

*Aid volatility: implications for
poverty eradication and stability*



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Context:1

- Some awareness in the literature (growth theory, investment etc) that ‘instability is bad for development’; also many studies from the micro-evaluation literature which assert this.
- Even some measures within the aid establishment which acknowledge and seek to diminish volatility (eg, the EU’s STABEX)
- But little attempt, until a few years ago, to assess the costs (and benefits?) of volatility in overseas aid flows.

Volatility and the aid-effectiveness debate

- The breakthrough was by Oliver Morrissey and Robert Lensink(2000) who showed that:
- (I) volatility damages the effectiveness of investment;
- (II) when included alongside investment, aid (especially in Africa) was not effective.
- Implication:lower volatility of aid receipts would increase aid effectiveness.

The IMF wades in

- However, what really put the cat among the pigeons was the claim by Bulir and Hamann(2003, 2005) that aid flows were, in most countries, much more volatile than domestic revenue and indeed ‘destabilising’
- This was emotive because domestic revenue is what the IMF tries to build up and protect: the Fund was accusing the donors of upsetting the applecart.

Was the IMF right? 1

- Bulir and Hamann's findings for the IMF have prompted many attempts at replication with the original data.
- Our own attempt (Hudson and Mosley, 2006, for DFID) finds that things are perhaps even worse than Bulir and Hamann claim: aid is between two and five times as unstable as domestic revenue, depending on the dataset and definition of variables that is chosen.

Was the IMF right to worry? Does aid volatility do harm?

- Apparently, yes. We calculate that, holding constant the level of domestic and world growth, a 10% increase in volatility is associated with a 1% decrease in growth (Mosley and Hudson, 2006)
- However, the effects of positive and negative volatility are not the same. Downside volatility, as one might expect, is worse (*ibid*)
- Volatility varies by aid type and country: worst with ‘reactive’ forms of aid, but NOT worst in poorest recipient countries

Table 8 : Impacts of Volatility on Growth: Overview

Estimation method	Panel data, fixed effects	3SLS combined with AR(1) forecasting equation		3SLS
Dependent variable	Growth of GDP	Investment		Poverty headcount
Investigator	This study (Table 7, column 4)	Lensink and Morrissey, 2000		Mosley and Suleiman, 2004 ¹⁰
Regression coefficients on independent variables:		Whole sample	Africa only	
Constant	8.632** (4.90)	15.16** (8.42)	4.26 (1.82)	-42.3** (4.64)
Aid as % GDP	0.064** (3.15)	0.22* (1.92)	0.23** (2.51)	0.034 (1.61)
Disaster measure	-2.419* (2.15)			
Aid volatility measure:				
‘Aid uncertainty’ ^{20/}		-0.77** (2.81)	-0.47 (1.29)	
Volatility as in this paper	-0.0993** (4.50)			0.175* (2.45)
CV of aid				
Lagged Volatility:				
Positive:	0.0635** (3.34)			
Negative:	Not significant			
World growth	0.317** (4.41)			
GDP per capita (logged in our study)	-0.591** (2.59)	-0.0003** (4.13)		2.23* (4.18)
GDP/cap, squared				-0.18** (5.12)
Time trend	-0.100** (8.18)			
Trade openness		0.059** (3.63)	0.142** (3.62)	0.095 (1.16)
Inflation (lagged one period)	-0.00015 (1.00)			
Ratio of money/GDP		0.114 (1.74)	0.246** (3.24)	
R2		0.36	0.57	0.61
Wald Statistic	99.47			
Number of obs	2554	88	43	663

Sources: as stated in row 3 of table. Figures in parentheses are Student's t-statistics: ** indicates significance of a coefficient at the 1% level and * indicates significance at the 5% level.

5. Conclusion

Why are aid flows unstable?

Possible explanations include:

- The domestic politics of donor countries: aid is not (has not been) politically important, hence is first to be cut in any recession;
- Coordination failures: inability by donors to agree about how recipient countries (especially failures in recipient countries) should be treated (Malawi 1997-, etc);
- Trust failures: fear by donors of ‘wasting taxpayers’ money’ and ‘not being seen to respond’;
- Shifts between aid modalities: from the ‘proactive’ to the ‘reactive’

The 'volatility-flexibility' trade-off

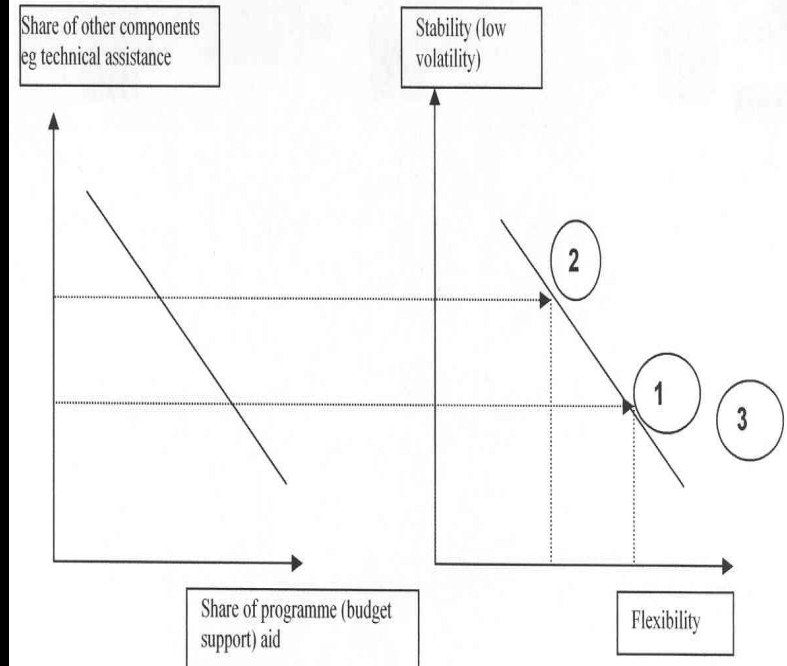
When there is a switch from more to less 'proactive' forms of aid (eg from budget support to technical assistance) volatility declines (left), but the flexibility of aid policy diminishes, which creates a 'trade-off' (right)

Table 3 Aid Volatility Disaggregated by Region and Policy Instrument

(standard deviation of net ODA for region and period stated)

	All developing countries, mean value	Africa South of the Sahara	South America	Far East	South Asia	Least developed countries
'Reactive' forms of aid						
Food aid (1975-2003, n=29, % of total aid flow)	0.68	0.55	0.58	1.04	0.76	0.48
Emergency assistance(1995-2003, n=9, % of total aid flow)	0.66	0.77	0.52	0.72	0.73	0.56
Budget support assistance(1986-2004, n=14, % of total aid flow)	0.47	0.42				0.51
Average, 'reactive' forms of aid	0.60	0.58	0.55	0.88	0.74	0.77
'Proactive' forms of aid						
Technical assistance(1966-2003, n=38, % of total aid flow)	0.32	0.18	0.44	0.37	0.53	0.23
Average, 'proactive' forms of aid	0.32**	0.18**	0.49	0.62	0.63*	0.50**
All aid	0.46	0.38	0.52	0.74	0.68	0.63

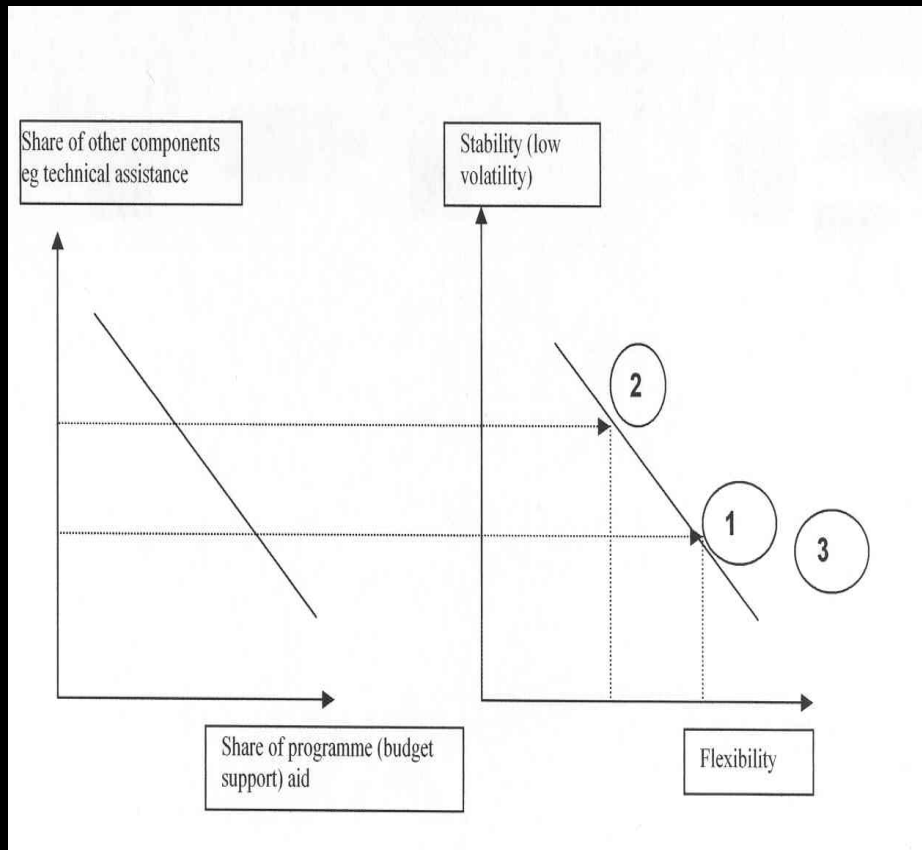
Sources: World Bank World Development Indicators; OECD Geographical Distribution of Financial Flows to Less Developed Countries. ** denotes difference between sample means (for 'proactive' and 'reactive' forms of aid) significant at 1% level, * denotes difference significant at 5% level.



What to do about volatility, 1: simple approaches

- (1) Increase donor multiplicity and competition: volatility tends to diminish with the number of donors supplying a given country.
- (2) Measures to increase trust and possibly ‘selectivity’ in aid negotiations: will diminish the incidence of sudden abrupt breakoffs of negotiations/withdrawals of aid.

What to do about volatility, 2: more complex approaches ('moving the trade-off')



Gelb and Eifert (2005) suggest that the trade-off can be moved by means of a *buffer fund* which provides a built-in stabiliser against abrupt shifts in aid disbursements. In their judgement, the associated flexibility/moral hazard problems will not be serious.

Main messages

- Volatility is bad for growth, hence for poverty reduction.
- Varies by aid type, hence shifts into more stable aid modalities e.g. technical assistance will help;
- But at a cost, since the donor loses flexibility. Buffer funds offer hope of restoring this at relatively low cost in terms of blunted incentives.