3 REFORM THE AID SYSTEM TO FIX THE SLOW-BURNING GLOBAL POVERTY CRISIS

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What's at Stake

As the heads of state of the G-20 countries meet in Washington on November 15 for their first ever summit, they should spare a thought for the world's poor. The summit is focused on the crisis in global financial markets, which indirectly affects most developing countries. But it should not ignore the problems with official development assistance (ODA) which directly affect the Main Street in the poorest countries. Long-term global stability depends as much on reducing global poverty as it does on fixing the regulations governing global private capital. So global leaders should take this opportunity to consider how to make ODA less volatile and more suitable for financing sustainable development.

Today's crisis emphasizes two old lessons of finance. Financial markets penalize policy weaknesses and mistakes. And financial markets amplify economic cycles. For many emerging markets these truths have meant that access to foreign finance has been a mixed blessing. It has permitted faster, and oftentimes more efficient, fixed capital accumulation. But it has also been associated with crisis and development set-backs. Not surprisingly, the empirical evidence on the link between external finance (excluding FDI) and development is weak. Some of the emerging economies that have been hardest hit by the current financial crisis, like Hungary, the Baltics and Iceland, are among those that enjoyed earlier growth benefits from capital opening, but must now face the consequences of their risky approach.

Most emerging markets have chosen a safer strategy, with cautious opening of domestic capital markets and an emphasis on stability. These countries have learned that the downsides of instability and the risk of crises can outweigh the efficiency gains from integrating rapidly with global finance. Their development policy has emphasized mobilization and use of domestic savings and the pursuit of macroeconomic stability with low and stable inflation and exchange rates.

Poor countries have found it harder to resist external finance in the face of limited domestic resources and large needs. They are heavily reliant upon ODA in the form of grants or cheap credits to build infrastructure and provide needed education, health and other social services. But just like private capital, ODA is subject to sudden stops and starts. And just like private capital, volatility in ODA undermines its effectiveness as a tool to finance sustainable development.

One problem with aid is that it is unpredictable. Rich countries promised to increase their ODA to $130 billion a year by 2010 at the Gleneagles G8 Summit in 2005, while doubling aid to Africa. But after a burst of large increases, primarily for debt relief, aid flows have declined in the last two years and the Gleneagles targets now seem unreachable. In today's environment, with domestic fiscal stimulus and bank bail-outs stretching deficits in rich countries, the prospects for rapid increases in ODA are dim. Thankfully, emerging market donors who are members of the G-20, like China, India and Korea, are picking up part of the slack. But these new donors have not formally announced specific future aid commitments, and in some instances they compete with other donors instead of complementing their efforts.

Like private capital, official aid tends to be concentrated on a few countries with good reputations. By design, ODA is sensitive to the policy and institutional environment of recipient countries. A handful of "donor darlings" that adopt orthodox economic policies, as defined in the capitals of the West, get the bulk of official aid. In some cases, this link is explicit: the threshold approach of President Bush's Millennium Challenge Corporation (MCC) and the allocation formula of the International Development Association (IDA) formally link aid volumes with policy measures. In other cases, the link is more implicit, dependent on a variety of factors, including non-economic considerations. Regardless, recipient countries have learned that being a "donor darling" one day is no guarantee of being a darling in the future. When countries change course, the aid tap can be turned off. Ownership and accountability for results in aid recipient countries suffer accordingly.

Again like private capital, official aid is highly volatile. In fact, for the typical aid recipient country, it is five times as volatile as GDP and three times as volatile as exports. As a result, ODA tends to amplify real business cycles in recipient countries. Worse, the aid system can also deliver massive real income shocks. In fact, on rare occasions, aid shocks of fifteen percent of recipient country income have been reported. Shocks of this magnitude have only been experienced by industrial countries during the Great Depression, the Spanish Civil War and the two World Wars.

Large, albeit rare, shocks have long-lasting effects on economies. The impact of shocks is not symmetrical. Investors appear to care much more about very bad outcomes than they do about the potential for bonanzas. In advanced countries, this can be seen in the equity market premium that is required to offset risk. In poor countries, there are several manifestations of high aid volatility. Some countries build financial balances, but that means leaving resources idle with high opportunity cost. In other cases, aid volatility results in distortions in the choice of investment projects. High return, but long gestation, projects are put off for fear that future funding might be hard to come by. Aid volatility is also linked to volatility in fiscal spending and volatility in real exchange rates.

Adding all the costs together, the deadweight loss from aid volatility could reach around 15 percent of total flows, equivalent to $16 billion per year or 2 percent of recipient country GDP. Such large costs suggest that reducing volatility should be a priority for donors.

It is theoretically possible that high aid volatility results from capricious policies in some recipient countries, or from the international response to humanitarian disasters or one-off aid appeals, like coordinated debt relief. In practice, these explanations account for little if any of the observed volatility. Volatility in official aid directed towards projects and programs is even higher than volatility in total aid. And volatility is the same for most recipient countries, regardless of their economic characteristics—income levels, policy performance, aid dependency, or geographic location.

On the other hand, aid volatility does depend significantly on donor country characteristics. Some countries, like the United States, exhibit high volatility (per dollar of grants or credits). Others, notably the Scandinavian donors, show very low levels of volatility. These donors provide steady support to the same countries and the same sectors year after year. Continental European countries and multilateral development banks fall between these groups.

What Should Be Done

Three actions would go a long way towards fixing official aid.

Reducing volatility should be a priority. Measures of disbursement volatility could easily be included in results management systems of aid agencies. As an example of volatility, consider US (non-military) aid to Pakistan. In the late 1990s, the US was receiving $100 million per year from Pakistan in net terms, as loan repayments exceeded disbursements. In 2001, as Pakistan became a front-line state in the war on terror, net US ODA rose to $880 million. A mere two years later, in 2003, aid fell to $113 million. It then quadrupled to $480 million in 2006. Instead of these stops and starts, a strategic approach towards aid to Pakistan would have been much more effective in promoting Pakistan's development and securing US interests in the region.

Multi-year financial programming mechanisms should become standard across all donors. Aid is best used when it supports long term development programs. That means that donors should be prepared to provide predictable indicative funding commitments for the duration of the program. New global funds and programs like the MCC do precisely this, but they are the exception rather than the rule. Most aid depends on annual budget appropriations.

Last, multilateral development banks should be encouraged to develop counter-cyclical instruments that can be deployed to offset the fluctuations in bilateral aid that will inevitably occur as legislatures juggle annual budget priorities. The International Development Association and other regional development banks are well placed to use their funds much more aggressively to smooth total aid flows. They could provide countries with insurance against aid shocks and sharply reduce the macroeconomic volatility caused by aid.

The Bottom Line

The summit serves as a reminder that managing global risk in a proactive fashion is key to avoiding global crises. In addition to the crisis in financial markets, there is a slow-burning global crisis of poverty and inequality that also threatens global stability. We can only hope that the world's leaders will take action to defuse this crisis by reforming the aid system.

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