



## The Fallout from the Financial Crisis (3): Will Aid Budgets Fall Victim to the Credit Crisis?

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- ◆ Aggregate aid figures might not decline after all, but much of the new resources might bypass the poorer, most vulnerable countries.
- ◆ Bilateral donors should therefore maintain their commitments to low-income countries, and especially shelter country programmable aid from cutbacks.
- ◆ The financial crisis should give a new impetus to governments' efforts to improve aid effectiveness.

### Aid at Risk?

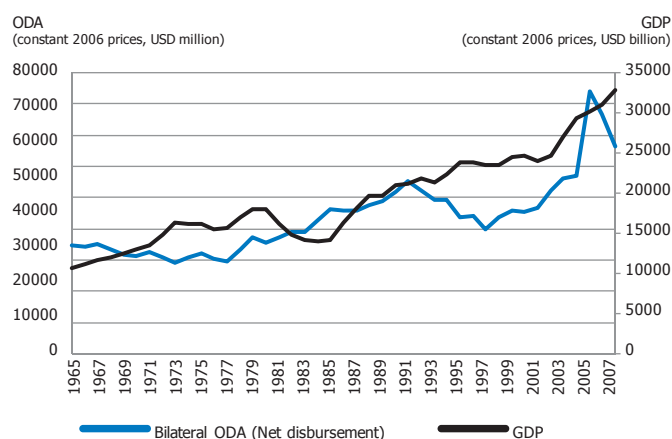
Over the last few months, the governments of OECD countries have pledged trillions of dollars in loans, guarantees, capital injections, and other assistance in their coordinated effort to prop up the global financial system. In comparison, annual aid flows, currently standing at around \$100 billion, are just "a drop in the ocean", in the words of Robert Zoellick, President of the World Bank.

Yet there are widespread concerns about how the financial crisis is going to impact upon aid budgets. David Roodman has argued that in the aftermath of the financial crisis even existing aid budgets are at risk<sup>1</sup>. He points to some particular examples (Finland, Japan, Norway, and Sweden) of sharp falls in aid during previous financial crises. During sharp economy-wide contractions, it does indeed seem the case that aid budgets suffer. In Finland, for example, during its 1990-93 banking crisis, GDP fell by nearly 11 per cent and development aid by 60 per cent.

So will aid levels fall? One important dimension to this question is the fiscal balance – one would expect, other things being equal, that governments with large deficits would be more prone to cut aid. By massive intervention to prop up the banking and credit system, governments are currently taking on huge financial commitments. Clearly governments are going to have to take some tough fiscal choices in the coming year.

Nevertheless, looking back on the impact of past economic cycles on the scale of aid disbursements, we actually find a rather ambiguous relationship between economic growth in donor countries and subsequent aid flows. While GDP and aid flows tend to move together over long periods, there are instances in which aid disbursements have become "decoupled" from economic growth in the OECD countries (Figure 1). The end of the Cold War, in particular, coincided with a sharp contraction of aid budgets for almost 8 years, as donor country governments reassessed the priority to be given to aid. In other words, unless the *raison d'être* of aid is questioned, aid flows tend to be quite resilient to mild recessions. Only in the case of a deep depression are aid flows at serious risk. If 2009 sees a growth slowdown or mild recession, in the context of important commitments made in Monterrey and Gleneagles, then aggregate aid figures might not decline after all.

Figure 1. **Bilateral ODA and GDP - DAC countries**



Source: OECD.Stat (2008) and World Bank (2008), *World Development Indicators* online.

1. [http://blogs.cgdev.org/globaldevelopment/2008/10/history\\_says\\_financial\\_crisis.php](http://blogs.cgdev.org/globaldevelopment/2008/10/history_says_financial_crisis.php)

## A Case for the Poor

What will most certainly happen, however, is a notable shift in the composition of resource flows towards multilateral contributions, as more funds are channeled through the IMF and the World Bank. In this sense, there is a danger that much of the new resources will bypass the poorer most vulnerable countries – and instead be destined almost exclusively for the emerging markets and middle income countries, in order to reduce systemic risks. Yet many of the poorest countries are still vulnerable in the context of the current crisis. A major challenge for bilateral donors is therefore to maintain their commitments to low-income countries, in particular by making sure that country programmable aid does not suffer from cutbacks.

Finally, the financial crisis should give a new impetus to governments' efforts to improve aid effectiveness, as per the Paris Declaration and the Accra Agenda for Action. Even in the face of the possible stagnation of aid budgets, there might be a pay-off if donors react in a way that is pro-poor. Indeed, a hard-budget constraint may help reduce some of the inefficiencies that have become inherent in the international aid system. Significant portions of aid budgets have grown enormously over the last 10-20 years – particularly technical cooperation – and yet the rationale for supporting such a large expansion of these expenditures, in terms of aid effectiveness, is more doubtful. Now, more than ever, policy makers need to protect aid volumes, and allocate them in a way that is pro-poor.