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# Dilemmas of Externally Financing Domestic Expenditures: Rethinking the Political Economy of Aid and Social Protection through the Monetary Transformation Dilemma

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## Abstract

The external financing of domestic government expenditures, as exemplified by the financing of social protection with official flows (aid and other official flows), faces what can be called a monetary transformation dilemma. This refers to the fact that official flows are in foreign currency and hence cannot be directly used for expenditures in domestic currency. Nor do domestic expenditures require foreign currency given that they can be financed through conventional domestic monetary and fiscal operations. The extent to which official flows are actually able to fund domestic expenditures therefore involves a range of macroeconomic management concerns, which are in turn prone to exacerbate the already thorny political relations between donors and recipient governments. This calls for a serious rethink of many of the accepted premises in the political economy of aid and social protection literatures, particularly with respect to the dominant focus on domestic governance rather than a broader systemic understanding of the often convoluted and contradictory external dynamics that domestic actors must contend with in the power relations that condition official flows.

Several examples can be highlighted. First, conventional measures of absorption, as used by the IMF, actually include income payments to foreigners, which seriously muddles our understanding of the extent to which aid flows represent actual redistribution. Second, large mismatches between the absorption and notional domestic spending of aid appear to be the norm in most of the countries studied in the macroeconomic literature on aid and, given the first point, absorption is generally overestimated in this literature. Third, the full absorption and spending of aid, as advocated by the IMF, is in contradiction with the need to accumulate reserves in the face of financial account liberalisations, as also advocated by the IMF and other IFIs. Fourth, the full spending of aid is similarly in contradiction with substitutive approaches to social protection, as commonly advocated by donors and IFIs, which imply no net increase in spending. Finally, the obscurity of these monetary transformation dilemmas exacerbates donor concerns about fungibility, transparency and accountability, thereby inciting donors to seek ways of strengthening their micro-control over the end uses of aid, as exemplified by recent innovations in aid modalities such as cash-on-delivery or payment-by-results. Impulses to control recipient countries obviously do not originate from the monetary transformation dilemma although the associated tensions nonetheless reinforce broader ideological predilections to subordinate recipient countries within donor-recipient power relations, in parallel with increasingly conservative reactions to welfare in donor countries, thereby running counter to donor commitments of respecting national ownership.



## Keywords

Aid (official development assistance); official flows; social protection; fiscal and monetary policy; political economy of development; international finance and development finance; balance of payments; structuralist macroeconomics.

## Figure



## Acronyms

| | |
|---|---|
| BoP | Balance of Payment |
| BPM6 | Balance of Payments and International Investment Position Manual, Sixth Edition (IMF) |
| DAC | Development Assistance Committee |
| FDI | Foreign Direct Investment |
| HIPC | Heavily Indebted Poor Country |
| IFI | International Financial Institution |
| IFS | International Financial Statistics (IMF) |
| IMF | International Monetary Fund |
| ODA | Official Development Assistance |
| OECD | Organisation for Economic Cooperation and Development |

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# Dilemmas of Externally Financing Domestic Expenditures: Rethinking the Political Economy of Aid and Social Protection through the Monetary Transformation Dilemma

In these times of development goals, first millennial and now sustainable, the scope of official development assistance (aid for short) has been extended and deepened in an increasing array of policy sectors, mostly notably social sectors such as those dealing with health, education and social protection. However, within the increasing focus on such social expenditures, and within the debates regarding aid effectiveness more generally, a deceivingly simple question is almost never asked: how can aid, which is constituted as foreign currency, be used for domestic expenditures denominated in domestic currency? Or why should it be used for such purposes? With a few exceptions, the technicalities involved in such transfers have been overlooked as unproblematic within the profuse literature on aid and on finance for development or social protection. The few exceptions are found in a specialised tangent on the macroeconomics of aid largely associated with the IMF (e.g. see IMF 2005, Berg et al 2007, Hussain et al 2009, and Berg et al 2015). These have been formative in clarifying how the technicalities can be problematic, although their insights rarely seep through even other allied silos of economic research on aid, let alone those in other disciplines. The technicalities nonetheless tap into an unexplored potential to re-examine many of the accepted premises in the political economy literature on aid or social protection, particularly with respect to the role of external pressures at a time when many believe that the age of coercive conditionalities has been left behind. The current social protection agenda serves as an ideal policy case for such re-examination precisely because social protection expenditures are, in principle, mostly denominated in domestic currencies.

As a first step in problematizing the conventionally assumed unproblematic, it is important to recall the fact that aid and net financial inflows are absorbed into domestic economies via trade deficits (ideally goods, but also services). In other words, the redistribution that aid is supposed to bring operates by allowing an excess of consumption and investment over production or earnings. This is not a theoretical proposition but a logical corollary derived from the balance of payments accounting identity. As such, it is well recognised by the IMF-associated literature mentioned above and was also an accepted premise in early development economics, as discussed by Fischer (2009, 2016). With respect to financial flows more generally, it is also well recognised by a range of post-Keynesian and structuralist economists dealing with macroeconomic and financial issues (e.g. see Thirwall 1979, 2010; or Kregel 2008), although these latter contributions rarely address the question of aid and are overlooked in the aid-related literature.

The implication of this classic insight is that aid is managed as foreign currency on the external accounts of recipient countries and is supplied primarily as a means to overcome foreign exchange constraints on development. This is distinct from domestic resources denominated in domestic currency, which various poor countries have often been quite successful in mobilising, in particular prior to the neoliberal era when countries could manage such matters behind relatively closed capital accounts.[1] A fundamental problem with much of the contemporary aid literature is that this distinction is not recognized, as epitomised by Sachs et al (2004), whose case for aid on the basis of a savings-gap model does not differentiate foreign from domestic savings.[2] The distinction is nonetheless vital for understanding the power levers that donors (including multilateral international financial institutions or IFIs) hold over recipient countries as strategic providers of foreign exchange, even in situations where aid and other official flows might only constitute a marginal addition to overall financing needs. This is particularly the case during tightening financial cycles when recipients face resurgent balance of payments constraints.

From this perspective, when aid is directed towards expenditures that are denominated in domestic currency, the intended transfer elicits what might be called a dilemma of monetary transformation from external to domestic resources. The quandary is that foreign currency cannot be directly spent on expenditures denominated in domestic currency. Rather, the foreign currency provided by aid is necessarily used for other foreign exchange transactions or else is held in reserves. For countries that do not possess reserve currencies, the external uses of domestic currency are also very narrow and restricted, and foreign exchange must be earned, borrowed or given in order to pay for external transactions. Aid intended for domestic expenditures is, in this strict monetary sense, perfectly fungible.[3]

In recent practice, receiving governments can either spend the foreign currency directly on imports or else sell the foreign exchange to the central bank in exchange for domestic currency, which can then be spent on domestic expenditures or else simply saved. In the latter exchange, the central bank in turn either sells or saves the foreign exchange. The aid is absorbed once the foreign exchange is used for imports, through whichever route. Spending therefore falls under the purview of fiscal policy. Absorption falls under the purview of monetary and exchange rate policy (if it follows the indirect route via the central bank). The exchange between the government and central bank in this sense is essentially equivalent to a domestic monetary expansion to finance a fiscal expansion.[4] The differences are that: aid allows this to happen without the government incurring debt with the central bank; aid provides

[1] For instance, see Serieux (2011) for a discussion of the persistently low savings and investment rates in lower income Sub-Saharan African countries since the 1980s, in contrast to their higher rates in the 1960s and 1970s.
[2] As pointed out by UNCTAD (2008: 56), the model of Sachs et al (2004) also borders on tautology.
[3] Hussain et al (2009, p.494) also note that '[aid] money is fungible' but they do not elaborate on this point, particularly in light of other literature on fungibility, as discussed later in this paper.
[4] Hussain et al (2009, p.492) make this point, but only with reference to cases where aid is not absorbed and the foreign exchange is held in reserves.

foreign exchange to buffer the balance of payments effects of fiscal and monetary expansion; and the extent to which the central bank allows absorption to occur through an increase in the non-aid trade deficit acts as the equivalent of sterilisation, thereby not requiring additional sterilization by the central bank.

Despite these qualifications, the fact remains that the receiving government effectively does not need aid in order to finance domestic expenditures, insofar as it can finance these expenditures through conventional domestic channels. Rather, it needs aid to finance its direct foreign exchange expenditures or else to relieve the indirect foreign exchange constraints on the rest of the economy. To the extent that donors do not clearly conceptualize this distinction is already setting up aid relations to much confusion and contention. Also, to the extent that the absorption and notional spending of aid do not match, as is the case of most of the countries studied in the limited literature on these issues, the coordination between monetary and fiscal policy becomes potentially fraught with tensions. In particular, the inflationary and exchange rate implications of absorbing less than governments spend (which appears to be the norm) runs against a variety of orthodox concerns regarding macroeconomic policy, as suggested by Hussain et al (2009). It also undermines the redistributive purpose of aid. These implications are therefore prone to exacerbate the already thorny political relations between donors and recipients regarding a range of issues, from expectations regarding monetary and fiscal policy, and current and capital account management, to the course of domestic policy that is notionally associated with aid.

While this transformation dilemma applies to any domestic expenditure, it is exemplified by social protection schemes such as cash transfers given that these are almost entirely in domestic currency (besides budget items such as technical assistance, which can nonetheless be substantial within certain programme budgets). Even without entering into a critique of the mainstream narrative regarding the virtues of cash transfers,[5] the entry of donors into such domestic policy spheres complicates the political economy tensions surrounding both aid and social protection. This occurs not simply by their entry as one distinct faction within a political settlement, as argued by Hickey and Lavers (2016), but also through the convolution that arises from the transformation dilemma, which muddles the various incentives and compulsions guiding both external and domestic actors in often contradictory ways. Many of the political economy contortions that recipient governments manifest must be understood, in this sense, as symptoms of these convoluted and contradictory tensions, rather than as causes of aid ineffectiveness.

In particular, because transfers from foreign to domestic resources are indirect, opaque, negotiated, generally in disequilibrium, and widely misunderstood, they have a strong propensity to exacerbate donor concerns about fungibility, transparency and accountability. Bolstered by a priori assumptions of the virtues of such types of aid, these concerns arguably incite

[5] For some critiques, see Mkandawire (2005), Adesina (2010), Fischer (2012), Lavinas (2013), and Saad-Filho (2016).

donors to seek ways of strengthening their control over the end uses of aid and/or intervening in domestic policy making as a means of dealing with the opacity and complexity of the intermediating financial processes. Obviously, impulses to control recipient countries do not originate from these tensions, but have long standing roots in colonial and post-colonial histories, especially since the neoliberal phase of structural adjustment programmes and beyond. However, the tensions associated with the obfuscating effects of the monetary transformation dilemma nonetheless reinforce the broader ideological predilections to subordinate recipient countries with donor-recipient power relations, in parallel with increasingly conservative reactions to welfare in donor countries, thereby running counter to donor commitments of respecting national ownership.

The implications of the monetary transformation dilemma within the context of social expenditures therefore offers an unexplored lens for a serious rethink of many of the accepted premises in the political economy of aid and related literatures, particularly with respect to power relations between donors and recipient countries in global aid practices. Such rethinking is explored in this paper, with the objective to gain a deeper appreciation of the systemic political as well as economic challenges facing global redistribution towards poorer countries. The first section provides background on the relationship of aid to external constraints. The second explores how the increasing emphasis of domestic expenditures by donors and IFIs exacerbates the monetary transformation dilemma. The third critically discusses how the monetary transformation dilemma has been implicitly conceived in the specialised macroeconomics of aid literature, together with some critiques of this literature. The fourth examines the blind spot in the general aid, social protection, or finance for development literatures with regard to these issues and suggests some of the unexplored implications. The article concludes by stressing the urgency of engaging in this rethinking given the currently tightening financial cycle and the re-emergence of stringent balance of payments constraints facing many developing countries, parallel to the ongoing emphasis of social expenditures by donors, IFIs, and global development agendas.

## 1 Aid and the external constraints of development

The role of the trade deficit in the absorption of countervailing flows on the balance of payments has long been a subject of notice in economics. Modern iterations stretch back to interwar and post-war apprehensions regarding international economic imbalances. Pre-war orthodoxy maintained that such imbalances were best resolved through strict gold standards and market-mediated clearances, although this position was severely discredited by the interwar experience in the 1920s and 1930s, particularly in the European peripheries, as discussed at length by both John Maynard Keynes and Karl Polanyi.[6] The post-war Marshall Plan in turn came to epitomise the ideal of

[6] See Polanyi-Levitt (2006).

how official financial flows could work to mediate these imbalances, following severe balance of payments problems in Europe due to the import intensity of immediate post-war reconstruction. Notably, while the Marshall Plan has often been criticised as merely guaranteeing the purchase of US exports as well as the repayment of US loans, it was precisely in this financial dynamic that its redistributive function was founded.

These concerns and experiences were also clearly articulated in emerging field of development economics with respect to the tendency of late industrialisation to generate trade deficits, thereby resulting in similar balance of payments constraints. As discussed in Fischer (2009), late industrialization and related development processes such as urbanization and the modernisation of consumption in the post-war era have usually resulted in chronic trade deficits for structural reasons, given that these processes are typically very import-intensive and structural/technological dependence results in a strong inelasticity of imports to growth, in particular with respect to capital-intensive and intermediate imports. Economic development (conceived with industrialisation at its core) is therefore constrained by the supply of foreign exchange to finance such deficits. Conversely, trade surpluses have generally been associated with austerity (and honouring international creditors) rather than development throughout most of the post-war era,[7] except in cases of exceptional commodity booms. The choice has generally been between trade deficits balanced by some counterpart net inflow, such as aid, debt, or foreign direct investment (FDI), or else choking growth by way of stunting or crippling industrialisation and related processes. This is in addition to the broader constraints and challenges involved in processes of late development, as amply discussed, for instance, in the more contemporary literature on industrial policy or developmental states. The recognition of these 'trade gaps' or foreign exchange constraints was common among the pioneers of development economics, such as Prebisch (1950), Lewis (1955), or Hirschman (1958), as well as in the later formalisation of 'two-gap' modeling associated with Chenery and Strout (1966). Contemporary recollections of these insights mostly refer back only to these later authors, while also de-emphasising if not entirely overlooking the centrality of industrialisation in these earlier theorisations.[8]

The classical rational for aid in early development economics was built on this understanding, complemented by the fact that aid absorption effectively requires deficits. Indeed, Chenery and Strout (1966) explicitly presented their two-gap model as a justification for aid. Fischer (2016) refers to

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[7] For instance, this was the case in the immediate aftermath of the Latin American debt crisis in the early 1980s, as seminally discussed by Diaz Alejandro (1984).

[8] For instance, Morrissey (2001: 39-40), Addison et al (2005), and Serieux (2011) all refer back to the Chenery models rather than the earlier origins of these ideas and also do not explicitly relate these to industrialisation. Thirlwall (2011), on the other hand, offers a more comprehensive survey of these earlier approaches, including the pioneers before Chenery, although he also does not explicitly place industrialization strategies at the centre of his analysis and also does not deal with the subject of aid. Indeed, the more recent post-Keynesian and structuralist contributions on these financial questions have found little if any inroad into the aid literature in part because they do not explicitly or specifically address aid (with the exception of Fischer 2009).

this as the symbiosis of redistribution and development, insofar as aid provides concessional and stable flows of foreign currency to poor countries in order to fund their external expenditures that emerge as requisites of economic development. The symbiosis does not solve the question of what causes development, but it highlights that aid, in its ideal form, at least removes the impediments for these causes to operate. The key condition that renders aid developmental in this sense is its confluence with productionist industrial policies and their tendency to generate trade deficits.

This is strongly evidenced, for instance, by the case of South Korea. The country ran very deep trade deficits from the 1950s right up to the mid-1980s, as reflective of its intense and rapid state-led industrialisation. It arguably only survived this hard constraint through generous supplies of foreign currency, first almost entirely through aid in the 1950s and then, as aid gradually tapered off in the 1960s and 1970s, through indirect support (such as demand for government services by the US military) and, more importantly, through generous supplies of official loans from the US and Japan (see Fischer 2016 for further detail). Ample supplies of aid and debt also allowed industrialisation to take place mostly on the basis of national ownership, as seminally emphasised by Amsden (1989), whereas FDI was very marginal before the 1980s. The experience of Taiwan differed in that the country managed to balance its trade earlier, by the mid-1970s, although it also ran deep trade deficits until then. It also relied much more on FDI from the mid-1960s onwards, although this was careful regulated behind closed capital accounts and was also supplemented by heavy doses of aid, as in South Korea.[9]

In the absence of industrialisation, aid mostly plays a welfare role of assisting countries to sustain consumption, particularly in the face of the cyclical import austerity that is characteristic of primary commodity producers. Such tendencies for austerity are driven by the secular trends of declining terms of trade faced by such economies, combined with various outflows of wealth that derive from their subordinate position within the international economic order (e.g. see Fischer 2015). The new orthodox hope since the 1980s has been that the demand generated from aid-augmented consumption, if conjoined with liberalisation and deregulation, would catalyse economic transformation led by the private sector through market adhering principles (based on the assumption that past attempts at economic transformation failed because of distortionary government interventions). However, as amply pointed out by numerous authors from both sides of the spectrum in the recent aid literature, such hopes have stood in stark contrast to actual experience.

Moreover, the new orthodoxy since the 1980s has implicitly tended to admonish trade deficits in developing countries. The theoretical position of this new orthodoxy actually postulates the opposite, that under liberalised conditions, finance should flow from rich capital abundant countries to poor capital scarce countries due to the presumed higher rates of profit in the latter, which implies trade deficits. Indeed, it is for this reason that the previous

[9] For data on Taiwan, see Hsiao and Hsiao (2001). On the careful regulation of FDI, see Wade (1990).

structuralist arguments are often conflated as part of this neoclassical theorising, even though their reasoning about the causes of trade deficits differs. Nonetheless, despite this orthodox theorising, trade deficits are implicitly admonished in practice through the pricing of perceived risk in commercial sovereign debt markets and also rhetorically through the exhortation of export-oriented strategies of development.

Underlying the practice and rhetoric is the flip in the external imbalances of the US economy, which went from trade surpluses and hence net financial outflows during the first three decades of the post-war period, to running deep trade deficits and net financial inflows since the 1980s. As noted by Arrighi (2003), this made it much more difficult for peripheral developing countries to run trade deficits and to compete with the US for international finance. It has been precisely in this context that the option of using trade surpluses rather than deficits to drive development has emerged (through augmented external demand rather than net financial inflows).[10] This is exemplified by the experience of China since the late 1990s, although interpreting this experience is nonetheless tricky due to the fact that China ran both current and non-reserve financial account surpluses during this period.[11] Besides major oil-exporters with small populations, most other countries have had much more tenuous experiences in running trade surpluses rather than deficits, in part because of the inherent tendency for economic development to intensify demand for imports and external finance, which tends to reassert deficits either once austerity is relaxed or exceptional external demand circumstances subside. Trade liberalisation has also accentuated this tendency given the increasing demand for non-essential consumer imports that typically accompanies liberalisation. The resultant deficits can be typically sustained in periods of surging international liquidity, such as in the 1970s and in the noughties up to about 2013. However, when such conditions subside, external constraints usually return with a vengeance, as we have been observing for an increasingly number of developing countries since 2013. This is especially the case given that periods of surging financial inflows generally have an effect of accentuating the structural import-intensity and dependence of these economies.

The admonishment of trade deficits in practice is relevant for questions of aid because, in the absence of trade deficits, aid is effectively not absorbed. Instead, it adds to the countervailing imbalance, thereby accentuating the outflows on the income or financial accounts that are implied by a trade surplus. In such circumstances, the justification for aid might reside in its hypothetical knowledge transfer, innovative, or demonstration effects, but the redistributive justification is effectively nullified. Indeed, as argued in Fischer (2009), a huge weakness in most of the aid effectiveness literature is the lack of consideration of the place of aid within broader balance of payments structures. In other words, aid can hardly be expected to be effective in a macroeconomic sense if it is not absorbed.

[10] See Kregel (2008) for a discussion of these two approaches.
[11] See Fischer (2010) and Yu (2013) for interpretations of this recent Chinese experience.

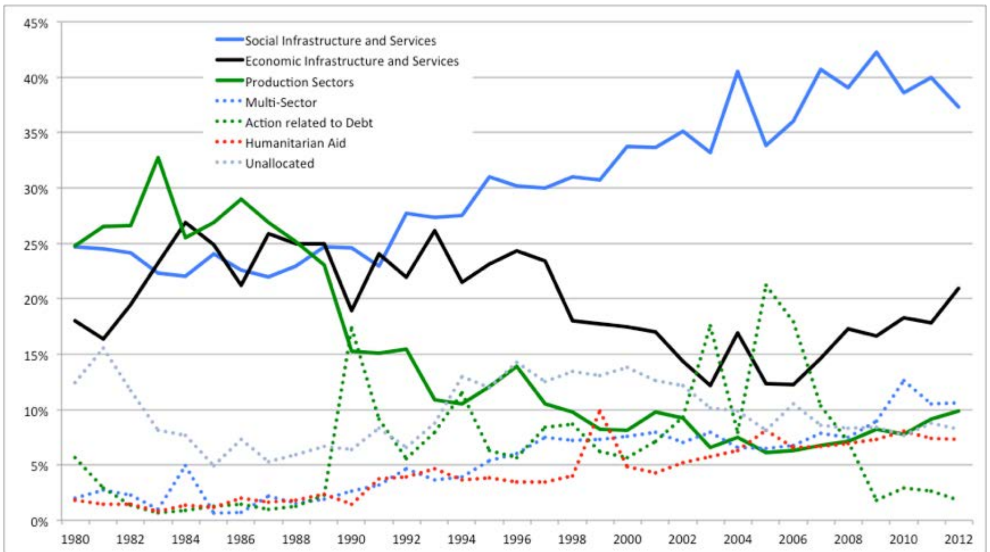
## 2 Aid for domestic expenditures, as exemplified by social spending

This foundational understanding of the role of aid is important because it clarifies a particularly potent range of external constraints faced by developing country governments in their attempts to execute various development strategies, which have been mostly ignored in the contemporary aid and political economy of development literatures. It also helps to clarify what I call the 'monetary transformation dilemma' when aid is oriented towards domestic instead of external expenditures, as explained further in the subsequent section.

The earmarking of various domestic expenditures, social or otherwise, has obviously been a feature of aid for a long time. It has also been a common feature of general budget support (GBS), which is often justified in terms of easing the macroeconomic complexities of managing aid flows towards domestic uses (e.g. see Hussain et al 2009). As such, there is nothing new about the dilemmas associated with such uses of aid, at least since the emergence of programme aid in the mid-1980s (e.g. see Wuyts et al 2016 for a discussion of project versus programme aid).

However, the complexities associated with aid for domestic expenditures have become more prominent due to the increased emphasis of such items since the 1980s. These are reflected by the rise of the 'social infrastructure and services' sector, which increased from 25 percent of total aid flows from all official donors in 1990 to around 40 percent by 2007, after which it plateaued at around this upper level, according to the OECD DAC data on committed ODA (see figure 1). In nominal terms, it more than tripled

**FIGURE 1**
**Committed Official Development Assistance decomposed by sector, as defined and estimated by OECD/DAC**




*Source:* Source: calculated from stats.oecd.org, extracted 24 September 2014.

from 21 billion USD in 2000 to 67 billion USD by 2012. This sector includes a large range of items, such as aid supporting governance, human rights, and ending violence against women, alongside social policy items such as education, health and social security/welfare.

The characteristic feature of most of these categories is their lack of any obvious need for foreign currency beyond so-called technical assistance (or consultancy services) from foreign experts. Health is one obvious exception, insofar as this sector requires substantial imported goods and services in most low-income countries (e.g. see Wuyts et al 2016). Tertiary education is another, particularly in matters related to science, technology and engineering, which are all key to industrial policy (e.g. see Mkandawire 2000; Lall and Pietrobelli 2005; Reddy 2011). Otherwise, there is a dissonance within this sector between the categories targeted by aid and the extent to which these categories actually need aid.

Conversely, the shift of aid away from 'production' and 'economic infrastructure and services' sectors over this same period also reduced categories that would more clearly require foreign currency as a direct consequence of aid spending. Aid to 'production sectors' fell from 25 percent of aid flows in 1980, to 15 percent in 1990, and then to a trough of about 6 percent in the mid-2000s, Similarly, aid to 'economic infrastructure and services' fell from around 25 percent of aid flows in the early-to-mid 1990s to a trough of 12 percent by 2006. Subsequently, both sectors partially recovered up to 2012 – economic infrastructure to 21 percent and production sectors to 10 percent – which reflects the slight restoration of mainstream consensus back in favour of infrastructure spending in particular (that is, infrastructure in the service of market-led international trade and private foreign direct investment). Nonetheless, the persisting primacy of the social sector remains evident.

The shift away from the production sector in particular reflects the bias against industrial policy and other forms of publicly funded intervention in investment, production and trade that has characterized the neoliberal era from the early 1980s onwards, when the emphasis of aid shifted from investment to poverty reduction (see a discussion of this by Wuyts et al 2016). However, this only became apparent in the ODA data in the 1990s. Indeed, the sharpest drop in aid to production sectors occurred in 1990 and appears to have been closely related to debt relief, which spiked in the same year. This most likely reflects the effects of the Brady Plan, which proved much more successful than the previous Baker Plan in drawing countries – at least those in Latin America – to adopt structural adjustment programmes. Along with the additional drop in the share of aid allocated to the economic sector, the trend was reinforced during subsequent financial crises in the 1990s. These corresponded with the increasing emphasis of governance-related aid expenditures in the 1990s under the so-called post-Washington Consensus, as well as the increasing focus on poverty reduction (both categories would be mostly recorded under the social sector). The latter emphasis on poverty reduction was then deepened further with the advent of the Millennium Development Goals (MDGs), which focused predominantly on social protection, health or education.

Whether ideological or opportunistic in motive, the fact that these shifts in aid corresponded with successive financial crises suggests an underlying impulse to separate, at least notionally, the supply of foreign exchange from the intended uses of aid in order to facilitate the diversion of the former to other uses.[12] These other uses would have principally been debt-servicing and, as foreign finance revived in the 1990s and again in the 2000s, other factor income payments to foreign investors. Such motives would have been more explicit in the 1980s, driven by concerns of rationing scarce foreign currency in the context of debt crises followed by austerity, stabilization and then SAPs.

Indeed, the impulse to conserve foreign currency would have driven shifts away from items in foreign currency even within the social infrastructure and services sector, as was implicit in the strong shift of aid away from tertiary education and towards primary education. While this was wrapped up in a variety of (contested) theoretical and empirical arguments regarding the more efficient and equitable use of aid or public expenditure in primary education,[13] the shift (and the compliance of governments) can also be understood in terms of the need to ration foreign exchange given that the foreign exchange needs of tertiary education can be quite substantial whereas those of primary education minimal. Similar objectives became more obscured with the emergence of the new poverty agenda in the 1990s and the MDGs and beyond from 2000 onwards. However, the underlying function has remained, insofar as the social protection policies that are currently popular with donors, such as cash transfers, are similarly rationalised by economic efficiency arguments and are in principle entirely constituted of domestic expenditures.

## 3 The macroeconomic management of aid for domestic expenditures

Within the classical approach to aid – that is, aid as understood to be financing external expenditures, whether directly or indirectly – the macroeconomic management of aid is relatively straightforward. Aid that is directly used by a government for its foreign currency expenditures technically has no domestic monetary and fiscal impact, except by way of easing the foreign exchange constraints of the government. The foreign exchange in question would be simply held in dollar accounts of the central bank and used directly to pay for foreign exchange expenditures of the government (e.g. paying for government purchases of imports, paying for technical assistance or outsourced government functions to foreign consultancy firms, or paying interest or

[12] See Wuyts et al (2016) for a related discussion of the emergence of programme aid in the mid-1980s, discussed within the context of Tanzania.

[13] E.g. see Psacharopoulos (1981, 1985, 1994) and WB (1994). See Mkandawire (2000, 2005) and Mamdani (2007) for critical assessments of these arguments and the debilitating effects that reduced expenditures had on African universities. In particular, the undermining of African universities ironically undercut their capacity to supply skilled labour to even primary schooling systems, let alone the wide range of other sectors crucial for human and economic development.

amortisation on public debt, etc.). Or, with project aid before the mid-1980s, this foreign exchange transaction for imports was often even directly managed by the donor in negotiation with the government, as discussed by Wuyts et al (2016). In this manner, the aid is not coordinated through foreign exchange markets or domestic monetary operations. Indeed, this point is briefly made by Hussain et al (2009, p.493) with respect to the exchange rate, price level and interest rate impacts of such direct use of aid. However, they then assert without justification that the more indirect exchange between governments and central banks is the more relevant case (see below) and deal no further with the former, which is the position that is maintained in most of the related literature. Nonetheless, this scenario of direct use clearly demonstrates how the classical understanding of aid as covering government foreign exchange needs is also associated with the least complicated macroeconomic management implications.

Even in the case of indirect mediation, aid would also have limited domestic monetary impact when its use is closely coordinated with the foreign currency expenditure needs of the economy, possibly even outside foreign exchange markets, to the extent that it is fully absorbed via increased imports within a short time lag. Such coordination is facilitated by relatively closed capital accounts, which allow the monetary authorities to mediate between scarce supplies of foreign currency and domestic needs and demands. Examples are thus largely confined to the early decades of the post-war period, prior to widespread capital account liberalisations, when the control and rationing of foreign exchange by developing countries was viewed as a norm. This probably also explains why these cases are ignored in the contemporary IMF-associated literature. Again, South Korea up to the 1980s provides the model example given that the government rationed and allocated foreign exchange – especially the foreign exchange supplied by aid – to supply particular prioritised investment projects.[14] Comparable practices were commonplace in a wide variety of other cases as well, to the extent that donors even directly handled the designated import purchases, as discussed by Wuyts et al (2016).

More arms-length transactions between governments and central banks have nonetheless become the norm in the more contemporary setting, especially with the rise of programme aid since the mid-1980s. This is particularly the case where explicit associations of aid to foreign exchange transactions by the government are discouraged, as epitomised by aid directed towards domestic expenditures. The separation is reinforced by rules regarding central bank independence or capital account openness, both of which strongly discourage governments from intervening in the allocation of foreign exchange, ostensibly leaving this to open market operations. Such circumstances are the exclusive focus of Hussain et al (2009) and the related IMF-associated literature, and as these authors elaborate, they add a degree of complexity to the macroeconomic management of aid.

[14] For instance, see discussions of this in Amsden (1989). Bangura (2015) also notes that aid in East Asia supported productive activities and economic infrastructure.

The complexity relates to what can be referred to as a dilemma of monetary transformation from external to domestic resources, given that foreign currency cannot be directly spent on expenditures denominated in domestic currency. This is essentially the inverse of what Keynes (1929) once identified as the transfer problem, with reference to Germany's need to pay reparations through current account surpluses rather than simply through the accumulation and conversion of the local currency (as noted by Hussain et al 2009, p.508; see also Milesi-Ferreti and Lane 2004). In the case of aid, the inverse quandary is that foreign currency cannot be directly spent on expenditures denominated in domestic currency. Rather, the foreign currency provided by aid is necessarily used for other foreign exchange transactions or else is held in reserves, whereas the domestic expenditures are financed through domestic monetary and fiscal operations. In other words, for countries that do not possess reserve currencies, there is effectively a partition between the two monetary circulations.[15] The external uses of domestic currency are similarly very narrow and restricted, and foreign exchange must be earned, borrowed or given in order to pay for external transactions. The transfer of aid to domestic uses must therefore be mediated, which implicates a coordination between monetary, exchange rate and fiscal policy. Aid intended for domestic expenditures is, in this strict monetary sense, perfectly fungible.[16]

The practice, as generally characterised in the literature, is that a recipient government (i.e. the finance ministry) sells the foreign currency to the central bank in exchange for domestic currency, which can be used to finance domestic expenditures or else simply saved. The central bank in turn either sells or saves the foreign exchange (i.e. reserves), and then also might engage in sterilisation operations in the event that it saves. In an apogee of work on these issues in the IMF in the mid-to-late noughties, Hussain et al (2009) framed this as a balance between absorption and spending. Absorption refers to the degree to which an increase in aid is associated with an increase in the non-aid trade deficit, according to the classic logic as discussed in the first section. As such, absorption falls largely under the purview of monetary and exchange rate policy, managed by central banks in terms of the amount of foreign exchange they are willing to sell in order to allow for an increase in the trade deficit. Spending is the degree to which recipient governments match the foreign exchange received through an increase in the non-aid fiscal deficit (either through increased spending or reduced taxation). Notably, this conception is based on macroeconomic aggregates whereby these outcomes occur through either direct or indirect secondary effects of aid inflows as they circulate within foreign exchange markets and/or the corresponding domestic money supply circulates within the domestic economy.

[15] Reserve currencies break down this partition. For instance, the US can pay its foreign expenditures with the money it issues rather than the foreign currencies it saves, which is widely attributed as a form of international seigneurage. Indeed, this is a central difference between central and peripheral monetary systems in the international economic order.

[16] Hussain et al (2009, p.494) also note that '[aid] money is fungible' but they do not elaborate on this point, particularly in light of other literature on fungibility, as discussed later in this paper.

Intergovernmental transfers are also implicit in this conception. Cases where donors maintain control over aid expenditures are not considered, such as is typical in non-governmental aid projects and even some bilateral projects involving off-budget aid. In such cases, aid transfers are presumably made through open market transactions and the increase in spending occurs privately, that is, not on the government budget. This renders such aid modalities more difficult for governments to evaluate in terms of aggregate levels of absorption and spending in the economy. Keeping this in mind, the conception discussed here is in terms of those flows that governments do control, which are also the flows that have the strongest influence on policy making.

The exchange between the government and central bank is effectively equivalent to a monetary expansion to finance a fiscal deficit. Correspondingly, the degree to which the central bank allows aid flows to be absorbed by selling the foreign exchange is equivalent to sterilisation, given that domestic money supply is soaked up by the central bank in the process (whereas open market purchases of foreign exchange do not reduce money supply). Hence, when absorption does not occur, then the former is effectively the same as a domestic monetary-fiscal operation in the absence of aid, except that foreign reserves are accumulated, as noted by Hussain et al (2009, p.495). As highlighted in the subsequent debate between Adam et al (2009), Buffie et al (2010) and Berg et al (2015), an additional issue faced by central banks in the event that aid is saved as reserves is the question of whether and how much to sterilise the resultant monetary effects of spending but not absorbing, with the orthodox position advocating fiscal restraint (e.g. see Buffie et al).

In this sense, aid is effectively not needed to finance fiscal deficits in domestic currency, although it nonetheless provides for a few advantages over purely domestic operations. One is that the monetary transfer from the central bank to the government occurs through selling the foreign exchange provided by aid rather than through selling government debt, thereby avoiding an increase in the public debt owed to the central bank (although the degree to which this distinction is important can be debated). By the same token, it avoids the crowding out effects of raising funds through public bond issues, if the government would instead choose this option to finance a deficit (again, the crowding out effect is debated and could in any case occur through sterilisation policies). Second, aid provides the foreign exchange to deal with the balance of payments consequences of increased government spending or money supply, particularly in economies with strong and inelastic demand for imports. Lastly, aid correspondingly allows for the option of sterilising the monetary expansion via absorption, as described above, whereas a purely domestic monetary expansion does not provide the foreign exchange for this course of action. Of course, all of these qualifications bring us back to the classic conception of aid as strategically addressing the external constraints of development, as discussed in the first section.

In the ideal case when aid is fully absorbed and also completely spent in the corresponding government budget, the macroeconomic effects of aid would be limited to a range of short-run adjustments (domestic monetary and fiscal effects obviously do not occur when aid is neither absorbed nor spent). As explained by Hussain et al (2009), these would occur through the lag between an increase in domestic and foreign money supply, versus the compensating increase in the trade deficit. This theoretically results in a tendency for higher price inflation and perhaps some real and/or nominal currency appreciation (although the higher price inflation might also bring a tendency for currency depreciation, depending on how this is managed). These presumed effects could of course be debated although no cases in their study fit this ideal of full absorption and full spending in any case.

As Hussain et al elaborate, the macroeconomic management of aid is more complex when absorption and spending do not match. In the one case of their study when absorption exceeded spending during an aid surge (Ethiopia from 2001-03), this appears to have been motivated by domestic stabilisation concerns and retiring public debt. Alternatively, increased spending in the absence of absorption has an expansionary domestic effect, theoretically bringing the potential for domestic price inflation and possibly some exchange rate depreciation, depending on how various policy factors are managed. The choice to not absorb appears to be motived by the objective of accumulating reserves and/or maintaining external competitiveness.

Indeed, the latter pattern (spending exceeding absorption) characterises most of the cases studied in this literature. For instance, Hussain et al (2009) identified one case (Ghana, 2001-03) where aid was not absorbed and barely spent and three out of five where spending was substantially more than absorption. Similarly, Martins (2011) observed on the basis of a cointegration analysis spanning 25 low-income African countries from 1980 to 2005 that, on average, around two-thirds of aid was absorbed in the short term while most was spent (for what it is worth, he observed almost full absorption in the 'long-run'). On average, therefore, the predominant trend has been for at least part of the foreign currency received from aid flows to be directed into reserves (or other financial account uses), more than matched by spending and hence with the effect of monetary expansion (unless of course subsequent sterilization is practiced).

## 3.1 Some critical reflections on this literature

There are serious conceptual and methodological problems with these studies, although these problems only accentuate the disjunctures observed between absorption and spending. The main problem is that all of these studies measure absorption in terms of the overall non-aid current account, even though they conceptualise absorption in terms of the trade account, as per the classic insights discussed in the first section. For instance, Hussain et al (2009) briefly rationalize absorption in terms of imports and trade deficits (p.492-93), but they then generalize this to currency account deficits for the rest of the article and empirically measure absorption in terms of non-aid current account deficits, not trade deficits. They refer to exports at another point (p.498), but only in terms of real effective exchange rates, not trade balances. Martins (2011) adopts the same convention, along with most of the IMF-associated work on these issues.

This conceptual slip is important because of the dominant role of the primary income account in the current account, and even the non-government secondary income account (following BPM6 reporting conventions; previously the current transfers account). From a redistributive or developmental point of view, the bulk of the primary income account is better understood as akin to financial account outflows, at least those parts that are attributed to remitted profits or interest payments on debt, precisely because these represent factor payments to foreigners rather consumption or investment. Indeed, Serieux (2011) includes these as part of his measure of 'reverse flows', together with a variety of measures on the financial account (e.g. he refers to these as debt servicing, capital flight and reserve accumulation, although his inclusion of reserves into the mix is arguably not appropriate).[17] In sum, he suggests almost half of aid between 1980 to 2006 was used to finance such reverse flows. Direct causal attribution is difficult to make, in terms whether aid directly contributes to or accentuates such outflows rather than simply adding to the stock of foreign exchange that is subsequently used for such purposes. Indeed, if such outflows are a necessary and relatively constant feature of these countries, then it might be argued that they should not matter in the aggregate given that the concern is whether an increased availability of aid increases import capacity beyond these regular outflows. This is a testable proposition, although the use of aggregated current accounts rather than disaggregated trade and income accounts evades the test.

Rather, in using the current account, it is not clear whether the purported measure for absorption is properly reflecting an increase in the trade deficit (financed via a surplus in current transfers), or else whether an increase in aid is actually offsetting an increase in the primary income account deficit. For instance, the latter scenario might occur when the increased supply of foreign currency is prioritized by the private sector for profit remittances or debt servicing rather than imports. This situation might happen, for instance, if aid is supplied contingent on or parallel to IFI conditionalities regarding financial account liberalization and/or tight monetary policies, both of which have been associated with surges of financial inflows and subsequent increases in interest or profit remitting outflows. Akyuz (2015b) also notes that non-repatriated profits are recorded as primary income outflows and then as FDI inflows on the financial account even though they technically do not represent any cross-border transaction or fresh inflows of foreign currency, which further obfuscates the assessment of absorption. These points highlight the importance of assessing aid flows relative to other disaggregated flows on the external accounts, which in many cases might dwarf the magnitude of aid flows.

Even within trade, the services account also includes many payments to foreigners that have a questionable developmental function. Many instead reflect classic structural attributes of dependent patterns of integration into the

[17] Even though reserves are treated as a financial outflow and, in most cases, are stored in low yielding assets, they nonetheless remain as assets under public (central bank) ownership and hence can be used at a later date, e.g. allowing for deferred absorption, as noted by Hussain et al (2009).

international economy dominated by foreign corporations, such as royalty payments, payments to foreign finance, insurance and real estate sectors, or transport dominated by foreign firms. Other payments such as technical assistance or consultancy services might possess some developmental attributes, although questions have also been raised about the efficacy of the substantial shares of committed aid that end up as these forms of payment. Many of these payments effectively never leave the donor countries, such as when a donor agency directly transfers aid funds to one of a myriad range of consultancy firms vying over such lucrative contracts in the donor country (e.g. DFID funding to Adam Smith Institute, PWC or Deloitte in the UK, etc.). Whether or not such aid expenditures result in beneficial developmental contributions, they effectively have no redistributive monetary function. However, according to recent IMF reporting conventions, they are actually reported on the secondary income account as if they do represent a cross-border flow of funds given that the transfer in kind is valued in monetary terms (e.g. see IMF 2014, p.237).[18] Even if contracted by the recipient government and hence involving at least a nominal cross-border flow, such as when a government is required by the terms of an aid or financing agreement to internationally tender an economic and social impact assessment, the outflow on the service account would be more or less an automatic consequence of the aid exchange. All of such transfers of technical assistance or consultancy services would be included in the calculus of absorption.

Moreover, dynamics on the trade, income or other accounts might have little to do with aid *per se* and estimated aid absorption in this sense might be as much a matter of coincidence as of conscious macroeconomic planning. For instance, loose international financial conditions might facilitate a large expansion of trade deficits given the easy availability of debt to finance such deficits. Similarly, an increase of FDI in mining would generally involve an increase in imports directly associated to the execution of the investment, particularly in large, capital-intensive enclave projects typically conducted by transnational firms. If these situations coincide with an increase in aid (as it has since the mid-noughties), this can give the appearance of strong aid absorption even though it is largely related to these other non-aid processes.[19] Inversely,

[18] Note that this contradicts the assertion made by Martins (2011) that the use of BoP avoids the inclusion of technical assistance into aid estimates (see below). According to IMF (2014, p.237), '[c]osts incurred in the donors economy should be included in the value of technical assistance' recorded on the balance of payment of the recipient country, given that it is treated as a transfer in kind.

[19] Indeed, this type of attribution problem is symptomatic in the econometric cross-country literature on aid effectiveness more generally. For instance, a dilemma that is rarely recognized is how to deal with the relative weights and the causal significance of various variables within each case, rather than simply the weighting of cases. For instance, if aid effectiveness is treated along the lines of a multiplier effect, with or without time lags, then countries with strong performance and where aid is relatively insignificant (such as China or India) would have a strong effect on determining a positive association between aid and performance even though aid ostensibly had no causal effect on performance in these cases. Similarly, countries receiving relatively large amounts of aid but with poor performance due to factors unrelated to aid (such as Sub-Saharan African countries during the lost decades of the 1980s and 1990s) would have a strong effect on determining a negative association between aid and performance, even

import capacity on the current account might also be related to contractions on the financial account, as was typical in the 1980s and late 1990s, or to collapsing terms of trade or demand in the few commodities that dominate a country's exports, as was again typical in the 1980s and even through much of the 1990s, depending on the commodity.

Depending on the case, these considerations can have major consequences on evaluations of absorption. To take the example of Zambia, the country went through an aid surge from about 2006 to 2013, when general government credits on the secondary income account were close to or exceeded around 400 million USD a year. At the same time, however, the goods trade surplus actually increased over these years, implying the opposite of absorption. This was obviously due to strong copper exports driven by high commodity prices, although it nonetheless indicates that aid absorption was not occurring through this channel. Instead, the services account deficit worsened significantly, driven by strong increases in freight transport debits, which rose from 208 million USD in 2006 to 742 million USD in 2013, reflective of the fact that the servicing of the commodity boom was dominated by foreign corporations. In this sense, one could plausibly argue that the increases in aid essentially compensated the international shipping industry. The primary income account remained in strong deficit, typically in excess of one billion USD a year and in some years exceeding the goods surplus. It was dominated by direct investment incomes, as would be expected by an export sector (copper) that is dominated by foreign enterprises, although to make evaluation even more difficult, the reinvested portion of this was very volatile. As a result, the non-aid current account deficit swung in and out of deficit, in some years perhaps implying absorption, although not absorption in the sense implied by the literature. Moreover, despite oscillation on both the current and financial accounts during these years, the central bank nonetheless accumulated reserves in every year besides 2013, in 2009 by more than one and a half times the amount of aid received.

From this example, it is clear how evaluating absorption by using aggregated non-aid current account balances puts into serious question even the limited amounts of absorption that are typically measured. For instance, given the heavy debt loads faced by African countries in the period studied by Hussain et al (2009) in the late 1990s and early 2000s, deficits on primary income accounts generally far outweighed aid flows and were in the same proportion as trade balances. The even longer period studied by Martins (2011) extends into the 1980s, when interest payments on debt were substantially rising in most of the low income African countries of his study, well beyond the balances registered in trade or else the meager amounts of aid received (Zambia is again a case in point). Hence the suggestion that aid was absorbed in such a context is misleading given that the estimated absorption would largely reflect rising interest payments on external debt or else other remittances to foreigners.

though, again, the association was ostensibly not due to aid but to much broader factors such as commodity crises, debt crisis, or structural adjustment programmes.

In these studies, deducting income account deficits from the non-aid current account would have resulted in significantly lower estimates of purely trade-based absorption and thus higher discrepancies with spending. Again, as mentioned previously, it might be counter-argued that these factor income payments represent a form of absorption nonetheless, with their attendant sterilization effects on domestic money supply (which is a concern for IFIs), and insofar as they need to be made anyways, they relieve the external constraints of the government or economy through one channel or another. However, this argument could equally be applied to the case of financial outflows, as any outflow could perform this sterilizing function, although this is generally not accepted given the principle that aid should increase domestic consumption or investment. As noted in the introduction, increased consumption operates through the trade account, not the income or other accounts.

In this regard, Hussain et al do recognise the counteracting role of the financial account in aid absorption (see p. 497-500). However, they do not explore the reasons why increased aid flows might be related to increased financial outflows, beside short-term portfolio adjustments, but only conclude that more research is needed. This is ironic, coming from IMF economists, given that the tendency would have likely been accentuated by the increasing financial openness and international financial integration of developing countries over the noughties and teens, as has been advocated by IFIs. In particular, openness and integration has intensified the requirement to build reserves in the face of the increasing intensity and volatility of cross-border financial flows, as analysed by Akyüz (2015a). While this point is not discussed by Hussain et al, it does point towards a tension between different IFI tenets, e.g. between absorption for stabilisation versus non-absorption to meet the needs of reserve accumulation as a consequence of increasing financial account openness and exposure. The dissonance evidently exacerbates the incongruity faced by recipient countries in their management of aid and other flows under the yoke of IFI tutelage.

A further problem that complicates estimates of absorption is the measurement of aid itself. Martins (2011) contends that the OECD DAC data is far from satisfactory because it is based on aid commitments but not actually disbursed aid, which is actually not precise because aid disbursement data are available at an aggregated country level from 1960 onwards, although not disaggregated by sector or other criteria, at least not until recently (disaggregated data on disbursements is now available from 2002 onwards). He also contends that much of the aid reported does not actually represent cross-border financial transfers to the country *per se*, such as in cases of technical assistance, and instead advocates for the use of balance of payments data to gain a more accurate reflection of actual transfers. Again, this critique is not entirely valid given that, as noted above, IMF (2014) specifies that technical assistance actually is valued on the balance of payments of the recipient country as a transfer in kind, so the same critique also applies to this alternative data source. Serieux (2011) also notes that the DAC data include debt relief, which similarly does not involve any actual monetary transfers (although as noted above, it nonetheless frees up foreign exchange for other purposes and, hence, has the equivalent effect, which is the reason why the DAC includes it). Again, debt relief is also included on the balance of payments as a form of exceptional financing and hence this issue is not resolved by this alternative data source.

Instead, Martins (2011) adopts a measure of aid based on IMF balance of payments data in order to reflect actual inflows of aid reported by the receiving country (i.e. presumably official transfers within the current transfers account of the current account, or what is now referred to since BPM6 as international cooperation within the general government classification of the secondary income account). However, this restricts him to only grants and not concessional loans, which he admits later in the article (p.1932). He justifies his choice with the rational that concessional loans have different macroeconomic implications than grants. While this may be true in certain respects, it is not for considerations of absorption given that financial flows are also absorbed via trade deficits and official flows in particular are controlled by governments and therefore directly face the same absorption versus reserve accumulation calculus of choice. His choice therefore leaves out a huge part of aid in the absorption equation. Indeed, the same point could be made for other official flows that, although not concessional, can play a crucial role in buttressing development strategies, as discussed in the first section with respect to South Korea. Based on OECD data presented in Serieux (2011, p.1107), grants generally amounted to slightly more than half of aid flows to Sub-Saharan Africa from the 1970s onwards, besides in periods of debt relief (which is counted as grants), e.g. in the early 1990s and especially in 2006. Hence, on this basis, Martins' estimate that two-thirds of aid was absorbed would be considerably lower if concessional loans were included, perhaps by close to half, especially once debt relief and technical assistance are deducted from the measure of actually disbursed grants, which would increase the share of loans in the DAC estimates. Hence, while Martins' critique of the DAC data raises some important issues (some of which might not be fully justified), his alternative measure does not solve the problem, which renders his empirical results quite unreliable.

These measurement issues are further complicated by the fact that tracing aid flows through various measures is actually quite difficult to do, given different categories of aid or channels of transmission. Off-budget forms of aid are one example, as discussed by Wuyts et al (2016) in the case of Tanzania, where project aid has continued alongside the emergence of programme aid since the mid-1980s, although no longer focused on supporting investment as in the past, but instead on poverty reduction. Similarly, while concessional lending in principle follows straightforward criteria, in practice it is notoriously difficult to distinguish within official lending given the complexity of such lending in terms of the variety of channels, the methods of reporting, and even whether concessionality was actually practiced even if contractually permitted. As argued above, even though non-concessional official flows are not counted as aid, they are nonetheless absorbed through the same macroeconomic mechanisms and can also support development in important ways, if only by providing counter-cyclical financing options, and should thus be included into a broader consideration of the absorption of development finance. The roles played by exceptional financing are also very difficult to decipher in the balance of payments data and it is not clear to what extent it is included in DAC aid calculations, beyond obvious inclusions such as debt relief.[20] These points reinforce the fact that Martins' study hugely underestimates the numerator of aid in the calculation of absorption, especially if we consider official flows more broadly.

Problems of data accuracy are an even more insidious challenge to the credibility of these absorption assessments, particularly in the case of regression analyses. To give a few simple examples, according to IMF balance of payments data (last accessed on 24 January 2017), Ethiopia was running a moderate current account deficit of 425 million USD in 2010, counterbalanced by a much stronger financial account surplus (an increase in net liabilities) of 2,369 million USD, and yet the country was apparently drawing down its reserves by 865 million USD instead of accumulating them, which is explained by a deficit in the net errors and omissions of 2,930 million USD. Inversely, in 2012, when the country was running a larger current account deficit of 2,985 million USD, counterbalanced by a smaller inflow on the financial account of 667 million USD, it was apparently accumulating 330 million USD of reserves, again explained by a 2,649 million USD surplus on the net errors and omissions. These examples are symptomatic of the balance of payments reporting of this country throughout the whole data range provided by the IMF, as they are of many other countries in Africa.

Without entering into an analysis of what these errors and omission might represent, it is clear that anyone who claims to know the actual current and financial account positions of Ethiopia over these years is either ignorant or lying (or has access to Bank of Ethiopia data that is not reported to or by the IMF, although we would again need to question the reliability of even these data). More precisely, it is clear that the current account data do not provide reliable indicators of actual absorption of income or financial flows, or of the reasons why the country might be accumulating (or drawing down) foreign exchange reserves. The implications of net errors and omissions are entirely different depending on where the bulk of them are derived from, i.e. from the trade, income or financial accounts. Similarly, the accuracy of the fiscal data also needs to be questioned in relation to questions of spending, particularly that they are more immediate objects of political contestation and hence prone to manipulation, as in all countries.

Hussain et al (2009) do acknowledge the problem of data accuracy, e.g. they admit in an endnote, p.508, that 'large errors and omissions in the balance of payments accounts [of some countries] could be partly responsible for measured fluctuations in the capital account.' However, they nonetheless present the aggregated non-aid current and financial account data as if there were no problem (p.499). They simply include the errors and omissions in the financial account, thereby assuming away the possibility that errors and

[20] According to current conventions, exceptional financing is consolidated in the IMF's analytical presentation of balance of payments, distinct from the secondary income or financial accounts, but it is spread throughout diverse accounts in the standard presentation.

omissions might have been derived from the trade or income accounts. To give an example of the magnitude of the problem that they assume away, the net errors and omissions deficit of Ethiopia, one of their cases, was -915 million USD in 2002, in the midst of the aid surge that they consider. This was greater than the goods deficit of -904 million USD in the same year. It was almost as large as the sum of the goods, services and primary income accounts (-992 million USD), which is more or less equivalent to the non-aid current account given that the secondary income account was dominated by (grant) aid flows. The net errors and omissions deficit might have represented unreported imports, enough of which might reverse the assessment of non-absorption of aid (based on the observation that the goods trade and non-aid current account deficits shrank in that year). However, it could equally represent unreported outflows on the income or financial accounts, which would support the hunch that the lack of aid absorption was instead facilitating illicit financial outflows (aka capital flight).

In addition to this, there are even contradictory indications on reserve accumulation. The IMF BoP data show that Ethiopia was running down its reserves by 471 million USD in 2002 whereas the stock data in the IMF International Finance Statistics (IFS) show that total reserves minus gold actually increased by 449 million USD in the same year (Hussain et al 2009 relied on the BoP data, indicating that reserves were falling). Notably, these contradictory indications on Ethiopian reserves from the two IMF data sources continue until the latest data available (2009 in the IFS data, as of 26 January 2017).

As a last point, it is also not clear how or to what extent the aid flow data include exceptional financing, as noted above. This amounted to a net inflow of 636 million USD in 2002, in contrast to 490 million USD of ODA according to the OECD DAC data base (last accessed 26 January 2017). Much of exceptional financing is presumably not counted as aid even though, in the Ethiopian case during these years as with many highly indebted poor countries (HIPCs), it constituted important and counter-cyclical official flows that apparently helped balance the external accounts.

Given the magnitude of discrepancies and errors and omissions, any measure of absorption on both the numerator and denominator sides of the equation must be treated with many grains of salt. If aid absorption in this literature is significantly overestimated due the range of factors discussed above, the resultant low levels of absorption are controversial because they indicate that little net resource transfer or redistribution to a recipient country is effectively taking place. The argument that redistribution is taking place through reserve accumulation, as a form of saving for the future, is tenuous. Indeed, reserve accumulation in LICs in the noughties and teens has arguably been spurred by the increased vulnerability associated with deepening financial integration. This requires increased reserve accumulation in any case, whether through aid or through other sources, including commercial borrowing, as has been increasingly common (e.g. see Akyuz 2015a). Notably, when conditions turn bearish (as they are currently for most developing countries), such savings can be equally wiped out, particularly when countries are forced to defend their currencies (such as Ghana in 2014 or Nigeria in 2015-16) thereby permanently removing this promise of future absorption from past aid savings. This is a point that Hussain et al (2009) overlook in their discussion of deferred absorption.

Also, the lesser the aid absorption, the greater are the challenges of managing aid flows because of potentially greater mismatches between absorption and spending. Moreover, the likelihood that aid is not absorbed to any great extent, as appears to be systemically the case, reinforces the point made previously that aid is effectively not needed to finance domestic spending increases associated with aid. The equivalent can be more or less achieved through purely domestic monetary operations, with more policy autonomy although without the backing of adding foreign exchange.

# 4 Elephants in the political economy of aid literature

Outside of the narrow specialized literature on the macroeconomics of aid, consideration of these monetary transformation dilemmas is simply non-existent within the burgeoning academic and policy literatures on aid, even in the more general economics literature on aid. For instance, besides the theoretical modelling contribution by Berg et al (2015), balance of payments analyses are absent from the rest of the articles in a special issue of *World Development* in 2015 on the macroeconomic management of aid, including any recognition that absorption occurs via trade accounts.[21] Such lacuna are characteristic of most of the aid effectiveness literature, including both critics and protagonists of aid, even though this literature is ironically dominated by economists, e.g. cf. Burnside and Dollar (2000), Easterly (2006), or Collier (2007), Sachs (2005),[22] or Addison et al (2005). As a result, there is little or no discussion of the broader external structural conditions under which aid, or official flows more generally, might or might not prove to be effective under various macroeconomic circumstances.

The politics related to these macroeconomic issues is therefore also barely recognized. The specialised macroeconomics literature does recognise that the macroeconomic management choices involved with aid are sensitive, albeit framed almost entirely in terms of political pressures on governments to spend aid regardless of whether or not it is absorbed (e.g. see Hussain et al 2009, or else in terms of credibility issues during aid surges (e.g. see Buffie et al.

[21] Berg et al (2015) do little to address the conceptual and methodological issues discussed above, although they do offer a critique of the more orthodox position of Adam et al (2009) and Buffie et al (2010), who argue against the absorb and spend advice of the IMF, and instead for 'fiscal restraint'. Buffie et al argue that recipient governments should use part of aid to pay down domestic government debt while conducting 'reverse sterilisation', based on the logic that the problem of aid surges that coincide with financial ('capital') outflows (or 'flight') rather than absorption is one that results from a credibility problem.

[22] Indeed, as noted earlier and in Fischer (2009), the savings-gap model promulgated by Sachs et al (2004) does not make the crucial distinction between foreign and domestic savings and thus proves irrelevant for understanding aid as foreign exchange.

2010). However, the actual politics involved in these or other issues are left mostly unexplored.

Otherwise, in the rest of the literature, the focus has instead been on how 'right' economic policies or domestic governance influence aid effectiveness, or inversely, how aid undermines governance and, via this, economic performance. There is some more critical literature that examines power relations within aid. However, there is no discussion about how the monetary processes involved in transferring aid condition governance, effectiveness, or power relations. The lacuna amounts to a proverbial elephant in the aid literature, or else the finance for development literature more generally.

The mainstream political economy literature in particular has been broadly influenced by the 'good governance' lens. It focuses on the questions of (domestic) governance, conceived as quality of domestic institutional environments and involving issues such as accountability, corruption, rent-seeking, elite capture, and the divergence of resources away from their intended purposes. For instance, in her influential work on the effects of aid dependence on governance, Bräutigam (2000) argues that prolonged aid dependence can create incentives for governments and donors that potentially undermine good governance and the quality of state institutions. Knack (2001) similarly argues that aid dependence can potentially undermine institutional quality by a variety of political economy effects such as weakened accountability, rent seeking and corruption, conflict over control of aid funds, draining human resources from local bureaucracies, and alleviating pressures to reform. Bräutigam and Knack (2004) further explain this through a combination of transaction costs, fragmentation, and incentive and collective action problems that make it more difficult for elites to build capable and responsive states. A similar emphasis is also characteristic of work of Bill Easterly (e.g. 2006, 2014) or even Angus Deaton (2013), for instance, in terms of framing the distortive effects of aid in terms of domestic governance, with the understanding that domestic governance is the primary factor determining the effectiveness of aid and economic performance more generally. Notably, these contributions are focused on the domestic sphere of governance in donor-recipient relations, and in particular on how aid distorts domestic elite incentive structures, rather than examining how international governance conditions the distortive, disciplinary and even sometimes punitive roles of aid. In particular, despite the fact that much of this work has been written under the aegis of the World Bank, the monetary circuits of aid and the constraints that these might impose on government decision making and elite behaviour remain unexplored.

This lens has subsequently influenced how issues have been framed in the 'Paris Agenda', referring to the series of donor declarations on aid effectiveness that started with the Paris Declaration in 2005. Bigsten and Tengstam (2015) categorise these into four: donor harmonisation; recipient country ownership of development priorities; alignment of aid flows with these priorities; and transparency and accountability. Despite its absence from these issues, the dilemma of monetary transformation from external to domestic resources is nonetheless relevant precisely because the monetary constraints involved might exacerbate donor concerns regarding transparency and thereby counteracting attempts of exercise principles of country ownership, as discussed further below. Indeed, these underlying tensions implicit in current aid agendas can help shed light on some of the convoluted and often contradictory meanings and practices of the principle of ownership, as discussed by Whitfield and Fraser (2009), Booth (2011) and Esser (2014).

Similar tensions underlie recent academic debates on the issue of fungibility, that is, the degree to which aid disbursed for use in certain sectors such as health and education is matched by government expenditure in those sectors (cf. Lu et al 2010; Harper 2012; Van de Sijpe 2013; Dieleman et al 2014; and Morrissey 2015). Fungibility in this sense is an important element in donor concerns about transparency, which is generally used in reference to recipient government transparency rather than donor transparency (e.g. see Bigsten and Tengstam 2015). However, none of these contributions consider the inherent monetary fungibility of foreign aid destined for domestic spending and how this might problematize conceptualisations of both fungibility and transparency, as discussed in the previous section. Indeed, in most of the fungibility literature, the matching of domestic sectoral spending with aid disbursements is not considered within the wider macroeconomic context of absorption, which is problematic given that increased spending in one area could be compensated by reduced spending in others, as is indeed often encouraged by donors, such as with the ongoing advocacy by the World Bank and other IFIs to fund cash transfers by removing various price subsidies.

The lacuna is reproduced in the social protection literature. For instance, Armando Barrientos has emphasised that aid should not be used to finance regular expenditures within social assistance programmes in developing countries given that this encourages a situation whereby such programmes do not become regular expenditure items on government budgets, undermining their long-term sustainability (see Barrientos 2013: chapter seven). He builds his argument on theories from the political economy of taxation regarding the behavioural responses of economic agents to the incentives generated by different forms of financing. However, he does not consider the transformation dilemma implied by the option of using aid to finance social assistance provided in domestic currency, even though this would arguably provide for a more primary rational in support of his contention, even before accounting for domestic incentive issues. Indeed, his equally sceptical view of the potential for global taxes or natural resource rents to fund social assistance is based on a similar assessment of incentive problems, whereas the monetary constraints discussed here would also support his scepticism given that such taxes and rents are generally denominated in foreign currency, and hence face comparable transformation dilemmas. Similarly, the recent work by Holmqvist (2012) on the external financing of social protection also ignores this monetary transformation dimension despite being so central to the topic he writes about. Instead, he offers a detailed discussion on questions of the magnitude of financing required, aid modalities, the adverse impacts that aid can have on institutional development and domestic accountability, and various approaches to conditionality that have been devised or theorised to deal with such adversities, without considering the monetary complexities of how such external financing might be absorbed and transferred to social protection sectors in the first place.

This monetary dimension is also absent from the otherwise innovative work on financing social policy led by UNRISD (e.g. see Hujo and McClanahan 2009, particularly the relevant chapters by Ortiz 2009 and Morrissey 2009), or else to other work in the policy literature on how aid might finance social protection (cf. UNRISD 2010; ERD 2010; DFID 2011; Garcia and Moore 2012). In relation to the work produced under the auspices of UNRISD, Bangura (2015) argues, like Barrientos, that social services and protection are central to the building of effective revenue bargains between governments and citizens and, as such, should be the exclusive preserve of domestic politics, whereas the funding of these sectors with aid risks short-circuiting this domestic bargain building and thereby 'the construction of effective state capacity in advancing the project of economic transformation.' What is notable from the perspective presented in this paper is that the case of not financing these social expenditures through aid or other external resources is strengthened precisely because such domestic expenditures are mostly denominated in domestic currencies and cannot be directly financed by aid in any case, except in the case of sectors such as health that have a high import content, as noted previously. The extent to which external finance is actually able to fund such policies – versus representing the credit side within complex negotiated processes between donors and recipients about domestic spending commitments – is an enormous blind spot in this literature, despite its underlying political economy approach.

## 4.1 *Of convolutions and compulsions*

The monetary as well as fiscal implications involved in the transformation from foreign to domestic resources effectively involves a terrain of intensely politicized debates and power struggles within donor-recipient relations, as well as within donor organisations and recipient countries themselves. This includes complex and politicised negotiations among networks of actors operating within often starkly asymmetrical power relations. The problem is that, in ignoring contestations over how aid actually gets disbursed and the complex and obscure negotiated processes by which disbursements actually manifest as domestic spending, many of the issues identified in the extant political economy literature are arguably better understood as symptoms of a broader balancing act between foreign exchange needs and donor expectations rather than as causes of poor aid effectiveness *per se*.

This distinction becomes particularly important when international conditions facing recipient countries become more bearish and austere, hence reviving the spectre of balance of payment constraints and crises, as witnessed in the swath of currency crises that hit many developing countries from 2013 onwards, after a decade of abundant foreign finance that led many to assume that such risks had ended. Notably, the ending of the boom cycle has been partly the result of monetary tapering in the US and the related unwinding of the commodity booms in oil and mining that also drove much foreign investment – both productive and speculative – to many of these 'emerging markets.' However, balance of payments constraints have also been simultaneously compounded by the import-intensity of most developing country economies and hence the emergence of current account deficits precisely as a reflection of accelerated economic growth, as discussed in the first section. This global context is important from a political angle because, as noted in the introduction, it augments the leverage of donors as strategic providers of concessional finance to countries that face these stringent balance of payments constraints, even in situations where aid might only amount to a marginal addition to overall external and domestic financing needs. The fact that donor positions might nonetheless result in a variety of contradictory and convoluted demands on recipient country governments could result in appearances of poor governance among the latter, which as noted, would amount to symptoms even though generally attributed as causes.

A few examples help to illustrate this last point that donors might, in many cases, give contradictory signals with regard to the management of aid flows, quite possibly emanating from different departments within even the same IFI. One is with regard to the tension on the absorption side, as already noted above, between the advocacy of absorption by the IMF and other IFIs, versus their general advocacy of financial account liberalisation. The latter in fact accentuates the necessity to accumulate reserves, hence encouraging this rather than absorption. This is especially notable in countries running current account deficits and yet that accumulate reserves via external borrowing, as discussed by Akyüz (2015a).

On the spending side, there is also a tension between increased spending versus explicit or implicit endorsements of fiscal restraint or even austerity in certain contexts (especially if we increase the remit of aid to include other official flows more generally, which are often less restrained in their use of conditionalities to enforce austerity). A good example of this is precisely found in the social protection agenda lobbied by large multilateral donors such as the World Bank. On one hand, the Bank has played a leading role in pressuring countries to adopt and expand cash transfer schemes, whether through means of direct programme financing or else as a conditionality within broader aid packages, as has been common in the HIPC approval process overseen by the IMF and related PRSPs. However, as part of these same processes, the same IFIs have explicitly linked the expansion of cash transfers to the removal of price subsidies, such as in food, fertilisers and other inputs, fuel and energy, which has been a long-standing tension between these IFIs and many developing countries. The latter policy position has been much debated despite the apparent orthodox consensus that price subsidies are inherently bad policy. However, an added implication of this explicit association is that the net effect, if implemented, does not increase overall spending, precisely because the expansion of social protection spending is proposed to occur in a substitutive rather than additive manner, reallocating expenditures from one budget line to another (see Fischer 2012 for some discussion of this in terms of social policy more generally). This is especially the case in circumstances where the fiscal weight of subsidies is much greater than cash transfers, as is common in African countries.

The irony is that an explicit substitutive approach to aid-associated spending would probably be criticised by the sections of the IMF that advocate for the full spending of aid. It might also run up against concerns regarding fungibility, if those concerned with fungibility would indeed examine such issues in a more systemic manner (which it appears they do not). The implications would also equally come under critical (and justifiable) scrutiny of the recipient government (and their informed constituencies), especially if it appears that much of the aid is not absorbed in any case. Indeed, this might partly explain why there has been so much resistance from governments, particularly in Africa, to remove subsidies.[23] In the face of such contradictory signals from donors and the contortions that a government must undergo as a consequence in order to appease various contending pressures, it is understandable how the said government could appear to be somewhat dysfunctional in the balancing act. This in turn encourages a self-fulfilling focus among both donors and academics on domestic governance issues as explanations for poor performance in the presence of large aid inflows, especially if resistance to the elimination of subsidies is tautologically interpreted as an indication of bad governance or policy.

In addition to such contradictory signals, transfers from foreign to domestic resources arguably exacerbate donor concerns about fungibility, transparency and accountability given that they are indirect, opaque, negotiated, and generally in disequilibrium (with respect to absorption and spending). This is especially the case given that most staff in both aid agencies and recipient governments would not understand the complexities of the processes involved, besides those who are directly involved with the technical aspects of such transfers.

Such concerns potentially lead donors to seek ways of bypassing the long route of accountability through the financial circuit and instead to strengthen their control over the end uses of aid. In other words, the idea that donors do fund domestic expenditures would appear relevant to them to the degree that they are able to control these domestic policies or else retain control over the domestic currency. This would therefore accentuate impulses

[23] More broadly, such subsidy policies are often treated as social protection expenditures by African governments. As was pointed out to me in conversation with Thandika Mkandawire, they generally cover much wider sections of the population than most cash transfer programmes, result from long and hard fought distributive struggles, and often include important cross-class dynamics that, in the social policy literature, are considered to be beneficial for the cultivation of more universalistic approaches of welfare and citizenship. Subsidy policies also often contribute to more production-oriented development strategies, although this runs against orthodoxy in the IFIs, which continue to insist that subsidies represent an inefficient and ineffective use of resources that would be better targeted to the poor, and hence their emphasis of refining targeting systems rather than broadening and unifying publically funded social protection systems. See discussion of this in the seminal paper by Mkandawire (2005); for an alternative consideration in the case of Iran, see Meskoub (2015). As was pointed out to me by Dwayne Woods, it is also ironic that the attribution of rent seeking is actually not at all obvious in the case of subsidies, given that these are generalised and thus cannot be controlled in a particularistic manner, versus cash transfers that can, despite the fact that the opposite is generally asserted, i.e. that subsidies are an indication of neopatrimonialism whereas cash transfers undermine this.

among donors to strengthen their influence in the sphere of domestic politics and policy making in recipient countries, including through explicit and implicit conditionalities such as those subsumed under Poverty Reduction Strategy Papers, in order to guarantee that disbursed aid actually translates into domestic expenditures (given the tenuous links between the two in such contexts, in contrast to traditional aid that was more explicitly connected to foreign exchange needs). Indeed, it is notable that the social protection agenda is often pursued by IFIs as a conditionality of structural adjustment programmes, stand-by loans, or debt relief agreements, rather than as an object of specific project or sector-specific programme financing. Or, as noted by Winther-Schmidt (2011), aid for social protection is often subsumed under general budget support.[24] While this facilitates its macroeconomic management, it also exacerbates concerns over accountability, thereby stoking the impulse to impose conditionalities. These donor concerns might also encourage the alternative impulse among donors to increase off-budget aid spending (as has been observed in some cases, e.g. see Wuyts et al 2016 in the case of Tanzania), or else to increase the foreign exchange component in the aid earmarked for social expenditures, typically through channelling aid towards technical assistance or consultancy services, such as on issues of improving efficiency of targeting, etc.

The recent policy advocacy of a 'cash-on-delivery' approach to aid disbursement by Birdsall and Savedoff (2010), or of the 'payment by results' strategy announced by DFID in 2014 (DFID 2014), might be understood as expressions of such impulses. The aim of such approaches is to strengthen the enforcement of donor control over negotiated and contracted agreements with recipient governments, by providing stronger tools of compliance in the end uses of aid. Further research on these strategies is required given that they are quite new (see some initial assessments in Chambers 2014 and Clist 2016). However, according to the framework discussed here, these policy innovations can be understood as part of a third wave of implicit conditionalities applied at an increasingly micro level, the first wave referring to SAPs and the Washington Consensus in 1980s and the second to those of the post-Washington consensus, good governance and the institutional emphasis in aid policy, as discussed in the second section. The third wave represents a further extension of explicit or implicit conditionalities into a greater range of domestic political arenas beyond the institutions related to economic policy, in this case including social policy.

These dynamics and implications are not exclusive to the specific case of aid directed towards social expenditures, although such aid provides a particularly poignant lens through which to examine some of these underlying

[24] Winther-Schmidt (2011, p.4) notes that 'many bilateral institutions channel much of their support to social protection as unearmarked core contributions through multilateral agencies such as the ILO, UN, EU and the WB, which makes it difficult to quote the exact bilateral contributions in this area…' and that '…social protection projects and programmes are often part of larger financial packages that are allocated at sector level and cut across several policy areas, making it difficult to extract the specific amounts that have been allocated to social protection.'

power relations and subtle forms of coercion embedded within the current aid system. In this sense, the donor emphasis of social protection might be understood as serving a further intensification of the trend started in the 1990s within the so-called 'Post Washington Consensus' of extending the conditionalities of structural adjustment policies in the 1980s to include new forms of implicit political conditionality, rather than representing a shift away from the traditional macroeconomic conditionalities (which are generally still subsumed within the broader range of conditionalities in any case). As argued by Shadlen (2002) with regard to the Post Washington Consensus, this would represent not so much a shift away from the 'monoeconomics' of neoliberalism, as per the use of this term by Hirschman (1981), but instead an extension of mono-ism towards a broader remit of 'mono-politics-and-economics.' In this sense, donor emphasis of social protection might be understood as reinforcing this institutional subordination of recipient countries within donor-recipient power relations, despite commitments to the contrary of respecting national 'ownership' under the Paris Agenda.

From the recipient side, the obfuscation related to the increasing emphasis of domestic expenditures similarly might exacerbate various tensions and power struggles at the domestic level. For instance, as donors weigh into the domestic political context, they often side with different ministries and even seek to dislocate conventional ministerial hierarchies, such as by bypassing finance ministries and attempting to empower social welfare ministries, which have traditionally been the much weaker junior partner (e.g. see a discussion of this by Hickey et al 2009 with regard to DFID policy). Indeed, the latter are often identified by the new trend of so called political economy analysis by donors as the domestic champions of particular donor agendas, while identifying finance ministries as bastions of resistance. Resistance might be due to more conservative (anti-welfare) or monetarist (anti-expansionary spending) biases, or perhaps simply because the executive has different views on the preferred development agenda to prioritize. The ministry prioritized by donors nonetheless comes to also have vested interests in pursuing the donor agenda, particularly if donors have managed to negotiate direct financing that bypasses finance ministries. Tensions would therefore be accentuated between various ministries and their competing and often conflicting spending priorities, in terms of how fiscal spending is transferred through various line ministries and operating budgets, or even outside of them, such as with off-budget aid or with aid directed towards supporting service provisioning by non-governmental organisations.

# 5 Conclusion

While many of these issues require further research, the monetary transformation dilemma nonetheless opens up an original front of research, asking important questions that have been thus far been neglected in the political economy literatures dealing with aid, social protection, and the financing of development more generally. In essence, the extent to which official flows are actually able to fund domestic expenditures involves a range of macroeconomic management concerns that are prone to exacerbate the already thorny political relations between donors and recipient governments. This calls for a serious rethink of many of the accepted premises in the existing literatures, particularly with respect to the dominant focus on domestic governance rather than a broader systemic understanding of the often convoluted and contradictory dynamics influencing both external and domestic actors.

Several examples have been highlighted in this paper. First, conventional measures of absorption, as used by the IMF and associated authors, are highly problematic given that they rely on aggregated current account data that includes income payments to foreigners, such as interest payments on debt and profit remittances. Second, mismatches between the absorption and notional domestic spending of aid appear to be the norm in most of the countries studied in the macroeconomic literature on aid, even more so once the first point above is taken into consideration, as well as broader definitions of aid and even other official flows. Third, the full absorption and spending of aid, as advocated by the IMF, is in contradiction with the need to accumulate reserves in the face of financial account liberalisations, as also advocated by the IMF and other IFIs. Fourth, the full spending of aid is similarly in contradiction with substitutive approaches to social protection, as commonly advocated by donors and IFIs, which imply no net increase in spending. Lastly, the obscurity of these monetary transformation dilemmas result in a strong propensity to exacerbate donor concerns about fungibility, transparency and accountability, thereby inciting donors to seek ways of strengthening their micro-control over the end uses of aid, as exemplified by recent trends in aid modalities such as cash-on-delivery or payment by results.

Impulses to control recipient countries obviously do not originate from these tensions, but have long standing roots in colonial and post-colonial histories, especially since the neoliberal phase of structural adjustment programmes and beyond. However, the tensions associated with the obfuscating effects of the monetary transformation dilemma nonetheless reinforce the broader ideological predilections to subordinate recipient countries with donor-recipient power relations, in parallel with increasingly conservative reactions to welfare in donor countries, thereby running counter to donor commitments of respecting national ownership.

This rethinking is particularly urgent given the currently tightening financial cycle facing developing countries, as witnessed by the swath of currency crises in 2013 and 2014, the wider systemic devaluations in 2015, and the re-emergence of stringent balance of payments constraints facing many developing countries. This in turn raises the need for concessional external financing while simultaneously reinforcing the leverage of donors as strategic providers of such finance, even in situations where aid might only amount to a marginal addition to overall external and domestic financing needs. This is occurring and in an orthodox ideological climate in which the mainstream consensus default response to crisis continues to be austerity and structural adjustment in order to achieve both primary fiscal surpluses as well as trade surpluses, while the private financial markets that increasingly dominate so-called development financing continue to penalise developing countries for running fiscal and trade deficits. At the same time, current international development agendas (e.g. the MDGs and now the SDGs) have increasingly emphasised the priority of directing international aid towards social expenditures, even though such expenditures could in principle be financed domestically if aid recipient countries were unconstrained to practice expansionary monetary and fiscal policy.

In this context, recipient governments must play a taut balancing act of preserving policy space between foreign exchange needs on one hand and donor concerns about fungibility and transparency in domestic expenditures on the other. In this manner, the tension between these tendencies, as highlighted by the monetary transformation dilemma, might in fact bolster the disciplinary and punitive roles of donors, while restricting the policy space of recipient countries despite donor commitments of respecting national ownership under the Paris Agenda of aid effectiveness.

Ultimately, the monetary transformation dilemma goes to the heart of the question of how to (re)construct a more effective aid system and an international financial architecture that are genuinely redistributive towards the poorest countries and in ways that do not undermine national self-determination or reinforce structural dependency. Indeed, while the focus here has been on social expenditures, the analytical insights could also be transferred to other important issues on the global agenda such as climate financing, insofar as these also involve the domestic absorption of external financial resources as an important consideration.

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