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Aid, Real Exchange Rate Misalignment, and Economic Growth in Sub-Saharan Africa

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Summary. — Generating sustained growth in Sub-Saharan Africa (SSA) is one of the most pressing challenges in global development. As the region clearly needs assistance to jump start its development, foreign aid becomes crucial. This paper investigates the nexus between foreign aid, exchange rate misalignment, and economic growth in SSA. Contrary to conventional wisdom, we do not find aid to be a major contributor to exchange rate overvaluation. In addition, we found that aid fosters growth but its impact is weaker in countries with overvalued exchange rates. Furthermore, we found that overvaluation reduces growth but its negative effect is ameliorated by financial development.

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1. INTRODUCTION

Generating sustained growth in Sub-Saharan Africa (SSA) is often cited as the most pressing challenge in global development. Given SSA's disappointing growth record, analysts predict that most of its countries will not meet the Millennium Development Goals (MDGs) by 2015. Prompted by this concern, the international development community has been considering a major scaling up of development aid, especially for those relatively well-managed countries that demonstrate ownership of development programs and progress in governance and institutional capacity (World Bank, 2008). Scaled up aid is necessary for these countries to finance their pressing needs and to eventually achieve the MDGs. However, aid-recipient countries would need to spend aid wisely, which would require both economic management institutions and political processes for enforcing transparency and accountability. Donors also have to adopt aid delivery mechanisms that promote ownership, transparency, and stakeholders' participation in the development process. These issues have already attracted considerable academic and policy interest.

However, rapid aid surges—like commodity-price booms—could also pose serious challenges for macroeconomic stability, especially if they produce significant disequilibria in the real exchange rate (RER) and induce the well known “Dutch Disease” phenomenon. Aid is a key determinant of the RER, through its influence on domestic spending and saving decisions. The more aid is spent, the larger is spending on non-traded goods and services, and the larger is the share of aid that is saved to build up net domestic-currency public sector assets, the larger is the ensuing RER appreciation, with potential negative effects on output and employment—the so-called Dutch disease. In this context, excessive aid

dependence could have a detrimental impact on non-traditional exports and thus undermine an effective source of dynamic growth. This is the main concern of this paper, where we ask the following pivotal question: what impact does real exchange rate misalignment, especially overvaluation, have on growth and aid effectiveness?

As an economy-wide relative price (of traded to non traded goods), the RER acts as a signal for inter-sectoral resource transfers and factor movements (human capital, labor, and physical capital) and, thus, provides the incentives to economic agents that largely shape economic activity. Since resource relocation is usually a resource and time-consuming process, RER misalignment can be costly, especially when such changes are frequent or substantial, or when they do not correspond to equilibrium adjustments. During relocation resources may remain idle, in the form of unemployment or excess capacity, negatively affecting the living conditions of the population.

The existing literature suggests that maintaining the RER close to its equilibrium level is a necessary condition for sustained growth and that countries that avoided overvaluation have been associated with sustained export-led growth and substantial export diversification (e.g., Elbadawi & Helleiner, 2005). Moreover, not only avoiding overvaluation is necessary for growth but a mild undervaluation may be good for growth (e.g., Aguirre & Calderon, 2005). Calamitsis, Basu, and Ghura (1999) point out the dual role of RER depreciation. On the

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upside, depreciation of the RER has a positive effect on growth by increasing capacity utilization and raising the profitability of traded goods sectors which in turn promotes private investment. Moreover, a depreciated currency provides an economy-wide incentive to new potential exportable products that might face high entry barriers under an excessively strong currency. Further, RER depreciation avoids the necessity of selecting beneficiaries for export subsidies (i.e., “picking winners”) as it promotes all exporting industries. On the downside, RER depreciation raises the cost of imported goods and since a large component of investment goods in developing economies is imported, such depreciation can dampen investment and lower growth.

Recently Rodrik (2008) argued that these empirical findings are, in fact, a reflection of a deeper causal effect: countries that have managed to engineer an RER undervaluation (e.g., China, Republic of Korea, Taiwan, Uganda, and Tanzania) appear to have indirectly resolved (or provided a cushion against) deep institutional constraints. First, weak institutions create a wedge between private and social returns. Second, to the extent that traded goods may be more “complex” and entail more transaction-intensive activities, the wedge between private and social returns may be more severe in traded than non-traded economic activities and can lead to static misallocation of resources in favor of the latter and greater dynamic distortions in the former. When the traded-goods sector is more dynamic, as would be expected in many low-income, small economies, an increase in the relative prices of traded to non-traded goods can improve static efficiency and enhance growth in a second-best fashion. Therefore, RER undervaluation can be an alternative approach for alleviating the costs associated with such institutional weaknesses. Another theoretical justification for engineering an RER undervaluation strategy is based on the view that traded goods (particularly new and non-traditional ones) are subject to a variety of market imperfections, such as information externalities (learning and cost-discovery externalities) and coordination externalities. These imperfections keep output and investment in traded sectors at sub-optimal levels. Again, by raising profitability of traded sectors, an RER undervaluation can be an effective strategy for increasing growth in a second-best world.

The above reviewed literature indicates the role of the RER as a growth fundamental and as a key ingredient for any successful export-oriented development strategy for low income countries. However, critics of the RER-led growth strategy argue that it is not feasible because the real exchange rate, being an endogenous relative price, is not an exogenous policy instrument at the disposal of economic authorities. On the other hand, more recently Levy-Yeyati and Sturzenegger (2007) have shown that sterilized intervention has been an effective instrument for achieving RER depreciation in the short-to medium terms. Moreover, even when recognizing that RER is not a direct policy instrument, proponents of the RER undervaluation—as a growth fundamental (e.g., Rodrik, 2008; Williamson, 1997) or as a facilitator of economic expansion (e.g., Eichengreen, 2007)—argue that while the RER is endogenous, it can nevertheless be managed. For example, Rodrik (2007) proposes several policy levers that policy makers might deploy for managing the real exchange rate.

Section 2 asks the key question as to why this study focuses on SSA and highlights the centrality of the RER in the overall development strategy of SSA. Section 3 reports estimation results for the determinants of the RER, based on a world sample of 83 countries and annual 1980–2004 data, focusing, among other fundamentals, on the role of aid. Given the focus on Africa, and as a robustness check of the relevance of the

global model to this region, the same model is estimated for a sub-sample of only SSA countries. The main results on the determinants of the RER remain intact, especially with regard to the role of aid. This allows us to subsequently derive measures of RER equilibrium and RER misalignment in SSA and analyze the role of fundamentals *versus* other short-term error-correction factors. Probing further, Section 4 builds a typology of RER misalignment across groups of African countries and highlights structural and policy characteristics that may explain such behavior. Section 5 reports estimation results for a growth model based on a world sample of 77 countries and 5-year data spanning 1970–2004. We also check for robustness of the growth results, especially with regard to the impact of RER misalignment and its interaction with aid, against the choice of RER misalignment index as well as the period of estimation. In both cases the pivotal findings of the main primary results are found to hold. The growth specification allows testing for the influence of foreign aid and RER misalignment on growth, controlling for standard growth determinants and allowing for key interactions between aid, RER misalignment, and financial development. Section 6 contains a summary of the key findings.

2. WHY ARE THE REAL EXCHANGE RATE AND FOREIGN AID SO CRITICAL FOR GROWTH IN SSA?

The literature suggests that resource misallocation away from export-oriented sectors has been substantial and particularly harmful in SSA.¹ The external sector is vital for most African economies since their domestic markets are small, their production base is not well-diversified, and human capital levels and the adoption of technology are low. For such countries, economic growth depends largely on the fate of the exporting sectors which provide the main source of foreign currency, contribute substantially to government finances, attract foreign direct investment and, eventually, lead to productivity gains that are at the heart of sustained growth.

Distorted relative prices arising as a result of exchange rate overvaluation affect human and physical capital accumulation. In turn, this affects exports and growth patterns. In the specific case of SSA, Cottani, Cavallo, and Kahn (1990) find that overvaluation is strongly related to low growth. It is also related to low productivity as capital does not go to the companies or sectors that could make the best use of it. Ghura and Grennes (1993) and Fosu (2000) obtain econometric evidence that confirms the negative impact of overvaluation on labor productivity for SSA countries, even when controlling for investment rates. The latter is consistent with the notion that not only investment declines as a result of overvaluation but that resources are also poorly allocated. Moreover, the level of the real exchange rate affects competitiveness directly, through the return to investing in traded-goods industries, and indirectly, by affecting the use of comparative advantages. This problem has been documented in the case of Africa by Elbadawi (1998) and Mengistae and Pattillo (2002). Furthermore, not only the level of RER impacts economic growth; fluctuations in the RER can also induce substantial uncertainty to investment decisions and, as a consequence, hamper investment and long-run growth (Caballero and Corbo, 1989). Bigsten *et al.* (2004) provide evidence that exporting activities in Africa increase firm productivity not just because of self-selection effects but also because of learning-by-exporting.

The World Bank (2000) has convincingly argued that in order for Africa to be successful in the 21st century, it needs to move away from its near total dependence on traditional

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