Aid, Public Investment, and pro-Poor Growth Policies

Addis Ababa
August 16-19, 2004

A Training Seminar Organized by the
Ethiopian Development Research Institute, the Department For
International Development, the Swedish International Development
Cooperation Agency, and the World Bank

Background

In many low-income countries, key challenges in the practical design and formulation of pro-poor growth strategies relate to the macroeconomic effects of foreign aid (most notably on tax effort and the real exchange rate) and the dynamic trade-offs that national authorities face in allocating public investment between infrastructure, education, and health, and also with respect to the spatial allocation of public investment.

In the context of its operational work in Ethiopia, the World Bank has developed an operational macroeconomic model providing new insights on these issues, by stressing for instance the distinction between food and nonfood aid, the interplay between supply and demand effects of foreign assistance, and by identifying the various channels through which different components of government investment are transmitted to the economy’s supply side. At the same time, new applied policy tools have been developed to incorporate some of these linkages between foreign assistance, public investment, and growth, and help policymakers to elaborate consistent quantitative assessments of alternative growth and poverty reduction strategies. These tools are now being used in several low-income countries.

The World Bank has also developed an applied Computable General Equilibrium model for Ethiopia. The purpose of the model is to investigate how public investment can contribute to stimulate growth, using the differentiated economic potential of rural areas and their linkages with urban development. The model includes the key relevant

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structural characteristics of Ethiopia’s economy. It is a stylized version of market and non-market relations in the Ethiopian economy. The model includes 12 activities, 8 consumer goods and 3 household and firm types which are classified according to their income size and to their activities. It also includes a zonal distinction between highlands and lowlands that captures some of the basic elements of differentiation between favorable and less favorable agricultural landscapes. Therefore, it can be used to simulate the impact of various policies on major economic indicators such as GDP growth, labor markets, incomes, the government budget and external trade.

Objectives

The purpose of the seminar is threefold.

- First, it aims to strengthen analytical and practical understanding of the recent policy research on linkages between foreign aid, the level and composition and spatial/sectoral allocation of public investment, and growth, in the design of poverty reduction strategies in low-income countries.
- Second, it aims to familiarize participants with two applied macroeconomic framework, developed recently at the World Bank, which can be used to quantify medium-term strategies whose objective is to stimulate economic growth and reduce poverty in Ethiopia.
- Third, the Government of Ethiopia is currently working on assessing the MDG needs for the country with the objective of developing a strategy by December 2004. This work will also be one of the key building block of the SDPRP 2. The training will contribute to support this effort by reinforcing the analytical capacity of the macroeconomic team working on these tasks.

Description and Contents

The seminar will consist of eight sessions:

- **Session 1.** Macroeconomic Effects of Foreign Aid: An Overview.
- **Session 2.** Poverty and Low-Growth Traps: Concepts, Evidence, and Policy Implications.
- **Session 3.** Public Investment and Growth: Issues and Empirical Evidence for Low-Income Countries.
- **Session 4.** Aid, Public Investment, and pro-Poor Growth: An Operational Macroeconomic Policy Framework for Ethiopia.
• **Session 5.** Spatial/Sectoral Allocation of Public Investment and Differentiated Sector Supply Response.

• **Session 6.** Presentation of the Ethiopia Computable General Equilibrium Model.

• **Session 7.** Presentation of the Ethiopia Social Accounting Matrix.

• **Session 8.** Discussion of the simulations.

Session 1 will review the various channels through which foreign assistance affects the economy, including Dutch disease effects (with a distinction between short- and longer-term effects), the impact of foreign assistance on the government budget (through tax effort, recurrent expenditure, and the level of public investment). It will also highlight the distinction between food and nonfood aid, and differences in the channels through which these components affect the economy.

Session 2 will provide a review of various notions of “poverty traps,” beginning with the “circular relationship” between growth and poverty, and continuing with more recent concepts emphasizing multiple equilibria, inadequate nutrition and health, gender inequality, and geography. Policy implications and empirical tests of the existence of poverty traps will then be examined. The last part of the session will examine the case of Ethiopia.

Session 3 will review the mechanisms through which the level and composition of public investment (disaggregated into infrastructure, education, and health) affect growth and the supply side in general. It will then examine the empirical evidence on the links between the level and composition of public capital formation and growth, with particular emphasis on the evidence for sub-Saharan Africa.

Session 4 will bring together much of the material examined in the previous session and will present a complete macroeconomic framework, developed recently at the World Bank, that captures the links between the level and composition of foreign aid, the level and composition of public investment, growth, and poverty reduction. The model (which is linked to a household survey) is applied to Ethiopia, and various policy simulations will be discussed. In particular, the model will be used to calculate the level of non-food aid consistent with the achievement of a specific poverty target at a given time horizon, and to estimate the growth effects of changes in the allocation of public investment.

Session 5 will review the various transmission mechanisms through which the Spatial/Sectoral allocation of public investment in economic infrastructure affects the economy. In particular, recent economic literature insists on the positive effects of public infrastructure on supply, growth and poverty reduction. Also, international experience shows in a consistent manner the link between growth and investment in favorable rural zones. The session will also discuss these issues in the context of Ethiopia.
Session 6 will bring together the issues discussed in the previous session and will present an applied Computable General Equilibrium Model (ECGEM) for Ethiopia developed at the World Bank, that captures the link between the sectoral/spatial allocation of public investment and growth. The key components and the limits of the model will be presented.

Session 7 will present the Social accounting Matrix (SAM) developed by the World Bank for the ECGEM. The data sources and the method of construction will be thoroughly discussed.

Session 8 will discuss various simulations based on alternative public investment policies using the ECGEM.

**Organization**

The seminar will take place from August 16 to August 19, at EDRI in Addis Ababa. It will be delivered by Pierre-Richard Agénor, Lead Economist at the World Bank (on leave) and Dr. Omar Aloui (Consultant, World Bank). Dr. Agénor has been one of the leading contributors to the analytical and operational research on the macroeconomics of poverty reduction, and is currently leading a research agenda on the composition of public investment and growth in low- and middle-income developing countries. Dr. Aloui has more than 15 years experience in agriculture economics and is also advisor to the Moroccan Minister of Agriculture and Rural Development. Karim El Aynaoui (Economist, the World Bank) will also participate in sessions 2, 6, 4 and 8.

PowerPoint files will be used for each presentation and will be circulated in handout form to all participants. Participants will also receive a CD-ROM containing all the background papers and training materials used and referred to during the seminar.

**Target Audience**

Ethiopian officials (economists, advisors to policymakers on macroeconomic policy at the federal and regional level), World Bank staff, staff from other international organizations (IMF, AfDB, United Nations), academics, and representatives of donor agencies.

**Information**

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