

Why Is Africa Constrained from Spending ODA?

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Attaining the MDGs in sub-Saharan Africa calls for a dramatic scaling up of Official Development Assistance. Yet governments have been constrained from spending the bulk of aid received in recent years. If aid cannot be spent, donors might ask: why give it? A better question is: what is preventing the spending?

A recent report by the Independent Evaluation Office of the IMF, *"The IMF and Aid to Sub-Saharan Africa"* supplies part of the answer. Governments in low-income countries bound by an IMF Poverty Reduction and Growth Facility (PRGF) spent, on average, only 28 per cent of their ODA receipts during 1999-2005. If their inflation rates exceeded five per cent, they spent, on average, only 15 per cent.

Inflation has been a preeminent concern for the IMF. A five per cent inflation threshold has been the trigger for its decisions about whether countries could spend aid or not. In other words, safeguarding macroeconomic stability—restrictively defined—has taken precedence over spending ODA.

What has been the IMF's justification? It has argued that ODA-financed government spending on domestic goods and services (not traded internationally) would outstrip their domestic supply. This would drive up the general price level and appreciate the country's exchange rate, damaging exports and economic growth.

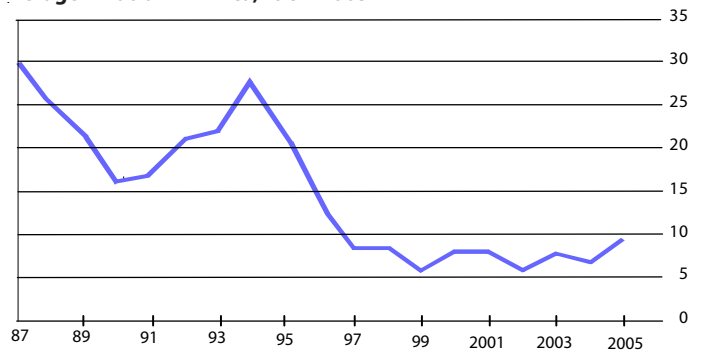
Yet, IMF's own research suggests that inflation rates of 5-10 per cent in Africa are not likely to harm growth. The IMF also now recognizes that adverse supply shocks (such as spikes in oil or food prices) could temporarily drive inflation above 10 per cent. Other credible research has found that the threshold below which inflation remains benign is 15 per cent, or even higher.

In contrast to the experience of some other regions, Africa has not experienced, on average, severe bouts of inflation. In the 1980s, its average inflation was below 25 per cent, and never exceeded 30 per cent. Beginning in 1994, its inflation plummeted, remaining anchored between five and 10 per cent during the PRGF years of 1999-2005 (See Graph). Similarly, its average fiscal deficit shrank rapidly: from about seven per cent of GDP in 1994 to almost two per cent in 1997. By 2005, it was a little less than two per cent.

When ODA to Africa began to increase in recent years, the IMF was not prepared to reverse gears on targeting such low inflation rates. Fiscal deficits (excluding grant financing) should have been increasing, not decreasing, in response to an upsurge of ODA. Instead, central banks channeled ODA into paying off domestic debt—including government debt held by central banks.

IMF practice has not kept pace with its own theory. In line with the logic of macroeconomic accounting, the IMF has recently asserted that the ideal scenario in response to a scaling up of ODA is that it be fully spent and 'absorbed'. In other words, not only should the government fully spend the domestic currency equivalent of ODA but also the central bank should eventually sell the corresponding ODA-supplied foreign exchange in order to facilitate greater imports (i.e., 'absorption'). Otherwise, ODA would not end up financing the transfer of additional real resources into the economy.

Average Inflation in Africa, 1987-2005



Source: IMF Economic Outlook database.

If ODA is not converted into payments for imports, it has to become a financial claim on foreign assets (either central bank foreign-exchange reserves or privately owned assets abroad). The same evaluation cited above finds that only 63 per cent of ODA was 'absorbed'; the remaining 37 per cent was used to accumulate foreign-exchange reserves or fuel private capital outflows. Just during 1999-2005, reserves in Africa increased from about three per cent of GDP to about 4.5 per cent. While using ODA to initially accumulate a modest cover of international reserves might make sense (especially in the face of future aid volatility), excessively stockpiling reserves implies that the central bank is undercutting the purpose of aid, namely, to transfer real resources into a country.

An overriding problem is that the monetary policy of central banks can often place tight restrictions on the scope of government fiscal policies. If central bank inflation targets are set below five per cent, governments are reluctant to spend ODA because of the fear of accelerating inflation above that threshold. They are also reluctant to widen fiscal deficits in order to increase MDG-related expenditures—even when such widening is financed by grants. And when the central bank does not sell reserves, it has to 'sterilize' the monetary impact of aid by selling government securities. This tends to drive up the real rate of interest and undercut fiscal expansion.

For ODA to have its full impact on expanding MDG-related expenditures, fiscal policies and monetary policies need to be coordinated. Fiscal policies should ensure that ODA is fully spent while monetary policies should ensure that ODA is fully absorbed. But under current policy regimes dominated by central banks, the role of fiscal policies has been no more glorified than containing deficits.

Such a regime has erected an imposing MDG roadblock. MDG-oriented development strategies clearly rely on more expansionary (ODA-financed) fiscal policies. Much of the increase in ODA will have to expand public investment to build more schools, health clinics, maternity wards, rural roads and irrigation systems. So, monetary policies should accommodate more expansionary fiscal policies. Instead, restrictive 'inflation-focused' monetary policies are currently blocking the fiscal expansion necessary for progress on the MDGs in Africa.