Post-Conflict Aid, Real Exchange Rate Adjustment, and Catch-up Growth

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This paper shows that post-conflict countries receive substantial aid flows after the start of peace. However, aid flows are not well-synchronized with country capacity to absorb them. While post-conflict countries' capacity to absorb aid is built up only gradually, aid flows peak immediately after peace is attained and decline thereafter. The rise in aid flows leads to the expectation of increased overall demand for tradable and non-tradable goods, shifts of resources and factors of production to the non-tradable goods sectors, and appreciation of the real exchange rate. This is essentially the basic story of the Dutch Disease. However, the evidence of this paper shows that many post-conflict countries reduced public debt and increased international reserves substantially. The latter forms of saving aid contributed to avoid significant real exchange rate appreciation suggesting little prima-facie evidence of Dutch disease during post-conflict.

The empirical evidence on growth reveals that aid is an important determinant of growth and that peace only affects growth when combined with large aid. Real exchange rate misalignment has a large, negative, linear effect on growth. As post-conflict periods have been characterized by moderate real exchange rate overvaluation, the latter has reduced growth. Moreover, aid and real exchange rate overvaluation have a combined negative growth effect. However, the negative effects of real exchange rate overvaluation decline to a large extent with financial development. Hence financial reform has an additional bonus to neutralize the negative growth effect of real exchange rate misalignment.