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The implications of aid as a financial flow amidst global imbalances

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The implications of aid as a financial flow amidst global imbalances

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Abstract:
Without denying the potential for publically-funded redistribution, as is done by market-advocates, we must acknowledge that the existing international aid architecture has largely failed in its purpose of inducing any significant degree of wealth redistribution between North and South, except in certain geopolitical special cases. Moreover, the fundamental reasons for this failure will most likely extend to current considerations of Finance for Climate Change. This failure is examined here through the lens of understanding Official Development Assistance as a financial flow within the context of global financial imbalances in the post-war period, as a means to reflect more broadly on recent debates regarding aid effectiveness in developing economies. The central focus of this conceptual examination is on what might be called the dilemma of monetary transformation in the transfer of foreign to domestic resources. This dilemma is poignantly illustrated by the dominant (albeit usually misconstrued) emphasis in the contemporary aid literature on the need and potential of aid to finance social expenditures in the Global South, such as on health and education spending or cash transfers. From the perspective of the monetary dilemma posed here, such emphasis ironically results in increased impulses among donors to meddle by way of conditionalities in the sovereign space of domestic political deliberations in recipient countries regarding the uses of government expenditure.

Extended Draft Abstract / Synopsis:
Without denying the potential for publically-funded redistribution, as is done by market-advocates such as Bill Easterly or Dambisa Moyo, we must acknowledge that the existing international aid architecture has failed in its purpose of inducing any significant degree of wealth redistribution between North and South, except in certain geopolitical special cases. Moreover, the fundamental reasons for this failure will most likely extend to current considerations of Finance for Climate Change. This failure is here examined through the lens of understanding Official Development Assistance as a financial flow within the context of global financial imbalances in the post-war period, as a means to reflect more broadly on recent debates regarding aid effectiveness in developing economies. The central focus of this conceptual examination is on what might be called the dilemma of monetary transformation in the transfer of foreign to domestic resources. This dilemma is poignantly illustrated by the dominant (albeit usually misconstrued) emphasis in the contemporary aid literature on the need and potential of aid to finance social expenditures in the Global South, such as on health and education spending or cash transfers. From a monetary perspective, such emphasis ironically results in increased impulses among donors to meddle by way of conditionalities in the sovereign space of

domestic political deliberations in recipient countries regarding the uses of government expenditure. This argument is elaborated in three sections.

The first section starts with the basic premise – as outlined in Fischer (2009), 'Putting Aid in its Place' (*J. of International Development*) – that aid effectiveness needs to be understood (and was understood by early development economists) by its potential to allow countries to run trade deficits (and, by consequence, net capital inflows). Since trade deficits usually result as a structural condition of late industrialisation, especially among post-war 'late-late' industrialisers, aid can prevent such deficits from choking off intensive developmental endeavours. Conversely, this potential of aid is lost if countries run trade surpluses (or else if deficits are not the result of developmental productivity enhancing investments, but rather, due to terms of trade or other negative shocks).

Using balance of payments and flow of funds data, the second section of the paper elaborates on the two paradigmatic phases of the post-war period, driven by imbalances stemming from the US, the gravitational centre of the international financial system. These two phases can be called, for lack of better terms, 'developmentalist' and 'neoliberal'. The first was the golden age of developmentalism and aid; up to the mid-1970s, the US was mostly in current account surplus and exporting net goods and finance abroad, thereby supplying and financing the trade deficits of first Europe and then developing countries undergoing intensive rebuilding and/or industrialisation efforts. In this context, aid was one among other forms of net capital outflow from the US supporting industrialisation, as best represented by the case of South Korea. However, this phase was also the age of dependency given that it represented the rapid expansion of US-based transnational corporations (TNCs) into the Global South through the vehicle of foreign direct investment (FDI), one of the main sources of capital export. This was classically depicted by the experience of Latin America – particularly by Brazil and the Southern Cone countries, which were the most industrially advanced in this region. Hence, the dialectic in this period – or the tension reflected by the imbalances – was between developmentalism and dependency, which in turn defined the theoretical terrain of development studies and the debates regarding aid in this earlier period. International financial liberalisation from the mid-1960s onwards extended the contradictions of this dialectic into the 1970s, allowing for faltering developmentalist attempts to counteract the constraints of dependency.

In the second phase, which started in late 1970s, the US moved into a position of persistently large and growing current account deficits, therefore absorbing finance from rest of the world, albeit alongside continued waves of financial liberalisation in the US and globally. Moreover, despite the overall net import of finance by the US economy from the rest of the world, the US economy has nonetheless continued to export net FDI, reflecting the continued expansion of the US corporate sector abroad (and the corporate sectors of other lead countries, e.g. the pattern is essentially the same for the UK; the pattern is different for Germany, in that German corporate expansion has taken place in the midst of current account surpluses).

Hence, the dialectical tension in this latter phase has shifted. On one hand, there has been a continued progression of Northern-centred transnational ownership and related international production networks, which has supported in the exceptional growth of a handful of developing countries such as China (albeit with exceptional characteristics dissimilar to most earlier post-war industrialisers, such as large trade surpluses, alongside the maintenance of a strongly developmentalist strategy). On the other hand, for most of this latter period (up until the recent commodity booms), most of the rest of developing countries have faced deficient demand and investment and anaemic growth due to stringent macroeconomic policy regimes and haemorrhages of wealth from their economies. The prospects for aid effectiveness in this latter phase have been far from evident given that the dominant trend in global financial flows has been regressive, as analysed in the paper through an historical trend analysis of the balance of payments of a collection of aid dependent countries in Africa, Asia and Latin America. In other words, aid flows have essentially been moving against a tidal wave of global financial imbalances. This perspective – as well as the distinction between two paradigmatic phases – is usually ignored by the prominent critics of aid, such as Easterly and Moyo.

The third section of the paper then frames current debates regarding aid effectiveness in light of the above analysis, with particular focus on issues related to the targeting of aid towards social spending, tied aid, institutional conditionalities (including recent 'cash on demand' proposals), and public debt financing. Notably, aid essentially represents transfers of foreign exchange. Insofar as these are not directly intended for financing imports or other foreign exchange needs (as would be suggested by using aid to finance trade deficits), then aid is effectively entirely fungible, almost by definition. In terms of the financial circuit, aid provisioning intended for domestic expenditure in domestic currency essentially amounts to a government printing money, albeit backed up by foreign exchange. The printed money is used for the said purpose (social or productive spending in domestic currency), while the foreign exchange provided is used for some other purpose related to the use of foreign exchange (purchase of imported goods or services, debt servicing, etc).

In this sense, the aid question is rooted in a problem of monetary transformation. When donors insist that aid should be spent on social spending, in reality, most social spending takes place in domestic currency (e.g. salaries). Hence, donors possess no direct control over aid money being allocated to these sectors except by way of conditionalities linked to these domestic expenditures (or else by way of donors directly controlling the domestic currency that they receive in exchange for the foreign exchange they provide, as is typical in the INGO sector and in some bilateral aid projects, although such direct project work has come under increasing criticism). Effectively, the actual aid money (i.e. the foreign exchange provided) never goes to those social sectors unless it is spent on foreign technical assistance (e.g. doctors and consultants) or imports (e.g. MRI machines). In consequence, insistence that foreign aid be used for domestic expenditures in domestic currency contributes to the impulses of donors to increasingly meddle into the domestic political deliberations of recipient countries through conditionalities and other mechanisms. Such meddling amounts to very round-about ways of committing an aid-recipient government to direct a certain proportion of its domestic expenditure into such uses (with domestic currency, which it rightly prints as a sovereign nation), thereby symbolically legitimising the use of the aid money to the donor. Recent proposals for a 'cash-on-demand' aid model can be seen as merely a new (and potentially very powerful) means of enforcing such donor impulses.

In a monetary sense, such meddling involves an encroachment on national sovereignty, insofar as it extends far beyond the issue of deficiencies in (foreign) savings and into domestic political deliberations. This insight is similar to common criticisms of the so called Post Washington Consensus and Good Governance approaches, whereby we have been seeing the proliferation of conditionalities extending beyond the traditional economic policy concerns of the Washington Consensus and into the realm of the political. These criticisms are clarified here from the perspective of international finance, whereby governments become increasingly bound by foreign and increasingly technocratic demands in terms of how they should be deliberating and conducting their own domestic expenditure, while the actual management of foreign exchange has become increasingly deregulated, liberalised and even denationalised (and aid simply contributing to that pool of foreign exchange).

The contention of this paper is that the aid question can only be resolved through a revival of the older developmentalist understanding of aid, which is largely ignored in current aid effectiveness debates (even by the pro-aid camp, which is dominated by regressional analyses that are poorly suited to catch these historical and structural dynamics). Indeed, this financial lens also helps to clarify some of the criticisms of tied aid, which have tended to demonise the idea of aid being spent on imports (physical, human, etc). In effect, aid money (as foreign exchange) can be directly used for nothing else other than imports and other foreign exchange needs (such as debt repayment). The fundamental problem with tied aid is not that aid is spent on imports, but that it locks countries into certain structural dependencies on donor countries, resulting in very little autonomy for receiving countries in deciding how to use the foreign exchange provided in a manner most suitable and effective for their local economy, as opposed to the economy of the donor country. Stipulations for international tendering and the high degree of contextual institutional competency required by many formally-untied aid programmes also effectively result in the tying of aid as an outcome. In contrast, successful cases of aid utilisation in the past (e.g. South Korea) were characterised by autonomy and effective national ownership in this regard (obviously permitted due to geopolitical circumstances), among other determining factors. Similarly, this financial lens redeems the use of concessional public debt financing for developing countries. Despite the demonization of debt financing by poor countries for much of the last thirty years and the associated celebration for FDI as a stable alternative, debt financing, as once pointed out by Arthur Lewis, remains the primary financing option that preserves autonomy and sovereignty so long as it remains manageable. Manageability depends in part on the productive investment of debt but also, perhaps more crucially, on the broader structuring of global imbalances, insofar as these should support net inflows to, rather than net outflows from, developing countries.

The paper concludes that the key to creating a truly effective aid system – or climate change financing mechanism for that matter – must be found in genuinely redistributive financing mechanisms that enhance rather than undermine national self-determination.