



## **Africa after the Africa Commission:**

What priorities for  
the German G8?

### **Absorbing Aid Inflows: Some Macroeconomic Considerations**

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## The macroeconomics of absorption: serious but not a show-stopper

- Anxiety about absorptive constraints is pervasive and such concerns have contributed, in part, to the slower than expected increase in aid since 2005.
- Absorption problems not inevitable but do require careful macroeconomic management. We have a pretty good idea what to do and we know where the main challenges arise (ODI Briefing, May 2005).
- Emphasis on flexible, country-specific responses but some general lessons can be learned.

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The central issue: spend and absorb  
...but how much and how quickly?

- The developmental rationale for aid requires aid is fully 'spent' (by the fiscal authorities) and fully 'absorbed' (by the economy as a whole).
- But if aid flows are 'too large' or 'too rapid'
  - Quality of spending may decline
  - Distortionary effects of aid flows are magnified (e.g. 'Dutch disease' / competitiveness problems)
  - Fragile governance structures may be put in jeopardy.



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## The macroeconomic objective

- Identify a rate (and form) of spending that maximizes the developmental impact of spending but entails a path for absorption which:
  - Respects medium-term fiscal sustainability...and does so credibly
  - Does not jeopardize short-run macroeconomic stability
  - Strikes a balance between public and private sector activities



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## Lessons I : No general prescriptions

- Severity and nature of absorptive capacity constraints , and hence capacity to scale up aid, very country-specific, depending on:
  - Structural characteristics, especially in factor markets
  - Initial macroeconomic conditions
  - Governance and implementation capacity
  - The aid architecture (e.g. GBS vs project support)



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## Lessons II: All macroeconomics is micro

- Labour market constraints
  - Including implementation capacity in public sector
- Credit markets and capacity to support adjustment, especially in short-run
- Tax structures and domestic resource mobilization
- Coherent fiscal and monetary policy coordination, especially when aid flows are volatile.



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## Lessons III: The importance of credible commitments

- Donors unable to credibly pre-commit to fund over long horizons
- Recipients unable to credibly commit to adjust spending to fluctuations in external finance
- => raises the risk that large *expected* future financing gaps emerge...private sector response to aid inflows is precautionary...aid not absorbed
- This can represent a major 'barrier to entry' scaling up aid

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## Lessons IV: Learn from commodity booms

- Aid increases since 2005 swamped by scale of primary commodity booms
- Similarities and differences
  - Central role of transparency and fiscal rules (e.g. EITI and Nigeria Fiscal Responsibility Bill)
  - Evidence of more flexible macroeconomic management
- But oil booms less predictable than aid occur independent of governance and capacity
- => better prospects for aid?



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## Policy implications: what can donors do?

- Longer, more credible and more stable commitments
- Support greater flexibility in macroeconomic management of aid flows
  - Reserve management strategies
  - Aid modalities
- Engagement with IFIs on development of coherent macroeconomic strategies for scaling up
- Learning from evidence on commodity price booms