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Why Aid Does Not Increase Savings Rates in **Sub-Saharan Africa?**

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Since the mid-1980s, sub-Saharan Africa has had the lowest savings and investment rates of any region in the world. It has also been the recipient of the highest levels of Official Development Assistance relative to output. Hence, many analysts have been concerned that ODA might be having a negative impact on domestic savings.

This would be the case if ODA mostly encouraged higher consumption rates, and did little to boost domestic investment. Has this been the case? This Development Viewpoint investigates this question (see Serieux, 2009).

Most previous analyses of this issue have presumed that aid could be used for either domestic consumption or investment. However, such analysis is incomplete since it also rests on the assumption that all ODA actually stays within the developing country.

Analyses have also fixated on the derived econometric relationship between ODA and domestic savings. This has been obtained by regressing the savings/GDP ratio on ODA/GDP (and other important explanatory variables, such as income per capita and the dependency ratio).

A resultant estimate of -1 for the coefficient for the ODA variable was presumed to indicate that ODA completely displaced domestic savings (and was, therefore, wholly consumed), while a coefficient of 0 would indicate that all aid was invested. Hence, an estimated coefficient that was negative and close -1 would help explain why both savings and investment rates remain so low in sub-Saharan Africa.

Displacing Savings

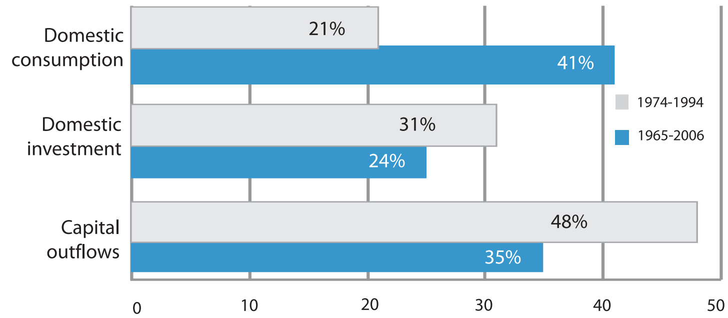
Most results have indicated that the coefficient ranges between -1 and 0 for the world as a whole and for most regions. But, curiously, the coefficient for ODA lies closer to 0 for sub-Saharan Africa than for other developing regions. This would appear to indicate that there is less displacement of savings by ODA in sub-Saharan Africa, and thus most aid is invested. But if this is true, why do domestic savings and investment remain so low in sub-Saharan Africa?

What such analyses ignore is that a significant part of ODA might be flowing back out of the country, without having had any impact on either domestic consumption or investment. In other words, the ODA-savings regressions have largely been misinterpreted. They have ignored reverse flows altogether – the third option for an outlet for ODA.

The reverse outflow of ODA could assume various forms. It could be used to reduce foreign liabilities, namely, by paying interest on foreign debt and principal payments on non-concessional debt. It could take the form of net acquisition of foreign assets by the private sector (capital flight) or by the public sector (reserve accumulation).

What does such a tripartite analysis (consumption, investment or capital outflow) reveal for sub-Saharan Africa? What share of ODA finances each of the three? To answer this question, we used panel data on relevant regression variables for 29 sub-Saharan African countries for the period 1965 to 2006. We regressed savings on total ODA/GDP as well as its two major components, Grants/ODA and Concessional Loans/GDP (together with other relevant variables).

ODA Results



Capital Outflows

We found that, at the margin, 35 per cent of ODA simply financed capital outflow. And only 24 per cent financed domestic investment. The remaining 41 per cent financed domestic consumption (see for the year 1965-2006). Grants had a significant coefficient of about -0.5 but loans were insignificant.

We then narrowed our period to 1974 to 1994, when ODA was almost continuously increasing, to see whether the trend of increasing ODA made a difference to those estimates. The percentage of ODA used to finance capital outflows jumped to 48 per cent while the percentage boosting domestic consumption dropped to 21 per cent. The record of financing domestic investment looked moderately better since the percentage rose to 31 per cent.

However, the overall results do not paint an encouraging picture. It is true that during the period in which ODA continuously increased, the share that financed domestic investment rose. However, this could be explained by the rising share of concessional lending vis-a-vis grants since the former had a positive impact on savings.

Most troubling was the rise in the share of capital outflows, namely, from 35 per cent (for the whole period) to 48 per cent (during the period of rising ODA).

The most likely outflows, especially during the late 1980s and early 1990s, were debt service payments. During the more recent period, accumulating foreign-exchange reserves may have become more important. But determining the composition of capital outflows is a topic for more in-depth research.

Reference:

John Serieux (2009). "Aid and Savings in Sub-Saharan Africa: Should We Worry about Rising Aid Levels?" Working Paper No. 50, Brasilia, International Policy Centre for Inclusive Growth.

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