A Note on European Development Policy after the Crisis

Arne Bigsten
Department of Economics
Gothenburg Centre for Globalization and Development
University of Gothenburg
SE 405 30 Gothenburg, Sweden
Email: arne.bigsten@economics.gu.se

January 2010

This workshop addresses three issues: Why should there be European aid? Where should it be directed? What modalities should be used? The answers to the first two questions seem straightforward, and I have discussed them before.[1] So here I focus on the last question. I do believe that the character of aid modalities[2] is a key determinant of aid effectiveness.[3]

To be able to reduce poverty developing countries need sustained growth. For Sub-Saharan Africa (the poorest region) to sustain the growth process and to achieve a real economic take-off it must become an attractive arena for private sector investment, and for that to happen it must provide an economic environment that is conducive to export production. Unless investors, domestic or foreign, find it in their interest to use Africa as a base for production for the world market, no investment boom will happen there. When aid policies are formulated one should therefore consider the implications of interventions for private investment and exports.

The global economy is in a deep crisis and global output and trade has declined dramatically. The developing countries have generally done better than the developed ones this time, but even they have had major economic setbacks and are certainly more vulnerable. Sub-Saharan Africa saw per capita incomes decline in 2009 for the first time in a decade. The declines in terms of trade and exports turned Africa's current account balance severely negative. In the North there is a process of deleveraging and flight to safety. This has reduced the capital inflows in the form of foreign direct investment and in the form of transfers. At the same time domestic fiscal revenues have declined. The challenge now is to contain the decline and then to get on track for sustained higher growth rates.

Although there is less interest in lending or investing money in Africa by industrial economies due to the crisis, the chances of productivity improvements and catch-up are there. The decline in inflows has had negative growth effects in developing countries, but in the medium term at least it is maybe not primarily lack loanable funds that constrain growth but the lack of good investment opportunities in the tradable sector. Rather low profitability in private

[1] See Bigsten, "EU Development Policy: The Way Forward", in *The Fragmented Power*, Ed. André Sapir, Bruegel, 2007, for a more comprehensive discussion on some of these issues.
[2] The Paris Declaration covering ownership, alignment, harmonisation, managing for results, and mutual accountability provided a comprehensive agenda for aid processes.
[3] The EU is committed to providing 0.7 percent of Gross National Income (GNI) in aid no later than 2015, and to support the debt reduction initiatives that are in place. Given the impact of the current crisis in Europe it seems obvious that many European countries will not honour this commitment.

investment in modern tradable production is the key concern. And profitability of investment is certainly linked to competitiveness in the international markets.

Donors now need to consider both what need to be done in the short term to stabilize the economies and what is required for long term growth and poverty reduction.

Let us first consider the stabilization issue. Globalisation has meant increased the vulnerability of poor economies to external shocks and that the scope for irresponsible policy has shrunk. The shocks were previously mostly related to trade, but they have increasingly come to be financial shocks. It is also noteworthy that financial flows to LDCs follow a pro-cyclical pattern, with negative effects on growth. The issue of stabilization is at the top of the agenda at present, but even in normal times African economies are vulnerable to economic shocks and need stabilization support.

Since many countries in SSA now suffer from significant budget shortfall, that donors should try to compensate for this. Here donors should coordinate their interventions to make efficient use of their resources to counter the current crisis. The European Community (EC) could also seek to secure the access of developing countries to the international financial markets to make it easier for them to pursue countercyclical macro policy. Since recipients generally have serious implementation and institutional constraints it would be preferable if aid can be given to suffering countries in the form of budget support.

What is the scope for comprehensive European strategies for long-term development assistance (beyond the crisis)? A key issue when we discuss European development policy is to consider to what extent and how the European Community should function as a coordinator of the activities of its member states. The official argument for the choice of direction of EC development policy is that it has comparative advantages in some respects. However, when looking at the aid activities of the EC it seems to do more or less the same things as its member states, which would suggest that it is just one more aid player making coordination more difficult rather than facilitating it. So far, the EC does not effectively fill any coordinating function. Nor is it clear that EC aid is more efficient than bilateral aid – rather the reverse. So it may be hard to see what the added value of EC aid is relative to bilateral aid.

However, one possibility would be to let EU formulate development policy statements that cover also the aid programmes of member states. In the long term one could even go so far as to let the bilaterals pool their resources in EC coffers. This would be a huge political challenge, and it is hard to see that it can be realised in the near future. If EC aid instead continues more or less on its present scale (the likely scenario in the short term), consideration needs to be given to how coordination can be improved between EC aid and bilateral aid – and with aid from other donors. Providing more general forms of aid, such as balance of payments support, would lessen the coordination problem and increase recipient ownership. To the extent that different donors finance the same project or programme, one donor (bilateral or the EC) could act as the coordinating agent responsible for government contacts and follow up.

Apart from coordinating classical aid interventions one also needs to consider the need to reduce the asymmetries which characterise the global economic system. This is required when it comes to the influence within the IFIs, but also with regard to policies on global public goods. There are many areas which are important here relating to e.g. international pandemics, environment, regulation of international transactions, and global financial stability. A related area is the international system of trade and WTO. Since the EC handles the WTO negotiations for all member states, this is a natural area of strong EC involvement. The EU should develop a policy on the IFIs. It should review the international aid architecture and evaluate if a better division of labour can be envisaged. One needs a better system of allocating resources to the multilateral institutions. The EU should also take a stance on the governance of global economic institutions.

Aid to governments affects growth and development via two main channels. It provides resources that can be used for investment (or consumption) and it affects government behaviour. It seems rather clear that the major constraints on development in SSA lie in the areas of policy and institutions. An important question in this context is therefore whether the international community including the EU can change institutions through aid and conditionality. The World Bank has been reluctant to push for accountable governance, but here the EU countries and the EC can take the lead because they are less constrained than the IFIs when it comes to making politically-sensitive interventions. The EC may here have a comparative advantage relative to the bilateral donors and the International Financial Institutions (IFIs) when it comes to pushing for changes on the governance front. Since these areas probably will become more important, this may be reason enough not to abandon EC aid.

The greatest political challenge in Africa has been on the side of policy implementation, where the severe problems are due to both lack of competence and lack of incentives to do the right things. For policy reforms to be credible and sustainable they should be grounded in a democratic process. Democracy has two important dimensions: electoral competition, and checks and balances. System scrutiny is needed to achieve honesty, and other systems are needed to achieve efficiency. Scrutiny is a public good and donors may need to consider what can be done to support it. They could stimulate peer group evaluations, help improve access to information and to build the capacity to analyse it. One could possibly seek to shift from classical policy conditionality to governance conditionality, since the former has tended to undermine accountability to citizens. A good system would be common to all donors, predictable and agreed. This is an area where the EC could have a comparative advantage relative to the member states. This would both push European democratic values, while it at the same time improving efficiency

To be able to integrate with the world economy, developing countries need to have systems in place that make it possible for them to be an arena for outsourcing and FDI generally. This requires systems that can guarantee quality and timely deliveries. If products are part of process and a marketing drive it is fatal to deliver late. Stability and security are therefore essential for LDCs if they are to benefit from the forces of globalisation. This certainly requires major infrastructure improvements, but in a situation when governance is poor donors may have to seek other routes to support investment. For example the Economic Partnership Agreements are a major new feature of the relationship between the EU and the ACP countries. This could certainly be used to support crucial country drives for private investment and export promotion. It may also be the case that the government lacks capacity to handle aid effectively, which means that it may be advisable to seek channels outside the government instead of overburdening it with project support. One could for example try to set up investment institutions that support private investment directly, rather than trying to do so indirectly via support for government infrastructure and the like. If this were successful it would also strengthening civil society, which would possibly enhance governance. So it seems possible that one could seek to establish investment banks operating in the commercial market.

Arne Bigsten