4

Strengthening Official Financial Support for Developing Countries

Mixed results from aid have led to a fall in aid

Slow progress in poverty reduction during the 1990s outside Asia increased concerns about the effectiveness of aid.[1] Many countries have achieved impressive growth rates with the support of aid flows, and since 1990 the share of people living in extreme poverty in developing countries has dropped from 29 percent to 23 percent, led by rapid progress in China and India. Nevertheless, growth has been slow in many of the poorest aid recipients (see chapter 3), and in Sub-Saharan Africa the share of the population living on less than a dollar a day stagnated during the 1990s, contributing to a growing perception that aid flows have failed to support development. This perception, in conjunction with fiscal pressures in donor countries and the declining strategic value of aid (from the perspective of donors) with the end of the Cold War, led to a sharp fall in aid over the 1990s.

Mixed progress in poverty reduction also led to a reevaluation of aid policies, and to a growing consensus on donor policies required to increase aid effectiveness. Perhaps most importantly, the allocation of aid is increasing to those countries with good policies. Despite high levels of aid, most countries with good policies can continue to absorb additional aid resources without seriously impairing the effectiveness of that aid. High aid levels to countries with good policies should not raise fears of excessive dependence. Over time, strong growth should generate the increase in tax revenues required for a decline in aid. Aid does not, in general, increase the volatility of government resources, and appropriate policies can ensure that aid does not contribute to inflationary pressures or cause excessive exchange rate appreciation. It is true that even in many countries with good policies, lack of administrative capacity lowers the marginal productivity of aid as aid levels rise. However, recent research indicates that aid levels to most countries with strong economic programs are well below the threshold where aid becomes ineffective. This analysis supports the view that a doubling of aid could make an effective contribution toward reaching the Millennium Development Goals, provided that the aid is allocated wisely.

Donors also have made progress in improving the design and administration of aid programs, although much more remains to be done. Greater efforts are directed at ensuring that policy conditions in adjustment assistance reflect a program that has the full support of the government and other domestic stakeholders. This new emphasis involves greater selectivity in aid disbursements. The administrative burden of aid is less because the share of tied aid is reduced, and the government is assuming more leadership in promoting aid coordination.

The policy framework

Providing a policy environment conducive to growth and development—
The growing consensus on how to improve donor policies has its roots in the mixed success of efforts to help developing countries recover from the failure of many economic policies of the 1970s and 1980s. Growth in many developing countries was depressed by unsustainable macroeconomic policies, financial repression, high trade barriers, pervasive state interventions in competitive markets, and complex administrative constraints on entrepre-

neurial activity. Donor programs during the late 1980s and throughout the 1990s thus increasingly focused on supporting efforts at providing an economic policy environment conducive to growth and development. Improvements in economic policies during the 1990s did help many developing countries to achieve substantial increases in growth rates over the "lost decade" of the 1980s. However, many of the poorest countries continued to be left behind, and it became clear that weak institutions and poor governance were at least as significant constraints on development as inflation and price controls.

—with a reform of donor policies—

At the same time, some instruments that donors used to support developing countries' economic programs proved inadequate. Compliance with conditionality under adjustment lending was mixed. Official lending and guarantees coupled with poor policies contributed to debt burdens. Aid programs increased the administrative burden in many countries where capacity was a principal constraint on growth. Recognition of these problems catalyzed efforts to strengthen the framework for adjustment assistance, provide debt relief, and reduce the administrative burden of aid by improving donor coordination. These efforts do not represent an entirely new departure: aid coordination, capacity constraints, and adjustment assistance have been a focus of analysis for some time. Nevertheless, in the past few years concerted efforts have been made to adjust donor policies in the context of recent experience. At the Bretton Woods institutions, this shift in assistance to low-income countries is being implemented through the Poverty Reduction Strategy Paper (PRSP) approach (see box 4.1).

—to increase the effectiveness of aid

These two debates over development policy—that a deepening of reform programs must address critical institutional and governance issues that constrain growth, and that donor policies must support country ownership, reduce the administrative demands of aid programs, and focus on development results—are intricately related. A greater focus on development outcomes may be useful in determining the overall allocation of funds by donors and as a basis for monitoring and evaluation of reform programs. The recognition that institutional capacity is a major constraint on growth underlines the importance of easing the administrative burden of aid. Recognition of the failure of aid to boost growth in many heavily indebted poor countries (HIPCs)—increases the legitimacy of focusing resources on debt relief. Ultimately, improved policies in developing countries and a more effective approach to aid should strengthen donor support for increasing aid resources. These messages underscore the important themes emerging from the United Nations (U.N.)'s Financing for Development (FfD) process (see box 4.2). Unfortunately, recent aid trends have been disappointing, and there appears to be little likelihood that a rise in aid will be significant and sustained.

Trends in aid

A widening gap between the availability of aid and the needs of recipients—

Aid flows dropped sharply over the last decade in real terms, and by 2000 stood more than 10 percent below the 1990 level. Expressed as a share of donors' gross national product (GNP), aid fell from 0.33 percent in 1990 to 0.22 percent in 2000. Only five donor countries reached (or surpassed) the U.N.'s target of 0.7 percent of GNP which was endorsed by Group of Seven (G-7) countries at the Earth Summit in Rio in 1992. At the same time, the need for aid continues to grow. Developing countries' population rose by 17 percent during the 1990s, and the number of people (outside China) living on less than $1 a day has remained roughly the same. Some 60 million people in developing countries are infected with the human immunodeficiency virus. The Millennium Development Goals cannot be met without increased aid. For example, preliminary calculations indicate that a doubling of aid, appropriately allocated, will be necessary to halve poverty by 2015. Estimates of the aid (above current levels) required to meet the goals for education, health, and the environment (see box 4.2) range from $35 billion to $76 billion.[2] Vigorous steps to increase the availability of aid resources, in conjunction with improved donor policies to support increased aid effectiveness, should be the top priorities for the international community.

—particularly over the last two years—

After a modest recovery in aid flows beginning in 1998, the past two years have seen a further decline. Concessional aid flows are measured in two

Box 4.1 The PRSPs

In December 1999 the Boards of the International Monetary Fund (IMF) and the World Bank approved a new approach to the challenge of reducing poverty in low-income countries based on country-owned poverty reduction strategies that would serve as a framework for development assistance. Much has been accomplished during the past two years—nine countries have completed their first full PRSP and three countries have completed their first annual PRSP implementation progress reports. Some 41 countries have also completed their interim poverty reduction strategies (I-PRSPs) and eight countries have subsequently submitted their PRSP preparation status reports for consideration by the Boards.[3]

The central message of the forthcoming Review of the PRSP Approach[4] is a substantial affirmation by low-income countries as well as development partners and civil society organizations of the value of the PRSP approach, and the importance of country ownership as a guiding principle, and a corresponding recognition of the need for flexibility to allow for different country starting points.

It is widely recognized that aligning donor programs with the PRSP is crucial to sustaining this approach. In part the PRSP approach has been designed to overcome long-standing problems of poor donor coordination, weak country ownership of donor-financed programs, and the fragmentation of governmental programs and institutions caused by multiple, and often inconsistent, donor interventions. Donor alignment is needed at various levels, both substantive (in ensuring that donors respect country priorities) and in terms of processes (to reduce the transaction costs associated with aid).

Key challenges of the PRSP for development partners include:

- *Pursuing new approaches to support government ownership*. Governments prepare their own poverty reduction strategies through a participatory process designed to build broad ownership at the national level. Medium-term reform programs supported by Poverty Reduction Support Credits (PRSCs) will be principally drawn from, or will elaborate on, policy measures contained in the PRSPs.[5]
- *More coherent partnerships and aid coordination*. PRSPs are intended to be instruments by which governments can achieve better aid coordination. It is good practice for the PRSP process to be inclusive of donors, and most countries are in fact doing this, including, for example, through the representation of donors on PRSP working groups.
- *Harmonizing and simplifying donor procedures*, alongside a *greater focus on development results* as opposed to monitoring and efforts to control inputs. Each PRSP is expected to include intermediate and longer-term indicators on poverty outcomes, to enable regular monitoring of progress, upon which governments would annually report. It is hoped that this will encourage governments and their external partners to focus on the same set of targets and indicators over a sufficiently long period, so as to reduce the costs associated with multiple reporting requirements, during which time it would be possible to measure results and to adjust domestic strategies and external assistance accordingly.

In the longer term it is expected that the PRSP will facilitate greater aid allocations to countries with good policy environments. To the extent that PRSPs reveal what a country is truly prepared to do (in terms of policy and institutional reforms and expenditure allocations), they should provide a reliable indicator for donors to allocate funds on the basis of policies. Over time a country's performance with respect to its PRSP objectives (both policy measures and development results) could help improve donors' judgments concerning the allocation of aid.

As reported in the upcoming Review, early evidence about the PRSP process is positive, and substantial investments are being made by low-income countries and development partners in making this approach work. While the quality of the early full PRSPs has varied (for example, in terms of participation, data collection, the realism of long-term goals, and institutional capacity to monitor expenditures and the link to poverty reduction), the process has helped promote ownership, encouraged a better dialogue within countries, broadened the understanding of development issues, and helped improve donor coordination.

ways: aid recorded as received by developing countries and aid recorded as provided by donor countries. The two measures are different because in any given year the concessional funding provided by donors to multilateral institutions is not the same as those institutions' disbursements to developing countries (see the data annex at the end of this chapter). Aid flows *received by developing countries* (excluding technical cooperation grants) fell by 3.8 percent in 2000 to $40.7 billion and they are estimated to have declined by a further 3.4 percent in 2001 (see table 4.1). Much of this decline was due

Box 4.2 The Financing for Development (FfD) process

The analysis presented in this document supports the agenda of the FfD conference that will take place in March 2002, in Monterrey, Mexico. The FfD process emphasizes the importance of a comprehensive approach to the mobilization of resources for development and of the flexibility and partnerships required to ensure that the needs and opportunities of different countries are taken into account in the support provided by the international community. The purpose of FfD is to assure the means to reduce poverty and reach the Millennium Development Goals as well as other internationally agreed-on development targets.

The FfD agenda recognizes that the means of reaching these goals must be defined broadly. Policy reforms in developing countries are required to boost growth and reduce poverty. At the same time, industrial countries need to open their markets to provide sufficient opportunities for developing countries to benefit from the world trading system, to help shape improvements in the international financial architecture, and to boost the aid resources required to help countries meet the development goals. The main messages of *Global Development Finance 2002* can be viewed under this paradigm:

- *Policies.* The discussion of country policies at the FfD conference will focus on improving the investment climate in developing countries. In particular, policies focused on maintaining macroeconomic stability, increasing openness to trade and foreign direct investment (FDI), improving governance, and strengthening financial sector institutions will help developing countries benefit from greater financial integration while reducing the potential costs. This document shows how a strong investment climate in the poor countries can boost the effectiveness of aid, increase domestic investment by limiting capital outflows and attracting more FDI inflows, and improve the productivity of investment. At the same time, this document outlines ongoing improvements in donor policies to strengthen administration of aid programs, increase the effectiveness of policy conditionality as a means of enhancing government credibility and commitment, ensure that debt relief is directed at countries with good policies, and ensure that guaranteed lending does not contribute to unsustainable debt burdens.
- *Opportunity.* All countries need to cooperate in integrating the developing countries into the world trading system. Industrial countries must cooperate through opening their markets (particularly in agriculture and textiles) and providing resources for capacity building; developing countries must cooperate through strengthening their infrastructure to support trade and lowering their own trade barriers. The launch of a "development round" following the Doha meeting of the World Trade Organization will involve negotiations of market access issues covering agriculture, services, and manufactures, as well as rules governing dispute settlement, disciplines on regional integration, environment, and trade-related intellectual property rights. In addition, negotiations may also take place regarding investment, competition, trade facilitation, and transparency in government procurement. This approach should enable progress to be made in improving market access for developing countries (assuming they are willing to negotiate on the basis of reducing their own barriers to trade), which is the main priority for the trade agenda.
- *Resources.* Poor countries with good policies will need increased assistance to meet the development goals articulated in the U.N.-sponsored Millennium Declaration. These goals include halving extreme poverty, achieving universal primary education, eliminating gender disparity in education, reducing infant and child mortality and maternal mortality, ensuring access to reproductive health services, and implementing a national strategy for sustainable development in every country. Progress since 1990 has been too slow to achieve most of the goals, and a stepped-up effort by developing countries, industrial countries, and multilateral institutions is required to have any chance of meeting them.[6] This effort should include a doubling of aid to achieve the poverty goal, provided that these resources are allocated to countries with good policies (where aid will be most effective) and with many poor people. Some of the funding needs required to meet the health and education goals are the same as those required to halve poverty, but some will require dedicated funding, such as the need to address communicable diseases or to promote "Education for All." A portion of these resources should be used to finance global public goods, such as the creation of new vaccines, and thus would not be channeled through individual developing-country governments.

In countries with poor policies, even very large amounts of aid are likely to achieve only a limited and short-lived impact on poverty. There is, therefore, an inevitable tension between allocating aid to achieve the maximum global progress toward the goals and allocating aid so that each country or region has a chance of meeting

Box 4.2 *(continued)*

those goals. To resolve this issue, priority attention should be focused on improving policies in countries where they are weak.

Finally, the international community faces a dilemma in supporting progress toward the goals in middle-income countries with poor regions. It may not be advisable to provide large amounts of aid to countries that have substantial financial resources but have not made progress in alleviating poverty in some regions. Since money is fungible, aid would in fact be financing the marginal expenditure by middle-income governments, which may be less productive in terms of reducing poverty than expenditures in very poor countries with good policies. Nevertheless, it is important for donors to consider how to address the severe poverty issues in some middle-income countries; one recommendation would be to fund relatively small projects aimed at demonstrating effective approaches to specific problems.[7]

to a drop in Japanese aid to East Asia, because disbursements against the large commitments made at the time of the Asian crisis fell. Preliminary estimates suggest a continued increase in aid to Eastern Europe and Central Asia, both due to stepped-up assistance to the Balkans and support for the efforts of the advanced Eastern European countries to join the European Union (EU). Aid flows have declined to Sub-Saharan Africa due to delays in implementation of reform in some countries; aid flows have declined to a lesser extent to South Asia despite a rise in humanitarian assistance to India following the devastating earthquake in 2001.

The amount of official development assistance (ODA) *provided by donors* fell by 1.6 percent in real terms in 2000 to $53.1 billion, or 0.22 percent of Development Assistance Committee (DAC) members' GNP (data on aid flows from donors for 2001 are not yet available). This decline, which reversed the upward trend that commenced in 1998, was due to two special factors: the above-noted fall in aid from Japan, and the removal of countries from the list of those eligible to receive ODA because their per capita incomes now exceed the cutoff for flows to be counted as aid.[8] Adjusting for the change in the DAC list, ODA fell by 0.2 percent in real terms in 2000. The decline was due to the fact that in the G-7 countries aid fell by 4.8 percent in real terms; aid from non–G-7 countries increased by 8.3 percent in real terms.

—and little sign of a reversal of this trend in the medium term—

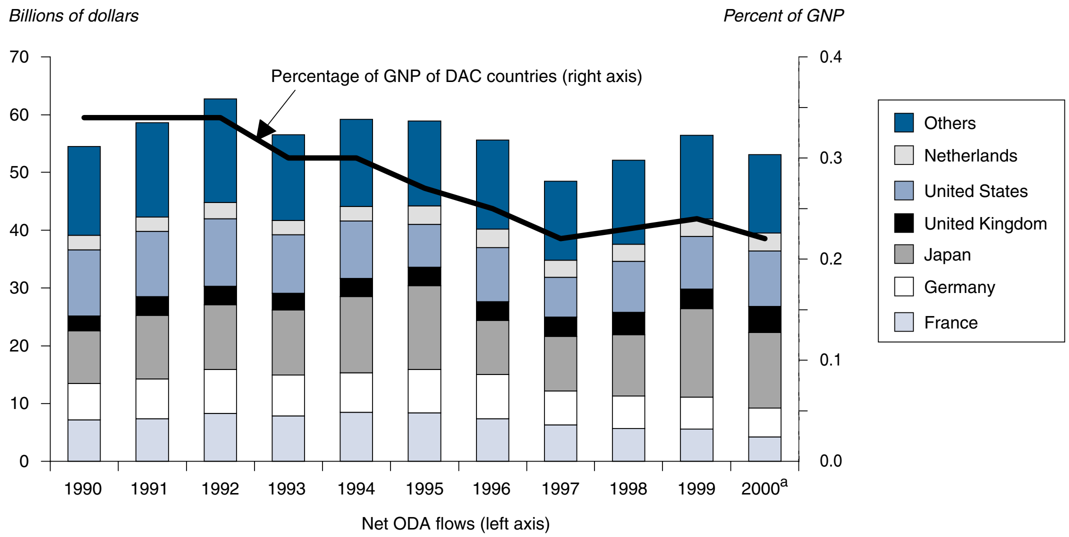
The prospects for a rise in aid over the medium term are mixed. Several donors, in particular the United Kingdom and several of the non–G-7 countries, have been able to set and meet medium-term targets for substantial increases in aid flows. However, there is little sign of substantial increases in aid from the four largest donors—France, Germany, Japan, and the United States—which together account for almost two-thirds of all aid. In

Table 4.1 Net official aid to developing countries, by type and source, 1990–2001
(billions of dollars)

Aid	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
ODA and official aid	45.1	49.5	46.4	41.7	48.1	46.3	39.7	36.1	39.0	42.3	40.7	39.3
Grants (ex tech coop)	30.1	35.1	30.5	28.3	32.7	32.8	28.1	26.6	27.9	30.2	29.9	29.6
Bilateral	26.5	29.5	23.9	22.5	24.6	26.2	21.8	19.8	20.5	22.0	22.6	22.5
Multilateral	3.6	5.6	6.6	5.8	8.1	6.6	6.3	6.8	7.4	8.2	7.3	7.1
Concessional loans	15.0	14.4	15.9	13.4	15.4	13.5	11.6	9.5	11.1	12.1	10.8	9.7
Bilateral	8.3	6.3	8.5	6.7	6.5	4.9	3.0	1.5	2.9	4.6	3.6	3.0
Multilateral	6.7	8.1	7.4	6.7	8.9	8.6	8.6	8.0	8.2	7.5	7.2	6.7
Memo item												
Tech coop grants	14.6	15.6	17.7	18.2	16.9	20.1	18.7	15.7	16.3	16.6	15.5	15.4

Note: Data are based on the OECD DAC definition of aid as measured by donors. These data differ from concessional flows reported in volume 2, which are primarily based on information collected through the World Bank Debtor Reporting System.
Source: OECD DAC; World Bank Debtor Reporting System; staff estimates.

Figure 4.1 ODA from donor countries in relation to their GNP, 1990–2000



a. Provisional data.
Source: OECD April 2001.

part, slow growth or declines in aid flows as recorded by the DAC reflect the removal of a few countries from the list of countries eligible for aid. For example, recorded aid flows from France were affected by the removal of French Polynesia and New Caledonia, the largest beneficiaries of French assistance, from the list of ODA recipients. In the United States the country's largest aid recipient, Israel, was removed from the list of aid recipients in 1997, while the general skepticism about the value of aid has limited the ability to rebuild the U.S. aid program. Germany's aid budget fell by 7.5 percent in 2000, and the integration of the former East Germany continues to put pressure on the German federal budget. Japan, which is running a large fiscal deficit aimed at boosting domestic demand, has announced a 10 percent cut in the aid budget for fiscal 2002.

—although the terrorist attacks on September 11 may translate into a short-term increase

The conflict stemming from the tragic events of September 11 is likely to spur a rise in aid in the near term. Donors typically respond rapidly and generously to disaster—for example in Kosovo and East Timor following the end of each conflict, in Central America following Cyclone Mitch, and in Turkey and India following earthquakes (in 1999 and 2001, respectively). Aid flows also rise sharply in times of global conflict—for instance, by 20 percent during the Gulf War of 1991. While these flows are an important element in maintaining uninterrupted trade flows and mitigating human suffering, they are temporary in nature and specific in their objectives. As worthy as these objectives are, they are unlikely to have a significant impact on long-term development goals.

The global war on terrorism is also likely to result in a temporary increase in aid as donors move to offset the economic and humanitarian needs in countries at the center of conflict. A total of $5 billion was pledged for Afghanistan in January 2002, although the bulk of this is expected to come from existing aid budgets. Commitments to Afghanistan in 2002 are expected to be almost $2 billion. However, absorptive capacity is limited and the actual inflow to Afghanistan, including the $350 million in emergency assistance already delivered since September 11, is expected to be on the order of $1 billion by the end of 2002.

Aid is not always focused on poverty reduction—

Aid has the greatest impact on poverty reduction when it is provided to countries with good policies and many poor people (World Bank 1998). All donors made a formal commitment to poverty reduction by endorsing the international developmental targets set out in the Organisation for Economic Co-operation and Development (OECD) DAC's *Shaping the 21st Century*. Most donors have policy statements that cite poverty reduction as the, or one of the, overarching goals of their aid programs. Trumbull and Wall (1994) estimate that ODA allocations are responsive to the needs of recipient countries, as represented by high levels of infant mortality (as well as issues surrounding political-civil rights). Nevertheless, donors have several motivations for aid that are not always consistent with allocating aid for the greatest poverty impact. Aid may be used to support countries with which the donor has strong historical connections. For example, Alesina and Dollar (2000) find that aid allocation is greatly influenced by whether a recipient was a former colony. Aid may be directed at solidifying regional ties; Japan's largest aid program is to countries in Asia. Aid also is used to pursue strategic interests: Alesina and Dollar (2000) find that recipients who vote with donors in the U.N. tend to get more aid, Maizels and Nissanke (1984) relate aid to arms transfers from the major donors, and Boschini and Olofsgard (2001) explain the decline in aid during the 1990s as being a byproduct of the end of the Cold War. Thus some of the disaffection with the impact of aid on poverty reduction does not reflect the intrinsic ineffectiveness of aid, but rather the large share of aid that is allocated on the basis of "strategic" criteria, instead of on the basis of the quality of policies and the number of poor. In this context the end of the Cold War may have improved the opportunities for allocating aid according to poverty alleviation, rather than to strategic criteria.

—and the share of aid going to low-income countries is falling—

The multiplicity of motivations for aid is neither surprising nor necessarily unfortunate. The use of aid to further other interests increases popular support for aid in donor countries, and may be entirely consistent with making progress in development. For example, the United States provided substantial aid to the Republic of Korea and Taiwan (China) during the 1950s and 1960s, most likely for strategic reasons. But these countries were spectacularly successful in reducing poverty, as well. However, the many motivations that underlie aid allocations may also have some role in impairing aid allocation from the standpoint of poverty reduction. The share of aid going to low-income countries has fallen from 61 percent in the early 1980s to 56 percent in the late 1990s. Considerable aid still goes to countries that have ready access to private capital flows, and countries that graduate from aid recipients to Part II of the DAC list of recipient countries do not always experience a reduction of aid flows (an estimated $9 billion was given to high-income countries or those on the Part II list in 2000). Moreover, aid to low-income countries with good policies equaled only 1.2 percent of their GDP (see table 4.2), slightly below the average for other low-income countries. This ratio has declined sharply since the early 1990s, which reflects the fall in overall aid and rapid economic growth in countries with good policies (as their share of aid has been stable). Thus substantial progress still is required to ensure that aid is directed to countries with good policies.

Table 4.2 Trends in aid allocation
(percent)

Aid allocation	1981–85	1986–90	1991–95	1996–99
Share of aid to low-income countries (percent of total aid)	61.2	62.1	55.1	55.7
Aid to low income with better than average policies (percent of GDP)	1.1	1.8	1.9	1.2

Note: Policy performance is measured by Country Portfolio Performance Review prepared by the World Bank.
Source: World Bank; OECD.

The macroeconomic impact of aid

Strengthening aid effectiveness will require continued progress in allocating aid to countries with good policies. But will increasing aid levels to countries with good policies in itself erode the effectiveness of aid? In the poor countries aid levels are often large enough to have important macroeconomic repercussions. Will the marginal productivity of aid (in terms of raising growth rates) decline as the share of aid in economic activity increases? Is aid likely to increase inflation, lead to excessive exchange rate appreciation, or erode the efficiency of government administration? And if the answer to any of these questions is yes, then should aid be reduced, or could changes in policy increase a country's ability to absorb aid productively? This section concludes that most poor countries with good policies should be able to maintain aid effectiveness while absorbing further increases in aid. There is no rationale for constraining aid to countries with good policies because they receive "too much" aid.

Aid and the sustainability of fiscal policy in the short term

With appropriate economic management, large amounts of aid do not increase inflation. Understanding the potential impact of aid on inflation requires an appreciation of how aid enters the government budget. Aid is received by the government as foreign exchange. The government then, in effect, sells this foreign exchange to its own central bank, which in turn credits the government's account in domestic currency (sometimes referred to as "counterpart funds"). Thus, the central bank now owns the foreign exchange, which it initially holds in its reserves; at the same time, the government now owns the domestic currency, which it initially holds in its account at the central bank.

Aid is not inflationary with policy coordination—

If decisions by the central bank and the government are not coordinated, it is possible for aid to increase inflationary pressures. For example, if the government spends the domestic currency (thus increasing the demand for goods and services in the economy), but the central bank does not spend the foreign exchange, then the domestic price level rises; in other words, nominal expenditures have risen, but the real resources being purchased have remained unchanged. In this case aid would be entirely inflationary. At the other extreme, the central bank may sell the foreign exchange, but the government does not spend its domestic currency holding. The extra supply of foreign exchange is an infusion of additional real resources to the economy (as purchasers of foreign exchange use it to buy imports); more goods are available, but nominal demand is unchanged. In this scenario the price level will fall—and aid would be deflationary. Finally, if the two decisions are perfectly coordinated (the central bank sells all the foreign exchange, and the government spends all the domestic currency), the net effect is to slightly reduce the price level. This is because the sale of dollars precisely offsets the initial increase in the nominal money supply, so that the nominal money supply is unaltered. Yet real economic activity is now greater and so the demand for real money balances will have risen. This will be satisfied by a decline in the price level. Usually the only circumstance in which aid becomes inflationary is if there is a coordination failure.[9] However, coordination of the two decisions is simple: expenditures of counterpart funds need to be matched with sales of reserves.

—which is facilitated by an appropriate definition of the government deficit

It is important to the credibility of government policy that the definition of the deficit used in discussions of macroeconomic policy reflect the noninflationary impact of aid. Because grants are essentially equivalent to revenue for the purposes of evaluating the inflationary impact of fiscal policy,[10] the appropriate definition for the fiscal deficit consistent with macroeconomic stability is the deficit after accounting for aid flows. In the case of concessional loans, ideally it is the grant component that should be treated as revenue.[11] In countries with large aid inflows, different treatments of aid in the fiscal accounts can have a significant impact on the reported size of the budget deficit. For example, in the late 1990s, Ethiopia had a deficit of 8 percent of GDP—if aid were treated as a financing item. Recalculated to treat grants and the grant component of concessional loans as part of revenue, the deficit was only 0.8 percent of GDP. By contrast, Zimbabwe in the late 1990s received very little aid and had a deficit of 5 percent of GDP. Using the definition of the deficit that treats aid as a financing item would indicate that Ethiopia's fiscal policy was more inflationary than Zimbabwe's, yet clearly the exact opposite was the case. Much of the framework for public discussion of fiscal policy comes from ideas articulated by economists and policymakers in industrial countries, where the problem of interpreting the impact of aid on the fiscal accounts does not arise. Therefore, the definition of the budget deficit used in aid-recipient countries should be such that a level of deficit deemed to be problematic in OECD countries should be similar to that which signals a policy problem in aid-recipient countries. Regional groupings of African countries are indeed starting to adopt their own norms analogous to the EU's stability pact, and it is essential that these norms be based on a definition of a deficit that corresponds to economic rationality and that produces figures that are well understood by the public.

Volatile aid flows need not translate into volatile government resources

Large amounts of aid to the poor countries with good policies are unlikely to increase the volatility of government resources or lead to excessive reliance on aid flows. Lensink and Morrissey (2000) find that instability of aid resources can have a negative effect on growth. Pallage and Robe (1998) find that aid has been more volatile than recipient countries' output, and aid has been pro-cyclical. However, other empirical work indicates that aid does not generally increase the volatility of government resources. Since the alternative to receiving aid is to finance expenditures through taxation, the appropriate benchmark for the volatility of aid is the volatility of revenues. In a sample of 36 African aid recipients, Collier (1999) found that the coefficient of variation on aid was slightly lower than for revenue. Bulir and Hamann (2001), in a global sample of aid recipients, find that aid is more volatile than tax revenues (with both expressed in U.S. dollars), but the difference was not statistically significant.[12] If aid and tax revenue are almost equally volatile (for example, in U.S. dollars) then unless aid and tax are *perfectly* correlated, aid must reduce overall volatility. Collier (1999) found a slight negative correlation between aid flows and revenues. In that case the addition of aid to revenues actually reduces the volatility of overall resources.

Aid may compensate for other sources of volatility. Guillaumont and Chauvet (2001) find that the effectiveness of aid rises as it is provided to countries that are prone to external shocks. There is some evidence that multilateral flows to poor countries help cushion against external shocks by compensating for withdrawals of private flows (see box 4.3). Collier and Dehn (2001) analyze the effect of aid on growth during periods of negative shocks in the context of the aid-growth model developed by Burnside and Dollar (2000). They find that an additional dollar of aid during an extreme negative shock period raises the growth rate by substantially more than in normal periods. By offsetting the initial income loss, the aid avoids the multiplier contraction in output. The magnitude of these multiplier effects suggests that the rate of return on aid during extreme negative shocks is remarkably high. Aid would be used most effectively in compensating for shocks if care is taken to distinguish between temporary shocks (that should be financed) and permanent declines in income (that should be adjusted to).[13] The international community increasingly recognizes the importance of aid in cushioning external shocks. For example, to offset the impact of external shocks expected in the aftermath of September 11, the estimates of low-income countries' possible resource requirements during the 13th Replenishment of the International Development Association (IDA-13) have been revised upward by about $2 billion.

Though aid does not usually increase the volatility of resources, it is possible that heavy reliance on aid could impose adjustment costs if aid were suddenly to decline. There are three circumstances that may cause aid flows to decrease.[14] First, per capita income in a recipient country can rise sufficiently so that the country is no longer eligible for aid. There is no need to be cautious of dependence on aid while the economy is poor, just because one day it will be sufficiently rich that it will no longer need any aid. Moreover, higher income is associated with a greater ability to finance expenditures from taxes; in 1998 current revenue equaled 14 percent of GDP in low-income countries, 19 percent in middle-income countries, and 29 percent in high-income countries. Second, aid may be cut off because economic policy deteriorates substantially; however, this is not a reason for a country with good policies to refuse aid. Finally, donors may

Box 4.3 The relationship between private and multilateral flows in poor countries

Multilateral flows to poor countries appear to have an inverse relationship to private flows. There are various interpretations in the economic literature of this relationship in the context of all developing countries. Dasgupta and Ratha (2000) argue that multilateral lending plays a stabilizing role during periods of credit rationing. Lerrick (1999) sees this relationship as evidence that multilateral flows crowd out private flows. Easterly (1999) and Svensson (2000) argue that multilateral lending programs create incentives for borrowing governments to delay economic reforms, so that private lenders withdraw in reaction to increased multilateral loans.

The inverse relationship between multilateral and private flows, however, need not imply "crowding-out" of private flows to developing countries. Indeed an inverse relationship in the short term may be consistent with a complementary relationship over the long term. With respect to short-term cyclical variables (for example, an increase in GDP growth or an interest rate hike in the industrial countries), private flows tend to behave procyclically (World Bank 2000a) whereas official flows are expected to react countercyclically. However, in the long term official flows may lead to an improvement in the structural, policy, and institutional environment of a country, which would encourage greater private flows. Several authors have also found empirical support for the catalytic effects of multilateral flows on private flows. Kharas and Shishido (1991) found that during 1974–85, by alleviating credit rationing and improving creditworthiness (by increasing international reserves, for example), official aid was able to generate spillover effects that attracted private flows. (See also Krueger 1998; Summers 1999; and Checki and Stern 2000.)

This relationship is borne out by statistical tests. Panel data analyses for low-income countries (for the period 1970–98) indicate a negative relationship between multilateral and private flows in the same period, but a positive relationship with a six-year lag. By contrast, bilateral flows (including grants) seem to have a significant and positive effect on private flows in the concurrent period, but a negative effect with a lag. This result may reflect the importance of strategic and noneconomic considerations in aid allocation by bilateral donors (Alesina and Dollar 2000).

sharply reduce levels of aid for reasons unrelated to the recipients, for example because donors confront widespread fiscal difficulties. Changes in aid flows tend to be implemented slowly, and it is unlikely that any such reduction in aid would present very sharp adjustment costs to individual developing countries. Nevertheless, this concern does underscore the importance of donors providing for stable aid flows over time.

Aid has a positive impact on growth in countries with good policies—

So far we have shown that there is little reason to worry about the adverse impact of aid on the sustainability of economic policies in countries whose economic policies are sound. We now turn to the question of whether increases in aid are likely to continue to have a positive impact on growth. There is growing evidence that aid has a positive impact on growth in countries with good policies. Earlier empirical studies had consistently found a weak relationship between aid and investment and showed little impact of aid on growth (see, for example, Griffin 1971; Snyder 1990; Boone 1994; and Reichel 1995).[15] However, Burnside and Dollar (2000), Collier and Dollar (2001a), and Durbarry, Gemmell, and Greenaway (1998) show that aid makes an effective contribution to growth in countries with good economic policies.[16] The extent of the impact on growth can be seen by looking at IDA, which is well targeted on low-income countries with reasonable policies. At the margin, an additional billion dollars of IDA funds raises the growth rate sufficiently to lift around 434,000 people out of poverty.[17] Collier and Dollar (2001b) find that in good policy environments aid raises investment by almost double the value of the aid; Collier and Dollar (2001c) also find that in good policy environments a $1 billion injection of aid raises FDI by $600 million.

—although appropriate policies may be necessary to limit "Dutch disease" effects—

The finding that *on average* aid has had a positive impact on growth in good policy environments does not imply that aid levels can rise forever without a resulting adverse effect on growth. Increasing levels of aid may erode growth by causing

"Dutch disease." Since aid is foreign exchange, it only directly augments the supply of those goods that are internationally tradable. It will thus lower their equilibrium price relative to those goods that can only be traded domestically (nontradables). This relative price change induces a resource shift in the economy from tradables to nontradables. Among the tradables are exports, so that aid will tend, all things being equal, to reduce exports. In fact, other things are not equal. The aid may enable governments to lower taxes on exports, which in the poor countries is typically the most heavily taxed sector. Additionally, aid might finance infrastructure expenditures that facilitate exports, such as roads and ports. However, it seems reasonable to expect that in most circumstances aid will indeed reduce exports. Van Wijnbergen (1986) found that increases in aid were associated with an appreciation of the real exchange rate in African countries. Several empirical studies present evidence of the adverse impact of the Dutch disease on exports (see, for example, Laplagne, Treadgold, and Baldry 2001; Soderling 2000; and Sekkat and Varoudakis 2000). Collier and Hoeffler (2000) show that, controlling for the level of economic policy as measured by the World Bank's Country Portfolio Performance Review, a rise in aid is associated with a decline in the share of primary commodity exports in GDP. Since for Africa these exports still make up around 70 percent of all merchandise exports, it is likely that aid in Africa reduces total exports.[18]

The question remains, is a decline in exports caused by aid-induced real exchange rate appreciation undesirable? It should be recognized that the Dutch disease is more of a problem if the aid flow is short-lived, so that adjustment costs are incurred when aid flows in and when it ceases. But aid to the poor countries is rarely a matter of a few years, and thus the value of aid will be greater than any distortionary effects due to real exchange rate appreciation. The reallocation of resources out of tradables could be undesirable if either exports are initially too low because of taxation, or because exports raise growth through learning and competition effects that enhance productivity; Kraay (1999) finds some evidence of this for China, and Bigsten and others (1999) for Africa. However, a more rational response to these problems would be to use aid to reduce taxation or to finance infrastructure facilities that help exporters.

—and access to large nontax resources may erode government accountability

The productivity of aid may decline due to reasons other than the Dutch disease. It may be possible for governments to have more resources than are good for their societies. Access to very large nontax resources can erode the accountability of government. Indeed, the history of accountable governments in the now-developed societies dates from the need for governments to raise tax revenue (see, for example, Hoffman and Norberg 1994). Similarly, Sachs and Warner (2000) establish that governance is worse in countries where the government has access to large rents from natural resources. Consistent with this theory, Knack (2000) finds that aid tends to be associated with increased corruption. On the other hand, Burnside and Dollar (2000) and Dollar and Svensson (2000) found that aid neither improved nor worsened policies. This is disappointing because it implies that aid may not induce reform; on the other hand, it indicates that aid does not appear to cause a generalized deterioration in economic policies.

A more likely reason for diminishing returns to aid is administrative and managerial congestion. If the really scarce resource in the public sector is competent and motivated civil servants, then each additional aid project, in competing for the same limited pool of skills, inflicts negative externalities on other projects. Beyond a point, these congestion effects can fully offset the direct benefits of the project. Similarly, Taslim and Weliwita (2000) argue that both public and private investments in developing countries are limited by the stock of entrepreneurial skills, so that increased aid is reflected in reduced saving.

The marginal productivity of aid depends upon the quality of policies—

Aid is likely to be subject to diminishing returns.[19] The Collier and Dollar (2001a) results indicate, however, that the level of aid where the marginal productivity is zero depends on the quality of policies, and this level is quite high for countries with good policies. Countries with the highest score on the World Bank's Country Portfolio Performance Review (CPPR) continue to enjoy aid's positive impact on growth at levels of aid up to 30 percent of gross domestic product (GDP). Durbarry, Gemmell, and Greenaway (1998) find that aid continues to make a significant contribution to growth up to 40 percent of GDP in countries with a stable macroeconomic policy environment.[20] The median CPPR among poor countries is 3.2, at which level (by the Collier and Dollar estimations) the impact of aid on growth would remain positive up to 19 percent of GDP, while aid averages 8 percent of GDP for poor countries with better than average ratings. By these calculations, 28 out of the 34 poor countries with better than average policies could continue to absorb increasing amounts of aid before the marginal productivity of aid drops to zero.[21]

Recent calculations indicate that a doubling of aid will be necessary to reach the goal of halving the share of the developing-country population that lives on less than $1 a day by 2015 (World Bank 2001b). But improvements in the allocation of aid are also critical to achieving the poverty goal. Collier and Dollar (2001a) develop a model for allocating aid that reflects the view that the impact of aid on poverty depends on the quality of policies.

A doubling of aid that is distributed according to quality of policies and the level of poverty implies significant changes in aid allocation. South Asia would receive an increase in the share of total aid from 11 percent in 1999 to 45 percent.[22] The largely middle-income regions of Europe and Central Asia, Latin America and the Caribbean, and the Middle East and North Africa would together receive only 4 percent of total aid, compared with about a third in 1999. The share of East Asia and Pacific would decline slightly, because the middle-income countries receive much less aid, but aid would expand sharply to Vietnam and the Philippines due to their relative poverty and good policies. Finally, the share of aid going to Sub-Saharan Africa would change very little, because some of the better performers would receive significant increases but other countries with very poor policies would experience an actual decline in aid flows. The increases in aid-to-GDP levels are modest for most countries, and for all of the countries with good policies aid remains well below the level where the marginal productivity of aid falls to zero. In Sub-Saharan Africa, the region with the highest level of aid relative to GDP, the average ratio of aid to GDP would rise only slightly. Finally, the doubling of aid would lift an estimated 15 million people permanently out of poverty each year, for a total decline of 225 million people in poverty by 2015 (20 percent of the population in poverty in 1999).

These estimates of the impact of aid are conservative. They assume that donors have no impact on the quality of policies or the elasticity of poverty reduction with respect to growth. It may be true that donors have had only a limited impact on policies, and that aid is often fungible (so that the kind of projects financed would not affect the poverty elasticity). However, a recent study of aid and reform in Africa concludes that donors could have a more systematic impact on policy if they increased aid as policies improved (World Bank 2001c), which is the allocation rule used in this simulation. Further, if the improvement in policies is reflected in better provision of public services that benefit the poor, then countries with good policies will have higher elasticities of poverty reduction with respect to growth. Thus the impact on poverty of a doubling of aid, allocated according to policies and the extent of poverty, is likely to be larger than assumed in this simulation.

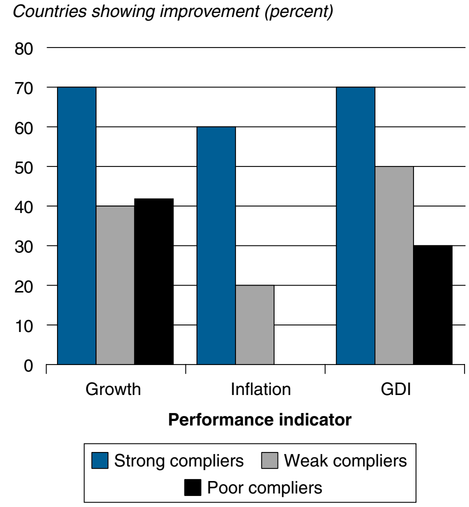
—so aid efficiency can be improved

Thus recent econometric evidence indeed suggests that countries can receive too much aid. The most likely explanation for this is neither the Dutch disease, nor the deterioration of governance, but the high congestion costs incurred by attempting to implement many aid projects through a bureaucracy with limited capacity. If this analysis is correct, it has five important implications: First, in countries with good policies, actual aid inflows are unlikely to be near the point where the marginal productivity of aid is zero (the saturation point). Second, in those poor countries that currently are close to or beyond their saturation points, the key task is to raise the saturation point by improving policy. Third, aid programs should aim to reduce congestion costs. Switching more aid from projects to programs would almost certainly raise absorptive capacity. Fourth, to the extent that the capacity constraint is due to a lack of competent and motivated civil servants, incentive systems in the public sector may need revision. Fifth, if the public sector faces real constraints upon its capacity to spend marginal resources effectively, it should reduce tax receipts relative to aid. While aid augments the resources available to the economy, taxation reduces them by introducing distortions (for example, increased income taxes may reduce the incentive to work). A sensible growth strategy for a very low-income economy with a dysfunctional civil service would be for rising aid inflows to be used partly for reducing the share of tax revenue in GDP.

Conditionality and adjustment lending

Strengthening the use of policy conditionality in adjustment lending is an important element in efforts to improve the effectiveness of aid (see World Bank 2001d). Policy conditionality refers to the practice of basing the disbursement of donor funds on the implementation of specific policies. Policy conditionality can support the effectiveness of adjustment assistance by helping to avoid disbursements to governments with inappropriate policies. For recipients, agreement on specific conditions for disbursement (as opposed to basing disbursement on a general evaluation of the government's program) can improve the transparency of donor decisions and the reliability of aid disbursements (Mosley 1999). By increasing the cost of backtracking on policies (in terms of worsening relations with donors or losing disbursements), commitments to donors can enhance the government's credibility in sticking to policies that face opposition from special interests or that have short-term costs but long-term benefits. Case studies of the strong reform programs in Ghana and Uganda suggest that conditionality was successful at facilitating clear decisions from political leadership and publicly signaling the government's commitment (World Bank 2001c). In turn, enhancing credibility can encourage more rapid adjustments to new policies by the private sector and hence reduce the short-term employment and output costs of adjustment. Greater compliance with conditionality under World Bank loans was significantly related to improved economic performance (figure 4.2).[23]

Figure 4.2 Compliance with conditionality and economic performance



Source: World Bank 1997.

Country ownership is key to success—

A country's commitment and capacity to implement the reforms supported by adjustment lending are key to effective adjustment and sustained development. Research on aid effectiveness indicates that when a country's commitment or implementation capacity is weak, conditionality is unlikely to be effective. In other words, conditionality by itself cannot lead to the adoption of better policies when there is no consensus for reform.[24] Conditions attached to adjustment lending may not contribute to successful outcomes in cases where donors lack adequate information (on local conditions, government capacity, and the extent of government commitment) or the interests of donors and recipients diverge. Conditionality is the outcome of a bargaining process that can be subject to failures of coordination and unintended outcomes.[25] To the extent that this process leads to a reform program that is not fully owned by the government, the success of the program can be severely undermined. Domestic political support is critical for the adjustment program (Rodrik 1996; World Bank 1998; Dollar and Easterly 1998; Dollar and Svensson 2000). Both cross-country reviews and individual case studies have confirmed the critical importance of strong country ownership of the adjustment program to the successful use of conditionality in adjustment lending (McClearly 1991; Berg 1991). Johnson and Wasty (1993) find that strong ownership was a major reason for success in 75 percent of adjustment programs with good results. The International Monetary Fund (IMF 1998) attributed poor implementation of IMF programs in Zambia (1978–91) and Uganda (late 1980s) to lack of ownership; these are in contrast to successes in Bolivia, Uganda in the 1990s, and Côte d'Ivoire, where ownership was strong.

Conditionality and World Bank adjustment lending have evolved—

Conditionality was originally directed largely at achieving macroeconomic stability and reducing market distortions, and adjustment assistance was conceived as a financing vehicle for short-term balance of payments support. Over the years, the policies covered by conditionality and the goals of adjustment lending have evolved in tandem with countries' broader reform agendas, and have become increasingly focused on long-run, structural, social, and institutional issues. The 1980s' narrow focus on short-term stabilization and addressing distortions gave way in the 1990s to greater attention to poverty reduction, institutions, and complex social and structural reforms. This shift included an explicit focus on good governance, with strong support for public sector management reforms.

Reflecting in part the growing long-run structural and institutional focus of countries' reform agendas, Bank-supported adjustment programs have grown more complex, even while the average number of conditions in adjustment loans has fallen significantly, from 61 conditions in the late 1980s to 33 conditions in fiscal 2000. The number of conditions tends to be higher and complexity tends to be a greater challenge in countries with weak performance and capacity, where adjustment lending is less successful (World Bank 2001d). This highlights the ineffectiveness of attempts to address performance deficiencies and capacity limitations through a larger number of more complex and detailed conditions, and confirms the importance of continuing to focus adjustment support in countries with good policy and institutional environments.

—and the quality of Bank adjustment lending has improved

The record of policy conditionality in promoting the objectives of adjustment programs, as reflected in the degree of compliance with agreed-on conditions, has improved in recent years. The problems affecting conditionality in the 1980s have been well documented.[26] Some of these problems may have persisted into the early 1990s. Killick, Gunatilaka, and Marr (1998) find that only 25 percent of World Bank adjustment operations from 1989–90 to 1993–94 were completed on schedule.[27] World Bank (1997) found that out of 35 adjustment operations in Sub-Saharan Africa, compliance was rated as strong in 10 countries, and as weak or poor in 25 countries. Indeed, the performance of World Bank adjustment lending improved sharply throughout the 1990s. Operations Evaluation Department outcome scores increased from 60 percent satisfactory in the 1980s to 68 percent satisfactory in fiscal 1990–94, and to 86 percent satisfactory in fiscal 1999–2000.[28] The World Bank's Quality Assurance Group found that the great majority of a sample of adjustment loans in 1999 were satisfactory or better regarding various dimensions of program design (World Bank 2000b). Bilateral aid evaluations also typically find satisfactory outcomes for a high proportion of adjustment programs (see, for example, USAID 2001; SIDA 1999).

It is of course difficult to attribute improved compliance wholly to improvements in the design of conditionality. There are several reasons why adjustment programs were more successful during the 1990s, including a more favorable international economic environment (at least in some years), greater selectivity on the part of the donors, and greater recognition of the importance of government ownership in crafting an effective adjustment program. It is likely that changes in the process of adjustment lending, including greater selectivity and encouraging ownership through a less intrusive approach to the design of reform programs, was at least as important as the change in the focus of conditionality to address underlying structural, social, and institutional issues. What is clear is that changes in the overall approach to adjustment assistance have contributed to more successful reform programs.

Aid coordination and the administrative burden of aid

The idea that donors could increase the effectiveness of aid by improving the coordination of their activities is not new (Pearson 1969). Donors have made extensive efforts to consult on their aid operations and thus avoid the imposition of conflicting or duplicative administrative requirements, and they have improved the quality and consistency of policy advice, most notably through consultative group meetings, round tables sponsored by the United Nations Development Programme, aid meetings under the auspices of the OECD DAC, the U.N.'s Development Assistance Framework (which harmonizes U.N. agencies' activities) and the Strategic Partnership for Africa. Successive IDA replenishment reports during the 1990s urged greater efforts at coordination. Considerable work remains to strengthen aid coordination, which is particularly important in the poorest aid recipients that receive very significant levels of aid relative to domestic resources.

Reducing administrative burdens—

Aid often imposes a substantial administrative burden on recipient governments (Van Arkadie 1986; Lister and Stevens 1992). Van de Walle and Johnston (1996) report that Kenya had 600 projects from 60 different donors during the mid-1980s, while Zambia had 614 projects from 69 donors. In Tanzania there were even more—over 2,000 projects from 40 donors. Administratively, 600 projects could translate over the course of a year into as many as 2,400 quarterly reports for various oversight agencies and perhaps 1,000 missions requesting meetings with key officials and comments on their reports. Disch (2000, p. 39) describes the multiplicity of import support programs in Mozambique in the late 1980s, each with different procedures and time delays that typically took six to nine months for importers to navigate. The result: skyrocketing import costs. Donors have competed with each other and with the government to recruit scarce local experts for projects, thus undermining the government's capacity (Eisenblatter 1999). Lancaster (1999, p. 501) notes the implications for budget management of uncoordinated donor projects negotiated with individual ministries, each demanding counterpart funding for recurrent costs. In addition to administrative burdens, failures in aid coordination can result in donors pressing inconsistent policy advice on governments. For example, in the mid-1980s the World Bank and the United States Agency for International Development urged the Kenyan government to reduce the role of the National Cereals and Produce Board at the same time as another donor was financing a major expansion of its facilities (Mosley 1986).

—and shifting away from tied aid—

One of the better-known impediments to aid effectiveness is tied aid, which often reflects donors' commercial interests rather than recipients' development needs. Various studies have found that tying requirements limit competition, increase administrative burdens, and lead to countries purchasing goods with an inappropriate technology with greater than desired capital intensity. The additional cost imposed by tying aid has been estimated in the range of 10–30 percent (OECD 2001; Morrissey and White 1994; and Jepma 1991). There are also significant indirect costs, including suspension of standard procurement procedures and higher cost maintenance due to dependence on imported parts that may not be readily available.

Considerable progress has been made to reduce tied aid requirements, and the share of bilateral aid that is tied has dropped from 65 percent in 1990 to 38 percent in 2000, though there is considerable variation across donors. The share of tied aid to the least developed countries is about 50 percent, higher than the average for all developing countries primarily because these countries receive more of the type of aid that is still subject to tying (for example, food aid and technical assistance). The DAC High Level meeting in May 2001 agreed on a recommendation to untie ODA to the least developed countries to the extent that is possible. By January 2002 many important components of ODA to the least developed countries will be untied, including balance of payments support and debt forgiveness. The OECD estimates that this will raise the level of untied aid to the least developed countries to 70 percent.

Changes in process can strengthen aid coordination and reduce administrative burdens

Procedurally, a number of different strategies for improving coordination have been advanced, including sectorwide approaches, greater donor specialization, more support for capacity building, and greater flexibility in some donor requirements. *Sectorwide approaches* can facilitate country ownership by reducing micromanagement by donors and by eliciting longer-term commitments from both sides to help build genuine partnerships. For donors, sectorwide approaches offer a realistic compromise between detailed micromanagement and provision of general budget support, since responsible ministries may be held accountable for results. Sectorwide approaches are most appropriate when both macro and sector reform processes are in place and when governments have a clear vision and ownership of objectives. In Uganda, for example, strong government motivation, active participation by civil society in program monitoring, and a credible medium-term budget process made the Universal Primary Education project a success (Brown and others 2001). However, sector finance is likely to be ineffective if either sector policies or macroeconomic and budget management are weak. In addition, *sectorwide* approaches may limit government's ability to reallocate funds across sectors, compared with disbursing aid through budget support programs.

Greater *donor specialization* is needed. The difficulties of aid coordination increase sharply as more donors become involved in any one area, so specialization along geographic or functional lines according to comparative advantage is desirable. Yet the trend has been toward increasing diffusion of donor activities, and World Bank (1999) found few examples of aid coordination efforts that led to greater specialization (see also World Bank 2001e). Reviewing aid to Ghana in the first half of the 1990s, Eriksson (2001) found a steady increase in the number of sectors for each bilateral donor and a decline in bilateral commitments per sector.

Capacity building is one key to progress. Limited capacity and institutional weakness impede the formulation of country-owned strategies, and undermine the trust donors need to allow countries to take responsibility for detailed financial and project management. Yet capacity building has been one of the least effective areas of donor activity, and in many of the world's poorest countries the quality of public administration has systematically deteriorated (Lancaster 1999). Some donor practices may have even contributed to the problem through insistence on special project management units that draw government officials from their regular duties, and recruitment of expatriate technical assistance personnel whose terms of reference are to substitute for local capacity rather than to build it. Regular civil service staff assigned to projects may be expected to give priority to project work even if there is a conflict with their normal responsibilities (Lancaster 1999; van de Walle and Johnston 1996).

More *flexibility* by some donor agencies is needed to transfer responsibility and accountability to recipients. Incompatible procedures for reporting, accounting for disbursements, and procurement raise transaction costs and inhibit closer coordination among donors, while severely burdening recipient governments. Greater delegation of decisionmaking authority to the field would also facilitate better coordination (World Bank 2001f).

Above all, government leadership is the key

Strong leadership from the recipient government is essential for successful aid coordination (Eisenblatter 1999). For example, Botswana, the fastest-growing country in Africa for some time (and in many years the fastest-growing country in the world) has had the vision and capacity to manage the aid process (Brautigam and Botchwey 1995). In Botswana the government maintains effective control of aid with strong institutions backing up a coherent vision. Donors are encouraged to specialize in specific sectors to build up their expertise and minimize administrative burdens (van de Walle and Johnston 1996). Likewise, the governments of Ghana and Uganda, two of the more successful reformers in Africa, have played an active role in coordinating donor activities.

Aid and debt relief

Strengthening the effectiveness of aid through debt relief—

The increase in concessional debt relief, and efforts to tie debt relief to effective reform programs, have been important components of efforts to strengthen the effectiveness of aid. Debt reduction in the form of concessional rescheduling of guaranteed commercial claims began in 1988 with the introduction of Toronto terms by the Paris Club, which allowed for a reduction of one-third for eligible claims. The level of debt forgiveness has subsequently been raised progressively, to 50 percent reduction (in net present value [NPV] terms) in 1991 (London or enhanced Toronto terms), and 67 percent NPV reduction in 1994 (Naples terms).[29] Donors forgave bilateral ODA claims, financed debt swaps, contributed to the buyback of commercial debt through the IDA debt reduction facility program, and supported programs to help debtor countries meet multilateral debt service obligations. Efforts to deepen debt relief for poor countries suffering from unsustainable debt burdens culminated in the HIPC Initiative. All in all, DAC donors have forgiven about $29 billion in debt over the past 30 years. Of this total, forgive-

Table 4.3 Forgiveness of ODA claims, 1970–2000
(millions of dollars)

	1970–89	1990–95	1996	1997	1998	1999	2000	1970–2000
Total	5,075	11,183	1,026	488	660	600	750	19,783
HIPCs	2,236	6,495	722	260	400	450	480	11,043
Other developing countries	2,840	4,689	304	228	259	150	270	8,740

Source: OECD DAC, national aid agencies, and staff estimates.

ness of ODA loans by DAC donors has amounted to almost $20 billion (see table 4.3), and donors have claimed credit in their aid budgets for the forgiveness of $8.5 billion in non-ODA claims, and have provided almost $400 million in grants in support of the IDA debt reduction facility. However, the figures recorded by the DAC probably underestimate the full extent of the debt relief, because they do not include irrevocable commitments to forgive future ODA claims, while for non-ODA claims the reporting norms are complex and have taken time to be fully integrated into the statistical systems of the export credit agencies.

—as 24 countries have reached the decision point under the HIPC Initiative—

The HIPC Initiative, launched in 1996, aims to increase the effectiveness of aid by helping poor countries achieve sustainable levels of debt while strengthening the link between debt relief and strong policy performance. Forty-two countries, primarily from the Sub-Saharan Africa region, are identified as eligible to receive debt relief under this initiative. In 1999 the scope of the initiative was widened to accelerate and deepen the provision of debt relief. As of December 2001, 24 countries have reached the decision point[30] (the point where debt relief is approved by the Executive Boards of the IMF and the World Bank, and interim relief begins). These countries are now receiving debt service relief which will amount to about $36 billion over time, a $21 billion reduction in the NPV of their outstanding debt stock (see figure 4.3).

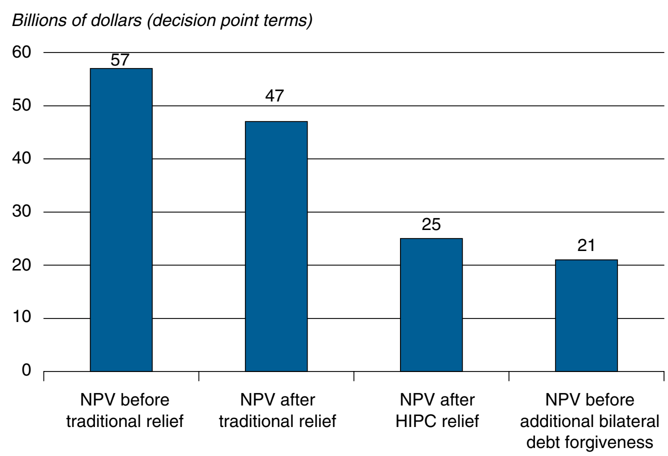
—resulting in a halving of the NPV of their external debt—

The 24 countries that have reached their decision points have experienced a halving of their external stock of debt in NPV terms. When combined with other debt reduction mechanisms, this implies a two-thirds reduction in their external indebtedness. The pace of delivery of debt relief increased in 2001. All countries that reached their decision points by the end of 2000 are now receiving interim relief, and their aggregate level of debt is forecast to fall from 60 percent of GDP in 1999 to 28 percent after debt relief. Current plans call for a reduction in debt service obligations by one-third ($1.1 billion) during 2001–03,[31] for an average savings of close to $50 million per country per year. Debt service as a percentage of exports for the 24 countries is expected to decrease from 16.8 percent in 1998–99 to 8.2 percent in 2001–03.

—while 4 of these countries have reached the completion point

As of December 2001 four countries (Bolivia, Mozambique, Tanzania, and Uganda) had reached the completion point, where the remainder of the committed debt relief is delivered. For example, Mozambique reached its completion point in Sep-

Figure 4.3 NPV of external debt of the 24 countries that reached their HIPC decision point



Source: World Bank.

Table 4.4 Impact of HIPC Initiative in 24 decision-point cases

	Before HIPC debt relief (1998–99)	After HIPC debt relief (2001–03)
NPV of total external debt	$57 billion	$25 billion
Debt as a percent of GDP	60%	28
Average debt service as a percent of exports	16.8	8.2
Average debt service as percent of GDP	3.7	2.1
Average debt service as a percent of revenue	27.4	11.9
Average social spending as percent of GDP	5.8	6.9
Average social spending as percent of revenue	35.5	39.9

Source: World Bank.

tember 2001, and will receive debt relief amounting to $4.3 billion, which will cut its debt by 72 percent (in NPV terms). As a result, Mozambique's annual debt service payments will be reduced to an average of 6 percent of export earnings and 10 percent of government revenue over 2000–10, as compared with 20 and 23 percent, respectively, in 1998. Another dozen countries could reach their completion point in 2002.

HIPC has helped provide a more effective environment for aid—

The HIPC Initiative, in addition to increasing resources for debt relief, has helped to support policy improvements and thereby contributed to aid effectiveness. Debt relief under the HIPC Initiative is intended for countries that are pursuing effective poverty reduction strategies, and increased social expenditures is a critical element. For the countries that have reached decision points under the HIPC Initiative, social expenditures are projected to increase about 1.1 percent of GDP compared with 1998–99 (table 4.4).

—which is reflected in ODA flows

There is some evidence that ODA flows to the HIPCs are being allocated to the better performers, a prerequisite for aid effectiveness. Countries that have either reached a decision point (indicating general agreement with donors on the economic program) or have sustainable levels of debt (indicating that their policies were adequate to achieve sustainable debt levels with traditional debt relief mechanisms) observed an increase of 3 percent in gross ODA flows since the initiation of the program in 1996. This is in marked contrast to ODA flows to countries with unsustainable debt levels that have not yet reached a decision point; in those countries, gross ODA has fallen by more than half since 1996. It should be noted, however, that ODA to the better performers excluding debt relief has declined by 2 percent since 1996. The HIPC Initiative has been essential to place beneficiary countries on a path to long-term debt sustainability[32] and has resulted in increased resources, as shown by the decline in actual debt service payments relative to earlier years. Even countries with significant payments arrears received an important, if more modest, increase in new financial resources, while the HIPC Initiative also will help normalize their relations with creditors. Nevertheless, it is of critical importance that donors maintain their ODA effort in the form of new money as well as debt relief, particularly as the expected supply response to lowering debt levels may take some time to occur.

—however, creditors need to continue to deliver on HIPC

Full participation by all creditors is essential to ensure that the 24 countries already at decision points reach sustainable external debt levels and, more broadly, to ensure that the HIPC Initiative achieves its objectives in full. While most bilateral creditors—including all Paris Club creditors—and the majority of multilateral and commercial creditors have already been delivering on their commitments to provide relief to HIPCs, a number of creditors have not. In particular, some of the non–Paris Club official bilateral and commercial creditors (representing about 10 percent of the debt relief to be delivered) along with a few multilateral creditors have not yet agreed to provide relief to the countries that have reached their decision points under the Initiative. Indeed, a small number of creditors have resorted to litigation as a means of recovering assets; of those, there are a few cases where claims of official bilateral or commercial creditors have been bought on the secondary market at a discount in order to maximize recovery through litigation.[33] Given the relatively small number of creditors involved, these problems will not likely undo the achievements of the HIPC Initiative. However, the litigation alone could prove to be very costly for individual HIPCs in terms of legal representation and the implications of adverse judgments.

Postconflict countries present a special challenge

The most important challenge for the HIPC Initiative in the year ahead is to bring the remaining eligible countries to their decision points as quickly as possible, so that these countries can begin to receive debt relief. This challenge presents special difficulties since most of these countries have recently emerged from, or are still engaged in, armed conflict, and many of them are struggling with governance issues. At the same time, these countries have a particularly acute need for debt relief because of their major reconstruction requirements and the urgent need for speedy and effective action to help break the cycle of violence, low growth, and severe poverty.

The framework of the HIPC Initiative has the flexibility to front-load assistance to countries affected by conflict, and a relatively large share of debt relief can be made available at an early stage, taking into account the profile of debt service payments due and the absorptive capacity of the country. To ensure progress toward sustainable growth, the structural and social triggers for the completion point will be customized to reflect the particular set of priorities and needs of the postconflict countries. For example, improvement in fiscal management and demobilization of excombatants were part of the completion point conditions for Guinea-Bissau.

Strengthening the effectiveness of official guarantees

In addition to aid flows, official agencies channel resources to developing countries through guarantees of private sector loans and investments. Export credit agencies' total exposure to developing countries reached an estimated $500 billion at the end of 2000—one-quarter of developing countries' total long-term external debt. Export credit agencies' new commitments to developing countries rose to an average $75 billion a year in the first half of the 1990s (mirroring the steep rise in private flows), and then declined in the wake of the Asian crisis.[34] Nevertheless, new commitments remained at $50 billion in 2000, or 40 percent of all commitments from private creditors, excluding bonds.

Export credit agencies have become increasingly more involved in investment insurance.[35] The Berne Union member agencies extended $13 billion of insurance against FDI projects in developing countries in 2000 (five times more than in 1990), and the total investment under cover by member agencies (the outstanding exposure or stock) rose to $58 billion at end-2000, compared with $9 billion in 1990. This strong growth in investment insurance mirrors the surge in direct investment flows (investment insurance by Berne Union members has covered on average around 12 percent of the FDI flows to developing countries) and has been important in privatization and private sector involvement in the provision of infrastructure services.

Multilateral institutions are expanding their guarantee activities

Multilateral institutions also expanded their guarantee activities during the 1990s. The guarantee programs of the World Bank Group, which are intended to serve as a catalyst for private sector activities in developing countries, supported $18 billion in flows in the second half of the 1990s, double the level of guarantees extended in the period 1990–95. Moreover, the financing leveraged by these guarantees is substantial: International Bank for Reconstruction and Development partial credit and partial risk guarantees of $2 billion helped galvanize almost $20 billion in total project costs. In poor counties, partial risk guarantees from IDA help insure private lenders against country risks that are beyond the control of investors. To date, three countries—Bangladesh, Côte d'Ivoire, and Uganda—have benefited from an IDA partial risk guarantee for a power project. The three guarantees total $206 million, and the aggregate project costs are $1 billion. The Multilateral Investment Guarantee Agency (MIGA) is in the forefront of efforts to facilitate investment in poor countries and to ensure that projects have a significant developmental impact. Since 1988, MIGA has issued 550 guarantees for projects in 79 developing countries. Total coverage issued exceeds $9 billion, bringing the estimated amount of foreign direct investment facilitated since inception to more than $42 billion. Poor countries accounted for over 20 percent of MIGA's gross portfolio on June 20, 2001, spread across 26 countries. The regional development banks, including the Inter-American Development Bank, the Asian Development Bank, the European Bank for Reconstruction and Development, and some of the smaller regional banks, have also developed wide-ranging guarantee programs.

Poor countries rely on guarantees for large external financial commitments—

Official guarantees have supported a limited volume of finance to the poor countries, compared with other developing countries. The export credit agencies' total exposure to the poor countries equals $40 billion at end-2000, or only 8 percent of the agencies' total exposure to developing countries. Most poor countries are not able to support large inflows of guaranteed finance, which is typically provided at nonconcessional terms. Nevertheless, export credit agencies are important for the poor countries: the agencies account for some 16 percent of the poor countries' long-term debt.[36] New commitments to the poor countries from export credit agencies were $2.4 billion in 2000, or 80 percent of gross capital market financing from private sources. Officially supported export credits can provide financing that would not otherwise be available from private sources, or that would be available only at prohibitive terms. In poor countries, official guarantees are nearly always required to access external finance for large projects; every major bank commitment over $20 million over the past five years has had some official guarantee. Official investment insurance also has helped facilitate investment flows to more than one-third of the poor countries, and it provided for about 30 percent of all FDI in poor countries.

Guarantee arrangements have played a particularly important role in facilitating greater private sector participation in infrastructure and in mining projects that require large investors (see box 4.4 on the Mozambique Mozal project). Access to officially supported export credits also may help build a reputation that facilitates access to nonguaranteed finance in the future. For example, in China two-thirds of all private source finance was guaranteed by export credit agencies in 1990, while today only 25 percent is guaranteed. Similar trends are evident for Latin American borrowers such as Chile and Brazil, and for Malaysia and Thailand prior to the 1997 crisis.[37]

—but these facilities have also increased poor countries' debt

While export credit agencies have made an important contribution to boosting the real resources available to poor countries, access to guaranteed finance also has contributed to unsustainable debt burdens. During the past decade, the HIPC countries have received almost $20 billion in loan commitments guaranteed by export credit agencies, and export credit commitments to HIPCs averaged $1.8 billion per year from 1990–96, when the HIPC Initiative began. Since then, steps have been taken to ensure that the debt reduction under the HIPC Initiative is associated with efforts to avoid incurring additional debt on nonconcessional terms. The HIPC Initiative framework provides that new external finance for these countries should be predominantly in the form of grants or loans on highly concessional terms. The injunction on nonconcessional borrowing was reinforced by the communiqué of the Development Committee in April 1999 and more recently by U.S. legislation that governs U.S. contributions to the HIPC Trust Fund.[38] The IMF also agrees with HIPC governments regarding limits on nonconcessional borrowing within the context of the Fund's concessional facility. These limits are established on a case-by-case basis, after an evaluation of the impact of new borrowing on the sustainability of the debt burden.

Some HIPCs are reducing their reliance on guaranteed loans

HIPCs that have reached a decision point, and hence have a policy framework in place that is agreed-on with the international community, have seen a reduction in export credit commitments from $0.9 billion per year in 1990–96 to $0.5 billion from 1997–2000. Moreover, in these countries very little by way of new export credits are going to public sector borrowers, with the bulk of the finance absorbed by the private sector. Countries within the HIPC group that have continued to attract significant export credit financing include those with sustainable debt burdens and important oil producers (for example Angola) or off-

Box 4.4 Official guarantees and the Mozal project

Official guarantees have helped attract external finance for the Mozal aluminum smelter, the single largest private sector investment ever undertaken in Mozambique and one of the largest projects to be developed on a limited recourse basis in Sub-Saharan Africa. The first phase of the project ($2.3 billion for the aluminum smelter) is already completed, and the second phase, which will double capacity, is under construction. Partially as a result of Mozal's success, private sector projects worth another $6.5 billion are in the pipeline.[39] Forty percent of the financing requirements were met by equity provided by the sponsors, the Billiton Group,[40] Mitsubishi Corporation of Japan, the Industrial Development Corporation of South Africa, and by the government of Mozambique. Loan financing was met by officially supported export credits, and loans and guarantees from the European Investment Bank and the International Finance Corporation (IFC) and several development finance agencies, including ones from Germany, South Africa, and France. The perceived political and commercial risks involved in the project were high, and the participation of IFC and official guarantors were an essential catalyst to draw in funding from private creditors.

The success of securing financing was largely due to a well-structured project with leading international sponsors, supported by Mozambique's impressive reform program and rapid recovery from the war. The country's proximity to South Africa and the return to operation of the Cahora Bassa hydroelectric power dam have also enabled Mozambique to become one of the few HIPC countries to have attracted substantial private sector investment from external sources. In addition, the project has been supported by a package of incentives, including exemptions from taxes on imported materials, corporate profits, and the income of foreign workers; allowance of repatriation of all dividends; and a first call on earnings for debt service payments. Such incentives are available to all exporting industries in Mozambique. The cost of energy was an important factor, and favorable rates were negotiated with the South African power utility. The government will receive 1 percent of the gross income from sales.

The Mozal plant, which is already in production, will double the country's total exports and add an estimated 7 percent to GDP, although the contribution to employment is limited (the project added 5,000 temporary workers during the construction phase but only 800 full-time, permanent jobs). As other planned projects develop exports should rise, by nearly 30 percent of GDP in 2010, although this will be partially offset by higher imports of raw materials, debt service on loans, and remittance of profits and wages of foreign workers. The net impact on the balance of payments in 2010 is estimated at less than 3 percent of GDP. Other benefits include infrastructure development, industrialization, and the promotion of regional integration.

These benefits must be balanced against the risk from the project's contribution to higher private sector debt. Borrowing by the private sector has already risen from an average of $36 million between 1990–98 to $340 million in 1999–2000, and it is expected to average well over $400 million over the next four to five years. Private sector debt service is projected to rise to 20 percent of exports over the next five years, assuming all the proposed projects are realized. While the projects promise to generate sufficient returns to cover debt service payments, the expected jump in the private sector's debt and debt service point to the need for vigilant monitoring by the authorities.

shore marine financing centers (Liberia) that can pledge assets as collateral.

Rethinking the costs and benefits of guarantees—
Export credit agencies are also taking steps to ensure that the activities they support (including guarantees and insurance) produce real economic and social benefits that are worth the buildup of debt. Several export credit agencies employ processes that screen projects for their effectiveness and are looking beyond standard issues such as environment and gender screening to include debt sustainability and development impact. In the United Kingdom, for example, the Export Credit Guarantee Department, in collaboration with the Department for International Development, has instituted a productive expenditure screening process that applies to all IDA-only countries. Public sector projects in poor countries are reviewed to ensure that the project supports the borrowing country's public expenditure priorities. For private sector projects the emphasis is on meeting environmental and social standards and examining the risks of the debt being assumed by the public sector or compromising the borrowing country's overall debt management strategy. Export credit agencies are also taking steps to implement common anticorruption measures, to re-

Table 4.5 Export credit commitments to HIPCs, 1990–2000
(annual averages in billions of dollars)

	1990–96	1997–2000
HIPCs at decision point	0.9	0.6
HIPCs with sustainable debt	0.4	0.6
Others	0.5	0.6
Total	1.8	1.7

Source: OECD.

voke insurance cover if corrupt practices are identified, and to blacklist corrupt companies.

—and limiting tied aid

Export credit agencies also are making progress to reduce the practice of attaching tied aid to export credit programs. In the past, export credit agencies have combined their own financing with official aid to create financing packages referred to as "mixed credits" or "parallel financing," where at least some part of the package is tied to the procurement of goods and services from specific countries. The practice of tied aid can impair the effectiveness of donor support for developing countries by increasing project costs, making procurement procedures more complex, and skewing decisions on technology and capital intensity. Under the terms of the OECD Arrangement on Guidelines for Officially Supported Export Credits, projects that are deemed to be financially viable with commercial loans will not receive any tied aid.

Data Annex

Aid definition and measurement

Defining aid. The international forum for defining aid is the OECD DAC.[41] There are two categories of aid provided by DAC donors: ODA and official aid (OA). The DAC list of aid recipients is divided into Part I and Part II recipients. Only countries on Part I receive ODA; those on Part II (which includes several countries in Eastern and Central Europe, and Israel) receive OA. Only ODA may be counted by DAC countries as part of their "aid effort."

ODA and OA are defined the same way: both consist of loans or grants to developing countries and territories by donor governments and their agencies that are developmental in intent and designed to promote economic welfare. ODA and OA loans are provided on concessional financial terms, with at least a 25 percent grant element (calculated as the NPV of the future payment stream discounted at 10 percent).

Measuring aid. Aid flows to developing countries can be measured in two ways: when *aid performance by DAC donors* is measured, ODA includes bilateral disbursements of concessional financing to developing countries plus the provision by bilateral donors of concessional financing to multilateral institutions (for example, IDA). When *resource receipts* by developing countries are measured, ODA (and, where relevant, OA) include disbursements of concessional financing from bilateral agencies and multilateral sources. The two measures will not be the same because the concessional funding received from donor sources by multilateral institutions does not match those institutions' disbursements to developing countries in any given year.

Aid and debt forgiveness. The directives for reporting aid statistics are agreed-on within the OECD DAC, and these include specific guidelines on the measurement of debt forgiveness. The impact on aid volumes varies depending on whether the claim being forgiven is an official development loan that was originally disbursed from the aid budget or a commercial loan extended or guaranteed by an official export credit agency. The forgiveness of an ODA loan does not give rise to any new net disbursement of aid. Statistically the benefit is reflected in the fact that because the cancelled or "forgiven" repayments will not take place, net ODA disbursements will not be reduced. The forgiveness of a non-ODA claim has an impact on net ODA. Such forgiveness can be counted by donors as part of their overall aid effort at the time the claim is forgiven. Statistically forgiveness of a non-ODA claim does give rise to a new disbursement of aid and net ODA disbursements will increase.

Official development finance. The concept of official development finance is broader than that of aid. It measures all receipts from official creditors. It includes (a) ODA and OA from bilateral sources, (b) grants and concessional and nonconcessional development lending by multilateral agencies, and (c) other official bilateral flows that are considered to be developmental in intent but for which the grant element is too low to qualify as ODA or OA.

Export credits: data sources and coverage

Data on export credits need to be interpreted with care. Export credit agencies typically provide insurance cover for repayment of both principal and interest; data provided to the Berne Union and to the OECD are based on agencies' exposure, including future interest payments. Also, agencies typically report the full value of contracts, including undisbursed amounts. It is therefore difficult to relate commitment data to actual disbursements. Specific complications arise when nonpayment by the debtor gives rise to arrears and rescheduling. Most agencies include arrears and rescheduled claims, including capitalized interest, in their reports to the Berne Union and the OECD, but interest accrued on arrears is not recorded as an increase in claims by the export credit agency. Similarly when unrecovered claims are regularized through a Paris Club rescheduling agreement, agencies do not record an increase in exposure in their reports to the Berne Union or the OECD despite the fact that the longer repayment periods on rescheduled claims increases the future interest at risk. The recording of rescheduling arrangements on concessional terms (that is with an element of debt reduction) also varies across agencies making the data for debtor countries experiencing debt servicing problems particularly hard to interpret.

The data provided by the export credit agencies are collected by both the Berne Union and the OECD. The Berne Union quarterly survey of member agencies includes data for about 60 developing countries and economies in transition on outstanding commitments, unrecovered claims, outstanding offers, and new commitments. The most attractive element of the Berne Union survey is that data are collected in the way most agencies actually keep their books; the concept commitment encompasses insured principal and, in most cases, interest on undisbursed as well as disbursed credits. This facilitates consistency in reporting and avoids errors that can arise when agencies are asked to make estimates of statistical concepts for which they have no hard numbers. The Berne Union data are available with a substantially shorter time lag than data from other sources. The data also provide a breakdown of total exposure into commitments on outstanding credits (representing a risk of future claims) and arrears and unrecovered claims (resulting from nonpayment and claims payments by agencies).

A limitation of the Berne Union data is that they are not readily comparable with other types of debt statistics, and they do not accurately reflect trends in new disbursements. Some agencies do not report export credit activity by the government (which may undertake export credit finance separately from the export credit agency). Most agencies include the insurance of certain transactions that are not exports; for example, insurance against exchange rate movements or insurance of preshipment risks, which do not involve export credits. Data presented in the annual reports of some export credit agencies refer to the full value of the exports supported, a measure that includes down payments by the buyer as well as self participation by the exporter in the credit.

The OECD compiles two types of data on export credits. The Statistics on External Indebtedness reports the stock of export credits on a basis broadly consistent with other external debt data: this is covering outstanding disbursed principal only. However, since this does not reflect the way most export credit agencies keep their accounts, estimation by either the reporting country or the staff of the OECD is required. The second set of data from the OECD is compiled by the Secretariat of the Export Credit Group, which records the flow of new commitments of export credits with initial maturities of over one year, and initial maturities of over five years, as well as the stock of officially supported short-term credits.

Notes

1. Aid is defined as grants plus concessional loans.

2. Of course, aid devoted to reducing poverty will also have an impact on education, health, and the environment. Thus these calculations are not entirely additional to the forecast of aid required to halve poverty. See World Bank 2001i.

3. These include Bolivia, Burkina Faso, Honduras, Mauritania, Mozambique, Nicaragua, Tanzania, and Uganda.

4. See http://www.worldbank.org/poverty/strategies/review/index.htm

5. See Interim Guidelines for PRSCs, available at www.worldbank.org.

6. In some cases, progress is not fast enough, while in others there has even been a deterioration (for instance, 14 countries saw increases in child mortality between 1990 and 1999).

7. See World Bank 2001a.

8. Ten countries or territories were removed from the list of ODA recipients on January 1, 2000: Aruba, French Polynesia, Gibraltar, the Republic of Korea, Libya, Macao, the Netherlands Antilles, New Caledonia, Northern Marianas, and the Virgin Islands.

9. In a few high-inflation countries where the domestic retail market is substantially dollarized, foreign exchange sold by the central bank could be used to buy nontradable goods, and thus contribute to inflationary pressures.

10. While aid should be treated as revenue in the fiscal accounts, it is not equivalent to revenue generated by taxes: (a) aid augments the resources available to the economy whereas taxation merely transfers them from the private sector to the government; (b) unlike taxation, aid does not distort relative prices; and (c) aid has radically lower costs of administration than taxes.

11. For example, for the International Development Association (IDA), the grant element is roughly 70 percent. Thus 70 percent of an IDA loan should be viewed as revenue, and 30 percent as a commercial loan. This approach does face some practical difficulties, in part because the ex ante calculation of the grant element depends on expectations regarding future exchange rates and interest rates, and in part because it could introduce inconsistencies between fiscal and external accounts.

12. Appropriately, both studies measured the volatility of aid in constant dollars, which provides an indication of the real value of aid resources available to the economy. Bulir and Hamann (2001) find that aid is significantly more volatile than revenues if both variables are expressed as a share of GDP, or if only the relatively aid-dependent countries are considered.

13. See World Bank 2000c, chapter 4.

14. One major aid program, IDA, has explicit allocation criteria, and the bilateral donors also follow criteria that are well understood (Alesina and Dollar 2000), so it is possible to define the conditions under which aid may fall.

15. A few of the earlier studies did find a positive impact of aid on growth (Dowling and Hiemenz 1983; Levy 1988; and Hadjimichael and others 1995).

16. Hansen and Tarp (2001) criticize the Burnside and Dollar result that policies enhance aid effectiveness as nonrobust to choice of sample. However, Collier and Dehn (2001) show that even on the Hansen-Tarp sample the Burnside-Dollar result holds up, once terms-of-trade shocks are included in the specification.

17. A one-off expenditure of $1 billion would result in a *temporary* phase of higher growth, but this temporary growth would take the economy to a *permanently* higher level of income. Thus, the poverty reduction produced even by a one-off injection of IDA funds is permanent.

18. Africa is probably the only region in which the Dutch disease effects of aid need to be considered, since aid as a share of both GDP and exports is much higher than in any other region.

19. With growth as the dependent variable, Collier and Dollar (2001a) find that the coefficient on the square of aid is significant and negative, indicating diminishing returns to aid.

20. However, Lensink and White (1999) found that aid in excess of 40 percent of GDP lowers the growth rate.

21. The Collier and Dollar results are based on GDP valued at purchasing power parity, which provide a standard measure allowing comparison of real price levels between countries (see World Bank 2001j), while this calculation uses GDP valued at dollars. Since the GDP of a developing country valued at purchasing power parity is typically larger than GDP valued in dollars, this calculation understates the number of poor countries where increased levels of aid will continue to have a positive impact on growth.

22. The increase in aid to India, which has about one-third of the world's extreme poor but only gets about 5 percent of total aid, is constrained to $10 billion. Absent this adjustment, the framework would imply massive and unrealistic increases in aid to India.

23. Based on case studies of African countries. See also Mercer-Blackman and Unigovskaya 2000, and Jayarajah and Branson 1995. In some cases, the complexity of conditions contributed to compliance failure.

24. See World Bank 1998 and 2001b.

25. The relationship between donors and recipients has been modeled both as the outcome of a bargaining game (Mosley, Harrigan, and Toye 1991) and in a framework where recipients are viewed as agents, implementing conditions desired by donors (Killick 1997; White and Morrissey 1997; Svensson 2000).

26. See Mosley, Harrigan, and Toye 1991; and Adam 1995.

27. However, measuring the extent of implementation of structural adjustment programs is problematic, because programs are intended to be flexible and are routinely modified or renegotiated during the course of implementation.

28. Weighted by disbursements, the scores for outcomes increased from 73 percent satisfactory in fiscal 1990–94 to 97 percent in fiscal 1999–2000.

29. The NPV refers to the discounted value of future debt service payments, where the discount rate is some market rate. This concept was introduced to measure the impact on the debt burden of different terms on rescheduling. It also provides a comparable measure of the debt burden among countries when a substantial share of outstanding claims is at concessional rates.

30. The 24 countries that have reached a decision point are Benin, Bolivia, Burkina Faso, Cameroon, Chad, Ethiopia, Gambia, Guinea, Guinea-Bissau, Guyana, Honduras, Madagascar, Malawi, Mali, Mauritania, Mozambique, Nicaragua, Niger, Rwanda, Senegal, São Tomé and Principe, Tanzania, Uganda, and Zambia.

31. Compared to actual debt service paid prior to HIPC assistance in 1998–99.

32. See Claessens and others (1996) on the importance of removing the debt overhang facing the HIPCs, and World Bank (2001g) for key aspects of maintaining external debt sustainability.

33. See World Bank (2001h) for a more detailed discussion of the status of creditor participation and for examples of litigation by commercial creditors against HIPCs.

34. New commitments include the value of new business insured, new lending facilities, and guarantees for new FDI (but excluding trade finance with maturities of less than one year).

35. Investment insurance by export credit agencies excludes commercial risks: it is normally limited to coverage of nationalization or expropriation without compensation, losses on investment due to war or civil unrest, and inability to convert and transfer or remit profits and dividends.

36. Differences in the definitions used in data from the export credit agencies and the private markets may distort this comparison.

37. Berne Union statistics.

38. This legislation stipulates that a HIPC country must commit to not borrow on nonconcessional terms for at least two years from any multilateral development bank benefiting from the U.S. contributions.

39. These include a factory to produce iron slabs, a gas pipeline, mining and processing of titaniferous mineral sands, and the expansion of the Mozal smelter.

40. Billiton, formerly a South African company but now listed on the London Stock Exchange, is the major shareholder in Mozal with a 47 percent stake. Billiton has substantial positions in the markets for aluminum, coal, nickel, ferroalloys, and industrial minerals.

41. Aid is also provided by a few countries that are not members of the OECD DAC, including the Republic of Korea, Turkey, and several oil-exporting countries in the Middle East.

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