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International aid and financial crises in donor countries

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ABSTRACT

The recent global financial crisis placed new economic and fiscal pressures on donor countries that may have long-term effects on their ability and willingness to provide aid. Not only did donor-country incomes fall, but the cause of the drop — the banking and financial-sector crisis — may exacerbate the long-term effect on aid flows. This paper estimates how donor-country banking crises have affected aid flows in the past, using panel data from 24 donor countries between 1977 and 2010. We find that banking crises in donor countries are associated with a substantial additional fall in aid flows, beyond any income-related effects, at least in part because of the high fiscal costs of crisis and the debt hangover in the post-crisis periods. Aid flows from crisis-affected countries are estimated to fall by 28% or more (relative to the counterfactual) and to bottom out only about a decade after the banking crisis hits. In addition, our results confirm that donor-country incomes are robustly related to per-capita aid flows, with an elasticity of about 3. Findings are robust to estimation using either static or dynamic panel data methods to account for possible biases. Because many donor countries, which together provide two-thirds of aid, were hit hard by the global recession, this historical evidence indicates that aggregate aid could fall by a significant amount (again, relative to counterfactual) in the coming years. We also explore how crises affect different types of aid, such as social-sector and humanitarian aid, as well as whether strategic interaction among donors is likely to deepen or mitigate the fall in aid.

1. Introduction: financial crises, economic downturns, and aid outflows

Aid's impact on growth in recipient countries has been the topic of a large empirical literature, with highly disparate findings (e.g. Doucouliagos and Paldam, 2008). Clemens et al. (2012) argue that many of the less favorable findings on aid's effects can be attributed to a failure to correct adequately for serious endogeneity issues. Donors tend to give more aid to countries with poor growth prospects, and even when researchers attempt to correct for this problem, their 2SLS estimates are biased towards OLS estimates due to weak instruments (Bazzi and Clemens, 2010; Roodman, 2009). Several recent studies using very different identification strategies have produced evidence that aid has small but positive and significant effects on growth (Clemens et al., 2012; Bruckner, 2011; Frot and Perrotta, 2012).

Moreover, aid may matter for other important outcomes. For example, Nielsen et al. (2011) show that, controlling for other factors, a negative aid shock (defined as a sudden reduction in aid of at least 0.5% of GDP) more than doubles the risk of violent conflict in the average country, from 2.1% to 5%. Young and Findley (2011) find that aid targeted to education, health, alleviation of conflict, governance, and civil society significantly reduces the incidence of terrorist events. For example, they estimate that a one standard deviation increase in education aid reduces the number of terrorist attacks by 71% on average, controlling for other variables and correcting for endogeneity. Cuts in aid associated with recent economic crises and growth slowdowns in donor countries could thus have potentially serious consequences.

This paper investigates how financial crises and economic conditions in donor countries have affected flows of international aid in the past, with the aim of understanding how the recent global financial crisis could affect future flows. We do this by

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analyzing a 24-nation panel dataset covering 1977–2010 to estimate the effects of banking crises and other economic and political variables on aid.[1] These effects turn out to be large, significant, and surprisingly long-lived, with aid from crisis-stricken countries falling relative to the counterfactual by more than 30%, even more than a decade after the banking crisis hits. Moreover, because they are estimated in regressions that control for donor-country per-capita income, these banking-crisis effects are additional to those of the economic downturns that coincide with the banking crises. As a result, the recent global financial crisis could substantially reduce aid in the years to come, given that the countries hit by banking-sector crises provided two-thirds of aid before the crisis.

1.1. Aid and economic slowdowns in donor countries

From the perspective of aid policy, the recent global financial crisis was distinctive. A key difference from the emerging-market East Asian and Tequila crises of the 1990s, when multilateral and bilateral donors provided substantial financial assistance to help spark recovery in the crisis countries, is that both of those crises took place at a time of sustained growth in donor countries. This time, it was the donor countries that were hit first by the financial crisis, with GDP falling by 3.2% in 2009 for rich countries as a group (International Monetary Fund, 2010). With the economic slowdown and fiscal strains that resulted from the crisis, donor-country policymakers have found themselves pressured to redirect aid funds to domestic needs such as unemployment benefits and emergency infrastructure programs. Aid from several bilateral donors, such as Ireland and Spain, fell sharply in the initial years after the crisis,[2] and although overall ODA from DAC donors continued to rise initially, in 2011 it too declined, by 2.7% in real terms (OECD, 2012).

What do we know empirically about the sensitivity of aid flows to donor-country economic and financial conditions? While there is an established literature that examines how recipient-country characteristics — such as income level, population, and political system — affect aid inflows (see, for example, Alesina and Dollar, 2000; Dollar and Levin, 2006), much less is known about these *donor-side* determinants of aid. Several recent papers have begun to fill this gap, mostly using panel data with donor fixed effects. Aid is positively associated with income per capita in most of these studies (Round and Odedokun, 2004; Boschini and Olofsgard, 2007; Chong and Gradstein, 2008), although one finds no significant relation (Faini, 2006). Faini finds that aid is lower when budget deficits and the stock of public debt are higher, but others find no statistically significant relationship between deficits and aid provision (Round and Odedokun, 2004; Boschini and Olofsgard, 2007). Analyses of survey data find that higher levels of financial insecurity in donor countries are associated with weaker voter support for foreign aid (Paxton and Knack, 2012). None of these studies explore the impact of financial crises in donor countries on aid provision, although two recent studies (discussed below) do.

1.2. The possible exacerbating effects of donor-country banking crises

Not all economic slowdowns are created equal, and it is possible that the nature and causes of any particular slowdown may influence its effects on aid flows. Roodman (2008) shows graphically that several OECD donor countries — Finland, Japan, Norway, and Sweden — reduced their aid flows substantially after they suffered domestic banking crises in the 1990s. Although Roodman does not provide further analysis, there are reasons to believe that banking crises could have direct effects on aid beyond their effects on incomes.[3] Bank rescues and recapitalizations place massive new fiscal demands on the public sector; even if the government is eventually able to recoup many of the costs of these rescues through asset sales, the short-term effect is to worsen sharply the government's cash flow. In their comprehensive analysis of systemic banking crises, Laeven and Valencia (2008) estimate that fiscal costs of banking crisis management, even net of recoveries from asset sales, average more than 13% of GDP. For the advanced economies, the fiscal cost has typically been less than that — perhaps 3 to 5% of GDP (in gross terms) — but Finland is estimated to have spent 12.8% of GDP to resolve its banking crisis in the early 1990s. With these additional costs added to the usual cyclical revenue shortfalls from recession, donors may find it more difficult to continue giving aid during and after those crises than they would in a normal downturn of the same magnitude.

This direct banking-crisis effect may be particularly relevant for aggregate aid flows in the wake of the recent crisis, for two reasons. First, two of the largest donors (in absolute terms), the United States and United Kingdom, were the major economies whose banking sectors were hit first, and most severely, by systemic crises beginning in 2007. Second, the crisis spread to banking sectors in other major donor countries in 2008, particularly those with the greatest exposure to US financial institutions (Laeven and Valencia, 2010).

Two other recent papers attempt to estimate the impact of donor-country financial-sector troubles on aid provision. Mendoza et al. (2009) use 1967–2007 data for the US only and show that stock market volatility, which they call “a proxy for financial volatility and economic uncertainty,” is associated with reduced ODA. The other study is more directly parallel to our paper: Frot (2009) uses data for a panel of donors for the 1986–96 period to estimate how financial crises affect aid flows. He finds that a banking crisis in a donor country decreases aid by 13% (when estimated as a level effect) or that aid falls by 5% per year after the

[1] Throughout this paper, we use “aid” as shorthand for official development assistance (ODA) provided by bilateral donors that have reported aid through the OECD Development Assistance Committee (DAC) for an extended period (a group that includes donor countries that are not members of the DAC).

[2] For details, see discussion and sources in Section 5 below.

[3] Devarajan (2008) questions this analysis, pointing out that since 1960 the only sustained decline in aid came in the 1990s, and not necessarily for economic reasons. He cites results from Paxton and Knack (2012) in arguing that “aid is motivated largely by non-economic factors.”