EFFECTS OF DEVELOPMENT AID ON DEVELOPING COUNTRIES´ TRADE FLOWS

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Abstract / Abstrakt

Alleviating poverty in the world became one of the main challenges of the global economy. Classified as economically advanced countries are committed to progressively increase their Official Development Assistance (ODA) to developing world, and to exert its best efforts to reach a minimum net amount of 0.7 percent of its gross national product by the middle of the decade (United Nations Millennium Declaration, 2000). However this topic became controversial and has been butt of considerable criticism. This form of financing economy of developing countries indeed runs multiple risks of money being wasted on its way to help the poor, this being due to the side effects that foreign aid runs. The question how to provide aid in most efficient way has arisen and has become subject of multiple studies. Most of the authors assess the foreign aid efficiency through their effects on the recipient countries´ economic growth. We however are more interested in studying its effects on the its export capacities, and those being studied from quantitative as well as qualitative point of view. We consider this being better measure for countries level of development.

Keywords: *official development assistance, aid efficiency, export flows, economic development*

JEL: *P33*

1 INTRODUCTION

Classified as economically advanced countries are committed to progressively increase their official development assistance (ODA) to the developing countries and to exert its best efforts to reach a minimum net amount of 0.7 percent of its gross national product by the middle of the decade (United Nations Millennium Declaration, 2000). Foreign aid is however a highly controversial topic and has been the butt of considerable criticism, as it runs multiple risks of money being inefficiently injected or even wasted on its way to help the poor. Thus the question about aid effectiveness has arisen and became subject of multiple studies. In most of the papers, aid effectiveness is measured by its effects on the economic growth. We find however more interesting to study the causality of aid inflows to export capacities (in terms of their quantity and structure) of the developing countries. Boosting international economy is indeed the crucial challenge for many developing economies today, export capacities being most of all results of healthy public investment structures, sufficient private investments, and of high quality of human capital - which are, in their turn, the main signs of countries development. Several authors suggest that the countries with higher income and development levels are likely to have higher and more diversified exports then those with lower levels (Imbs and Wacziarg, 2003). And the relationship between export capacities and development seems to function in two-ways. Traditional development models suggest that in addition to other structural changes, economic development requires a shift from dependence on primary exports towards diversified manufactured exports (Chenery, 1979; Syrquin, 1989), especially with increasing returns to scale (Matsuyama, 1992). This can be explained first by the fact that manufactured goods tend to have high income elasticity of demand and so have more opportunities for export market expansion (Osakwe, 2007). In addition, export diversification has been recommended as a long-term policy response towards stabilizing export earnings of commodity dependent countries - while the primary exports can help to achieve growth, they are not supposed to be substantial growth promoting (Osakwe, 2007). Also, the shift from primary to manufactured exports diminishes the risks of economic instability due to primary exports, and thus encourages investment, thereby increase economic growth (Ghosh and Ostry, 1994). Another authors argue that manufactured exports tend to offer greater potential for sustained learning and more spillover benefits to other activities, and thus improve the ability of all industries to compete internationally (Herzer and Nowak-Lehnmann 2004; Hausmann and Klinger 2007). In addition, while primary commodity dependence was shown to be the cause of poor governance (Pritchett et al., 2001), manufacturing exportation is supposed to contribute to growth of the middle class, which favours the further strengthening of institutions necessary for sustaining growth and development (Johnson, Ostry and Subramanian, 2007). Moreover, the primary exports are associated with the risk of civil wars (Collier and Hoeffler, 2001).

Thus the question arises to what extent development aid helps building better export capacities, those being studied in terms of the amount of the developing countries´ trade outflows in total, but also, and mainly, in terms of their structure. We are indeed interested whether foreign aid supports the shift from dependency of developing countries on exporting primary products. In the first part, we are going to present empirical studies linked to the potential effects of foreign aid inflows into developing economies on their respective world trade outflows; while in the second part we will study the facts and figures of these two flows for four different regions, in order to later try to determine the causality of foreign aid on exports –their quantity as well as quality - and thus assess the foreign aid effectiveness.

2 POTENTIAL EFFECTS OF AID ON TRADE (LITERATURE REVIEW)

Aid - if injected into private investment directly to local entrepreneurs (instead of insufficient local credits), or into public investments in form of infrastructure and human capacities (in order to mobilize the national resources for productive investment purposes, and to attract foreign investments as well as reach higher absorptive capacities) - can help the country to "move up the technology ladder", improve their competitiveness and diversify their economies (F. Al-Marhubi, 2000, Banhabib and Spiegel, 2002; Collier, 2002, (Lall, 1992; Collier, 2002). The works on trade also underlines the importance of macroeconomic policy (Osakwe, 2007). Providing aid is likely to be linked to indicators of macroeconomic stability, to name just few like inflation or healthy institutional framework, which in their turn seems to be necessary for creating productive diversification and competitiveness in developing countries (Levchenko, 2004). Indeed, as governance structures improve so does the capacity for a country to develop a diversified exports base.

At the same time however aid represents several side effects that can offset its positive effects on trade. First, there is a risk that the developing country uses aid to pay for its imports without having to sell exports of an equivalent value and is not inspired to reinforce its capacities. Lowering of exports and possible shift in domestic production from tradable goods to non-tradable goods can appear. Thus aid can have very similar effect on the country's real exchange rate as the impact of the discovery of a natural resource, often known as "Dutch Disease" (e.g.Heller 2005, Rajan and Subramanian 2005), that is known to reduce the international competitiveness of tradable, and thus impede the situation on international markets. Further possible challenge linked to the aid and its effects on trade is that the demand for aid services may reduce the supply of skilled labor to the private sector – one of the main engines of exports. This effect can be compared to the study of Kochhar et al (2006) who find that the evolution of manufacturing in India may have been affected by the intense demand for skills in services which has raised wages, attracted creative and inventive managers from manufacturing to services, and reduced growth in labour-intensive and tradable manufacturing. Kochhar et al call this effect the „Bangalore Bug". Heller and Gupta (2002) argue that aid creates a moral hazard as it reduces the incentive to adopt good policies and reform inefficient institutions. The literature also suggests that aid can be considered as of risky "unearned income" and thus cause the phenomenon known as "resource curse", and increase the feasibility of "patronage politics" (Collier 2005, Moss et al 2006). This is due to the fact that it lacks sufficient incentives to build local institutions and to establish a clear social contract with the population (see Birdsall and Subramanian, 2004), which are in their turn of the main prerequisites of capacity buildings.

3 FACTS AND FIGURES

For the foreign aid flows, we use the data from the Organization of Economic Cooperation and Development (OECD). The trade data in our work are sourced from the international trade database Chelem of the research center CEPII. For both flows, we found the data for four different developing regions during the period from 1967 to 2009.

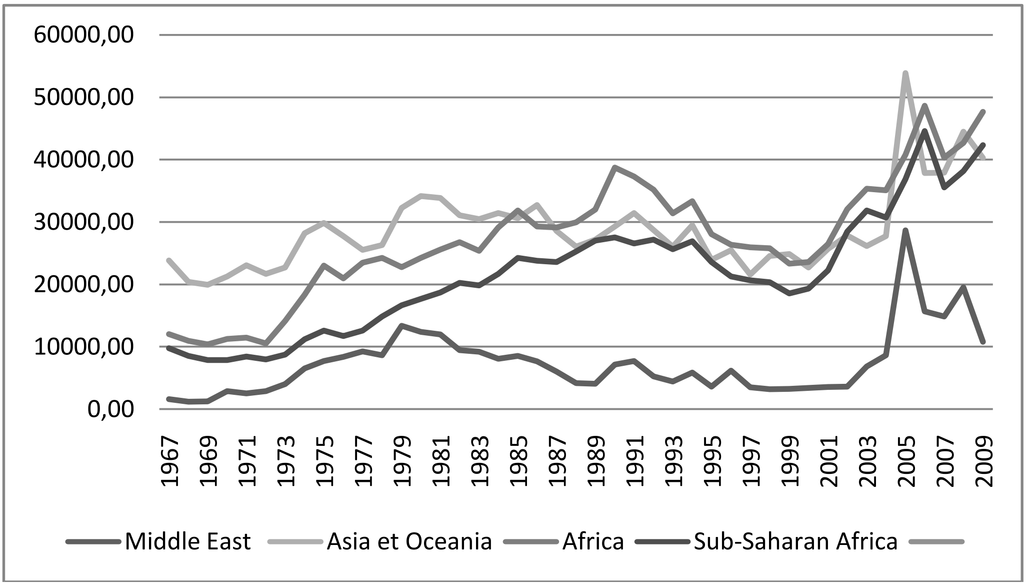

Figure 1 Evolution of inflows of ODA
Source: CHELEM-CEPII

During the Cold War, foreign aid under the leadership of the IFIs was highly conditional on the adoption of drastic economic and institutional reforms, focused on external and internal macroeconomic reform with specific conditionality on deregulation, privatization, and macroeconomic variables such as inflation and public sector deficits. The aid was, indeed, mainly perceived as of the ways to align poor countries to the political system of the "West block". After the cold war, we thus observe the decreasing trend in aid flows. However the new global geopolitical system with its new challenges point out to the need to alleviate poverty in the world. Thus, in 1999, Executive Board of the IMF decided to transform its Enhanced Structural Adjustment Facilities (ESAF) into the Poverty Reduction and Growth Facilities (PRGF) via International Development Assistance (IDA), with aid being since directed to achieve goals related to alleviation of poverty, later defined, as Millennium Development Goals (MDG 8, 2000).). The aid, at least on a formal level, marked a fundamental shift in the procedures of conditional lending, and instead of imposing conditionality and demanding policy alignment from recipient countries, donors are now expected to alien their funds with the partner's countries policies, and draw their conditionality from a nationally elaborated strategy on development and poverty reduction (Tarp, 2006). Classified as economically advanced countries are committed to progressively increase their official development assistance (ODA) to the developing countries and to exert its best efforts to reach a minimum net amount of 0.7 percent of its gross national product by the middle of the decade (United Nations Millennium Declaration, 2000).

Because the concept of aid changed at the crossing point of centuries, we decided to divide our study into two time sections; first we try to find the effects of aid flows on exports for the period before between 1967 and 1999, while later we are interested in determine the causality during the period from 2000 to 2009.

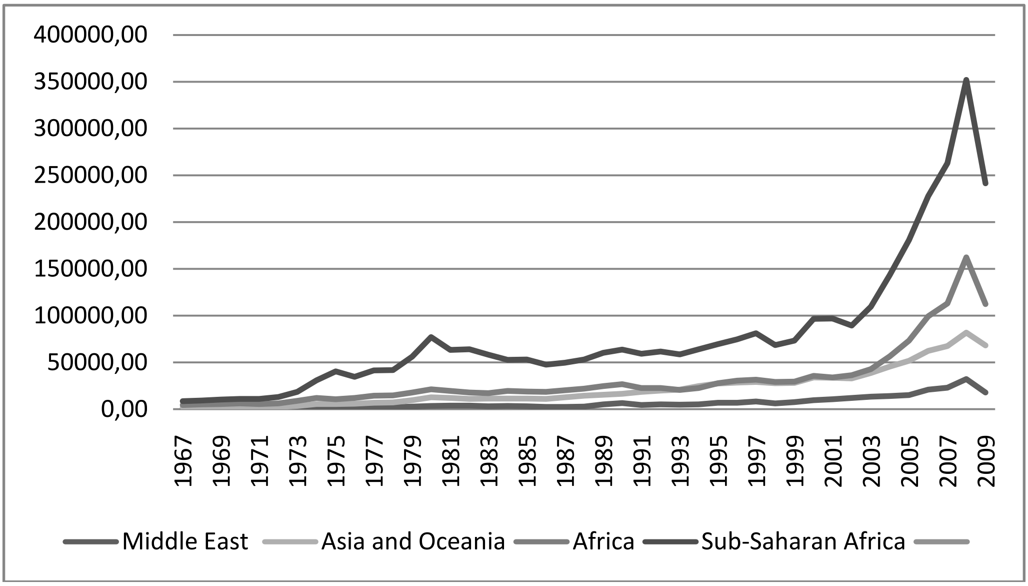

Figure 2 Evolution of world exports from 4 groups of countries (in mil. USD)
Source: CHELEM-CEPII

After the period of import-substitution strategy, the majority of developing countries has focused on achieving greater openness, first through the stimulation of exports during the 1970s and 1980s, and then later through a more concerned attempt at trade liberalisation. The process of trade liberalisation and market-oriented economic reform that has started in many developing countries in early 80s intensified in the 90s. A number of countries in East Asia continued their own dynamic industrial and trade policies initiated in the 60s. Other countries, mostly in Africa, have gone through the reform programmes designed and directed by the IFIs. We consider that this might be the explaining factor of the high correlation we found between aid inflows and trade outflows for the region "Africa", which is of 0.78 for the period before 1999 (of which

0.81 for Sub-Saharan Africa) - while it is just of 0.01 for Middle East and of 0.12 for Asia and Oceania, who´s trade evolutions were less related to IFIs conditions.

The correlations are significantly higher for all of the regions during the period after 2000. The causality of 0.59 for Middle East is not very strong however is considerably higher than during the first period. We find a significant causality for Asia and Oceania that is of 0.72, as well as for Africa that continue following the same trend as before with the correlation of 0,78.

We mentioned earlier however that export quantities are not sufficient variables to assess the efficiency of foreign aid as regards to the export capacities of developing countries. This is why we continue studying the evolution of different export sectors, their performance, and dependence on aid inflows into the developing regions. Just to mention than because we found the region of Sub-Saharan Africa being explanatory for the trends in correlation between aid and exports flows of the whole Africa, thus we continue focusing just on that region.

Table 1 Average growth rates of exports for different sectors from 1967 – 1999 and 2000 to 2009

	Middle East		Asia and Oceania		Sub-Saharan Africa	
	1967-99	2000-09	1967-99	2000-09	1967-99	2000-09
minerals	39,24%	21,08%	39,12%	19,94%	5,87%	16,60%
energy	20,22%	11,39%	17,21%	18,82%	22,49%	22,28%
agriculture	8,94%	5,42%	5,61%	8,64%	4,94%	6,74%
manufactures	11,72%	15,40%	13,31%	7,86%	8,21%	10,70%
other	12,58%	29,70%	11,73%	13,32%	12,03%	8,45%
ODA	7,88%	29,53%	0,64%	8,52%	2,42%	9,45%

Source: CHELEM-CEPII

The Middle East region is clearly specialised in energy exports. In 2009 this sector represents 54% of the trade outflows from the region (Chelem - CEPII). However its rate of growth for the period after 2000 – which is of 11.39%, is lower than the rate of 20.22% from before 1999. For minerals the trend seems being the same – marking lower growth rates for the second period (21.08%) than for the first one (39,24%). On the other hand however, even if representing small share of the total exports, the trade outflows of manufactured products increase, at a rate of 15.40% after 2000 against the rate of 11.72% for the period before. This explains, even if almost insignificant, however decreasing trend in dependency of the region on primary exports.

As regards the trade outflows from Asia and Oceania, it is important to mention that they already rely on manufactures, however with decreasing trend. Their share in total exports is of 52.65% in 2009, against 62.60% in 1999. Other main sector for this region´s exports is energy, representing 19.33% of the trade outflows of the region in 2009, and agriculture with the share of 15.66%. For both of these sectors the growth rates for the period after 2000 – 18.82% and 8.64% respectively - are higher than during the period before 1999, with respective rates of 17.21% and 5.61%.

The world exports from the Sub-Saharan region rely on the energy sector – representing 57.28% of the total exports in 2009, which is even more than the exports of the Middle East; and are still the fastest growing - at average rate of 22.28% from 2000 to 2009. Manufactures represent only 19.70% of exports of the region, however growing at a faster average rate for the period after 2000 – which is of 10.70% - than before 1999 when the rate was reaching 8.21%. Insignificant however growing rate for agriculture - with the average of 6.74% after 2000 - against 4.94% for the period before, explains slightly growing tendency for the share of agriculture in the Sub-Saharan region. International trade outflows of minerals represent the lowest share of the regions trade along with others, however with increasing rates. The situation of African export structure thus seems quite dramatic however with rising trend in manufactures exports as shown above.

Table 2 Correlations between aid flows and export flows from 2000 to 2009

	Middle East	Asia and Oceania	Sub-Saharan Africa
minerals	0,41	0,4	0,83
energy	0,08	0,39	0,82
agriculture	0,01	0,57	0,85
manufactures	0,33	0,46	0,79
other	0,67	0,73	0,18

Source: CHELEM-CEPII

The first column of Table 2 clearly shows higher causality between aid and exports for the sectors of minerals, manufactures, and other - with their respective correlations of 0.41, 0.33, and 0.67, against 0.08 for energy and 0.01 for agriculture. It is indeed important to note that even if the growth rates studied above are proving the situation of export structure in the region of Middle East are improving, the role of aid in this is however not certain. Even if higher than for energy sector, the causality of aid flows in the exports of manufactured products doesn't reach significantly high value.

The second row of the table indicates a very strong effects of aid on the sector of „others" in the region of Asia and Oceania, and lower however still explaining for exports in agriculture, with correlations of 0.73 and 0.57 respectively. The effects of aid flows on export of manufactured goods, with correlation of 0.46 are not very significant. Thus we can argue that foreign aid is not helping to improve the structures of exports in the region.

The third column indicates a very strong correlation between aid and exports of all of the sectors but the sector "other". This means for us that aid is not helping the region to improve its shares of manufactures in the world trade and thus is not very helpful in improving the region´s export structures.

4 CONCLUSION

Our results show a very high causality between aid and export flows' quantities for all of our groups of developing countries, after the end of the last century. On the other hand, however, we found no, or very insignificant, causality between aid and trade structure evolutions in these regions. We conclude that even if aid tends to help developing countries to increase their exports, the way it is injected is not specifically helpful in building capacities for diversified exports. As a result of what the donors run higher risks of harming recipient country´s economy with the potential side effects that foreign aid represents.

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