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World Institute for Development
Economics Research

CALL FOR PAPERS
AERC/UNU-WIDER Research Project
THE MACRO-ECONOMIC MANAGEMENT OF FOREIGN AID
Deadline: 29 July 2011

Organization

Proposals for papers on the macro-economic management of foreign aid are sought by 29th July 2011 under this project led by the Africa Economic Research Consortium and the World Institute for Development Economics Research of the United Nations University (UNU-WIDER). Papers will be presented at a conference to be held 24-25 November 2011 prior to the AERC Biannual Research Workshop at a venue to be communicated later.

Topics

Papers of the following type will be considered:

- Conceptual and theoretical papers that build new models with the objective of embedding the characteristics of aid more fully into the conceptual and theoretical analysis of its macro-economic impact. Particular attention should be paid to modelling alternative policy scenarios or the impact of aid on the supply-side (e.g. via infrastructure and institutions).
- Policy papers exploring the macro-economic management of aid. These should highlight success and failure, and make recommendations for improvement. Policy papers should analyse fiscal dimensions, monetary policy, and exchange-rate management as well as how production incentives in particular sectors (e.g. agriculture and manufacturing) are affected by aid flows (including between tradables and non-tradables, and the role of aid-financed infrastructure).
- Country case studies from the Africa region (including North Africa) as well as other developing regions. These will include the aggregate time-series effects of aid, as well as aid's impact on important sectors such as agriculture (using econometric techniques, applied general equilibrium models, and analytical narratives).
- Papers comparing the macro-economic effects of aid with other types of capital inflow, including remittances, foreign direct investment, resource-revenues, and portfolio flows. These may be country case studies or cross-country papers (including comparisons between Africa and other regions).

Requirements and Key Dates

Proposals must consist of: (i) a one-page summary of the paper setting out the issues to be analysed together with the methods to be used (ii) a CV for each author (including in the CV: nationality, gender, age, and full contact details). Submission of proposals by 29th July 2011 to: macroecon@aercafrica.org. Authors of proposals will be informed of the decision of the project

directors by 29th August 2011. Final papers for presentation at the conference must be received by 1 November 2011. Conference and travel arrangements will be organized and provided for the successful authors.

It is planned to publish the papers in a journal special issue or in a book after their dissemination as working papers. Only papers not presently under consideration for publication elsewhere will be considered. Target Length: 8,000 words.

Motivation for the Project

For aid-recipient countries together with their donor partners, a major issue is the effective management of aid inflows to achieve development objectives. Creating an appropriate *macro-economic framework* around aid is essential to this task. This is especially so when the aid inflow is large in relation to the economy's size and the scale of the government's budget—which is often the case in low-income countries, especially those recovering from conflict.

Aid has the potential to relax *supply-side* constraints and increase the economy's potential output, especially in the tradable sectors (both exportables and import-substitutes). Aid may then have favourable effects on the rate of growth, the balance of payments, and government revenue (through the rise in the tax base associated with growth). Much recent attention has been devoted to aid's role in financing infrastructure, which is critical to improving the supply-side of poor economies. Aid's role in financing human capital investment may also 'shift the supply curve rightward' over the longer term, as the social returns from education and health improvements kick in. Aid can also help to move exports 'up the value chain' by, for example, projects for the domestic processing of commodity exports.¹

However, aid also has a potentially negative effect on growth, originating in its *demand-side* effects. Aid in large volumes raises domestic demand and, with inelasticity in the production of non-tradables, the relative price of non-tradables may rise relative to tradables (a 'spending effect'). This real-exchange rate effect may then cause an adverse response on the supply-side, with domestic factors of production being drawn away from exportables and importables production and into the non-tradables sector (the 'resource movement effect'). If the exchange rate is flexible then some appreciation in the nominal exchange rate is to be expected as well with the same impact on incentives to produce tradables. This adverse impact is known as 'Dutch Disease' in the debate following the early literature on resource-windfalls.² By lowering growth and widening the trade deficit, it may lead a country into more aid-dependence, not less.

Dutch disease is a potential consequence of any large inflow—aside from resource-revenues, remittances have also received attention (Lopez et al., 2007). Whether aid has a significant Dutch

¹ The upgrading of Rwanda's coffee quality is one aid success story (Easterly and Reshef, 2010: 4).

² Fiscal and monetary responses often cause difficulty: Budina et al. (2007) discuss fiscal policy to manage oil revenues in Nigeria.

Disease effect depends in part on the macro-economic framework.³ A key role is played by monetary policy, with the sale of treasury bills to absorb ('sterilize') some of the liquidity associated with the inflow and dampen the spending effect.

A well-designed macro-economic framework must be constructed around aid (as with any inflow), including well-crafted fiscal and monetary responses (Addison and Roe, 2004).⁴ This is often in a context where aid itself is volatile, and pro-cyclical. The thinness of domestic financial markets can impede sterilization, and the need to sell large amounts of treasury bills can distort incentives within the banking sector with potentially adverse effects on funding private investment.⁵

There are also major institutional issues in improving the capacities of ministries of finance and central banks to manage the process effectively, especially in fragile states. The conflict and post-conflict countries within the fragile-state group have special problems as well since the volume of aid can be very large, the supply-side very weak, and the macro-economic management capacity very thin (Addison and McGillivray, 2004).

For aid, a fundamental issue is how well and how quickly the investments that aid finances, in infrastructure for example, improve the supply-side of the economy. Success in shifting the supply-curve rightward in the tradables sector (agriculture in particular) can dampen, or offset, any negative impact of any real appreciation on incentives to produce and invest in the tradables sectors.⁶ Support from aid to industrial policies that encourage diversification of the supply-side of the economy, and add more domestic value to local commodities (both in agriculture and minerals), can also help. However, there are also some potentially difficult trade-offs that need consideration. For example, investment in human capital via health and education, should ultimately improve the economy's supply side, but this effect is longer term, while in the short term, the aid-inflow to finance better health-care and schooling may have a Dutch Disease effect.

These issues have been regularly discussed in the research and policy communities.⁷ Some observers make the strong statement that Dutch Disease is a major consequence of aid, and will always be, whatever policy response is in place.⁸ In part, this reflects a focus on aid's first-round spending effect ignoring aid's role on the supply-side. Early-generation Dutch Disease theory did not give much attention to the use of the inflow to invest in the supply-side to reduce the problem. The theory behind Dutch Disease is largely within a static (fixed GDP) context, with either an implicit or explicit assumption that all productive factors are employed.⁹ This is not a

³ See Adam and Bevan (2004, 2006); Prati and Tressel (2006).

⁴ This is true of all inflows (Budina et al., 2007).

⁵ Hauner (2009) and, for Uganda, see Atingi-Ego (2006).

⁶ Some success is evident in Burundi, for example (Nielsen and Madani, 2010).

⁷ See: Adam and Bevan (2006); Adenauer and Vagassky (1998); Atingi-Ego and Sebudde (2000); Elbadawi (1999); and Fielding (2010).

⁸ Glennie (2008); Moyo (2009).

⁹ That is, the economy starts from a position on its full-employment production frontier.

realistic assumption for low-income countries, especially those coming out of conflict, and in which war has pushed economic activity far below its pre-war production frontier (Addison and Murshed, 2005). The intertemporal dimension (including the behaviour of agents) that is crucial for designing the policy response is largely absent in Dutch Disease models. Richer models are urgently needed that place the issue within a growth context. Devarajan et al. (2008) is one such analysis: their study finds the real appreciation to be far less significant in a dynamic setting with forward-looking agents (and provided that aid flows are smooth rather than volatile: a key result for policy). Consequently, this project must engage in theoretical innovation.

Aid's role in improving institutions is also critical here and probably results in significant differences with other types of external inflow. For example, in contrast to a resource-windfall, much aid tends to be associated with, and partly finances, institutional improvements (often in the macro-economic management area) whereas oil and other resource revenues are often not used this way (Collier, 2006). The scale of such improvement is of course much discussed, including the relationship between aid, economic reform, and growth (Hansen and Tarp, 2001). But it is the case that there is a much more explicit link between aid and the goal of institutional improvement than other types of flow such as resource-revenues and remittances that might cause Dutch Disease problems.

The empirical evidence, from country case studies and cross-country data, is also very mixed (and the case studies themselves are quite patchy in country coverage).¹⁰ Rajan and Subramanian (2010) find an adverse impact of aid on manufacturing exports, reinforcing their earlier aid-growth study (Rajan and Subramanian (2008)). But Arndt et al. (2010) overturns the results of Rajan and Subramanian (2008) and shows a robust positive impact of aid on growth in line with the priors of growth theory. This would indicate that Dutch Disease is not as significant an issue as is sometimes argued. The success in achieving economic growth in Africa in recent years—and the very respectable growth experienced in the aid-dependent economies of Ghana, Mozambique, Rwanda, Tanzania, and Uganda—would seem to cast doubt on the significance of Dutch Disease as a major problem or would indicate significant policy success in offsetting its effects. But a systematic interpretation of the evidence, including a good spread of country-case studies, is essential to moving beyond casual impressions and to build a more robust evidence base than we have at present.

In summary, Dutch Disease is a potentially serious consequence of aid, and may well have played a role in making aid less effective in some countries. This is an empirical question—and one that needs the support of theoretical innovation as well—and it is now time to investigate the issue in depth with analytical rigour. Accordingly, while there are a number of dimensions to the management of aid, *this project will focus most attention on the Dutch Disease issue as the core research question*. On this basis, and in consultation with policy makers, we aim to reach some

¹⁰ Studies include: Adenauer and Vagassky (1998); Atingi-Ego (2005); Atingi-Ego and Sebudde (2000); Elbadawi (1999); Nyomi (1998); Sackey (2001); Selaya and Thiele (2010); Vos (1998); White and Wignaraja (1992); Yano and Nugent (1999).

consensus on what has happened, and what needs to be done, policy-wise, to improve the macro-economic framework around aid and guide appropriate investments to improve the supply-side of aid-recipient economies. The analysis should also generate results that are applicable for the management of other types of inflow, such as resource-revenues and remittances.

Select Bibliography

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