



Keeping ODA afloat: no stone unturned

If past experience is anything to go by, today's financial crisis will deal a hard blow to official development assistance flows. It could take ODA years to recover, dampening prospects for achieving the MDGs by 2015. Keeping aid afloat – ensuring that aid flows are sustainable and predictable – is critical to helping developing countries cope and also to stabilizing global demand. This is a tall order, given the scale of the crisis. Fresh new thinking is often the only way out of desperate situations such as this. UNCTAD puts one option on the table in this policy brief. The proposal may strike some as ambitious, naïve, or otherwise unviable. But today especially, every possible solution deserves consideration.

The current recession, and some of the stimulus measures being introduced to combat it, is compounding budget deficits and budget reallocations in many donor countries. ODA is a soft target in such situations; during past banking crises, it has dipped anywhere from 20% to 40%. A recent study¹ found that the crises affecting Finland, Japan, Norway and Sweden in the 1980s-1990s were all followed by a substantial decline in foreign aid, ranging from 10% in Norway to 62% in Finland. Furthermore, ODA levels tend to recover very slowly – in Sweden's and Norway's case, six-to-nine years after the trough, according to the same study. Finnish and Japanese aid flows, meanwhile, have yet to return to their pre-crisis peaks². Given the depth of today's crisis, the recovery period is likely to be similarly long.

Recent econometric calculations by UNCTAD of all donor countries that have undergone a banking crisis in the past 30 years confirm the positive correlation between banking crises and shrinking ODA (see figure). In the year of the crisis, average ODA drops by about one percentage point. In the following year, the cumulative drop is about four percentage points, and in the fifth year, 30 percentage points. While the dip is partially driven by the extraordinary experience of Finland, the dotted line in the figure shows that the slump is significant even when that country is excluded from the analysis.

What will this mean for developing countries, especially those whose development, domestic spending and daily survival depend heavily on foreign aid?

First of all, if ODA recovers from the present crisis as slowly as it did previously – say, three

to four years hence, just when world markets are beginning to pick themselves up again – developing countries will be caught short, lacking the productive capacity they need to take advantage of reviving opportunities.

Second, since some donors set their aid targets as a percentage of GDP, a drop in GDP could lead to a drop in aid. Moreover, aid budgets are usually fixed in domestic currency; and if that currency depreciates against the recipient's currency, the value of the aid budget in the recipient currency will decrease as well. The UK's aid budget, for example, is expressed in pounds, whose exchange rate has fallen steeply in recent months. Its recent depreciation will thus translate into a «real» decline of British ODA for most of the countries receiving that aid.

This dire situation cannot be addressed through worn-out remedies. New thinking will be needed – and indeed, several innovative proposals are already on the drawing board or in the trial stages, including a currency transaction tax, global lotteries, vulnerability funds, subsidized investment funds for developing countries, and markets targeting ethical investors. Another solution that merits serious thinking, even if it initially appears utopian, would be to create safe, ODA-specific endowments funded by the interest on the assets. The endowment model has worked repeatedly well for educational institutions, and could similarly fulfil the critical need for predictable ODA flows.

Predictability has generally not been assured thus far, because aid budgets, like other government budget lines, are subject to annual or pluriannual decision-making processes. If aid agencies were

¹ David Roodman, "History says financial crisis will suppress aid", 13 October 2008, http://blogs.cgdev.org/globaldevelopment/2008/10/history_says_financial_crisis.php.

² Some of the countries that cut their aid in the 1980s-1990s have recently pledged to increase it, despite mounting domestic difficulties in facing the current crisis.



instead provided with an endowment, and their activities funded through the interest earned on principal, this would give them a degree of independence and help stabilize the global economy in the process. In order to eliminate debt roll-over problems this endowment could be created by issuing government consols (“consolidated annuities”; i.e., government bonds with no maturity date). The aid agency could then use the interest revenues from the consols to fund its activities – but would be prohibited from using the capital.

Is it feasible?

Several concerns could be raised about this proposal, but all of them can be addressed.

The first concern might emanate from financial markets and voters in reaction to a large and sudden rise in the country’s debt-to-GDP ratio. However, the funding mechanism proposed by this policy brief would involve an increase in “gross” but not “net” government debt, since the newly issued government bonds would be held by one of the government’s own agencies, with no change to the aggregate balance.³

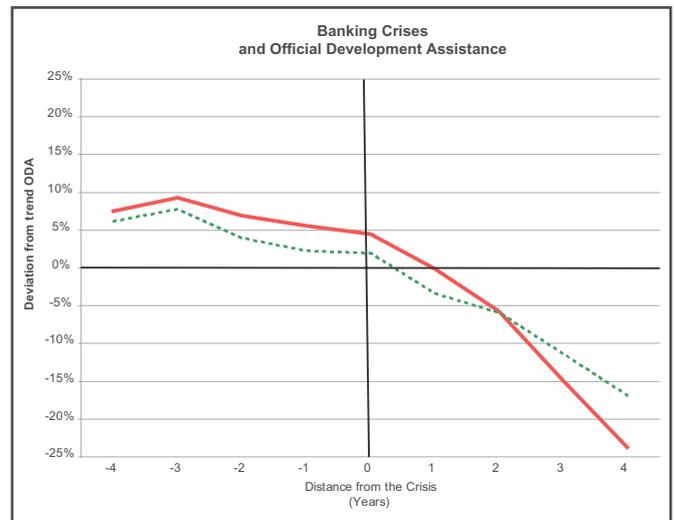
A second concern could be that the government would fail to honour the consols – the reason being that because they represent debt the government owes to itself, defaulting on them would be of little consequence. While this possibility is fairly remote, the concern could be dismissed if the aid agency were allowed to sell some of the consols and use the proceeds to buy other types of long-term government bonds – as long as it were not also allowed to hold risky assets. If there were any defaults on the consols, and the consols were held by any party other than the government, that party would view the default as a sovereign default, with all the damaging impact such an event can engender.⁴ The government would thus have a strong incentive to honour its obligations.

A third possible concern is that the proposed funding mechanism would not protect the quantity of aid from fluctuations in the exchange rate of the donor currency. This could be addressed by endowing the aid agency with government bonds denominated in a mix of currencies – or by having aid agencies from different countries exchange part of their endowment, which would also allay the second concern. In fact, donor governments might even consider endowing the aid agencies with debt instruments issued in emerging market currencies and thus develop a useful new market for debt denominated in such currencies. Clearly, however, the costs and benefits of altering the currency composition of the endowment need to be evaluated carefully, because linking the aid budget to the value of the currency of emerging market countries could lead to procyclical aid flows.⁵

In everyone’s interest

As previously mentioned, the endowment proposal may appear ambitious and politically unviable – especially in today’s global economic environment, where donor governments are likely to give higher priority to domestic concerns than external obligations. But the magnitude, complexity and global dimensions of the current crisis are such that all possible responses must be considered.

It is now widely accepted that the crisis can be tackled only through coordinated global responses that involve not just developed but also emerging, transition and developing economies. For the latter, foreign aid provides the main, and in some cases the only, source of the financing needed to prevent their sliding into deep recession and losing their hard-earned productive and exporting capacities. For these countries, the kind of stimulus package that more advanced nations are able to offer themselves is simply out of reach. But their economic survival depends on keeping demand healthy. And given the extent of global interdependence today, maintaining aid commitments and stabilizing aid flows will do much more than help recipient countries: it will also help stabilize global demand, which is in everyone’s interest.



The solid line includes all DAC donors that underwent a banking crisis in the 1970-2002 period. The dashed line excludes Finland. Both lines measure the percentage deviation of ODA from its long-run trend.

Source: UNCTAD calculations, based on OECD data.

³ Holding total aid constant, the proposal only involves a shift in the composition of government budget, with aid moving from non-interest current expenditure to interest expenditure.

⁴ Ugo Panizza, Federico Sturzenegger and Jeromin Zettlemeyer, «The Economics and Law of Sovereign Debt and Sovereign Default», Journal of Economic Literature, forthcoming. Mr. Panizza is a senior economist at UNCTAD.

⁵ For a discussion of “original sin” in international finance see Eichengreen, Hausmann and Panizza (2007), “Original Sin, Debt Intolerance and Currency Mismatches: Why They Are Not the Same and Why It Matters”, in S. Edwards (ed.), Capital Controls and Capital Flows in Emerging Economies: Policies, Practices and Consequences. NBER and University of Chicago Press.