Riding the Wave: Monetary Responses to Aid Surges in Low-Income Countries

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ABSTRACT. We focus on the management of highly persistent shocks to aid flows, including PRSP-related increases in net flows, in the presence of currency substitution by the domestic private sector. Such shocks have beneficent long-run effects, but when currency substitution is high they can produce dramatic macroeconomic management problems in the short run. What is the appropriate mix of money and exchange rate targeting in such cases, and the role of temporary sterilization? We analyze these and related issues in an intertemporal optimizing model that allows a portion of aid to be devoted to reducing the government’s seigniorage requirement. Our results argue that a managed float, with little or no sterilization of increases in the monetary base, is the most attractive approach.

KEYWORDS: Aid, Sterilization, Currency Substitution, Seigniorage, Africa.
1. Introduction

Since the early 1990s, African central banks have struggled to find the appropriate mix of money and exchange rate targeting when faced with highly persistent shocks to aid inflows (including PRSP- and HIPC-related increases in net flows).1 In many episodes, higher aid flows have attracted equally large inflows of private capital.2 The combined surge of official and private capital flows is beneficial in the long run but confronts policy makers with dramatic monetary management problems in the short run. The recent experiences of Uganda and Tanzania illustrate the policy conundrum. Following periods of steadily improving macroeconomic management and relatively stable growth, both countries saw official aid flows jump by several percentage points of GDP around the turn of the millenium. In a response suggestive of “fear of floating” (Calvo and Reinhart, 2000), the central banks quickly intervened in the foreign exchange market and bought up large quantities of aid dollars. Initially this intervention was combined with aggressive bond sales to sterilize the impact on the money supply; but sterilization caused real interest rates to rise sharply in the countries thin bond markets, fueling a large and rapid increase in debt-servicing costs and forcing the central banks into a decisive policy reversal. In Uganda this took the form of a greater willingness on the part of the authorities to let the exchange rate float, while in Tanzania aggressive intervention persisted but sterilization efforts were cut back and reserve money growth was allowed to exceed its IMF program target by a substantial margin (reflecting in part the authorities assessment that domestic money demand was rising sharply — see Buﬀie et al., 2004). The policy debate is still far from resolved and further changes in the policy stance have occurred in both countries. Here and elsewhere in Africa, policy makers confront the same diﬃcult question: what combination of changes in inﬂation, nominal and real exchange rates, and real interest rates should be used to absorb a persistent aid surge?3

The natural place to look for answers is in the vast literature on capital ﬂows to emerging market economies, which has wrestled with many of the problems that concern Africa’s central banks. But while the capital inflows literature is large, it contains little in the way of clean, precise results. This is not surprising. A full and rigorous treatment of the issues associated with capital inflows requires the analysis of multiple scenarios in multiple
models (fixed vs. flexible exchange rates and passive vs. active monetary policy, for a start). Researchers in the field have steered well clear of this task, relying instead on general theoretical principles to evaluate the likely effects of capital inflows and alternative policy remedies.

Conjecture informed by theory can generate useful insights. There is a limit, however, to what it can achieve. Despite all that has been written, the existing literature has not moved beyond a check list of things to think about. Controversy persists therefore regarding the efficacy of bond sterilization, the appeal of alternative approaches to absorbing domestic liquidity, and the relevance of underlying concerns about “overheating.” The lack of firm conclusions has inter alia prevented the literature from settling on a coherent bottom line for policy. Calvo, Leiderman, and Reinhart (1994), for example, recommend countering the undesirable effects of capital inflows through a combination of sterilization, fiscal adjustment, greater exchange rate flexibility, and (perhaps) higher reserve requirements. This may be the right policy response, but it is hard to escape the impression that it is a concession to ignorance, that the unspoken rationale is more or less: “We don’t have a good handle on the repercussions of different policy measures, so do a bit of everything and hope for the best.”

The message we take away from this critique is that it is time to get on with the job of analyzing capital inflows with the aid of fully articulated macromodels. Accordingly, the present paper solves a dynamic general equilibrium model for an array of policy scenarios that delineate the tradeoffs associated with alternative strategies for managing large capital inflows. Having the African context in mind, we calibrate the model(s) to data from Ghana, a country in the early stages of an expected surge in official and private capital flows. Ghana is an especially interesting case because the aid surge is occurring against the background of moderately high inflation and an already large domestic debt stock. In this fragile macroeconomic environment, the same policy challenges witnessed in Uganda and Tanzania are beginning to emerge but have assumed greater importance.5

The rest of the paper is organized into seven sections. Following Buffie (2003), section 2 develops the core structure of an optimizing two-sector currency substitution model in which aid accrues directly to the public sector. The government spends most but not all of the
aid; consistent with the data for Sub-Saharan Africa, we assume that 25% of the extra aid is devoted to reducing the government’s seigniorage requirement. Hence inflation decreases in the long run.

In sections 3 and 4 we solve the model for the polar cases of a pure float and a crawling peg. It turns out that neither of the polar exchange rate regimes delivers satisfactory results. A pure float keeps short-run inflationary pressures in check at the cost of extreme instability in the real exchange rate and severe contraction in the nontradables sector (assuming prices are not highly flexible in the downward direction). Under a crawling peg, on the other hand, the path of the real exchange rate is stable but not the price level — higher aid spending and private capital flows trigger a tremendous upfront spike in the CPI. Thus policy makers have to choose their poison; a commitment to fix or float entails the sacrifice of at least one important macroeconomic target.

Seeking a better menu of choices, we examine two alternative strategies in sections 5: (i) temporary sterilization of capital inflows in a crawling peg and (ii) a managed float that targets the long-run equilibrium real exchange rate. In the Ghanaian economy, sterilization has limited appeal. Temporary, very large bond sales can reduce the initial price level spike by 40-70%; but the spike that remains is large in absolute terms (P jumps 2-6%), and the real interest rate may increase 10-20 percentage points in the short run. By contrast, a managed float allows large official and private capital inflows to be absorbed without adverse side effects on inflation, stability of the real exchange rate, the real interest rate or real output. In practice, it may not be easy to quantify the policy rule that guides the perfect managed float. But this is not a serious problem. Our results indicate that for a wide range of parameter values the central bank should lean heavily against nominal appreciation: roughly speaking, the right managed float is 60-80% of the way toward the crawling peg end of the continuum.

Section 6 investigates the robustness of the results to the time profile of aid flows (gradual vs. sudden increases) and a different specification of sticky prices (one that reflects inertial inflation). The final section recapitulates and discusses promising directions for future research.
2. The Core Structure of the Model

We work with a simple currency substitution model of a small open economy that produces a nontraded good and a composite traded good. Real output is fixed in both sectors and the world price of the traded good equals unity. The private sector divides its wealth between domestic currency $M$, foreign currency $F$, and government bonds $B$. Bonds are indexed to the price level $P$, so $B = Pb$, where $b = B/P$. Other notational conventions are as follows: $C_i$ and $Q_i$ are consumption and output in sector $i$; $e$ is the nominal exchange rate; and $P_n$ and $E$ are the relative price of the nontraded good and aggregate real expenditure measured in dollars (i.e., units of the traded good).

Preferences and the Private Agent’s Optimization Problem

All economic decisions in the private sector are controlled by a representative agent who derives utility from consumption of traded and nontraded goods and from the liquidity services generated by holdings of domestic and foreign currency. To obtain concrete results, we assume preferences take the form

$$U = \int_0^\infty \left[ \frac{C(C_n, C_T)^{1-1/\tau}}{1-1/\tau} + h \frac{\phi(M/P, eF/P)^{1-1/\tau}}{1-1/\tau} \right] e^{-\rho t} dt,$$

where

$$C(C_n, C_T) = \left[ k_oC_T^{(\beta-1)/\beta} + k_1C_n^{(\beta-1)/\beta} \right]^{\beta/(\beta-1)},$$

$$\phi(M/P, eF/P) = \left[ k_2(M/P)^{(\sigma-1)/\sigma} + k_3(eF/P)^{(\sigma-1)/\sigma} \right]^{\sigma/(\sigma-1)},$$

are linearly homogeneous CES aggregator functions; $h$ and $k_o - k_3$ are constants; $\rho$ is the pure time preference rate; $\tau$ is the intertemporal elasticity of substitution; $\beta$ is the elasticity of substitution between traded and nontraded consumer goods; and $\sigma$ is the elasticity of substitution between domestic and foreign currency.

The private agent solves his optimization problem in two stages. In the first stage, $C_n$ and $C_T$ are chosen to maximize $C(C_n, C_T)$ subject to the constraint $P_nC_n + C_T = E$. The optimal choices $C_n$ and $C_T$ are subsumed in the indirect utility function

$$V(P_n, E) = C[C_n(P_n, E), C_T(P_n, E)] = E/c(P_n),$$
where
\[ c(P_n) = \left( k_o^\beta + k_1^\beta P_n^{1-\beta} \right)^{1/(1-\beta)}. \]

As a byproduct of optimization, we get the solution for the exact consumer price index:
\[ P = ec(P_n). \] (2)

For future use, note also that
\[ \pi = \chi + \gamma \dot{P}_n/P_n, \] (3)

where \( \pi = \dot{P}/P \) is the inflation rate; \( \chi = \dot{e}/e \) is the rate of currency depreciation; and \( \gamma = k_1^\beta P_n^{1-\beta}/[k_o^\beta + k_1^\beta P_n^{1-\beta}] \) is the consumption share of the nontraded good. 7

In the second stage of optimization, the private agent chooses asset holdings and expenditure to maximize
\[
U = \int_0^\infty \left\{ \frac{[E/c(P_n)]^{1-1/\tau}}{1-1/\tau} + h \frac{\phi(M/P, eF/P)^{1-1/\tau}}{1-1/\tau} \right\} e^{-\rho t} dt,
\] (1')

subject to
\[ \tilde{A} = M + Pb + eF, \] (4)
\[ \tilde{M} + P\dot{b} + e\dot{F} = \tilde{P}_nQ_n + eQ_T + Pg + rPb - eE, \] (5)

where \( \tilde{A} \) is nominal wealth; \( \tilde{P}_n \) is the nominal price of the nontraded good; \( g \) is real lump-sum transfers; and \( r \) is the real interest rate. Equations (4) and (5) are the wealth constraint and the nominal budget constraint. We designate the traded good to be the numeraire and define \( A \equiv \tilde{A}/e \) and \( m \equiv M/e \). Dividing (4) and (5) by the nominal exchange rate then produces
\[
A = m + \frac{P}{e} b + F,
\]
\[
\frac{\dot{M}}{e} + \frac{P}{e} \dot{b} + \dot{F} = P_nQ_n + Q_T + \frac{P}{e} g + \frac{P}{e} rb - E.
\]

Since
\[
\frac{\dot{M}}{e} = \dot{m} + \chi m,
\]
\[ \dot{A} = \dot{m} + \frac{P}{e} b + \frac{P}{e} b(\pi - \chi) + \dot{F}, \]

and

\[ \phi(M/P, eF/P) = \phi(m, F)/c(P_n), \]

the private agent’s optimization problem can be written as

\[
\begin{align*}
\max_{\{m, F, E\}} U &= \int_0^\infty \left[ \frac{E^{1-1/\tau}}{1-1/\tau} + h \frac{\phi(m, F)^{1-1/\tau}}{1-1/\tau} \right] c(P_n)^{(1-\tau)/\tau} e^{-\rho t} dt, \\
\text{(1'')} \text{subject to the single constraint} \end{align*}
\]

\[ \dot{A} = P_n Q_n + Q_T + cg + (r + \pi - \chi) \underbrace{(A - m - F)}_{(P/e)b} - E - \chi m. \] (5')

\[ c(P_n) = P/e \text{ multiplies } g \text{ because the traded good is the numeraire but transfers are indexed to the price level. For the same reason, } \pi - \chi \text{ multiplies } A - m - F. \]

The Maximum Principle furnishes the necessary conditions for an optimum. These consist of

\[
\begin{align*}
E^{-1/\tau} c(P_n)^{(1-\tau)/\tau} &= \omega, \quad \text{(6)} \\
h\phi(m, F)^{-1/\tau} \phi_m(m, F) &= E^{-1/\tau}(r + \pi), \quad \text{(7)} \\
h\phi(m, F)^{-1/\tau} \phi_F(m, F) &= E^{-1/\tau}(r + \pi - \chi), \quad \text{(8)} \\
\dot{\omega} &= \omega(\rho + \chi - r - \pi) \quad \text{(9)}
\end{align*}
\]

where \( \omega \) is the multiplier attached to (5'). Equations (6)-(8) hold no surprises. As expected, the marginal utility of consumption equals the shadow price of wealth and the marginal rate of substitution between consumption and \( m \) or \( F \) equals the income foregone from holding that type of money. The co-state equation (9) may look less familiar, but it is nothing more than a standard Euler equation. Differentiate (6) with respect to time and substitute for \( \dot{\omega} \). This gives

\[ \dot{E}/E - \gamma \dot{P}_n/P_n = \tau(r - \rho), \] (10)

where the term on the left side is the percentage change in aggregate real consumption.\(^9\)
The Nontradables Sector

$P_n$ adjusts to clear the goods market in the nontradables sector. This requires

$$C_n = Q_n,$$  \hspace{1cm} (11)

where $C_n$ is retrieved from the indirect utility function by invoking Roy’s Identity

$$C_n = -\frac{\partial V}{\partial P_n} = E \frac{k_o^\beta P_n^{\beta}}{k_o^\beta + k_1^\beta P_n^{1-\beta}}.$$  \hspace{1cm} (12)

The Public Sector Budget Constraint

Money is injected into the economy whenever the central bank accumulates foreign exchange reserves $Z$ or runs the printing press to finance the fiscal deficit of the central government. For now, we ignore bond sales and open market operations. The balance sheet of the central bank and the budget constraint for the central government are thus

$$M = H + eZ,$$  \hspace{1cm} (13)

$$\dot{H} = P(g + rb) - eX,$$  \hspace{1cm} (14)

where $H$ stands for the domestic component of the monetary base and $X$ is sale of aid dollars net of government imports. In the ensuing analysis, a fraction $\psi$ of new aid pays for transfers to the “poor” (i.e., the representative agent); the rest is used for general budget support.

The constraints in (13) and (14) can be combined into one. Manipulations similar to those used to derive the private budget constraint give

$$\dot{m} = c(P_n)(g + rb) + \dot{Z} - X - \chi m$$  \hspace{1cm} (15)

for the consolidated public sector budget constraint.

Net Foreign Asset Accumulation and the Balance of Payments

One last equation completes the core structure of the model. Summing the private and public sector budget constraints produces the accounting identity that foreign asset accumu-
Economic surplus equals national saving or the current account surplus:
\[ \dot{F} + \dot{Z} = P_n Q_n + Q_T + X - E. \] (16)

2.1 The Steady-State Outcome

The long-run equilibrium is independent of the exchange rate regime. The results in this section apply equally therefore to a crawling peg, a clean float, or some type of managed float.

Across steady states, \( \dot{m} = \dot{F} = \dot{Z} = \dot{E} = 0, r = \rho, \) and \( \chi = \pi. \) Imposing these conditions leads to

\[ h\phi(m, F)^{-1/\tau} \phi_m(m, F) = E^{-1/\tau}(\rho + \pi), \] (7')
\[ h\phi(m, F)^{-1/\tau} \phi_F(m, F) = E^{-1/\tau}\rho, \] (8')
\[ \pi \frac{m}{R} = \frac{c(P_n)(g + \rho b) - X}{D}, \] (15')
\[ E = P_n Q_n + Q_T + X. \] (16')

Equations (15') and (16') state that aid allows consumption to exceed national income and that revenue from the inflation tax \( R \) equals the fiscal deficit after grants \( D. \) (Hereafter we use the shorter term fiscal deficit and omit “after grants.”) The other two equations are the steady-state versions of the first-order conditions for domestic and foreign currency. This group of equations and the nontradables market-clearing condition in (11) can be solved for \( P_n, E, \pi, m \) and \( F \) as a function of \( X. \) From (11) and (16') we get the obvious results that aid increases consumption and the relative price of the nontraded good:

\[ dE = (1 + \eta/\gamma)dX > 0, \] (17)
\[ dP_n/P_n = dX/\eta E > 0, \] (18)

where \( \eta = \beta(1 - \gamma) \) is the compensated own-price elasticity of demand.

The impact on the fiscal deficit is more complicated as it involves both direct and indirect effects. Recall that the government spends a fraction \( \psi \) of extra aid on poverty reduction. Thus the direct effect on the deficit is favorable: real transfer payments net of aid decrease
by \( d(cg) - dX = (\psi - 1)dX \). But aid also drives up the relative price of the nontraded good, which increases the internal debt measured in dollars by the amount \((c'P_n/c)cbdP_n/P_n = \gammacbdX/(\eta E)\). The overall impact on the deficit is therefore

\[
dD = (\psi - 1 + \gamma s \rho / \eta) dX \geq 0,
\]

(19)

where \( s \equiv cb/E \), the ratio of the internal debt to national income inclusive of aid. \((E = P_nQ_n + Q_T + X \text{ at a steady state.})\) We assume \( \psi < 1 - \rho s \gamma / \eta \) so that, in keeping with policy makers’ intentions, the seigniorage requirement declines.\(^{12}\)

With the solutions for \( P_n \), \( E \) and \( D \) in hand, it is now easy to determine how inflation and asset demands change. Equations (7\(~\)'\), (8\(~\)'\) and (15\(~\)'\) yield

\[
dR = m(1 - \epsilon) \frac{d\pi}{\pi m} + \frac{\pi m}{E} dE,
\]

(20)

\[
dF = \frac{(\sigma - \tau)\theta_m F}{i} \frac{d\pi}{\pi m} + \frac{F}{E} dE,
\]

(21)

where \( i = \rho + \pi \) is the nominal interest rate; \( \theta_j \) is the share of liquidity services provided by currency \( j \); and \( \epsilon = (\tau \theta_m + \sigma \theta_f) \pi / i \) is the elasticity of money demand with respect to inflation. Figure 1 depicts the solutions in (19)-(21). The D schedule in the second quadrant summarizes the general equilibrium relationship between aid and the fiscal deficit, while the R and F schedules in the first and fourth quadrants show how seigniorage \((R \equiv \pi m)\) and holdings of foreign currency vary with inflation. The positive slopes for the \( R \) and \( F \) schedules assume \( \epsilon < 1 \) and \( \sigma > \tau \). Neither assumption is particularly restrictive. The first keeps the economy away from the slippery, downward-sloping portion of the seigniorage Laffer curve. (When \( \epsilon > 1 \), long-run comparative statics results are perverse and the equilibrium path is indeterminate.) The second implies that lower inflation reduces the demand for foreign currency and elicits the return of flight capital. Although theory does not guarantee this result, there is not much doubt that it is easier to substitute between the two currencies than to substitute intertemporally in consumption.

When more aid flows in, the fiscal deficit declines from \( D_o \) to \( D^* \). The increase in
real consumption also raises the demand for domestic and foreign currency, shifting the $R$ and $F$ schedules upward to $R'$ and $F'$ [see the second term on the right side in (20) and (21)]. The reduction in the fiscal deficit ensures that inflation falls and that the real money supply increases. Private capital flows could go either way since lower inflation and higher consumption spending exert conflicting effects on the demand for foreign currency. Normally, however, the currency substitution effect dominates the outcome: point H lies to the north of point G provided $\sigma$ is not unusually small (see the appendix).

This ends the formal notation-intensive part of the paper. Most of the space in the next four sections is devoted to intuitive, non-technical explanations of how aid affects the economy’s equilibrium path. Additional equations appear only insofar as they are needed to state important results or describe extensions of the core model. All of the algebra involved in solving for the steady-state outcome, deriving key conditions, and characterizing the dynamic systems associated with different policy regimes may be found in the appendix.

### 2.2 Remarks on the Specification of the Model

Four aspects of the model merit comment. First, the assumption that the foreign asset does not earn interest is innocuous. What is critical, especially in the section on sterilization, is that the foreign asset and domestic bonds are not perfect substitutes; hence the domestic interest rate is not tied down by the interest parity condition. Second, when aid spending shifts out the demand curve in the nontradables sector, the real exchange rate would appreciate less if the supply curve were not vertical. This does not substantively alter the results. The only change in the solutions is that the compensated elasticity of demand, whenever it appears, is replaced by the sum of the demand elasticity and the general equilibrium elasticity of nontradables supply. Third, if aid financed government purchases of nontraded goods instead of lump-sum transfers to the private sector, the outward shift of the demand curve and the increase in the relative price of the nontraded good would be twice as large. It is not necessary to introduce a new policy variable in order to analyze this scenario: we can mimic the effects in the present model either by halving the compensated elasticity of demand for the nontraded good or by doubling the size of the aid inflow. Finally, is it correct to assume that part of the aid inflow is earmarked for budget support? This may seem artificial given
that officially all aid is spent. But aid is readily fungible with other revenue sources. The relationship between aid and the fiscal deficit is thus a matter for empirical investigation.

In our working paper (Buffie et al., 2003), we used data for 1991-2000 from Gupta et al.’s (2002) sample of 39 low-income countries to evaluate the impact of aid on the fiscal deficit and the domestic financing requirement. It turns out that in Sub-Saharan Africa 21 cents of the aid dollar substitutes, on average, for domestic financing. (The number rises to 30% in the second half of the nineties.) The interesting issue is whether this fraction is large enough to complicate macroeconomic life by attracting substantial private capital inflows. Our answer is an emphatic yes.

3. Polar Exchange Rate Regimes

On paper, flexible exchange rates and strict targeting of the money supply are the norm in SSA. But the commitment to money-based stabilization and market-determined exchange rates is far from absolute, especially in periods of adjustment to large external shocks. Many countries have responded to large aid inflows by shifting to managed floats and partly accommodating monetary policy.

The decision about how much to manage the exchange rate is a decision about how much to move in the direction of a fixed exchange rate. Most of the information relevant to this decision is contained in the outcomes at the endpoints of the policy spectrum. Accordingly, we start by investigating the transition path associated with a pure float. Section 3.2 analyzes the polar opposite case of a crawling peg.

3.1 Flexible Exchange Rates

The Euler equation (10) is part of the dynamic system in every exchange rate regime. To get this equation in the right form, solve (11) and (12) for $P_n$:

$$\frac{dP_n}{P_n} = \frac{dE}{(\eta + \gamma)\bar{E}}.$$  (22)

Interpret the differentials as time derivatives and substitute for $\dot{P}_n/P_n$ in (10). This delivers

$$\dot{E} = \frac{\tau(\eta + \gamma)}{\eta} E(r - \rho).$$ (23)
In a pure float the central bank never intervenes in the foreign exchange market. With \( \dot{Z} = 0 \), the Euler equation (23) and

\[
\dot{m} = c(P_n)(g + rb) - X - \chi m \quad (15')
\]
\[
\dot{F} = P_nQ_n + QT + X - E \quad (16')
\]

comprise a 3x3 dynamic system in which \( F \) is predetermined and \( m \) and \( E \) are jump variables. To solve the system we need to figure out how the equilibrium values of \( P_n, r \) and \( \chi \) vary with \( m, F \) and \( E \) on the transition path. Equation (22) already relates \( P_n \) to \( E \). For \( r \) and \( \chi \), it is natural to combine information in the asset demand equations with the path for the equilibrium inflation rate. Note from (2), (22), and (23) that

\[
\pi = \chi + \frac{\gamma_T}{\eta} (r - \rho). \quad (24)
\]

Equations (7), (8) and (24) can be solved for \( \pi, \chi \) and \( r \) as a function of \( m, F \) and \( E \). Substituting the reduced-form solutions \( r(m, F, E), \chi(m, F, E) \) and \( P_n(E) \) into (23), (15') and (16') then gives a self-contained system of three differential equations in \( m, F \) and \( E \). The full mathematical solution is presented in the appendix. As usual, the stationary equilibrium is a saddle point; consequently, the path of \( F \), the only state variable in the system, drives the paths of the jump variables, \( m \) and \( E \).

Figure 2 provides a bird’s eye view of the transition path. Since \( P_n \) depends only on \( E \) and aid is constant after its initial jump, the \( \dot{F} = 0 \) schedule is horizontal at the steady-state level of expenditure \( E^* \). At points above the schedule, expenditure exceeds income, the current account shows a deficit, and the stock of foreign currency is decreasing. Conversely, when \( E < E^* \), the current account registers a surplus and \( F \) is increasing. The KK and MM schedules show how \( E \) and \( m \) vary with \( F \) on the convergent saddle path. (To repeat, \( F \) is the driving variable in the system.) KK slopes upward as saving depends positively on the gap between \( F \) and its desired level. The slope of MM is indeterminate, but for the range of values covered by the numerical simulations the schedule is positively sloped as in Figure 2. Finally, the NN schedule tracks the path of \( P_n \), mirroring the solution in (22).

After aid increases, the stationary equilibrium shifts from ABC to GHJ. Anticipating lower inflation, the private agent tries to exchange foreign for domestic currency at \( t = 0 \).
In a floating rate system, however, the private sector cannot reduce its collective holdings of foreign currency by trading dollars for domestic currency in the foreign exchange market. The desire to hold less foreign currency leads instead to appreciation of the nominal exchange rate and lower saving. To understand why saving declines, consider the special case where \( F_o = F^* \) and points J and G are vertically above points A and C. In this case, the economy jumps immediately to the new steady state, with a downward jump in the price level raising \( m \) to \( m^* \). (All of the adjustment occurs through \( P \) because \( M \) is predetermined.) Since actual wealth equals desired wealth, the private agent is content to consume at the new level of permanent income. Now carry out the same thought experiment with \( F_o > F^* \). The price level still adjusts to supply the desired quantity of real money balances at \( t = 0 \). But since \( F_o > F^* \), the private agent wishes to consume more than \( E^* \); the wealth effects associated with adjustment in the exchange rate and the price level create both the desire and the means to temporarily consume in excess of permanent income. Thus expenditure increases more than aid (\( E(0) > E^* \)), the current account worsens, and the real exchange rate (\( 1/P_n \)) overshoots its steady-state level \( [P_n(0) > P^*_n] \). Observe also that capital inflows are associated with lower real interest rates \( [\dot{E} < 0 \text{ in the Euler equation (23)}] \) and that current account (CA) deficits persist throughout the adjustment process \( (\dot{F} < 0, \forall t) \).

The spending boom that accompanies aid might seem to be a source of trouble for the price level in the short run. But this is not the case. Higher demand for domestic real money balances, spending of foreign currency wealth, and the consumption boom all stem from the perception that the fiscal deficit and inflation will be lower in the future. Even a temporary increase in inflation is inconsistent therefore with a perfect foresight equilibrium.\(^{15}\)

### 3.1.1 Numerical Results: How Big Are the Effects?

Table 1 lists the parameter values used to calibrate the model. \( m_o, \pi_o, b_o, \gamma_o \) and \( X_o \) are close to the values seen in Ghana in 2003. Data for Ghana also informs our choices (albeit more loosely) for \( \rho, \psi \) and \( F_o \). The values for the deep parameters \( \beta, \sigma \) and \( \tau \), however, are guesses based on econometric estimates for other LDCs. Below we comment briefly on the rationales for the numbers assigned to these parameters and to \( \rho, \psi \) and \( F_o \):

- **Elasticity of substitution in consumption between traded and nontraded consumer goods** (\( \beta \)). Fixing \( \beta \) at .50 implies that the compensated elasticity of demand for the nontraded
good is .25 initially. This agrees with the finding in empirical studies that compensated elasticities of demand tend to be small at high levels of aggregation.\textsuperscript{16}

- \textit{Elasticity of substitution between domestic and foreign currency} ($\sigma$). There are no reliable estimates of $\sigma$ for Ghana or any other country in Africa. For Latin America the numbers range from 1.5 to 7 (Ramirez-Rojas, 1985; Marquez, 1987; Giovannini and Turtleboom, 1994; Kamin and Ericsson, 1993). Not trusting the high-end estimates (7??), we decided to let $\sigma$ vary from .75 to 3.

- \textit{Time preference rate} ($\rho$). Across steady states, the real interest rate is fixed by the time preference rate. The value assigned to $\rho$ (8\%) is slightly less than the average real rate paid by short-term treasury bills since 1992 (8.25\% according to IMF 2003, p.66).

- \textit{Elasticity of intertemporal substitution} ($\tau$). Most estimates for LDCs place $\tau$ between .10 and .50. (See Agenor and Montiel, 1999, Table 12.1.) Since Ghana is one of the poorer LDCs, we set $\tau$ equal to .25. We also conducted runs with $\tau = .50$. The results did not differ substantively from those for $\tau = .25$, except in the scenario for sterilization.

- \textit{Ratio of foreign currency to national income} ($F_o$). Foreign currency deposits in the domestic banking sector are 60\% of reserve money in Ghana. This suggests $F_o = .06$, but the true value is higher because a good deal of foreign currency is held outside of the domestic banking system. We arbitrarily set $F_o$ at .15. This is in line with dollarization ratios in other parts of the Third World.\textsuperscript{17}

- \textit{Share of aid inflow set aside for deficit reduction} ($1 - \psi$). A share of .25 is consistent with the value .21 that Buffie et al. (2003) obtain from panel data for Africa in the 1990s (Ghana’s share, .23, lies right on the regression line) and with the commitment of the Ghanaian government to dedicate 20\% of HIPC debt relief to deficit reduction (IMF 2004a, p.31).

We chose units so that $P_{no} = E_o = 1$ and carried out simulations for the case where aid inflows increase by 3\% of national income (the projected increase for 2004-2013).\textsuperscript{18} Since the aid shock is large, linearization error is a potential problem. To address this concern, we solved for the transition path using a variant of the procedure recommended by Novales et al.(1999).\textsuperscript{19}

\textbf{Steady-State Outcome}

Figure 3 reports the results for $\sigma = .75$, 2 and 3. The real exchange rate is $1/P_n$ and the current account deficit (inclusive of aid) is measured as a percentage of national income (GDP + aid), with positive values signifying a deficit.

In each run, the long-run effects of the aid shock are significant. The value for $\psi$ implies that the fiscal deficit decreases by .75\% of GDP. This reduces the steady-state inflation rate from 25\% to 11-15\%. Cumulative private capital inflows range from .7\% to 10\% of national
income, while the real exchange rate appreciates 11%.

**The Transition Path**

What happens on the way to the long-run equilibrium depends mainly on the currency substitution parameter $\sigma$. For $\sigma = .75$, private capital inflows are small and the economy moves quickly to the vicinity of the new steady state. But when $\sigma = 2 - 3$ the ride is a bit wild. Consumption spending strongly overshoots its steady-state level; as a result, the real exchange rate $(1/P_n)$ appreciates 19-24% in the short run and the current account deficit, *inclusive of aid*, jumps to 2.3-3.7% of national income. There are also pronounced fluctuations in $\pi$ and $r$. The real interest rate decreases 1.5 percentage points in the first year; it rises thereafter but is still 1-1.3 percentage points lower at $t = 3$. Because of the temporary decrease in the real interest rate, the fiscal deficit and inflation also overshoot their steady-state levels.

**Caveat**

Unfortunately, the results in Figure 3 presume far too much flexibility of nominal prices. Consider how the economy adjusts in the short run. According to the model, the nominal exchange rate appreciates 22-46% at $t = 0$ to forestall incipient capital inflows ($F$ is predetermined). Since the real exchange rate appreciates “only” 12-24%, the nominal price in the nontradables sector has to immediately fall 11-29% to keep demand equal to supply. This strains belief to say the least. But if nominal price adjustment is incomplete the economy slides into a recession — probably a deep recession given the magnitude of nominal appreciation at $t = 0$. We return to this point later in section 4.

**3.2 A Crawling Peg**

Under a crawling peg, the money supply adjusts endogenously through the capital account to satisfy money demand. But while domestic currency can be swapped for foreign currency at the central bank, the total dollar value of currency holdings is predetermined. Thus $J \equiv m + F$ is the state variable in the dynamic system defined by (15), (16) and (23). To bring $J$ into view, add (15) and (16). This gives

$$\dot{J} = c(P_n)(g + rb) + P_nQ_n + QT - E - \chi m. \quad (25)$$
We assume the government lowers the rate of currency depreciation $\chi$ to its new steady-state level immediately at $t = 0$. The inputs needed to solve (23) and (25) are thus limited to (22) and the reduced forms that show how $r$ and $m$ vary with $J$ and $E$ on the transition path. The latter are buried in the first-order conditions (7) and (8). After substituting for $\pi$ from (24) and replacing $F$ with $J - m$, we have

$$h\phi(m, J - m)^{-1/\tau} \phi_m(m, J - m) = E^{-1/\tau}[r(1 + \gamma \tau/\eta) + \chi - \rho \gamma \tau/\eta],$$

$$h\phi(m, J - m)^{-1/\tau} \phi_F(m, J - m) = E^{-1/\tau}[r(1 + \gamma \tau/\eta) - \rho \gamma \tau/\eta],$$

Equations (7'') and (8'') deliver the reduced-form solutions $r(J, E)$ and $m(J, E)$. When these are substituted into (23) and (25), the system is ready for linearization (everything on the right side depends on $J$ and/or $E$). The solution is portrayed in Figure 4. The SS schedules in the first quadrant are potential saddle paths, while the NN schedule in the second quadrant again tracks the path of $P_n$.

Figure 4 looks much like Figure 2, except $J$ replaces $F$ on the horizontal axis. This difference is critical. In the case of a pure float we know that $F^* < F_o$ and hence that real spending overshoots its steady-state level. Under a crawling peg the transition path is less well defined because $J^*$ may be either larger or smaller than $J_o$. The steady-state solutions for $m$ and $F$ yield (see the appendix)

$$J^* < J_o \quad \text{iff} \quad \sigma > \tau(1 + \rho/\pi \theta_f) + \frac{i \rho (1 - \epsilon)(\eta + \gamma)}{\pi \theta_f \left[ \pi \mu (\eta + \gamma) - \rho \sigma \gamma + \eta (1 - \psi) \right]} \frac{J}{E},$$

where $\mu \equiv m/E$ and $\theta_f$ is the share of liquidity services provided by foreign currency holdings. Although this condition is complicated, it admits of a straightforward intuitive explanation. Spending is higher and inflation lower at the new steady state. Both factors increase the private agent’s demand for liquidity services. An increase in liquidity services, however, does not necessarily require an increase in total currency holdings. Note from the first-order conditions (7') and (8') that a straight swap of foreign for domestic currency increases the supply of liquidity services by $\pi$. Consequently, when inflation is high and currency substitution easy ($\sigma$ large), the private agent may respond as in Figure 5, increasing consumption of liquidity services by holding much more domestic currency but less total
money. The precise condition for this to happen is stated in equation (26). If σ satisfies the inequality, then currency substitution allows the private agent to enjoy more liquidity services while spending down part of his wealth. The steady-state equilibrium shifts from A to C and the paths for expenditure, the real exchange rate, the current account, and the real interest rate are qualitatively the same as the paths in a pure float. The item missing from the list is the impact effect on the price level. Since the nominal exchange rate is predetermined, the big increase in spending at $t = 0$ triggers large jumps in the nominal price of the nontraded good and the CPI.

The dynamics are quite different when the condition in (26) does not hold: on path AGH, expenditure and the real exchange rate undershoot their steady-state levels, the real interest rate rises, and the current account registers surpluses instead of deficits. Moreover, expenditure may decrease initially (path AKL), causing the real exchange rate to depreciate and the price level to jump downward at $t = 0$. The result is odd but it cannot be ruled out by plausible parameter values.

### 3.2.1 Numerical Results and Comparisons with a Pure Float

How does switching from a pure float to a crawling peg affect the paths of key macroeconomic variables? We should be able to say a lot about this without taking a stand on the condition in (26). In a pure float, spot appreciation of the nominal exchange is large enough to reduce the price level even though spending, motivated by the positive gap between $F_o$ and $F^*$, rises more than aid (75-120% more for $\sigma = 2 - 3$). By contrast, when the central bank operates a crawling peg (i) the exchange rate does not adjust rate at $t = 0$ to blunt initial inflationary pressures and (ii) spending depends on the gap between $J_o$ and $J^*$, which is ambiguous in sign and smaller than $F_o - F^*$. Thus intuition argues that in comparisons of the two systems a crawling peg buys smaller current account deficits (or possibly current account surpluses) and greater stability of the nominal and real exchange rate at the price of higher inflation in the short run.

The condition in (26) does not hold for $\sigma = .75$ in Figures 6.1-6.2. In this run, the real interest rate rises, the current account improves, and inflation and the real exchange rate undershoot, approaching their steady-state levels from above. In the other two cases, the
qualitative properties of the transition path are the same (apart from the initial jump in the price level) as in a float. Under a crawling peg, however, inflation and the real interest rate decrease less, the real exchange rate appreciates much less, and the current account deficit is smaller.

Two other results should be mentioned. First, in the run for $\sigma = .75$, the increase in the real interest rate is small: $r$ jumps initially to 9.4%, but by the end of the first year it falls back below 9%. Second, inflationary pressures are confined to the spike in the price level at $t = 0$. Although the spike is large ($P$ jumps 5-9%), the path of the CPI drops below the pre-aid path within 6-7 months and the inflation rate for the first year (measured as the cumulative percentage increase in the price level over the first year — the real world definition of inflation) decreases from 25% to 19-20%.

4. Sticky Prices

There is some unfinished business connected with the analysis of aid in a pure float. Turn back to Figure 3. The numbers look nice but they rely on extreme downward price flexibility to preserve full employment when the nominal exchange rate appreciates 22-46% in the short run. We conjectured that real output would decrease sharply if, instead, nominal prices were sticky downward. This needs to be confirmed before drawing any conclusions about the efficacy of managing aid flows in flexible vs. fixed exchange rate systems.

We introduce sticky prices à la Calvo and Vegh (1993). The price of the traded good is set by the exchange rate but firms in the nontradables sector adjust prices only when they receive a random “price-change signal.” Firms that receive a signal choose a new price by forecasting the future paths of the price level and excess demand. Price adjustment is thus forward-looking. Calvo (1983) shows that when the price-change signal obeys a Poisson process

$$\dot{P}_n = (\pi_n - \chi)P_n$$

$$\dot{\pi}_n = -\delta[D_n(P_n, E) - \bar{Q}_n], \quad \delta > 0,$$

where $\bar{Q}_n$ denotes notional output (i.e., the level of output associated with a normal capacity utilization rate). Equation (27) follows from the fact that, at any given point in time, the
nominal price of the nontraded good is fixed by past price quotations. (More precisely, at any time \( t \) the set of firms that adjust their prices is of measure zero.) Equation (28) is a higher-order Phillips Curve. It says that the change in \( \pi_n \), the inflation rate in the nontradable sector, is a decreasing function of excess demand. The parameter \( \delta \) is larger the shorter the length of the average price quote.

Sticky prices add two variables to the dynamic systems analyzed earlier. In a pure float, both \( \pi_n \) and \( P_n \) are jump variables.\(^{24}\) Under a crawling peg, \( \pi_n \) is a jump variable but \( P_n \) is predetermined. Nontradables output is demand determined in both exchange rate regimes.

### 4.1 A Pure Float

The plot for \( Q_n \) in Figure 7 tracks the path of \( [Q_n(t) - Q_{no}] / Q_{no} \), the percentage difference between nontradables output at time \( t \) and its pre-aid level.\(^{25}\) Although the compensated elasticity of demand is only .25, substitution toward traded goods — induced by appreciation of the nominal exchange rate — easily dominates the expansionary income effect of higher aid flows. Consequently, \( Q_n \) declines in every case. When \( \sigma = 2 - 3 \), the recession in the nontradables sector is protracted and severe as large private capital inflows force the nominal exchange rate to appreciate 27-33% at \( t = 0 \). For \( \sigma = .75 \), capital inflows and nominal appreciation are comparatively modest; nevertheless, \( Q_n \) falls 2.5% on impact.\(^{26}\)

Recession is not the only problem policy makers face. The real exchange rate overshoots its steady-state level much more than in the flexprice model, especially in the runs for \( \sigma = 2 - 3 \). Moreover, the impact on the real interest rate changes dramatically. When prices are flexible, the real interest rate decreases temporarily from 8% to 6.4-7.6%. With sticky prices, the rate jumps to 14-24% in the first year. This is a natural byproduct of the transitory recession: \( r \) is higher on the transition path because aggregate consumption spending rises over time [see the Euler equation (23)] as demand and output recover in the nontradables sector.

The adverse impact on the real interest rate is important, for it implies that the simulation results underestimate the real output losses from floating. Our model assumes constant output in the tradables sector. But if a higher return on treasury bills increases the cost of working capital or depresses investment spending, then tradables production will con-
tract and the demand curve in the nontradables sector will shift further to the left. In a more elaborate model that captured these linkages, the recession would be deeper and more persistent than in Figure 7.

4.2 A Crawling Peg

The results for a crawling peg in Figure 8 are what policy makers dream about. Inflation decreases smoothly without an initial spike in the price level. The current account (not shown) records a small surplus and the real exchange rate moves toward its long-run equilibrium value in a gradual, orderly manner. For a couple of years, the economy also enjoys higher output and lower real interest rates. What makes everything work is that the budget-support component of aid effectively finances a perfectly credible exchange-rate-based stabilization (ERBS). The small ERBS component (1/4 of the total aid package) ensures that inflation decreases monotonically even though real spending rises 4-6.5\% in the short run.

Does this mean that a crawling peg with fully accommodating monetary policy solves all macroeconomic problems? Probably not. Few macroeconomists have trouble with the notion that prices are sticky downward. But are prices sticky upward as well? For reasons that are hard to justify, we suspect that price adjustment is asymmetric in Sub-Saharan Africa and that the flexprice specification is correct for many branches of the nontradables sector (e.g., the informal sector) when nominal price increases are required to clear the market. The pure flexprice model of sections 2-3 may exaggerate the initial upward jump in the CPI, but the sticky-price model is overly optimistic in assuming the problem away. Doubtless the truth lies somewhere inbetween.

5. Alternative Policies

The long-run equilibrium inflation rate declines when aid serves in part to reduce the fiscal deficit. So far so good. But expectations of lower inflation elicit large private capital inflows. This complicates macroeconomic management because staying out of the foreign exchange market is not a genuine option: central banks that rely on a pure float passively acquiesce to (i) stupendous appreciation of the nominal exchange rate, (ii) lower employment in both the tradables and nontradables sectors (assuming wages and prices are not exceptionally flexible
(downward), (iii) overshooting of the real exchange rate, and (iv) large current account deficits. A crawling peg eliminates the threat of a harsh recession and secures greater stability of the real exchange rate but leaves the government with the problem of negotiating an initial big spike in the CPI.

Since neither a crawling peg nor a pure float produces fully acceptable results, we move on to the analysis of alternative policy strategies. In section 5.1 the central bank temporarily sterilizes capital inflows; in section 5.2 it operates a dirty float, intervening in the foreign exchange market to prevent extreme fluctuations in the nominal exchange rate.

5.1 Temporary Sterilization

The price level jumps when aid flows increase and the central bank maintains a crawling peg. Inflation decreases rapidly, however, after the initial spike in the CPI; temporary sterilization comes to mind therefore as a strategy for smoothing the paths of money growth and the price level. To fix ideas, suppose the government sells a large block of bonds at \( t = 0 \) and then redeems the debt in future periods, viz.:

\[
\dot{b} = -\alpha[b(t) - b_o], \quad (29)
\]

\[
\implies b(t) = b_o + [b(0) - b_o]e^{-\alpha t}. \quad (30)
\]

Initial bond sales are \( b(0) - b_o \) and the parameter \( \alpha \) determines how fast the debt is paid off. The steady state is unchanged — \( b \) eventually returns to \( b_o \).

Figures 9-10 and Table 2 show the outcome when bond sales at \( t = 0 \) are 8% of GDP and 80% of the newly issued debt is redeemed over ten years (\( \alpha = .161 \)).\(^\text{28}\) We carry out runs for \( \tau = .35 \) and \( \tau = .50 \) as well as \( \tau = .25 \) because, unlike in previous sections, the paths for the real interest rate and capital flows are highly sensitive to the value of the intertemporal elasticity of substitution.

A quick scan of the results reveals plusses and minuses. On the plus side, temporary sterilization is helpful in smoothing the path of the price level. The inflation rate drops to 13-18% at \( t = 0 \) and then declines monotonically toward its steady-state level. This is accomplished with a much smaller prefatory spike in the CPI (1.5-5.7% vs. 5-9% in Figure 6.1). Compared to the no-sterilization case, inflation is one percentage point lower in the
first year and slightly higher in subsequent years. Preferences decide which path is superior, but we suspect most policy makers would opt for the smoother path proffered by temporary sterilization.

The drawbacks of the policy concern the impact on the real interest rate and the size of the initial bond sale. In the runs for $\tau = .50$ the real interest rate fluctuates between 11 and 21 percent in the first year. This is worrisome enough, but when $\tau = .25 - .35$ the rate vaults to 16-43% and takes two full years to fall back to 9-11%. It is also disturbing that the modest reduction in price volatility requires so much debt to be sold so quickly. The assumption in (30) that all bond sales occur at $t = 0$ is an artificial simplification. A fair interpretation of the policy rule, however, is that open market operations increase the internal debt by 7–8% of GDP in the span of 6-9 months. This is probably the outer limit of what is feasible in the Ghanian bond market, yet the price level spike still exceeds 2% in the six cases where $\sigma = 2 - 3$ (see the last panel in Table 2).

It is easy to understand in light of these results why most African governments have employed a mix of sterilization and foreign exchange sales to counteract the short-run inflationary pressures created by high aid flows. The problem with relying on sterilization alone is that bond sales push up the real interest rate and thereby attract the capital inflows they are trying to neutralize. Observe in Figure 10 and Table 2 that high real interest rates are associated with massive overshooting of private capital inflows and large offset coefficients. This makes life difficult for the central bank. Sterilization works by reducing liquidity and raising the real interest rate to a level that induces the private agent to curtail expenditure (relative to the no-sterilization path). At the margin, the withdrawal of one dollar of domestic currency from circulation reduces liquidity services by $i$ dollars (33 cents worth in Table 2). When the private agent exchanges foreign for domestic currency at the central bank, $\pi$ dollars of the cut in liquidity services is restored, leaving a net loss of $r$ dollars. This is only 24% of the decrease in liquidity services achieved from selling bonds for domestic currency [$r/i = \rho/(\rho + \pi) = .24$ for differential changes]. The central bank is not powerless, but capital flows severely constrain its ability to manage the path of liquidity.
5.2 A Managed Float

“... the question of the appropriate exchange rate regime for African countries remains open. None of these countries has a ‘pure’ floating exchange rate, opting instead for the common intermediate case of a ‘managed’ float ...” (Leape, 1999, pp.126-127)

The preceding results may explain why most countries prefer managed floats to either a pure float or a crawling peg. Policy is too passive in a pure float: while inflation decreases strongly, the nominal exchange rate is allowed to appreciate to the point where output contracts in the nontradables sector. A crawling peg errs in the opposite direction, imperiling a different target: when the government commits to a fixed path for the exchange rate it throws away the policy instrument that is most effective in combatting the short-run inflationary pressures created by higher aid spending and accompanying private capital inflows. Nor does more active monetary policy resolve the targets-instruments problem. A crawling peg combined with temporary sterilization reduces the initial price spike; but, as we have just seen, this often produces very high real interest rates and may require bond sales on a scale that is not feasible.

A managed float gives policy makers the freedom to find the middle ground between too much and too little intervention. The right amount of intervention depends, of course, on the weights attached to the targets for output, inflation, the real exchange rate, and the real interest rate. Rather than derive a complicated intervention rule by optimizing over a quadratic objective function that incorporates all of these targets, we assume the central bank sells/buys foreign currency whenever the real exchange rate \((1/P_n)\) is above/below its long-run equilibrium level:

\[
\dot{Z} = \Omega \frac{P_n - P_n^*}{P_n}, \quad \Omega > 0.
\]  

Equation (31) relates the flow accumulation of reserves to deviations of the real exchange rate from its target value. In addition, \(Z\) may jump at \(t = 0\). The initial purchase of reserves and \(\Omega\) are chosen jointly to ensure that the existing nominal price of the nontraded good clears the market at \(t = 0\). The intervention strategy, in other words, is to let the exchange rate appreciate enough to reduce inflation but not so much as to drive the nontradables
sector into a recession. Other targets do not influence the intervention rule; it turns out, however, that the rule postulated here also greatly reduces volatility of the real exchange rate and the real interest rate.

Figure 11 shows the outcome when the initial stock of reserves is 5% of GNP. At long last, we have something that can be pronounced an unqualified success. In contrast to the polar exchange rate regimes, the managed float reduces inflation immediately without any adverse side-effects on output, the current account balance, or the real exchange rate. To quantify the underlying policy rule, we compared the paths of the exchange rate and reserves in the managed float with the path of the exchange rate in a pure float and the path of reserves in a crawling peg. Both comparisons point to substantial intervention. Appreciation of the nominal exchange rate at $t=0$ is 10-17% vs. 22-46% in a pure float. Cumulative reserve purchases are 52-88% as large as in a crawling peg, with the figure exceeding 75% when $\sigma = 2 - 3$. The “optimal” exchange rate, in other words, is about 3/4 of the way toward the crawling peg end of the spectrum.

6. Other Scenarios

This section examines the sensitivity of the results to alternative specifications of aid flows and sticky prices. To economize on space, we present numerical results only for $\sigma = 2$. Results for runs with $\sigma = .75, 3$ are available upon request.

6.1 Gradual Aid Flows

The right type of managed float avoids both a spike in the price level and excessive appreciation of the nominal and real exchange rate. It is, however, a complicated, imperfect solution to the macroeconomic problems associated with a sudden aid bonanza: a lot of information and a fair bit of technical expertise is needed to calculate the parameters of the policy rule in equation (31). An alternative, easier-to-implement strategy is to defer some aid to the future. If capital inflows and spending increase gradually along with aid, then macroeconomic stability may be compatible with a crawling peg or a pure float — with continued operation of a simple, transparent exchange rate regime.
Pursuing this idea, suppose aid rises toward its permanent level $\bar{X}$ at the rate

$$\dot{X} = c[\bar{X} - X(t)], \quad c > 0.$$  \hfill (32)

Delayed gratification should not be punished. The present value increase in aid is the same therefore as in the case where $X$ increases instantaneously from $X_o$ to $X^*$. This implies

$$\bar{X} = X_o + \frac{c + \bar{r}}{c}(X^* - X_o),$$  \hfill (33)

where $\bar{r}$ is the world market interest rate.

In Figure 11, $\bar{r}$ is 5% and the extra aid is phased-in slowly over a period of five years. Disappointingly, the results are similar to those in Figures 6.1 and 7. This reflects the logic of Life Cycle theory. Since the private agent anticipates higher aid flows and lower fiscal deficits in the near future, the paths for real expenditure, private capital flows, and other key macro variables are about the same as when aid increases instantaneously. The spike in the price level is still very large in a crawling peg, and sharp contraction in the nontradables sector, temporarily high real interest rates, and overshooting of the real exchange rate are still severe problems when the currency floats. In short, gradualism helps, but not enough to matter.

6.2 Inertial Inflation

In the specification of sticky prices developed by Calvo (1983), the price level is sticky but not the inflation rate. This detail is critical. The quick response of inflation is the reason an abrupt reduction in the rate of crawl works well in the Calvo model. Earlier we expressed doubts about the notion that prices are sticky upward. In this section we wish to make the additional point that different sticky-price models give different results. The strong, uniformly positive results in the Calvo model do not carry over to models in which sticky prices stem from inertial inflation.

There are a variety of ways to model inertial inflation. For illustrative purposes, we adopt the specification in Calvo and Vegh (1994). In their formulation,

$$\pi_n = \omega + \alpha[D_n(P_n, E) - \dot{Q}_n],$$  \hfill (34)
\[ \dot{\omega} = \Lambda (\pi_n - \omega), \]  

(35)

where \( \omega \), the rate of nominal wage growth, is predetermined. Equation (34) says that firms in the nontradables sector react to excess demand by raising prices faster than wages. The rationale for (35) is less clear; presumably workers aim for wage increases that track price growth at the firms that employ them.

Consider again what happens when aid increases and the government immediately reduces the rate of crawl \( \chi \) to its new steady-state level. It is apparent from equations (34) and (35) that the path to the new steady state will involve alternating periods of expansion and contraction. In the short run, nontradables output and \( \pi_n \) increase. But the initial expansionary phase must be followed by a contractionary phase if \( \pi_n \) is to trek downward in the direction of \( \chi \). Because \( \pi_n \) increases initially, the contractionary phase is often prolonged and deep. Panel A of Figure 12 assumes \( \Lambda = 1 \) and \( \alpha = 5 \). Although price adjustment is fast and inflation is not highly inertial, the expansionary phase is exceedingly brief and the subsequent recession lasts three years.

We should acknowledge that some of our other results are sensitive to the Calvo-Vegh pricing rule. In particular, while a managed float continues to dominate a crawling peg and a pure float\(^\text{31} \), it does not cure all macroeconomic problems: since wage and price inflation in the nontradables sector decrease only when firms operate with excess capacity, a recession is inevitable regardless of how the exchange rate is managed. This conclusion probably does not apply to all types of aid. Intuition suggests, for example, that spending aid money to increase supply might reduce inertial inflation without subjecting the economy to a recession. There is no pain-free solution, however, when aid affects only aggregate demand.

7. Concluding Remarks

The dynamic response to persistent official capital flows is linked to the degree of budget support they provide and the strength of private portfolio substitution. When these take even ordinary values, portfolio adjustments dominate the short-run dynamics and produce some distinctly unpleasant tradeoffs. A pure float, in particular, performs very poorly. Portfolio pressures produce a nominal appreciation that is an order of magnitude larger
than the required real appreciation, and unless the prices of nontraded goods are perfectly flexible, the real exchange rate overshoots and substitution effects drive the economy into a deep recession. A crawling peg does better, but allows a short-run spike in inflation; bond sterilization can prevent the inflation spike, but only at the cost of a rapidly rising interest burden. In our preferred “managed float” scenario, the central bank uses unsterilized foreign exchange intervention to target the modest real appreciation needed to absorb the aid inflow. Real interest rates then stay low and macroeconomic adjustment is rapid. Our analysis suggests that African central banks have been correct to intervene substantially in the face of recent increases in aid, and to discount the argument that rapid domestic liquidity expansion necessarily calls for a combination of bond sterilization and cleaner floating.

We close with some thoughts about two extensions of the analysis that would test the robustness of our conclusions in a broader policy context. The first concerns aid flows that support public investment. We have equated aid with transfer payments to the “poor” (i.e., the representative private agent). It is also desirable to investigate the repercussions of aid that finances rehabilitation of social and physical infrastructure. This type of aid brings many new effects into play. If productive capacity increases proportionately in the tradables and nontradables sectors, then appreciation of the real exchange rate will be strictly temporary. Furthermore, if private capital and infrastructure are complements, aid may produce large multiplier effects and a nontrivial increase in tax revenue in the long run. The complications that arose here from private capital inflows augmenting aid flows would then materialize in the case where all aid is spent. Related to this, we conjecture that productive aid — aid that has a strong positive impact on permanent income and the equilibrium private capital stock — will elicit immediate, large increases in private consumption and investment. In the short run, therefore, it might prove very difficult to contain inflationary pressures. This pushes the “optimal” managed float more in the direction of the middle ground between a fixed exchange rate and a pure float. How much more is not clear absent careful analysis. For what it is worth, our prior is that the macroeconomic tradeoffs associated with aid and the right policy intervention are sensitive to the type of aid.

The second extension acknowledges that African central banks have to worry about more than just aid shocks when deciding on the appropriate exchange rate regime. We are cur-
rently working on a stationary, discrete-time version of our model in which aid shocks compete with other important shocks for policymakers’ attention and some portion of aid may in fact represent a response to other shocks (e.g., to the terms of trade). We look for desirable intervention and sterilization rules, given a plausible loss function and given the observed joint distribution of shocks and aid. This approach links the analysis in the current paper with the growing literature on monetary policy rules in the open economy (e.g., Svensson, 2000). The conclusions we have emphasized here — including the merits of managed floating and the limited role for bond sterilization — seem likely to survive if the environment is dominated by autonomous and reasonably persistent changes in aid. What remains to be seen is whether these conclusions constitute a serious challenge, under more general circumstances, to rules that incorporate greater exchange rate flexibility and/or more aggressive bond operations.
Appendix

In this appendix we complete the solutions for the steady-state outcome and for the dynamic systems that control the transition path in a pure float and a crawling peg.

I. The Steady-State Outcome

The steady-state solutions for $E$ and $P_n$ are given in equations (17) and (18) in the main text. To get the solution for $\pi$, equate $dR$ in (20) to $dD$ in (19). This yields

$$d\pi = -\pi\mu - \rho sk + (1 - \psi)(1 - k) \frac{dX}{E} < 0$$

where $\mu \equiv m/E$ and $k \equiv \gamma/\eta < 1$. Under the assumption that $\psi < 1 - s\rho\gamma/\eta$, the fiscal deficit and inflation fall.

After substituting for $\pi$ and $E$ from (A1) and (17), equations (7') and (8') can be solved for $m$ and $F$. The solutions are

$$\frac{dm}{m} = \left[ \frac{1}{1 - k} + \frac{\epsilon}{\pi\mu(1 - \epsilon)} \left( \frac{\pi\mu - \rho sk}{1 - k} + 1 - \psi \right) \right] \frac{dX}{E} > 0, \quad (A2)$$

$$\frac{dF}{F} = -\left[ \frac{(\sigma - \tau)\theta_m}{i\mu(1 - \epsilon)} \left( \frac{\pi\mu - \rho sk}{1 - k} + 1 - \psi \right) - \frac{1}{1 - k} \right] \frac{dX}{E}, \quad (A3)$$

where $i = \rho + \pi$ is the nominal interest rate and

$$\theta_m = \frac{\phi_m m}{\phi_m m + \phi_F F} = \frac{im}{im + \rho F}$$

$$\theta_f = \frac{\rho F}{im + \rho F} = 1 - \theta_m$$

are the shares of liquidity services provided by domestic and foreign currency. The impact on $F$ is uncertain, but there is a very strong presumption that foreign currency holdings will decrease. Observe in (A3) that $i\mu(1 - \epsilon)/\theta_m = (i\mu + \rho F/E)(1 - \epsilon)$ is the ratio of liquidity services to national income, scaled down by $1 - \epsilon$. The reciprocal of this, which multiplies $\sigma - \tau$, is a huge number. Private capital flows out therefore only when domestic and foreign currency are extremely weak substitutes.
II. Flexible Exchange Rates

In a pure float the dynamic system consists of

\[
\begin{align*}
\dot{m} &= c(P_n)(g + rb) - X - \chi m, \\
\dot{F} &= P_n Q_n + Q_T + X - E, \\
\dot{E} &= \frac{\tau(\eta + \gamma)}{\eta} E(r - \rho),
\end{align*}
\]

(15"

along with

\[
\begin{align*}
\frac{dP_n}{P_n} &= \frac{dE}{(\eta + \gamma)E} \\
\end{align*}
\]

(22)

and the reduced-form solutions \( r(m, F, E) \) and \( \chi(m, F, E) \). The latter are obtained by solving (7), (8) and (24) for \( \pi, \chi \) and \( r \). After simplification, we get

\[
\begin{align*}
\dot{r} &= \frac{\rho \eta}{\tau \sigma (\eta + \gamma \tau)} [(\tau - \sigma) \theta_m dm/m - (\tau \theta_m + \sigma \theta_f) dF/F + \sigma dE/E], \\
\end{align*}
\]

(A4)

\[
\begin{align*}
\dot{\chi} &= - \left[ \frac{\rho}{\sigma} + \frac{\pi(\tau \theta_f + \sigma \theta_m)}{\tau \sigma} \right] \frac{dm}{m} + \left[ \frac{\rho}{\sigma} + \frac{\pi(\tau - \sigma) \theta_f}{\tau \sigma} \right] \frac{dF}{F} + \frac{\pi}{\tau} \frac{dE}{E},
\end{align*}
\]

(A5)

The requisite machinery is now in place. Linearizing (15"), (16") and (23) around the steady state \((m^*, F^*, E^*)\) produces

\[
\begin{bmatrix}
\dot{m} \\
\dot{F} \\
\dot{E}
\end{bmatrix} = \begin{bmatrix}
c_1 & -c_2 & c_3 \\
0 & 0 & k - 1 \\
c_4 & -c_5 & c_6
\end{bmatrix} \begin{bmatrix}
m - m^* \\
F - F^* \\
E - E^*
\end{bmatrix},
\]

(A6)

where

\[
\begin{align*}
v &= \rho \eta / \tau \sigma (\eta + \gamma \tau) \\
c_1 &= \frac{sv(\tau - \sigma) \theta_m}{\mu} + \frac{\rho}{\sigma} + \frac{\pi(\tau \theta_f + \sigma \theta_m)}{\tau \sigma} - \pi, \\
c_2 &= \frac{P_n^{\gamma \mu} b v (\tau \theta_m + \sigma \theta_F)}{F} + \frac{m}{F} \left[ \frac{\rho}{\sigma} + \frac{\pi(\tau - \sigma) \theta_f}{\tau \sigma} \right], \\
c_3 &= s(k + \sigma v) - \frac{\pi \mu}{\tau}, \\
c_4 &= \frac{\tau(\tau - \sigma) \theta_m v(\eta + \gamma)}{\mu \eta}, \\
c_5 &= \frac{\tau(\tau \theta_m + \sigma \theta_F) v(\eta + \gamma)}{\eta F / E}
\end{align*}
\]
\[ c_6 = \tau \sigma v(\eta + \gamma)/\eta. \]

The system is saddlepoint stable. (Saddlepoint stability requires \( c_2 c_4 - c_1 c_5 < 0 \), which holds for \( \epsilon < 1 \).) On the unique path that converges to the stationary equilibrium,

\[
m(t) - m_o = m^* - m_o - \frac{R_1}{R_2} (F^* - F_o) e^{\lambda_3 t}, \tag{A7}
\]
\[
F(t) - F_o = (F^* - F_o) (1 - e^{\lambda_3 t}), \tag{A8}
\]
\[
E(t) - E_o = E^* - E_o - \frac{F^* - F_o}{R_2} e^{\lambda_3 t}, \tag{A9}
\]

where

\[
R_1 = \frac{\lambda_3 - c_6 + c_5 R_2}{c_4} \geq 0,
\]
\[
R_2 = k - 1 > 0,
\]

and \( \lambda_3 \) is the system’s negative eigenvalue. Note that (A7) and (A9) can be written as

\[
m(t) - m^* = \frac{R_1}{R_2} [F(t) - F^*] \geq 0 \tag{A10}
\]
\[
E(t) - E^* = [F(t) - F^*]/R_2 > 0. \tag{A11}
\]

These are the equations for the MM and KK schedules in Figure 2 in the text.

It is clear from (A9) that expenditure overshoots its steady-state level at \( t = 0 \). Furthermore, since \( \dot{E}, \dot{F} < 0, \forall t \), the real interest rate is lower

\[
r(t) = \rho - \frac{1}{\tau} \frac{1 - k}{E R_2} (F^* - F_o) e^{\lambda_3 t} < \rho
\]

and current account (CA) deficits persist throughout the adjustment process

\[
CA(t) = \dot{F}(t) = -\lambda_3 (F^* - F_o) e^{\lambda_3 t} < 0.
\]

More work is required to show that the price level decreases on impact and the inflation rate is continuously lower. Recall that the nominal money supply is predetermined. Thus

\[
\frac{e(0) - e_o}{e_o} = -\frac{m(0) - m_o}{m_o}
\]
\[ m^* - m_o + \frac{R_1(F^* - F_o)}{R_2m_o} \]

After substituting for \( m^* - m_o \) and \( F^* - F_o \), this becomes

\[
\frac{e(0) - e_o}{e_o} = - \left\{ \left( \frac{R_2\sigma}{(\sigma - \tau)\theta_m(1 - k)} + \frac{\lambda_3 - c_6 F}{c_4} \frac{F}{m} \left[ \frac{(\sigma - \tau)\theta_m K}{i\mu(1 - \epsilon)} - \frac{1}{1 - k} \right] \right) \frac{dX}{ER_2} < 0, \right. \]

where

\[
K = \frac{\pi \mu - \rho sk}{1 - k} + 1 - \psi > 0. \]

The solution for the jump in the price level is obtained from (2), (22), (A9), and (A12):

\[
\frac{P(0) - P_o}{P_o} = \frac{e(0) - e_o}{e_o} + k \frac{E(0) - E_o}{E_o}
\]

\[
\Rightarrow \frac{P(0) - P_o}{P_o} = - \left\{ \frac{R_2}{1 - k} \left( \frac{\sigma}{(\sigma - \tau)\theta_m - k} \right) + \frac{F}{E} \left[ \frac{(\sigma - \tau)\theta_m K}{i\mu(1 - \epsilon)} - \frac{1}{1 - k} \right] \right. \]

\[
\times \left( \frac{\lambda_3}{c_4\mu} + \frac{\sigma}{(\sigma - \tau)\theta_m - k} \right) \left. \right\} \frac{dX}{ER_2} < 0. \]

Finally, equation (22) and the first-order conditions (7) and (8) yield

\[
\frac{k_2}{k_3} \left( \frac{m}{F} \right)^{-1/\sigma} = \frac{\eta(\tau + \pi)}{r(\eta + \gamma\tau) - \rho\gamma\tau}. \]

\[ m/F \text{ rises and } r \text{ falls, so } \pi \text{ must decrease at } t = 0. \text{ This guarantees continuously lower inflation on the transition path to the new steady state. (After jumping at } t = 0, \text{ the path of } \pi \text{ is continuous, with } \dot{\pi} = w((F^* - F_o)). \text{ For } w > 0, \dot{\pi} < 0. \text{ When } w < 0, \dot{\pi} > 0, \text{ implying that } \pi \text{ approaches its steady-state level from below.)} \]
III. A Crawling Peg

A crawling peg gives rise to the system

\[
\begin{align*}
\dot{E} &= \frac{\tau(\eta + \gamma)}{\eta} E(r - \rho), \\
\dot{J} &= c(P_n)(g + rb) + P_n Q_n + Q_T - E - \chi m,
\end{align*}
\]

(23) (25)

where, to repeat, \( J \equiv m + F \). Equations (7′) and (8′) give

\[
\begin{align*}
\dot{m} &= \frac{\sigma \pi \mu}{\Delta} dE + \frac{m}{F \Delta} [\tau \rho + \pi \theta_f(\tau - \sigma)]dJ, \\
\dot{r} &= \frac{\rho i \eta}{\Delta F(\eta + \tau \gamma)} \left( \frac{J}{E} dE - dJ \right),
\end{align*}
\]

(A15) (A16)

where

\[
\Delta = \tau[\theta_f i + \theta_m \rho(2 + 2 \rho \theta_m / \theta_f)] + \sigma \theta_m \pi^2 / i.
\]

Routine algebra now delivers

\[
\begin{bmatrix}
\dot{J} \\ \dot{E}
\end{bmatrix} = \begin{bmatrix}
-n_{16} & n_{17} \\ -n_{18} & n_{18}
\end{bmatrix} \begin{bmatrix}
J - J^* \\ E - E^*
\end{bmatrix},
\]

(A17)

where

\[
\begin{align*}
n_{16} &= \frac{P_n b \rho i \eta}{\Delta F(\eta + \tau \gamma)} + \frac{\pi m}{F \Delta} [\tau \rho + \pi \theta_f(\tau - \sigma)] \\
n_{17} &= k(1 + \rho s) + \frac{s J \rho i \eta}{\Delta F(\eta + \tau \gamma)} - \frac{\pi^2 \sigma \mu}{\Delta} - 1, \\
n_{18} &= \frac{\tau \rho i (\eta + \gamma)}{\Delta(\eta + \tau \gamma)}.
\end{align*}
\]

Under the weak restriction \( \eta > \rho s \gamma \), the steady state is a saddle point and the solutions for \( J \) and \( E \) read

\[
\begin{align*}
J(t) - J_o &= (J^* - J_o)(1 - e^{\lambda_2 t}), \\
E(t) - E_o &= E^* - E_o - (J^* - J_o) R_3 e^{\lambda_2 t},
\end{align*}
\]

(A18) (A19)

33
where $\lambda_2$ is the system’s negative eigenvalue and

$$R_3 = \frac{n_{18}}{n_{18}(J/E) - \lambda_2(F/E)} > 0.$$  

To locate the position of $J^*$, add the solutions for $m^*$ and $F^*$ in (A2) and (A3):

$$J^* - J_o = \begin{cases} \frac{J}{1-k} + \frac{m}{i\rho}[\tau \rho + \pi \theta_f(\tau - \sigma)]\frac{\pi \mu - \rho s k + (1 - \psi)(1 - k)}{(1-k)(1-\epsilon)} & \text{Impact of $E$} \\ \frac{i \rho (1 - \epsilon)(\eta + \gamma)}{\pi \theta_f [\pi \mu(\eta + \gamma) - \rho s\gamma + \eta(1 - \psi)]} & \text{Impact of $\pi_f$} \end{cases} \frac{dX}{E}. \quad \text{(A20)}$$

Higher spending increases total currency demand proportionately, but the impact of lower inflation depends on initial conditions ($\pi_o$, $\theta_f$) and the relative magnitudes of the substitution parameters $\sigma$ and $\tau$. For $\sigma$ sufficiently large, the second term is negative and larger in absolute value than the first. Solving for the borderline value of $\sigma$ produces

$$J^* < J_o \quad \text{iff} \quad \sigma > \tau(1 + \rho/\pi_f) + \frac{i \rho (1 - \epsilon)(\eta + \gamma)}{\pi \theta_f [\pi \mu(\eta + \gamma) - \rho s\gamma + \eta(1 - \psi)]} \frac{J}{E}. \quad \text{(A21)}$$

**IV. Temporary Sterilization**

When the government engages in temporary sterilization,

$$\dot{b} = -\alpha[b(t) - b_o]. \quad \text{(29)}$$

This alters only one equation in the flexprice crawling peg variant of the model. The public sector budget constraint is now

$$\dot{m} + c(P_n)\dot{b} = c(P_n)(g + rb) + X + \dot{Z} - \chi m, \quad \text{(A22)}$$

so (25) changes to

$$\dot{J} = c(P_n)(g + rb) + c(P_n)\alpha(b - b_o) + P_nQ_n + Q_T - E - \chi m. \quad \text{(A23)}$$

Proceeding as before yields

$$J(t) - J_o = J^* - J_o + h_2 e^{\lambda_2 t} + [b(0) - b_o]R_4 e^{-\alpha t}, \quad \text{(A24)}$$

$$E(t) - E_o = E^* - E_o + h_2 R_3 e^{\lambda_2 t} + [b(0) - b_o]R_5 e^{-\alpha t}, \quad \text{(A25)}$$
where

\[ R_4 = (\alpha + \rho)\left(\frac{n_{18}J}{F} + \alpha\right)/H, \]
\[ R_5 = (\alpha + \rho)n_{18}E/FH, \]
\[ H = \alpha^2 + \alpha\left(n_{18}J/F - n_{16}\right) + \frac{n_{18}}{F}(n_{17}E - n_{16}J). \]

At \( t = 0 \), \( J \) jumps downward by the same amount as \( b \) jumps upward. Thus

\[ h_2 = J_o - J^* - [b(0) - b_o](1 + R_4) \]
NOTES

1. The Poverty Reduction Strategy Paper (PRSP), articulates a country’s medium-term macroeconomic and public expenditure program. In the majority of countries the PRSP anticipates increased public expenditures financed in part by sustained increases in net aid flows, including from debt relief payments arising from the Highly Indebted Poor Countries (HIPC) initiative.


3. Dissatisfaction with the policy choices is evident in Ouanes, Nyawata and Jonassen (2001) radical suggestion (p.21) that aid inflows should not exceed a country’s “sterilization capacity.”

4. Calvo, Leiderman and Reinhart (1994) argue that it is best to absorb capital inflows through a float on the grounds that appreciation of the nominal exchange rate reconciles appreciation of the real rate with with lower inflation. Schadler et al. (1993) and Fernandez-Arias and Montiel (1996) worry, however, that floating may result not only in extreme volatility of the nominal exchange rate but also in greater appreciation of the real rate. Assessments of sterilization are equally diverse and inconclusive. Calvo (1991) and Calvo, Leiderman and Reinhart hold that sterilization is self-defeating: the higher real interest rates that accompany bond sales worsen inflationary pressures by increasing the fiscal deficit; moreover, higher interest rates attract additional capital inflows, necessitating further bond sales, etc. Echoing this position, Schadler et al. first assert that “sterilization is discredited as a response to capital inflows” (p.3), but then acknowledge that “sterilization is often effective in insulating an economy for short periods of time from some of the unwanted effects of surges in inflows” (p.30). This latter view is close to that of Lopez-Mejia (1999), Khan and Reinhart (1995), Held and Szalachman (1998), and Fernandez-Arias and Montiel (1996), who contend that sterilization is effective in the short run but hard to sustain because of rising fiscal costs.

5. Ghana has been struggling off and on for twenty years to find the right policy response to large aid inflows. See Younger (1992) for an account of the 1987-1994 period.

6. It is more common to write the price index as \( P = (k^\beta e^{1-\beta} + k^\beta \tilde{P}^{1-\beta})^{1/(1-\beta)} \), where \( \tilde{P} \) is the nominal price of the nontraded good. This is the same expression as in equation (2).

7. It easy to confirm that \( \gamma = P_n C_n / E \). See equation (12) that follows in the text.

8. We exploit here linear homogeneity of \( \phi \) and the fact that \( P/e = c(P_n) \).

9. Aggregate real consumption is nominal expenditure \( \tilde{E} \) divided by the price level \( P \). Since \( \tilde{E}/P = E/c(P_n) \), the term on the left side in (10) equals the percentage change in real consumption.
10. For simplicity, we ignore interest payments on reserves. This ensures that the long-run impact of aid on real income and the fiscal deficit is independent of the exchange rate regime.

11. Note from (13) that \( \dot{M}/e = \dot{H}/e + \dot{Z} \), as changes in \( e \) affect the domestic currency value of foreign exchange reserves but not the money supply.

12. This condition holds comfortably when we calibrate the model to the data in Section 3.1.

13. In the latter case, the fraction of aid reserved for budget support should be halved in order to keep the impact on the fiscal deficit the same.

14. A recent IMF study stresses this point: “Aid also serves as a way for the government to finance its domestic expenditures, as an alternative to domestic tax revenue or borrowing, either from the public or from the central bank. It may seem, therefore, that the financing of expenditures such as the hiring of nurses is an alternative use for aid, in addition to imports. But this approach to the function of aid is misleading; after all, the purpose of aid is not to allow the domestic expenditure. After all, the government could always simply borrow from the central bank (i.e., print money) to finance these expenditures.” (Berg, 2005, p.3)

15. See the appendix for a formal proof that the price level decreases on impact and that inflation is continuously lower on the transition path to the new steady state.


17. See Kamin and Ericsson (1993), Savastano (1996), and Balino, Bennett, and Borensztein (1999).

18. HIPC debt relief is projected to reduce debt service from 14.1% of export earnings in 2003 to 4.4% for the period 2004-2013 (IMF 2004b). The reduction is equivalent to 3.1% of 2003 GDP.

19. The paths for inflation, the real interest rate, the current account balance, etc. were generated by substituting the linearized solutions for the variables in the core dynamic system into the static nonlinear model. This “semi-Novales” procedure retains more of the nonlinear structure of the model and thereby reduces linearization error. In the full Novales procedure, the linearized solution for the core dynamic system is used only to impose stability conditions on the relationship between the paths of the state variables and the paths of the jump variables. The solution paths for all endogenous variables (\( r, \pi \), etc.) and for the state variables are computed from the original nonlinear model. We computed fifteen solutions using both the semi-Novales and full Novales procedures. The results were very close in every case (often differences did not appear until the third or fourth decimal place). Since the semi-Novales procedure is faster and easier to program, we used it to generate the solutions.

20. Observe that terms involving \( (r - \rho)d(\gamma \tau / \eta) \) do not enter into the solution because \( r - \rho = 0 \) evaluated at a steady state.
21. Aid is funneled to the private sector through lump-sum transfers. Since $\gamma_o = .50$, approximately half of the extra aid money is spent on nontraded goods. If aid financed some project that involved a larger component of nontraded spending, the initial increase in the price level would be greater. When all aid is spent on nontraded goods, for example, the upward jump in $P$ at $t = 0$ is about twice as large as in Table 2.

22. Due to continuous-time compounding, the increase in the price level over the calendar year is greater than 10% when $\dot{P}/P = \pi = .10$ (i.e., $e^{.25} - 1 = .284$). The figure reported for inflation in the first year is the constant level of inflation that produces the same increase in the price level at $t = 1$ as in the model.

23. Forecasts are mathematically correct and weighted by the probability the price quote will be in force at time $t$.

24. To solve the floating rate model, real money balances measured in units of the nontraded good has to be introduced as a state variable.

25. We assume fast price adjustment: $\delta = 5$ in Figures 7 and 8. The path for the current account is not shown because it differs little from the path in the flex-price case.

26. The severity of the recession is sensitive to the intertemporal elasticity of substitution. When $\tau = .50$, the decrease in $Q_n$ at $t = 0$ is 5.5% for $\sigma = .75$, 8.7% for $\sigma = 2$, and 9.5% for $\sigma = 3$. Recovery is fairly rapid, but $Q_n$ is still 1.6-4% lower at $t = 1$.

27. For $\sigma = 3$, there is an imperceptible deficit in the short run.

28. Paying off the debt more quickly results in higher real interest rates.

29. This drawback of sterilization is emphasized by Schadler et al. (1993) and Calvo, Leiderman and Reinhart (1994).

30. Interestingly, numerous empirical estimates find offset coefficients close to those in Table 6. See Agenor and Montiel (1999, p.204).

31. We have not presented results for a pure float and inertial inflation. They are too awful to contemplate.

32. For a couple of reasons, we do not consider the assumption that aid is permanent to be especially limiting. First, empirical measures of aid generally show strong persistence in African countries. Even after removing a linear trend, for example, the variance of variables like real aid per capita or the aid-to-GNP ratio tends to be dominated by low-frequency components. [Thus while Bulir and Annan (2001) emphasize the volatility of aid, their analysis applies to the short-run “cycle” — i.e., the component that remains after using the Hodrick-Prescott filter to remove a slow-moving nonlinear “trend.” The trend itself shows very substantial persistence, even when applied to linearly detrended aid series.] Second, intuition suggests that temporary aid inflows will produce results qualitatively similar to but quantitatively weaker than in the case of permanent aid flows. (The present model applies, of course, if the government converts temporary aid into permanent aid by spending only its annuity value.)
33. Theory suggests that the crowding-in effect on private investment could be quite strong. See Buffie (1995).

34. Since they will shortly be used in linearizing (23) and (25), the solutions in (A15) and (A16) are evaluated at the stationary equilibrium.

35. The steady state is a saddle point iff

\[ n_{17} - n_{16}J/E < 0, \]

or

\[ \gamma\rho s - \eta - (\eta + \gamma)\frac{\mu}{\Delta} \left[ \frac{J}{F} \pi (\rho + \pi \theta_f) + \sigma \pi \left(1 - \theta_f \frac{J/F}{<1}\right) \right] < 0. \]

The second and third terms in the stability condition are negative. The first term is positive, however, because the feedback effects between changes in expenditure, the real exchange rate, and the real interest payments on the internal debt are mutually reinforcing. This is a nuisance, not a serious problem. Instability is a threat only if \( \eta \) is unusually small and variations in the real exchange rate unrealistically large. Even in the extreme case where \( \gamma = .80 \) and real interest payments on the internal debt are 10% of national income, \( \eta > .10 \) ensures stability.
References


International Monetary Fund, 2004a, “Ghana: Second Review Under the Poverty Reduction and Growth Facility and Request for Waiver of Non-observance of Performance Criteria.” (Prepared by the African Department.)


