

Contents lists available at [ScienceDirect](#)

Economic Analysis and Policy

journal homepage: www.elsevier.com/locate/eap

Full length article

Structural economic vulnerability, openness and bilateral development aid flows



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ARTICLE INFO

Article history:

Received 11 March 2016

Received in revised form 4 December 2016

Accepted 5 December 2016

Available online 21 December 2016

JEL classification:

O1

F35

F41

Keywords:

Structural economic vulnerability

Bilateral aid flows

Trade openness

International financial integration

ABSTRACT

This study investigates the relationship between countries' structural economic vulnerability (EVI) and the bilateral aid received from donors, including in the context of higher degree of trade openness and/or financial openness. The empirical analysis suggests that donors' bilateral aid supply to Least developed countries (LDCs) increases when the latter experience higher EVI. A rise in EVI in non-Least developed countries (non-LDCs) does not lead to higher donors' aid supply. Furthermore, the analysis indicates that the impact of EVI on bilateral aid inflows could be dependent upon the degree of trade openness or financial openness but not on both together.

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1. Introduction

Among developing countries, the least-developed countries (LDCs) are considered as the poorest and most vulnerable to natural and external shocks. In effect, the LDC category was established by the UN in 1971 and comprises low-income countries facing structural impediments to the achievement of sustainable development. The structural handicaps refer here to human resource deficiency and a high level of economic vulnerability. Hence, the selection and graduation of a country from the LDC category rely on three criteria: the gross national income (GNI) per capita; the human assets index (HAI); and the economic vulnerability index (EVI). The latter is at the heart of our study and will be described below (see [CDP](#),¹ 2015, for more details on these criteria²). As we will see, structural economic vulnerability is considered here as “the risk that economic growth [in a given country] is markedly and extensively reduced by shocks” ([Guillaumont, 2009](#), p. 197).

Graduation from the LDC category has occurred only since 1991, that is, 20 years after its creation. Since then, only 4 countries have graduated from this category: Botswana (in December 1994), Cape Verde (in December 2007), the Maldives (in January 2011) and Samoa (in January 2014).

It is worth noting that this category was revised by the United Nations in May 2016 and comprises (as of today) 48 countries,³ of which 34 are located in Africa, 13 in Asia and the Pacific Islands and 1 (i.e., Haïti) in the Caribbean.

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¹ Committee for Development Policy (of the United Nations).

² Other details are also provided on the website of the United Nations Office of High Representative for the Least Developed Countries, Landlocked Developing Countries and Small Island Developing States (UNOHRLLS): <http://unohrlls.org/about-ldcs/criteria-for-ldcs/>.

³ See the list online at http://www.un.org/en/development/desa/policy/cdp/ldc/ldc_list.pdf.

Given the variety of exogenous shocks that LDCs are confronted with and since the amplitude and frequency of these shocks tend to be higher than in other developing countries, the international community has been paying special attention to these countries. The United Nations Resolution (A/RES/70/1) adopted by the General Assembly of the United Nations on 25 September 2015 (also referred to as the 2030 Development Agenda) provides a good example of the willingness of the international community to support LDCs' development: Paragraph 43 of this Resolution states *inter alia* that "ODA providers reaffirm their respective commitments, including the commitment by many developed countries to achieve the target of 0.7% of gross national income for official development assistance (ODA/GNI) to developing countries and 0.15%–0.2% of ODA/GNI to least developed countries".

A large body of the development aid literature has been devoted to the determinants of bilateral aid allocation (i.e., the official development aid allocated by donors to recipient countries in a bilateral framework). However, very few studies have focused on how shocks and exposure to shocks affect bilateral aid supply. One of these scarce studies is that of [Dabla-Norris et al. \(2015\)](#), who, in a bilateral framework, investigated several questions, including: to what extent does the business cycle in donor countries influence their aid outlays? Has this impact been large and persistent during past recessions? How do macroeconomic conditions in aid-dependent countries influence their aid receipts? What happens to aid flows during synchronized recessions—in which both the donor and the recipient experience large negative shocks? Their findings are as follows. Bilateral aid flows are on average procyclical with respect to the business cycle in both donor and recipient countries. While aid outlays contract sharply during severe downturns in donor countries, they rise steeply when aid-receiving countries experience large adverse shocks.

Incidentally, this aid literature has also highlighted the importance of recipient countries' trade openness to donors' aid allocation; for example, according to [Alesina and Dollar \(2000\)](#), donors provide more aid to reward developing countries for the good quality of their economic policies, in particular their trade liberalization policies. In the meantime, the effect of recipient countries' financial openness, that is, their international financial integration on donors' aid allocation has received less attention. Moreover, it is well known that, while both trade and financial openness could generate substantial benefits to countries, they could entail risks, including inducing a rise in the structural vulnerability of recipient countries.

Against this backdrop, it would be interesting to explore the question of how donors behave in terms of bilateral aid supply when recipient countries experience greater structural vulnerability, in particular in the context of higher levels of international trade and financial openness. This question is all the more relevant that [Amprou et al. \(2007\)](#) and [Guillaumont \(2008\)](#) contended that structural factors, such as vulnerability to exogenous shocks, should be taken into account when allocating aid. To the best of our knowledge, this is the first study to explore the relationship between the bilateral aid allocated by donors and the structural economic vulnerability in recipient countries, including that in the context of higher degrees of trade and international financial openness. Furthermore, as far as we know, this question has not been investigated in the empirical literature on the determinants of development aid allocation. This study aims to fill this gap by considering whether the effect of recipient countries' structural economic vulnerability on donors' bilateral aid supply depends on their degree of international trade openness and financial integration.

The empirical analysis suggests that when LDCs experience higher level of structural economic vulnerability, they enjoy higher bilateral aid from donors. However, a rise in structural economic vulnerability in non-Least developed countries (non-LDCs) is not significantly associated with donors' bilateral aid supply to these countries. Incidentally, while greater trade openness in LDCs is associated with higher bilateral aid inflows, greater international financial integration in these countries appears to be associated with lower bilateral inflows. Results also indicate that the impact of structural economic vulnerability on bilateral aid inflows could be dependent upon the degree of trade openness or financial openness but not on both types of openness simultaneously.

The rest of the paper is organized as follows. Section 2 provides a brief literature review on the concept of structural economic vulnerability. Section 3 briefly discusses the links between trade openness, financial openness and structural vulnerability. Section 4 provides a short literature review on the determinants of development aid, and Section 5 presents the empirical model. Section 6 discusses the estimation strategy, while Section 7 interprets the estimations' results. Section 8 deepens the previous analysis by examining whether the impact of structural economic vulnerability on bilateral aid depends on the level of both trade openness and financial openness. Section 9 concludes.

2. Brief literature review on the concept of structural economic vulnerability

The concept of "vulnerability" is not new, and has been the subject of a growing literature in development macroeconomics (see, e.g., [Brugliu et al., 2008](#); [Guillaumont, 2009](#); [Gnanon, 2013, 2014a,b](#)). It usually refers to the concept of "risk". In the macroeconomics area, vulnerability is considered as shocks to economic growth (see also [Seth and Ragab, 2012](#)), whilst in the microeconomics area, the emphasis has been placed on shocks to the well-being of individual households. [Naude et al. \(2009\)](#) provided a general definition of "vulnerability", considering it as the risk that a "system" undergoes negative change due to a "perturbation". In the same vein, [Gallopín \(2006\)](#) defined "vulnerability" as the likelihood of a system being affected negatively by some sort of perturbation or sudden "shock" extending beyond the normal range of variability. Following [Essers \(2013\)](#), in a macroeconomic setting, one can consider the system to be an individual country and the perturbation to be a number of macroeconomic shocks.

The empirical application of the concept of "economic vulnerability" dates back to the 1990s, in particular the work of [Brugliu \(1993, 1995\)](#) on small island developing states (SIDSs). Since then, many studies have been carried out on the

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