5	3.5	4.0	3.5	3.0	3.3	3.7
20	MALI	3.5	4.0	4.0	3.0	3.5	3.6	3.7
35	RWANDA	3.0	3.5	3.5	3.5	3.0	3.3	3.5
47	NIGER	3.0	3.5	3.5	3.0	3.0	3.2	3.3
61	BURUNDI	2.5	2.5	3.0	2.5	3.0	2.7	3.0
64	DR CONGO	2.0	2.5	2.5	2.5	2.0	2.3	2.8
76	ZIMBABWE	1.0	2.5	3.5	2.0	1.5	2.1	1.8

Elements from questionnaire for question 13 of CPIA score

Rating	Budget-Policy Link	Forward Look in Budget	Consultation with Spending Ministries	Budget Classification	Budget Comprehensiveness
1	If there is a budget, it is not a meaningful instrument, nor an indicator of policies or tool for allocation of public resources	There is no forward look in the budget	No meaningful consultation with spending ministries	No consistent budget classification system is used	More than 50 percent of public resources from all sources do not flow through the budget
3	Policies or priorities are explicit, but are not linked to the budget	There is no forward look in the budget	The budget is formulated in consultation with spending ministries	The budget classification system does not provide an adequate picture of general government activities	A significant amount of funds controlled by the executive is outside the budget (e.g., 10-25%), and a number of donor activities bypass the budget.
5	Policies and priorities are linked to the budget.	Multi-year expenditure projections are integrated into the budget formulation process, and reflect explicit costing of the implications of new policy initiatives	The budget is formulated through systematic consultations with spending ministries and the legislature, adhering to a fixed budget calendar.	The budget classification system is comprehensive and consistent with international standards.	Off-budget expenditures are minimal, and transparent.

World Bank and selectivity: continued

- IRAI (IDA Resource Allocation Index)
- ARPP (Bank’s Annual Report on Portfolio Performance)
- governance factor: relatieve score op WBI indicatoren
- CPR (IDA country performance rating)

  = (0.8*IRAI +0.2*ARPP)*governance factor

2005 data	Burundi	Tanzania	Vietnam	Bolivia
IRAI	3.0	3.8	3.7	3.7
ARPP	3.0	3.0	4.5	3.0
Governance factor	0.7	1.2	1.0	0.9
CPR	2.2	4.3	3.8	3.2

II.2 IMF

- Selectivity
  - not in choice of countries, due to mandate
  - in principle strict conditions
- Alignment
  - strongly aligned in sense of Paris Declaration
  - Poverty Reduction and Growth Facility (PRGF)
- Harmonisation
  - mandate form other donors to supervise macro-economic governance, emphasis on the short run and demand side
  - division of labour with WB not always clear
- Policy dialogue and conditionality
  - claims to have adapted to PRSP environment
  - often heard critcism: too much old style conditionality

II.3 The regional development banks

- Broadly comparable with World Bank

III. Cracks in the aid paradigm

III.1 The MDGs

III.2 The MCA

III.3 Vertical Funds

III.1 The MDGs

- Different origin of PRSP and MDG approaches
  - MDGs: UN General Assembly
  - PRSP: WB and IMF
- MDGs and PRSP in principle compatible
  - focus on poverty
  - results oriented
- But there are major areas of tension
  - choice of poverty goals
  - selection of targets
  - two contrasting stories about the importance of institutions for development

III.2 Millennium Challenge Account

- Bilateral US initiative
- 2002, operational 2004
- Separate organisation: Millennium Challenge Corporation
- Strong on selectivity
- Poor on Harmonisation and Alignment

The 16 MCA indicators

Indicator	Category	Source
• Civil Liberties	Ruling Justly	Freedom House
• Political Rights	Ruling Justly	Freedom House
• Voice and Accountability	Ruling Justly	World Bank Institute
• Government Effectiveness	Ruling Justly	World Bank Institute
• Rule of Law	Ruling Justly	World Bank Institute
• Control of Corruption	Ruling Justly	World Bank Institute
• Immunization Rate	Investing in People	World Health Organization
• Public Expenditure on Health	Investing in People	World Health Organization
• Girls' Primary Education Completion Rate	Investing in People	UNESCO
• Public Expenditure on Primary Education	Investing in People	UNESCO and national sources
• Cost of Starting a Business	Economic Freedom	International Finance Corporation
• Inflation Rate	Economic Freedom	IMF WEO
• Days to Start a Business	Economic Freedom	International Finance Corporation
• Trade Policy	Economic Freedom	Heritage Foundation
• Regulatory Quality	Economic Freedom	World Bank Institute
• Fiscal Policy	Economic Freedom	national sources, cross-checked with IMF WEO

Selection criteria

- Low and middle-income countries
- Above median score on at least half of every series of indicators, and above median score for corruption
- Scores are calculated and made public, comments awaited, final decision by MCC
- 25 countries at present eligible, of which 11 have made a proposal that has been accepted

Eleven countries have 'compacts' for a total of almost $3 billion

- Armenia
- Benin
- Cape Verde
- El Salvador
- Georgia
- Ghana
- Honduras
- Madagascar
- Mali
- Nicaragua
- Vanuatu

Financial means of MCA

Year	Requested	Voted
2004	$1.3 billion	$1.0 billion
2005	$2.5 billion	$1.5 billion
2006	$3.0 billion	$1.75 billion
2007	$3.0 billion	$1.75 billion
2008	$3.0 billion	

Spent (early 2007): $0.4 billion

III.3 Vertical funds

- Exhibit many of the weaknesses of traditional projects
  - high transaction costs
  - donor driven
  - undermine national ownership and institutions
- Appear to have quickly become the most popular vehicle for donor proliferation and fragmentation

Definition

- Initiatives at supra-national level
- Specific targets
- Separate organisation
- Often multi-donor
- Sub-sector or thematic orientation
  - climate change
  - agricultural research
  - tropical diseases, etc.

- In contrast with country oriented approach of new aid modalities

Some examples

- GFATM (Global Fund to Fight AIDS, TB, and Malaria)
- GAVI (Global Alliance for Vaccines and Immunization)
- GEF (Global Environment Facility)
- CGIAR (Consultative Group for International Agricultural Research)
- EFA-FTI (Education for All Fast Track Initiative)

- Spectacular increase in field of health

Stop TB Partnership

FIND FOUNDATION FOR INNOVATIVE NEW DIAGNOSTICS

iOWH

DNDi Drugs for Neglected Diseases *initiative*

MALARONE DONATION PROGRAM

President's Emergency Plan for AIDS Relief (PEPFAR)

Global Alliance to Eliminate Leprosy (GAEL)

Initiative on Public-Private Partnerships for Health

Concept Foundation

Accelerating Access Initiative

TREAT 3 million by 2005

RBM ROLL BACK MALARIA

SECURE THE FUTURE

Medicines for Malaria Venture

APOC

A FUTURE FREE OF LF Global Alliance

2020 THE RIGHT TO SIGHT

MTCT PLUS

iavi International AIDS Vaccine Initiative

GAVI ALLIANCE

gain Global Alliance for Improved Nutrition

CLINTON FOUNDATION

ACHAP

Global Polio Eradication Initiative

GLOBAL ALLIANCE FOR TB DRUG DEVELOPMENT

International Trachoma Initiative

GBC

HIV VACCI... TRIALS NETW...

Pfizer DIFLUCAN PARTNERSHIP

mvi malaria vaccine initiative

step forward A GLOBAL CARE INITIATIVE from ABBOTT and the ABBOTT FUND for ORPHANS and VULNERABLE CHILDREN

Children's Vaccine Program

Global Health Council

EMVI The European Malaria Vaccine Initiative

...ltilateral Initiative on ...

Global Campaign FOR MICROBICIDES

Hope for African Children Initiative

MECTIZAN DONATION PROGRAM

NetMark Public-Private Partnership

Schistosomiasis Control Initiative

US Presidential Initiative FIGHTING MALARIA SAVING LIVES IN AFRIC...

The Micronutrient Initiative

PDVI Pediatric DENGUE VACCINE INITIATIVE

When are vertical funds useful ?

1. When they contribute to ‘global public goods’
   - country related criticism becomes void in this case
   - but in reality vertical funds often produce national, even local goods and services

2. When they provide additional financial means
   - that outstrip the external costs created at country level
   - it is not clear whether this is the case

IV. Lessons for Belgium

- Learn from good practices of other donors
- Develop a H&A business plan
- Address institutional weaknesses
  - division of labour with BTC
  - integration in foreign affairs
  - results-based autonomy for aid officials
  - folly of regionalisation of development co-operation

Good bilateral donor practices

- A central ODA department
- Major responsibility shift towards fields offices
  - ‘one window’ approach
- Redefine role of headquarters
  - policy guidelines and supervision
  - HRM
  - quality management
- Adapt financial and audit control mechanisms
- Manage aid modalities flexibly (‘portfolio approach’)
  - ABS, SBS, programmes, ‘new style’ projects, TA, …
- Better co-ordinate
  - bilateral and multilateral
  - direct and indirect bilateral

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