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The Macroeconomics of Scaling-Up Aid:

What We Know in Kenya, Malawi and Zambia

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Last week at the United Nations, the MDG Africa Steering Group discussed the Gleneagles Scenario. The participants reiterated the need for scaled-up aid in order to support the attainment of the Millennium Development Goals (MDGs). At the same time, a report issued by the International Monetary Fund (IMF) assessed the macroeconomic implications of scaling-up aid in Benin, Niger and Togo. The report acknowledged that higher levels of aid will put moderate to sizable pressures on inflation and real exchange rates (IMF, 2008).

Concerns about such macroeconomic outcomes often constrain the full use of aid. Policies become too restrictive to allow full spending and absorption, even when aid is scaled-up. Countries are advised to maintain high interest rates, adopt inflation-targeting, and limit public expenditure. Macroeconomic policies have not been expansionary enough to increase MDG levels of spending.

To identify how concerns about macroeconomic instability have curtailed an effective response to MDG scale-up, we look at the cases of Kenya, Malawi and Zambia. These countries are confronting human development challenges and all of them receive resources to respond effectively, but they are not using those resources fully.

We compare spending and absorption *before* and *during* the aid surge periods to demonstrate the stance taken by the macroeconomic authorities in each country. Full absorption implies that the current account deficit was financed by an amount equal to or greater than the increase in the flow of aid. Full spending means expansion of the budget deficit before grants during the aid surge by an amount equal to the increase in aid.

The table shows that all of the aid was absorbed in Malawi, but only 59 per cent was spent through government fiscal expansion. Malawi had lower international reserves, mainly because of high absorption. Interestingly, the real exchange rate depreciated and the inflation rate fell by 15.4 percentage points. Hence full absorption of aid in Malawi did not result in macroeconomic instability.

In Zambia, 39 per cent of the aid was absorbed and only 6 per cent was spent. As expected, the level of international reserves increased. The inflation rate fell slightly. Surprisingly, the real exchange rate appreciated in the face of low absorption and spending of aid receipts. Despite the restrictive macroeconomic stance, Zambia experienced a less encouraging macroeconomic outcome.

Aid Absorption, Spending and Macroeconomic Outcomes, Averages

	Malawi		Zambia		Kenya	
	1999-02	2003-06	2001-03	2004-06	1995-99	2000-04
Aid absorbed (%)	-	100	-	39	-	33
Aid spent (%)	-	59	-	6	-	22
Inflation rate	28	12.6	21.7	18.1	6.4	4.5
Real exchange rate	103.2	75.5	108.2	139.6	69.9	72.6
Reserves ($US millions)	213.3	182.2	322.1	373.3	735	1,244

Source: Serieux et al. (2008).

In Kenya, 33 per cent of the aid was absorbed and 22 per cent was spent. A significant portion of the aid was used to settle domestic debt and build-up reserves. The level of international reserves almost doubled. The inflation rate fell, but the real exchange rate also appreciated.

The above cases are classic examples of a pre-emptive macroeconomic policy driven by fears of a "Dutch disease" effect. What is often forgotten, however, is that short-term macroeconomic movements are normal and expected after resources are scaled up. Large and persistent changes in inflation and exchange rates indicate a lack of supply response. Despite these obvious facts, the low level of absorption and spending in these countries is a direct consequence of macroeconomic conservatism.

According to their Poverty Reduction Strategy Papers (PRSPs), fiscal policy in Malawi and Zambia focuses on keeping the overall balance at less than 1 per cent of GDP. The targets for inflation are set at less than 5 per cent. In Kenya, the inflation target for the period 2005–2007 was 3.5 per cent.

Earlier publications of the International Poverty Centre have emphasized the urgent need for large-scale programmes to meet the MDGs. We reiterate those recommendations. Fiscal and monetary policies have to be expansionary in order to scale-up resources in the interest of achieving the MDGs. Macroeconomic management must encourage full spending and absorption of aid.

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