How Financial Crises in Donor Countries Affect Aid

If aid flows follow historical patterns, the global financial crisis could reduce aid significantly over the medium term

The global financial crisis has been a major shock to the developing countries, reducing their income growth rate by 7 percentage points between 2007 and 2009. International aid has helped to cushion this shock, but there is now a risk that aid budgets could come under pressure. It is the donor countries that were hit first by the crisis, and as a group they suffered steep declines in income last year. Given the strains on their economies, donors’ willingness to give aid could fall, even though the need for aid remains great.

A recent paper by Dang, Knack, and Rogers looks at patterns of aid giving by donor countries hit by financial crises in the past, to give some insights into what may lie ahead. There is clearly cause for concern, because past experience shows that donor-country financial crises may be especially detrimental to aid giving. When banking crises hit five donor countries (Finland, Japan, Norway, Sweden, and the United States) in the 1980s and 1990s, average aid from these donors stagnated for a decade or more while aid from other donors continued to rise steadily (figure 1).

Of course, these drops in aid from crisis countries could reflect other factors—most obviously, the fall in per capita income that tends to accompany banking crises. Finland’s overall economic crisis in the early 1990s, for example, was especially deep and could have led to a sharp decline in aid even had there been no banking crisis. The authors therefore explore the relationship between banking crises and aid econometrically, to take account of such income effects and other important predictors of aid levels. They base their analysis on a comprehensive International Monetary Fund database of systemic financial crises, together with aid data from the Development Assistance Committee (DAC) of the Organisation for Economic Co-operation and Development.

They find that donor-country banking crises are associated with a sharp and long-lived drop in aid disbursements, over and above income effects. Five years after a systemic banking crisis hits, aid from the crisis country is an estimated 17 percent lower than it would have been in the absence of a crisis. Surprisingly, at that point aid is still declining (again, relative to the no-crisis counterfactual): it does not bottom out until 10 or 11 years after the crisis hits, at which point aid is down by an estimated 24 percent.

Nor does the result hinge on just a few outliers. Analysis based on a broader World Bank data set on banking crises—which includes both systemic and nonsystemic crises, for a total of 23 crises in 17 countries in recent decades—strongly confirms the finding that banking crises reduce aid. Moreover, these banking-crisis effects come in addition to the direct effects that declining incomes could have on aid: over the long run, each 1 percent decrease in GDP per capita is associated with a drop of about 3 percent in aid outflows.

One likely channel for these large banking-crisis effects is fiscal. In the wake of a crisis, aid is forced to compete in the budget with financial sector bailouts and other crisis-related expenditures. The fiscal channel could also explain why aid stagnates for so long after a banking crisis hits. Major banking crises have effects on fiscal positions that are especially large and long lasting, with public debt increasing by a daunting 86 percent on average in the first three years of crisis, according to Carmen Reinhart and Ken Rogoff (“The Aftermath of Financial Crises,” American Economic Review 99 [2009]: 466–72). Given these magnitudes, it is quite plausible that debt pressures lead governments to cut back or at least restrain growth in aid for years afterward.

What do these results imply for the likely path of aid disbursements over the next decade? If aid flows follow historical patterns, the global financial crisis could reduce aid significantly over the medium term (at least relative to the counterfactual). Not only have donor-country incomes dropped, but several donors have suffered banking crises or severe strains on their banking systems—including the United States, the United Kingdom, and

Figure 1. Trends in Mean Aid Disbursements from Crisis and Noncrisis Countries, 1977–2007

Note: First year of crisis normalized to year 1 for crisis countries.
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Ireland, which together accounted for a third of DAC aid in 2008. Historical patterns suggest that aid from these crisis-hit countries could fall by a fifth to a quarter in the coming years (again relative to the counterfactual).

Past is not necessarily prologue, of course. This analysis does not take into account any possible strategic interactions among donors, which may be particularly important at a time when the macroeconomic downturn and banking crises have been highly synchronized across donor and recipient countries. If donors coordinate, they may be able to reduce the collateral damage to aid. But if donors respond to others’ aid cuts by cutting back themselves, aid could take a severe hit in the years ahead.