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WHY IS 'THE DUTCH DISEASE' ALWAYS A DISEASE? THE MACROECONOMIC CONSEQUENCES OF SCALING UP ODA

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WHY IS 'THE DUTCH DISEASE' ALWAYS A DISEASE?* THE MACROECONOMIC CONSEQUENCES OF SCALING UP ODA

Terry McKinley**

ABSTRACT

This working paper examines the validity of the claim that 'scaling up' ODA in developing countries will cause 'Dutch Disease' effects that slow growth and human development. The most common concerns are increased inflation and exchange-rate appreciation. Consistent with a recent IMF re-appraisal, the paper maintains that such problems can be mitigated if ODA is properly 'spent' and 'absorbed'. However, many governments either do not spend ODA (because of the fear of inflation) or do not 'absorb' it (because of the fear of appreciation). The paper argues that the critical issues are whether 1) increased government spending is focused on public investment and 2) increased imports are focused on capital goods. A central point is that in many developing countries, under-utilized productive capacities can readily respond to rising government demand for domestic goods and services. The paper ends with the warning that although the short-run macroeconomic impact of ODA can be managed, its longer-term impact could, indeed, be adverse if it reduces efforts to mobilize domestic resources, such as public revenue and national savings.

* And why are the Dutch always blamed for such a malady?

** UNDP, New York.

1 INTRODUCTION

Why do many economists believe that in developing countries a large surge of capital inflows, such as Official Development Assistance, will lead to a 'Dutch Disease', and not development? What, exactly, is a 'Dutch Disease' and why is it considered to be invariably detrimental to development?[1] This brief paper attempts to address these issues.

The advocacy of the U.N. Millennium Project for a large scaling up of Official Development Assistance to reach the Millennium Development Goals has raised fears about a new epidemic of 'Dutch Disease' among developing countries. However, recent research by the International Monetary Fund has helped contribute to a more sensible, balanced evaluation than before of the validity of such fears (IMF 2005a and Gupta et al. 2005).

If ODA is effective, it should lead to a transfer of real resources to a developing-country recipient. And these resources should, it is assumed, contribute to improved human development and enhanced prospects for domestic capital accumulation and sustained economic growth. However, even if there were a real transfer of resources in the short term, such success would not lead necessarily to sustained growth and human development. These two issues are separable. This paper addresses primarily the short-run dynamics and focuses on the effects of ODA on growth.[2]

TABLE 1
ODA As a Share of National Income and Investment

Grouping	Aid as % of GNI 1990-94	Aid as % of GNI 2000-03	Aid as % of GCF 1990-94	Aid as % of GCF 2000-03
Low-Income Countries	3.4	2.6	13.9	11.9
Sub-Saharan Africa	6.6	5.3	40.7	27.0

Source: Nkusu 2004, Table 1 and World Bank, *World Development Indicators* 2004 and 2005, Table 6.10. GNI is Gross National Income and GCF Gross Capital Formation.

Until recently, ODA has been falling as a share of the gross national income of recipient countries and as share of their gross capital formation (Table 1). In low-income countries, for example, aid accounted for about 12 per cent of gross capital formation in 2000-2003, which was down from almost 14 per cent in the early 1990s. In sub-Saharan Africa, this share declined from almost 41 per cent in the early 1990s to 27 per cent in 2000-2003.

2 THE 'DUTCH DISEASE' DIAGNOSIS

Fears of a 'Dutch Disease' customarily assume that a sizeable inflow of ODA will exacerbate macroeconomic instability, namely, by raising inflation and appreciating the real exchange rate. Moreover, it is also assumed that growth will be impaired because exchange-rate appreciation will hamper the competitiveness of a country's export sector (Rajan and Subramaniam 2005).

Let us examine whether such a chain of events is inexorable. In this regard, the IMF's recent formulation of an analytical framework for assessing this phenomenon is a useful starting point (IMF 2005a and Gupta et al. 2005). It distinguishes between two dimensions of

this process: 1) spending aid and 2) absorbing aid. For a real transfer of resources to occur, both spending and absorption should occur. However, this happens infrequently.

The option of neither spending nor absorbing aid is not viable. Nonetheless, some countries, such as Ethiopia and Ghana, which have enjoyed a sizeable influx of ODA have tried this approach (IMF 2005a, p. 48). Many other countries have either spent aid without absorbing it or absorbed aid without spending it. It is rare for countries to have both spent and absorbed aid even though this represents the most desirable option. It is important to recognize that the timing of both actions could vary depending on country circumstances. Spending could be spread out over a period of time, as could absorption.

How does a government spend aid? It transfers the foreign exchange provided by ODA to the central bank in return for an equivalent value of domestic currency. It then uses this domestic currency to purchase domestic goods and services.[3] The surge in domestic purchases tends to drive up mainly the output prices of domestic non-tradables. One reason is that the output prices of tradables are determined, in contrast, by external markets. Another is that government expenditures are supposed to disproportionately favor non-tradables.

When the output prices of non-tradables rise, their input prices (such as wages) can also rise. Such increases also spill over, however, to the input prices of tradables. Since the output prices of tradables are set by external competition, the profits of the tradable sector are squeezed. A rise in the prices of non-tradables vis-à-vis those of tradables will cause an appreciation of the real exchange rate.

The nominal exchange rate will have to depreciate in order to compensate for the rising domestic price level. If the exchange rate is flexible, market forces will eventually compel depreciation; if the exchange rate is fixed, the authorities will have to devalue the domestic currency. In the five countries experiencing aid surges that have been examined recently by the IMF (Ethiopia, Ghana, Mozambique, Tanzania and Uganda), there was depreciation of the exchange rate, not appreciation (IMF 2005a). In other words, 'Dutch Disease' effects were not immediately apparent.

In response to the fall in profits due to rising input costs, resources are supposed to flow out of tradables and into non-tradables. If tradable sectors are more productive than non-tradable sectors (because of the pressure to be efficient exerted by international competition), then the productivity of the whole economy should fall.

3 HOW TO TREAT A 'DUTCH DISEASE'

Assuming that such tendencies occur, how can they be countered? The immediate danger of a 'Dutch Disease' depends, in large part, on the responsiveness of aggregate supply to a surge in domestic demand for goods and services. Many developing countries have idle, underutilized productive capacities that could be readily mobilized to respond to this increased demand (Nkusu 2004).

Models that assess the threat of a 'Dutch Disease' often assume that economies are on their 'production possibility frontier'—namely, fully utilizing all available productive resources. The corollary is that the expansion of public-sector spending inevitably 'crowds-out' private spending. The reality, in contrast, is that many economies experience widespread

unemployment and underemployment (Nkusu 2004). Once the unrealistic assumption of full employment is relaxed, the immediate likelihood of a 'Dutch Disease' diminishes.

Nevertheless, even if productive resources are not fully utilized, underdeveloped economies are plagued by many specific supply bottlenecks, e.g., lack of infrastructure or skilled personnel. These problems suggest that governments should focus ODA on removing these bottlenecks, which impede the responsiveness of aggregate supply. Public investment can play a central role in this effort.

An adverse impact of ODA could be partly mitigated if the government directly uses its new stock of foreign currency to purchase imports instead of domestic goods and services. This implies that this extra foreign currency leaks back out of the economy—instead of stimulating demand for domestic goods and services. Thus, the potential for inflation would be reduced. This option has, of course, disadvantages as well as advantages. The multiplier impact of government expenditures would be minimized, for instance.

Government could enhance this option by importing capital goods, which should raise domestic productivity. This has been the traditional rationale for ODA (see Hussain and Chowdhury 1998, Chapter 4). The so-called "Two Gaps" model, which underlies this rationale, assumes that the main constraint on growth is lack of foreign exchange, not domestic savings. Nevertheless, even if capital goods are purchased, imports will still rise relative to exports, thereby exerting depreciating pressure on the exchange rate.

If government purchases domestic goods and services, the potentially inflationary impact could be mitigated if it invested in public goods, such as roads, electricity grids, irrigation works, schools and health clinics. Such infrastructure increases the productivity of the private economy—eventually expanding aggregate supply in order to match the increase in aggregate demand from government expenditures. Under these circumstances, public investment will 'crowd-in', or stimulate, private investment.

This could be a vital stimulus to sustaining a domestic process of capital accumulation. The positive effect of public investment on private investment in low-income countries, such as in sub-Saharan Africa, has recently been recognized by the IMF (Gupta et al. 2005).[4] However, the IMF stresses the importance of physical infrastructure. Instead of increasing in low-income countries, however, public investment has been falling. A recent IMF study of fiscal policies in eight pilot countries revealed that public investment had fallen by one per cent of GDP between 1994-98 and 1999-2003, compounding a negative earlier trend in many of them (IMF 2005c).

In order to highlight the importance of public investment, it would be helpful to modify the way that it is treated in fiscal analysis. Public capital expenditures do not, for example, have the same impact as current expenditures. Thus, they should not be treated the same in fiscal terms. They create more public capital, increasing the net worth of government holdings. Moreover, they help expand the productive capacity of the whole economy.

If government borrows to finance public investment, the presumption is that the increased revenue from higher growth would pay off the debt. Thus, the ratio of public debt to GDP should remain relatively stable. This implies that while the government should strive, over time, to keep the current budget in balance, it should have the leeway to borrow to finance capital expenditures (see IMF 2004 for the counter-argument). However, it would be preferable to use ODA (and grants in particular) to finance public investment. But fiscal analysis should

help underscore the central importance of public investment in ensuring a positive impact of ODA on growth, instead of lumping capital and current government expenditures together.

There are various ways in which public investment could help overcome 'Dutch Disease' effects and foster growth. Some analysts claim that the macroeconomic impact of ODA could be enhanced if public investment were directed to increasing the productivity of tradables (Rajan and Subramaniam 2005). This would attenuate inflationary pressures.[5] But a similar impact could be achieved through increasing productivity in non-tradable sectors since their prices initially rise because of the disproportionate increase in demand for their output (see Adams and Bevan 2004).[6] In any case, these options illustrate that fiscal policy is capable of mitigating a 'Dutch Disease'. One of the major channels would be public investment because it can stimulate private investment and direct resources to expand aggregate supply in strategic economic sectors.

4 SUPPORTIVE MONETARY AND EXCHANGE-RATE POLICIES

To be fully effective, fiscal policy has to be supported by monetary and exchange-rate policies. This will depend on the actions of the central bank, namely, how it uses the ODA-supplied foreign exchange that it receives from the government. The central bank could keep the foreign exchange tucked away as reserves, and let the impact of government expenditures take its course. The impact is then likely to be inflationary.

Alternatively, it could sell the foreign exchange to the private sector, thereby drawing domestic currency back out of the economy. By buying domestic currency and selling foreign currency, the central bank contributes to appreciating the nominal exchange rate (undoing some of the depreciating impact of the original injection of liquidity through government expenditures). In the short-to-medium term, this appreciation might adversely affect the tradable sector. But well designed public investment programmes could nullify this impact over time. Moreover, the danger of a 'Dutch Disease' appreciation might be exaggerated if the aggregate effect of government expenditures has already been pushing in the opposite direction, namely, depreciating the exchange rate.

The availability of additional foreign exchange—along with the effect of appreciation—should facilitate the purchase of imports. Such a course of action would not normally result in balance of payments problems since aid is, in effect, financing the increase in the current-account deficit.

Of course, the composition of net imports matters, particularly for growth prospects. If the imports are capital goods, growth could be accelerated. If the imports are basic foods, for example, they could help hold down domestic food prices, and thereby improve the consumption of poor households. If the imports are luxury consumer items, the rich could benefit, and opportunities to raise growth or directly enhance human well-being might be diminished.

The appreciation of the exchange rate plays an integral role in boosting net imports, and thereby causing a transfer of real resources. But the appreciation could also affect the capital account, precipitating an outflow, especially if wealth holders then expect depreciation.

Basically, in the short run the foreign exchange provided by ODA can either be stored as reserves, used to purchase imports or leak out of the economy as capital outflows. Purchasing imports is usually the preferable option. If an economy is unstable, the private sector could use the additional foreign exchange to take capital out of the economy. However, if the central bank fears such an outcome, it could retain the foreign exchange as reserves—or sell the reserves over an extended period of time. These are the short-run options open to policymakers when they contemplate spending and absorbing ODA.

5 THE ACCUMULATION OF RESERVES

Often, monetary authorities have opted to accumulate reserves. This is one of the drawbacks of allowing independence of the central bank. The results: the expansionary impact of fiscal policy is neutralized by restrictive monetary or exchange-rate policies. The two sets of policies are inconsistent. Fiscal policy should lead and monetary and exchange-rate policies should move in the same direction.

Central banks of developing countries have been building up foreign-exchange reserves at a rapid rate in recent years (Table 2). Reserves more than tripled, for example, between 1996 and 2004. In East Asia and the Pacific, they increased by over 3.8 times and in South Asia by about 5.7 times (from a much smaller base). The increase was smaller in sub-Saharan Africa, i.e., 2.8 times. Nevertheless, such a build-up of reserves has notable opportunity costs since these resources could have been used to finance domestic investment. A recent paper by Stiglitz and Charlton (2005) argues that such an excessive build-up of reserves imparts a deflationary bias to the economies of developing countries. Accumulating reserves takes precedence over investing in growth.

TABLE 2
Gross Foreign Exchange Reserves of Developing Countries 1996-2004 ($ billions)

Group	1996	1998	2000	2002	2004e
All Developing Countries	519	588	668	922	1592
East Asia & Pacific	200	233	273	408	775
South Asia	25	33	43	80	142
Sub-Saharan Africa	21	27	34	35	58

Source: World Bank, *Global Development Finance* 2005, Table A.48 'e' means estimated.

This large precautionary build-up has been a reaction to the instability triggered by the increased globalization of financial flows. The lack of regulation of the capital account has also contributed to making monetary policies more restrictive because it leaves countries very vulnerable to financial shocks. As a consequence, significant proportions of ODA have been diverted into reserves, aborting the transfer of real resources into developing countries (see the case studies of Ethiopia and Ghana in IMF 2005a).

As a related phenomenon, many developing countries have been striving in recent years to achieve sizeable current account surpluses. This implies that they have been saving more than they have invested. Thus, they have been exporting their 'excess' savings—mostly to rich industrial countries such as the United States (McKinley forthcoming). Table 3 shows that the

aggregate current account balance of all developing countries swung from a deficit of about US$ 94 billion in 1998 to a surplus of about US$ 113 billion in 2003. During this period, net equity and debt flows changed little while capital flight (part of the 'balancing item') slowed down. However, what skyrocketed—by a factor of 18—was the yearly change in reserves. Unfortunately, through holding foreign-exchange reserves, developing countries are financing a higher level of consumption in rich countries, not growth in their own economies.

TABLE 3
External Financing of all Developing Countries 1998 and 2003 ($ billions)

	1998	2003
Current Account Balance	-93.7	112.8
Net Equity Flows	178.1	176.6
Net Debt Flow	54.9	60.0
'Balancing Item'[a]	-122.9	-57.4
Change in Reserves[b]	-16.3	-291.9

Source: World Bank, *Global Development Finance* 2005, Table A.21.

Notes: 'a' includes errors and omissions and net acquisition of foreign assets. 'b': a negative denotes an increase.

6 THE EFFECTS OF RESERVE ACCUMULATION

Instead of piling up as reserves, ODA should serve as a mechanism to facilitate the transfer of more real resources to developing countries. This aim is accomplished, in effect, by increasing net imports—namely, financing more imports of resources and slowing down the exports of resources. In order to achieve this objective, however, central banks have to release the foreign exchange provided by ODA. Any so-called 'Dutch Disease' effects are likely to be an integral part of this desired transfer of resources, not a clinical disorder.

What is apparent from the gross statistics is that because governments have become traumatized about the danger of 'Dutch Disease', they have been aborting a resource transfer by stockpiling ODA-supplied foreign exchange as reserves. This is an example of "spending but not absorbing ODA". In this case, if the government wants to combat domestic inflation, it will have to 'sterilize' the additional injection of domestic currency by selling government securities in exchange for it. Its net foreign assets, i.e., its foreign exchange reserves, will rise but its net domestic assets will decline correspondingly since its liabilities (e.g., bonds) to the private sector will increase.[7]

The downside of such a policy is that domestic real rates of interest would likely rise in order to attract buyers of government securities. Hence, private investment could be negatively affected. Moreover, the immediate opportunity cost of hoarding the reserves would be the lack of absorption of additional real resources, such as capital imports. The economy would suffer not only because loanable funds would become more expensive but also because capital imports would be minimized. Sterilization through selling government securities is designed to reduce the inflation precipitated by the ODA-induced increase in government expenditures (and the ensuing increase in the money supply). However, a more effective option would be to sell the foreign exchange accumulated as a result of aid, instead of "spending but not absorbing aid".

7 THE FEAR OF INFLATION

Some governments have chosen another option altogether, namely, "absorbing ODA but not spending it". Under this scenario, government expenditures do not increase. Instead, the domestic-currency equivalent of ODA could be used to reduce the existing stock of debt. Governments might find such an option attractive if they face large debt burdens or high inflation. By thereafter selling ODA-supplied foreign exchange to the private sector, central banks can draw domestic currency out of the economy and reduce inflationary pressures. However, since the growth of the money supply would slow, the exchange rate is likely to appreciate, perhaps markedly. The reason is that there never was the initial expansion of government expenditures.

This strategy relies on stabilization of the economy and a decline in interest rates (because of reduced debt) to stimulate private investment. But such an outcome is uncertain, especially since the domestic money supply is contracting (and putting upward pressure on the interest rate). Moreover, the tradable sector is likely to suffer. And public investment will not be able to serve as a stimulus to the economy.

Fear of inflation and associated macroeconomic instability is a prime factor in motivating authorities to sterilize ODA-induced government spending (by selling securities) or not to spend ODA at all. In both cases, the result will be an accumulation of 'idle' reserves. Governments are likely to choose such a suboptimal alternative because they have been urged to employ monetary policies that adhere to strict 'inflation targeting' (either explicitly or implicitly).

TABLE 4
CPI Inflation, 1991-2003 (% change in local currency)

Group	1991-2000	2001	2002	2003
World	3.3	1.5	2.0	1.8
Developing Countries	8.6	3.9	3.4	3.9
--Upper Middle Income	7.3	3.2	1.9	2.6
--Lower Middle Income	8.3	4.6	3.8	4.2
--Low Income	10.2	3.8	3.9	5.2

Source: World Bank, *Global Development Finance* 2005, Table A.9.

Utilizing such policies, developing countries have been strenuously trying to reduce inflation since the early 1990s. Table 4 shows that while average CPI inflation in all developing countries was 8.6 per cent during the 1990s, it was down to only 3.9 in 2003. The trend of declining inflation characterized all three categories of developing countries: upper middle-income, lower middle-income and low-income. Inflation rates are now, on average, in low single digits in developing countries.

Such rates are consistent with the target range of 3-5 per cent per year frequently incorporated in IMF programmes. However, striving to maintain such low inflation can have a deflationary impact on growth, particularly because such an approach often relies on maintaining high real rates of interest. Such a policy stance can precipitate prolonged recessionary conditions, in fact, if the source of inflation is adverse supply shocks—a common

occurrence in low-income countries (see IMF 2005b, p.24). Such a restrictive stance is of particular concern now with the rise in international oil prices.

As a result, the IMF has recently moderated its stance to accommodate inflation rates of 5-10 per cent, instead of insisting on rates in low single digits (IMF 2005b, p. 19). Allowing inflation to rise to moderate levels stems from the recognition that a dramatic scaling up of ODA, as envisaged for the MDGs, will expand domestic demand pressures, at least in the short run.

8 THE NEED FOR CAPITAL IMPORTS AND DOMESTIC INVESTMENT

Relaxing inflation targets is a welcome, though limited, change. It will encourage governments to spend ODA instead of stockpiling it as reserves. But a 'Dutch Disease' phobia will still discourage governments from using ODA as a means to finance an increase in net imports. This will imply that resources will not be freed up from exports and import substitutes for allocation to domestic investment.

The following macroeconomic identity highlights the desirable general scenario.

$$\mathbf{Y \equiv (I_G + C_G)\uparrow + I_P + C_P + (X - M)\downarrow}$$

The identity indicates that if ODA is both spent and absorbed, then government expenditures (I_G and C_G) should increase while net exports (X – M) should decrease. There is a transfer of real resources that is initially accommodated through a boost in real government expenditures. But such a transfer is not a sufficient condition for sustaining economic growth. This will depend, in part, on whether net imports accommodate an increase in capital imports and government expenditures accommodate an increase in public investment.

For sustainable economic growth to occur, capital imports (M_K) will have to contribute to an increase in private investment (I_P). Similarly, public investment (I_G) will have to increase and be able to stimulate private investment. Boosting investment will have a multiplier impact on income. These two channels, capital imports and public investment, are depicted below.

$$\Delta \mathbf{M_K \rightarrow \Delta I_P}$$

$$\Delta \mathbf{I_G \rightarrow \Delta I_P}$$

As a second-round effect of increased government expenditures, private expenditures should rise. At issue is the relative importance of private consumption (C_P) and private investment (I_P).

9 MOBILIZING DOMESTIC RESOURCES

ODA's impact on domestic investment is a crucial issue. Equally important is the impact of ODA on domestic resource mobilization, namely, on the ability (and willingness) of the government to mobilize public revenue and the desire of the private sector (households and businesses) to save.

An influx of ODA that finances government deficits could be a disincentive to governments to augment public revenues.[8] While this impact is plausible, the evidence for it is mixed. A 2003 IMF study finds a modest negative impact of aid on the mobilization of domestic revenues, especially if aid is provided through grants not loans (Gupta et al. 2003). However, it is difficult to separate such a second-round effect from other overriding factors, such as trade liberalization (Keen and Simone 2004).[9]

The impact of ODA on the mobilization of domestic revenue deserves more expanded treatment than is provided here. It is clear, however, that a priority for the use of ODA should be to enhance national capacities to mobilize public revenue. On average, tax revenue has fallen marginally or changed very little in recent years in developing countries (Table 5). The unweighted average for tax revenue as a percentage to GDP in low-income countries is now about 15 per cent. But this average level should be regarded as a *minimal* threshold. Governments need to find ways to augment revenues to a level that is at least one fifth of GDP if they are to attain the capacity to supply essential public services and finance their own public investment.

TABLE 5
Tax Revenue in Developing Countries (Per cent of GDP)

Group	Tax Revenue (Early 1990s)	Tax Revenue (Early 2000s)
Developing Countries	17.9	17.6
Low-Income Countries[a]	15.2	14.8
Sub-Saharan Africa	16.3	15.9
Asia & Pacific	13.6	13.2

Source: Keen and Simone 2004 (referenced in Gupta et al. 2005, Table A5). 'a' denotes PRGF-eligible countries.
Note: Percentages are unweighted averages.

In addition to concern about a negative impact of ODA on domestic revenue, there is also concern that an aid surge will weaken efforts to raise domestic savings. This will depend, to a great extent, on whether ODA boosts both public investment and private investment.

The following macroeconomic identity helps clarify the relationship among savings, investment and the trade balance. In a non-conventional way, it separates out public investment (I_G) from government consumption (C_G) in order to highlight the role of both public and private investment. Hence, the left hand side of the macroeconomic identity represents private savings (S_P) and public savings, which is defined by the current budget balance—i.e., taxes (T) minus current government expenditures (C_G).[10]

$$\mathbf{S_p + (T - C_G) \equiv I_P\uparrow + I_G\uparrow + (X - M)\downarrow}$$

What the identity shows is that if the real exchange rate appreciates, then the trade balance will deteriorate because imports (M) will rise relative to exports (X). This could correspond to a lower level of domestic savings. But a significant proportion of ODA-financed government expenditures injected into the economy should be public investment (I_G). And such investment, along with other supportive public measures, should stimulate private investment (I_P).

Hence, increases in public and private investment should correspond to an increase in domestic savings. The identity illustrates that the impact of ODA on domestic savings is integrally related to the performance of investment. But the identity does not reveal the behavioral relations among these variables. For instance, the debate between Neo-classical economists and Keynesians is over the causual relationship between savings and investment. Does investment boost savings (through the Keynesian multiplier) or does savings determine investment (through Say's law of supply creating demand)?

As an injection of foreign savings, ODA has the potential to bolster domestic investment. But this depends, in the first instance, on ODA's conversion into public investment. If government expenditures fuel a domestic consumption boom, this is likely to spill over into an intensified appetite for imported consumption goods. As ODA-induced consumption grows, private savings (S_P or disposable income minus consumption) is likely to fall.

Transforming aid into domestic public investment is critical to forestalling such a trend. But also critical is the development of a healthy domestic financial system. Despite enjoying financial deepening since the 1990s, commercial banks in developing countries remain reluctant to lend for long-term productive investment (see McKinley 2005). Instead, they lend primarily for short-term purposes, i.e., for consumer durables, working capital, trade and government securities. When governments attempt to 'sterilize' ODA-provided foreign exchange reserves, as this paper has already discussed, they are likely to drive up the real rate of interest and dampen the demand for loanable funds. This will abort the expansion of the economy that the ODA-financed increase in government expenditures could have stimulated.

The weakness of the financial system in most developing countries highlights the need for directing a significant proportion of ODA to strengthening it. This represents a form of 'investment' in national capacities that—like development of the state's capacity to mobilize revenue—can reap high returns. Strengthening the financial system is essential to mobilizing domestic savings and allocating it to private investment, and thus to long-term sustainable growth.[11]

10 CONCLUDING REMARKS

The response of this paper to the question in its title ("Why Is 'The Dutch Disease' Always a Disease?") is that the impact of ODA need not be negative. 'Dutch Disease' symptoms, such an appreciation in the real exchange rate, might arise in the wake of a surge in ODA but such symptoms can be a sign that ODA is having its intended effect, namely, promoting a transfer of real resources to developing countries.

An ill-advised use of an ODA surge can pose macroeconomic problems, such as rising inflation and an appreciating exchange rate can. But if the additional foreign exchange is used not only to increase government expenditures but also to boost net imports, these problems should be manageable. In other words, the best use of ODA is to both 'spend and absorb' it.

The composition of government expenditures and the composition of net imports do matter, however. If ODA is to contribute to sustainable growth, governments should prioritize public investment and encourage capital imports. Both can help contribute to an ensuing rise in private investment relative to private consumption. If an ODA surge is allowed to fuel primarily a consumption boom, then its long-term net impact might well be negative.

This paper stresses the importance of channeling aid into strengthening national capacities to mobilize public revenue and domestic savings. Most governments in developing countries need more public revenue, not less. So ODA should not be allowed to substitute for more concerted efforts to improve tax systems. Similarly, financial systems need to be strengthened in order to improve the mobilization of domestic private savings. Additional incentives and reforms are also needed to encourage financial institutions to lend for long-term private investment. These are issues related to the longer-term challenge of enhancing the 'absorptive capacity' of developing countries.

Governments should be able to manage the short-run macroeconomic effects of a surge in ODA. The ultimate impact of ODA depends, however, on how it affects public revenue and domestic savings. While this paper introduces these issues, a fuller discussion will be taken up in future papers.

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NOTES

1. The term 'Dutch Disease' was used to describe the adverse impact of a discovery of natural gas on Dutch manufacturing because of a surge in income and consequent appreciation of the real exchange rate.

2. ODA could be used for multiple desirable purposes. It could prevent a decline in human development, such as combating the HIV/AIDs epidemic. It could directly promote human development, such as improving child nutrition. Or it could contribute to domestic investment, such as in infrastructure or human technical capabilities, which should accelerate economic growth. This paper concentrates on the last aspect.

3. It could also import foreign goods and services—a point to which we return later.

4. "Public investment can crowd-in private investment in [sub-Saharan Africa]. Crowding-in likely reflects the complementarity of private investment with some components of public investment, especially infrastructure" (Gupta et al., 2005, p. 25).

5. Even if the real exchange rate appreciates, this could benefit tradable sectors if a sizeable proportion of their inputs were imported. In addition, governments could use various measures—such as the targeted selling of foreign exchange—which could enhance the competitiveness of export sectors by facilitating their access to imports.

6. Adams and Bevan maintain that such a focus on non-tradables would have a regressive distributional impact on the poor. Others have argued that promoting tradables would be pro-poor. However, a much more disaggregated approach would be needed in order to clarify the distributional implications. The categories of 'tradables' and. 'non-tradables' are too broad to lend themselves to useful policy conclusions.

7. The central bank could have achieved a similar impact by increasing the reserve requirements of commercial banks or moving public-sector deposits from commercial banks to the central bank.

8. Some commentators advocate that ODA should be used to lower tax revenue in order to transfer more resources to the private sector. But most developing countries need to raise their level of tax revenue, not lower it.

9. In those countries with decreases in revenue, trade liberalization has often been a major cause. In sub-Saharan Africa, for example, trade taxes have dropped by two percentage points of GDP; this represents a decline of over one third in such revenue (Gupta et al. 2005, Table A5).

10. As discussed earlier, some fiscal analysts have advocated that the IMF should shift the focus of its budget analysis from the overall fiscal balance (including capital expenditures) to the current fiscal balance in order to give greater encouragement for financing infrastructure (see IMF 2004). Our macroeconomic identity is based on this procedure.

11. The need for strengthening financial institutions in developing countries should be obvious whether one's perspective on the savings-investment relationship is Neo-classical or Keynesian. We reserve a more elaborate discussion of the savings-investment nexus for another paper.

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