

Session 2

Aid Modality and Aid Effectiveness

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Policy-Based Lending Operations
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ADB

Overview

A successful aid program requires matching elements of **development strategy**, **appropriate aid strategy** supported by **well-designed modalities** and **effective implementation**.

Aid Modality:

An instrument that transfers aid from donors to recipients

Outline of the Presentation:

- Economic rationale of Aid
- Economic rationale behind aid modalities
- Aid effectiveness and aid modalities
- Choice of aid modality

Overall:

Help put PBL in a broader perspective

What is foreign aid?

Aid

- Transfer of money, goods, and knowledge from donors to recipient countries
- Concessionary (25% grant) capital flows from donors to recipient countries

Aid vs. commercial capital flows

Official Development Assistance (ODA)

- Concessionary resource flows from donors to recipient governments

Effective development Assistance (EDA)

- Grants and grant equivalent of loans

Why foreign aid?

Supply Side Motives

Altruistic: Humanitarian, crisis, developmental motives (global public good), resource availability

Non-altruistic: Foreign policy and commercial motives

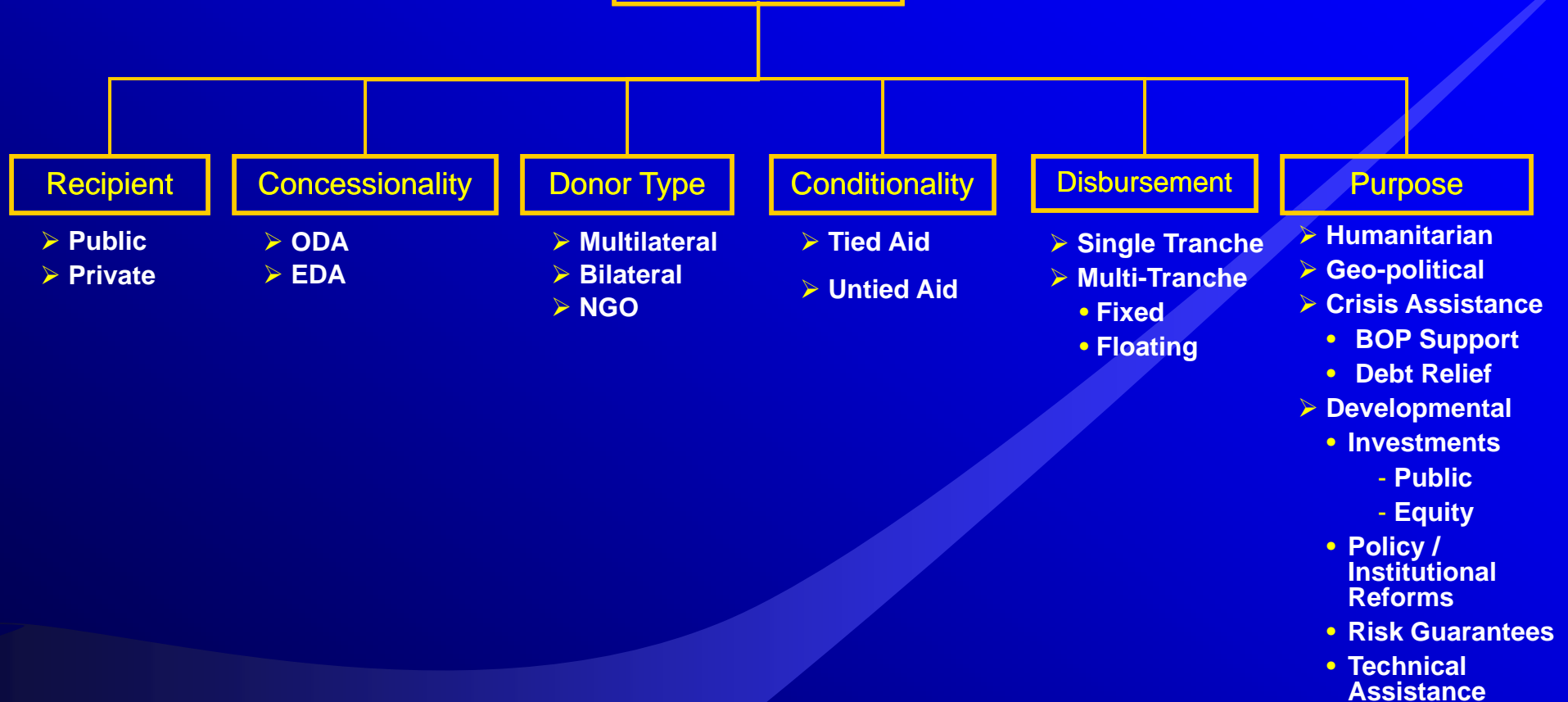
Demand Side Motives

Recipient countries need money, goods, and knowledge but unable to finance due to local and international market imperfections:

Development Bank Paradigm

- Information asymmetry in capital markets
- Many good projects have:
 - Long gestation periods
 - Heavy sunk costs
 - Social benefits occur far in the future
- High risk for commercial lenders
- Commercial capital flows end-up in few countries

AID Loans/Grants



Evolution of Developmental/Aid Paradigms

Aid/Development Thoughts in 1950s and 1960s

Marshall plan

Big – push

The gap models

Income distribution, basic needs

Evolution of Developmental/Aid Paradigms

Aid/Development Thoughts in 1990s

End of Cold War: Geopolitical and foreign policy motives no longer mattered

Altruistic goals occupy center stage.

Post-Cold War empirical evidence - "No effect of aid on growth"
- Inconclusive evidence of the 1980s

Disappointing growth outcomes of the first generation
conditionality-based structural adjustment initiatives in the
1980s

Continued misery and destitution in aid-dependent Sub-Saharan
Africa

Growing demand for "participation" and inclusion, by NGOs

Evolution of Developmental/Aid Paradigms

Aid/Development Thoughts in 1990s

Growing claim that “poverty reduction” was being marginalized by too much focus on growth

Poor coordination among donors - Taxing the capacities of LDCs and diffused aid delivery.

New empirical results - effective aid conditioned on good macroeconomic environment.

Institutional Deficit and Rule of Law - Governance

Evolution of Developmental/Aid Paradigms

New Aid Paradigm (NAP) how aid is delivered is as important as the aid itself.

DAC (1996) proposed the international development goals:

- local ownership
- partnership

The "**Challenge of Inclusion**" - "driver's seat" vs "passenger" in the development enterprise.

World Bank's *Comprehensive Development Framework*

Evolution of Developmental/Aid Paradigms

2005 Paris Declaration on Aid Effectiveness:

- (i) Ownership
- (ii) Alignment
- (iii) Harmonization
- (iv) Managing for results; and
- (v) Mutual Accountability and Partnership

The Millennium Challenge Account (MCA, 2004) of the US government

The 2006 UN Millennium Development Goals (MDG).

Inclusive Growth?

Aid Modality

A tool, an instrument, or form that transfers aid from donors to recipients.

Two basic forms:

- Project Aid
- GBS – General Budget Support

Project Aid

A form of aid to finance activities with a limited objective, budget, and time-frame to achieve specific results

Earmark expenditures to specific activities to achieve coherent objectives with defined outputs and inputs

GBS

Covers financial assistance as a contribution to host government's overall national budget in support of general development strategy agreed between donor and host country government.

Do it all by donors or write a cheque and monitor the progress ?

PBW and SBW

Donor dysfunction and recipient dysfunction



Table 1.1 Development Priorities and Aid Modalities

Era / Priorities	Aid Modality
1950s: <ul style="list-style-type: none"> • Capital Deficit • Knowledge and Technology Gaps 	<ul style="list-style-type: none"> • Project Aid (PA) and BOP support • Technical Assistance (TA)
1970s: <ul style="list-style-type: none"> • Income Distribution • Basic Needs 	<ul style="list-style-type: none"> • More PA for rural development and investment • Ditto
1980s: <ul style="list-style-type: none"> • Stabilization • Structural Reforms 	<ul style="list-style-type: none"> • Project Aid • BOP Support • SALs and Secals (Sectoral Adjustment Loans)
1990s: <ul style="list-style-type: none"> • Structural Reforms • External Debt 	<ul style="list-style-type: none"> • Project Aid • SALs and Secals • Program Aid linked to debt relief; HIPC Initiative; Sector Development
2000s: <ul style="list-style-type: none"> • Institutional Deficit • Poverty Reduction 	<ul style="list-style-type: none"> • Project Aid • Program Lending for Institutional Reform, Sector Development, Rule of Law • PRSC / IMF's PRGF

ADB Aid Modalities

PROJECT LOANS

A form of aid to finance specific activities with a limited objective, budget, and a timeframe to achieve specific results

SECTOR LOANS

Assistance to a sector or subsector for project-related investments in a geographic area (area slice), over a period of time (time slice), or both.

- Enable an integrated focus on
 - sector development perspectives
 - sector policies
 - sector development plans and institutions
- Sector lending is appropriate when a number of **subprojects are to be financed**

ADB Aid Modalities

PROGRAM LOANS

Provide assistance in developing a sector and improving performance through **appropriate policy and institutional improvements**

- Finance is to cover the **immediate adjustment costs** arising from policy reforms
- Potential to have sector-wide and economy-wide impacts

ADB Aid Modalities

SECTOR DEVELOPMENT PROGRAMS (SDP)

Combination of an investment (project or sector) and a policy-based program as well as attached technical assistance (TA)

- SDP fosters an integrated and generally long-term approach to sector needs
- Useful when a sector requires both investments and some policy reform, but where the investment component is unlikely to be accomplished without policy reforms

ADB Aid Modalities

EMERGENCY ASSISTANCE LOANS (EAL)

Short-term and small loans to help rebuild high priority physical assets and restore economic, social, and governance activities after emergencies

EALs are designed to mitigate immediate losses to priority assets, capacity, or productivity rather than to provide relief or comprehensive reconstruction

ADB Aid Modalities

FINANCIAL INTERMEDIATION LOANS (FIL)

Provided to eligible financial intermediaries (FIs) for on-lending to subborrowers for eligible subprojects, at the FI's own credit risk.

- Provided to FIs to finance specific development projects whose individual financing requirements are not large enough to warrant direct supervision by ADB
- FILs are provided in support of private sector-driven economic growth and poverty reduction
- Considered when there is effective demand for credit by potential sub-borrowers which cannot be met through existing sources

ADB Aid Modalities

MULTITRANCHE FINANCING FACILITY (MFF)

Flexible framework for loans and guarantees, applied to an investment program coming out of a roadmap; spread over time in “slices” or tranches; combines physical and nonphysical investment activities

- Typically will include multiple subprojects, sequenced over the medium to long term,
- Provides a financing plan for a program of investments in an integrated package or series of related projects intended to achieve an overall development outcome
- Provides the ability to secure financing “as it is needed” against the agreed plan. Commitment fees only applied on committed amounts

ADB Aid Modalities

NON-SOVEREIGN PUBLIC SECTOR FINANCING FACILITY

Loans and guarantees for development projects on a direct basis to selected non-sovereign public sector entities without central government (sovereign) guarantees

- ADB assumes the credit risk of the borrower without additional support from the central government
- Financial terms are set on a commercial basis, similar to private sector loans

ADB Aid Modalities

REFINANCING FACILITY

Selective support to the restructuring of existing projects that may require additional capital or that could benefit from improved financing arrangements

- Designed to provide additional flexibility and facilitate ADB's involvement in existing projects and programs
- Also allows expansion of projects with additional capital and the provision of management, technical, and policy advice

ADB Aid Modalities

LOCAL CURRENCY LOANS

Loans structured in the local currency of a DMC

Offering loans denominated in a local currency may help borrowers mitigate the potential mismatch between borrowing in a foreign currency and having income streams to repay liabilities in its domestic currency

PRIVATE SECTOR OPERATIONS

Risk Guarantees

Equity Investments

Direct Loans

Modality (terminology) Harmonization

GBS

- Direct BS, Multi-sector BS, SBS
- ADB ?

SWAps

A mechanism for coordinating support to public expenditure programs with the objective of improving efficiency and effectiveness

Characteristics:

- Significant funding for a single policy/expenditure program
- Government leadership – country ownership
- Donor coordination, single source (TF)
- Gradual transition to GBS approach

ADB: Project Loans, Sector Loans, SDP, Program Loans, Program Cluster Approaches

The ADB logo consists of the letters 'ADB' in a white, serif font, centered within a dark blue square.

Modality (terminology) Harmonization

Program-Based Approaches (PBAs)

Similar to SWAps, may include more than one sector

Programmatic Approaches

Fosters an integrated and generally long-term approach to sector investment and reform needs

ADB – MFF, Sector Loans, SDP

DPL

World Bank's term for PBL

PRSC

WB's programmatic approach tied to medium term PRSP, typically consists of 2–3 single-tranche operations

Aid Effectiveness

Aid Effectiveness – Effect of Aid on GDP growth

Aid Effectiveness - General

1980 – Inconclusive

1990 – No effect on growth, increase the size of the government

Aid is effective under “good macro economic environment”

Aid Effectiveness – Grant vs. Loans

Government Allocation Responses to Loans and Grants

Aid Modality	Investment	Consumption	Tax Effort / Revenue	Borrowing
Grants	(-)	(+)	(-)	0
Loans	(+)	0	(+)	(+)

Clements et al. (2004); Odedokun (2003, 2004); Djankov, Motalvo and Reynal-Querol (2004).

- Loan conditions of good macro promote growth; grants don't (Swada et al. 2004)
- Degree of concessionality has no relationship to growth (Cordella and Ulku, 2004)
- Grants have a growth effect in poor, badly governed, highly indebted countries (Cordella and Ulku, 2004)

Project Vs Budget Support (Cordella & Del'Ariccia 2003)

- Unconditioned PA and BS has no Growth Effect
- BS conditioned on good macro positively related to growth
- PA conditioned on good macro has negative impact on growth

Tied vs. Untied Aid (Miguel-Florensa 2006)

- Tied aid has negative impact on growth
- Untied aid has a positive impact under good macro

Relative Characteristics of Aid Modalities

	Project	Sector	SDP	Program	GBS
Scale-Up Potential	Low				High
Donor Control	High				Low
Policy Change Prospects	Low				High
Implementation Failure Risk	Low				High
Fiduciary Risk	Low				High
Political Risk Vulnerability	Low				High
Cross-Cutting Benefits	Low				High
Donor Harmonization	Low				High
Recipient Ownership	Low				High
Transaction Cost	High				Low
Fungibility Risk	Low				High
Corruption Vulnerability	Low				High

Transition from yellow to red represents rising intensity from low to high

Aid Modality Choice

