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The political economy dimensions of macroeconomic management of aid in Ghana

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The political economy dimensions of macroeconomic management of aid in Ghana

Robert Darko Osei,* Freda Asem, and George Domfe

October 2013

Abstract

This paper contributes to the debate on aid effectiveness by looking at the ‘how’ of aid effectiveness. In other words it provides an assessment of whether aid only filled a financing gap or whether it, in addition, helped influence the political economy in a way that engendered growth. Ghana provides a good case for an assessment of this question as it saw significant aid inflows over the last two and a half decades and also recorded significant growth and poverty reduction. The paper asserts that aid has impacted positively on growth, in part through the creation of an enabling environment for private sector-led growth. It also argues that aid has helped shape macroeconomic management in Ghana, identifying three channels through which aid has supported macroeconomic management. First, aid has supported both physical and social infrastructure and therefore growth. Second, aid has helped reduce fiscal instability by limiting domestic borrowing. Third, it helped shape the general policy direction in Ghana. It concludes by arguing that the aid-induced policy has helped in the operation of a more effective and efficient market system in Ghana today.

Keywords: aid, macroeconomic management, political economy

JEL classification: F35, H11, O23

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Acronyms

CEPA Centre for Policy Analysis
NDC National Democratic Congress
NLC National Liberation Council
NPP New Patriotic Party
ODA official development assistance
SSA sub-Saharan Africa

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1 Introduction

There have been, and continue to be, numerous studies on aid effectiveness in the literature with different conclusions. This debate is not likely to cease in the near future for a number of reasons. First, most developing countries have large infrastructure deficits in a phase of rapidly growing population. Second, the potential of developing country governments to finance these infrastructure deficits is limited as the potential for domestic resources mobilization remains low. Therefore aid and other external inflows remain critical, if important milestones with respect to economic and social developments are to be met. Of course, this was the early logic of aid, which still remains true today. As Harrigan and Younger (2000: 185) put it, ‘...poor countries lack capital, so if wealthy countries transfer capital to them, they should grow out of poverty’.

However, the early optimism that was associated with aid seems to have been somewhat watered down. Maybe the diminishing optimism has to do with the fact that after over 50 years of aid to developing countries, poverty remains rife in many of these countries, particularly those in sub-Saharan Africa (SSA). Aid to Africa is noted to have come mainly from both bilateral and multilateral sources with the multilateral aid ranging between 26 per cent and 34 per cent of total net aid disbursements. In addition, about two-thirds of the aid received has been in the form of grants (Loxley and Sackey 2008). So why does global poverty remain such a big problem in the face of all this aid? Is it because aid has not been effective? Is aid really down the rat hole (Boone 1994)? Is it a case of diminishing returns to aid (Hansen and Tarp 2001)? Is aid a scapegoat for development policy failure? After all, development policy is not all about aid.

Aid is termed effective if it is able to contribute significantly to poverty alleviation or sustained poverty reduction. Effective aid supports institutional development and policy reforms that are at the heart of successful development. According to McGillivray (2005), empirical research on the macroeconomic impact of aid has shown that per capita income growth would have been lower in the absence of aid. There are, however, other studies that provide inconclusive, often contradictory findings to this assertion. So why does aid now appear to be working in promoting growth after decades of little or no clarity in research over its effectiveness? Views as to why this is so include the fact that donors are paying more attention to the developmental criteria in the design and application of aid activities (McGillivray 2005). Another reason why aid is now thought to have a positive impact may be because recent studies employ better empirical methods and have access to better data, making it possible to observe such an impact. Thus, aid might always have been effective and that earlier studies were simply not able to observe such an impact (McGillivray 2003).

Given the development challenges of today, one will be forgiven for arguing that aid will remain with us for the next few decades. Therefore the question of whether aid has been effective or not, and the nature of the parameters that drive the degree of effectiveness, will continue to be asked. In this paper we wish to contribute to the debate by providing an assessment of how aid flows to Ghana, a major recipient of aid in SSA, has contributed to macroeconomic management. In particular, we look at how aid influenced this political economy, and how that, in turn, helped shape the macroeconomic management in Ghana. Ghana is a good case because not only has it seen significant aid inflows over the last two and a half decades but it has also recorded good successes in terms of economic growth and poverty reduction. Does this correlation mean aid has been effective for Ghana? How has aid helped shape the political economy dimensions of the management of the macroeconomy? These questions, among others, form the basis this paper.

The paper is organized as follows. Section 2 discusses the political economy of Ghana with emphasis on how politics has influenced macroeconomic developments of the country. In section 3 we discuss the economic trends of Ghana. This mainly includes fiscal and monetary performance over the post-independence period to 2010. In section 4 the trends in aid inflows over the years, as well as correlates with key macroeconomic variables, are discussed. Section 5 presents some of the key econometric evidence on aid effectiveness for Ghana. We then discuss the macroeconomic management of aid in Ghana in section 6, with the conclusions presented in section 7.

2 The political economy of Ghana

2.1 The economy at the time of independence

Ghana's economy at independence in 1957 was a small, open one and heavily dependent on international commerce. As with many developing economies of the time, it was dualistic in nature, traditional labour-intensive production techniques co-existing with the modern capital-intensive techniques in all sectors of the economy (Killick 2010).

In the early days of independence, Ghana subscribed to a central planning approach, which seemed to be consistent with the development thinking at the time. The premise was that central planning would ensure that resources of the state, both human and material, were employed to ensure equity. Consequently the state participated directly in the productive system of the economy as it created new enterprises in addition to buying the few failing gold mines and large trading companies (Killick 2010).

Key features of the central planning process that were particularly manifest in Ghana included legislative controls on imports, capital transfers, licensing of industries, minimum wages, the rights and powers of trade unions, prices, rents and interests rates. While the country achieved an appreciable level of infrastructural development, much could not be said of economic growth. The expansion in gross domestic product (GDP) during this period only kept pace with the population growth rate of 2.6 per cent.

2.2 Major changes after Nkrumah (late 1960s and 1970s)

The National Liberation Council (NLC) that toppled the Nkrumah government had no interest in a particular ideology. Killick (2010) argues that the NLC was not concerned with any 'body' of economic ideas. Its preoccupation was the restoration of efficiency to the economy. The pro-capitalist civilian government that was elected in 1969 concerned itself with development. At that time, the chief problems facing the country were the imbalance in the country's foreign payments, high inflationary pressures and rising unemployment rates (Killick 2010). The main economic policy over this period was the promotion of entrepreneurial skills of Ghanaians to enable them partake more in business activities (Asem et al. 2013).

The economy over this period started to stabilize with inflation coming down. However, this period was short lived as the government was overthrown in a coup de etat in 1972. The decade of the 1970s generally was one of political instability with a number of military take-overs (Jedwab and Osei 2012). The period was also characterized by drought and the oil price shock. As noted by (Asem et al. 2013: 25) '... very frequent and capricious overthrow of

governments over this period meant no consistent policy reform agenda could have been pursued’.

The era of economic reforms

Persistent drought around the turn of the decade (1979–83) led to unprecedented records of bushfires in the early 1980s. Decline in food production brought severe famine in its wake and the repatriation of about a million Ghanaians from Nigeria. This compounded the already precarious fiscal situation. The government thus had no other alternative than to agree to the economic recovery programme (ERP) in 1983 (Kraev 2004).

The reforms were designed on the basis of the neo-liberal orthodoxy, with a particularly optimistic view that the market mechanism would promote efficiency and development (Aryeetey and Tarp 2000). The ERP had three broad objectives. First it sought to improve macroeconomic stability through improving tax effort, reducing government expenditures, creating incentives for domestic production, and devaluing the cedi. Second, the government sought to reduce its involvement in direct production by privatizing state-owned enterprises. Third, it sought to incentivize the private sector by intensifying monetary reforms and reducing private corporate tax rates (Asem et al. 2013).

The reforms chalked some degree of success and made Ghana appear as a frontrunner in adjustment in the eyes of the international community. In the late 1980s, the government embarked on a series of democratization reforms such as decentralization, which culminated in the reintroduction of multi-party democracy in 1992 (Asem et al. 2013). Overall, Ghana enjoyed remarkable political stability during the period of reforms, albeit with occasional protests but no civil unrest and systematic effective opposition (Kraev 2004).

In 1992, the then military government of Rawlings transformed itself into political party and was democratically elected under the name National Democratic Congress (NDC). They remained in power until 2001 when they were defeated by the main opposition party, New Patriotic Party (NPP). It has been argued that the NPP pursued more private-sector-friendly policies over its two terms (see Asem et al. 2013; Jedwab and Osei 2012).

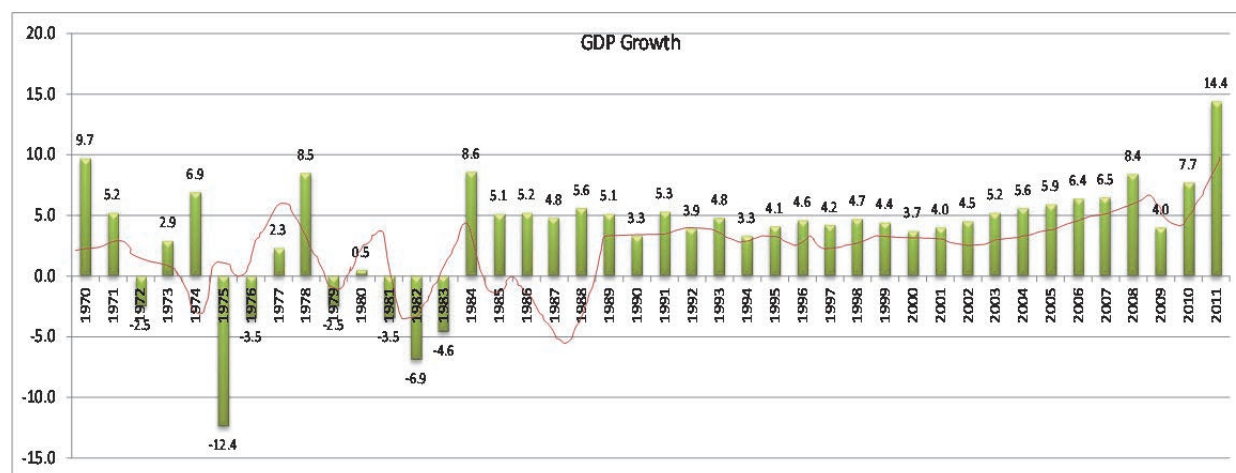
3 Economic trends in Ghana

3.1 Trends in growth

Two distinct periods can be discerned from the economic growth trends for Ghana. The first, which spans between 1970 and 1983, saw growth averaging near zero and with very large swings (Figure 1). The economy generally oscillated for most part of this period. This has been attributed in part to internal factors—economic mismanagement and political instability, and also exogenous factors, including: severe droughts in 1975–77 and 1981–83; adverse shifts in the country’s terms of trade; oil shocks of the 1970s and increasing rates of interest on external debts following adjustments in the developed market economies to curb inflation (see Killick 2010; Lloyd et al. 2001). The second phase spans the period of economic recovery to 2011. This period has recorded generally positive growth on average, with the added feature of the beginnings of an acceleration in growth in the last 10 years of the sample. Economic growth has been significant especially between 2002 and 2008, averaging about 6.1 per cent per annum. In the year 2011, the economy grew at an unprecedented rate of 14.4 per cent, making it the fastest growing economy in the world. This growth, though, was principally driven by oil production which started during the last quarter of 2010.

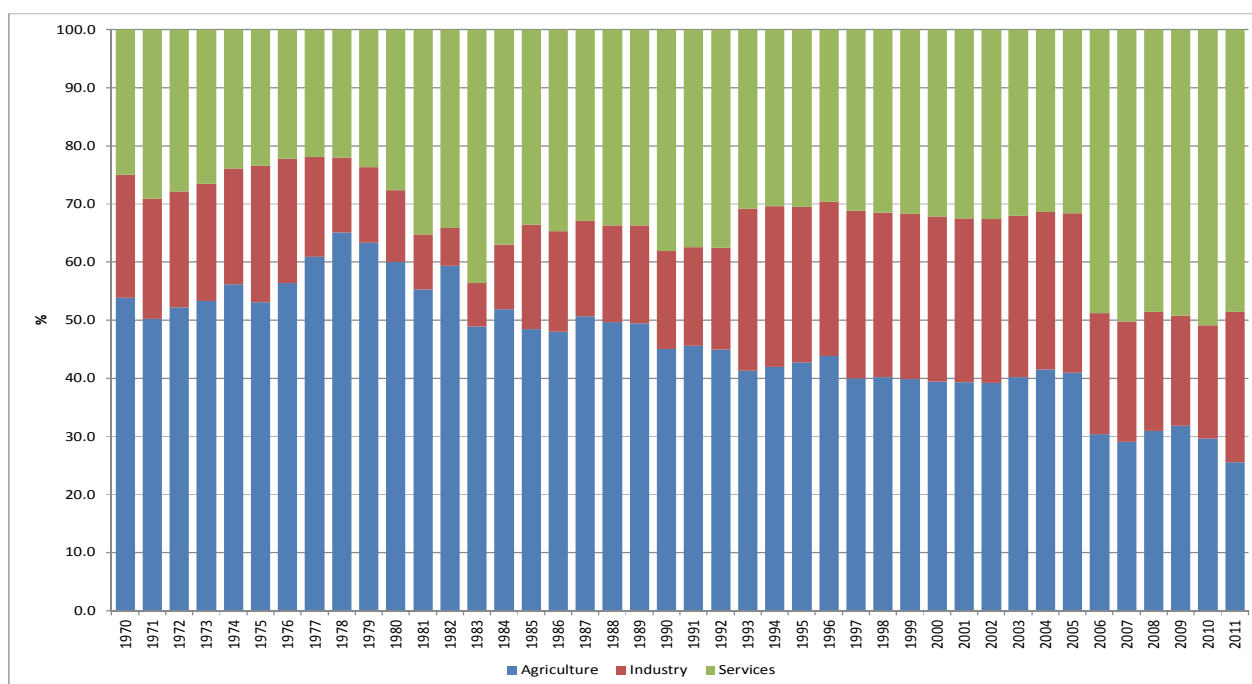
While the agricultural sector was the largest contributor to GDP in the past, this trend has changed with the services sector assuming that position since 2006. There is no doubt that part of this change has been engineered by the recent rebasing exercise which affected the GDP from 2006. It is important to note that with oil production, the industrial sector's share in GDP is likely to pick up. However, this will mainly be reflected in the mining subsector with no guarantee of improvements in the manufacturing subsector. For this reason among others, Osei (2012) cautions that this changing structure is not the growth-enhancing type. He maintains that for the changing structure to be developmentally transformative, it must be associated with increasing growth and the importance of high-value manufacturing.

Figure 1: Trends in economic growth, 1970–2006



Source: WDI-World Bank (2012) and Ghana Statistical Service.

Figure 2: Sectoral contribution to GDP, 1981–2010



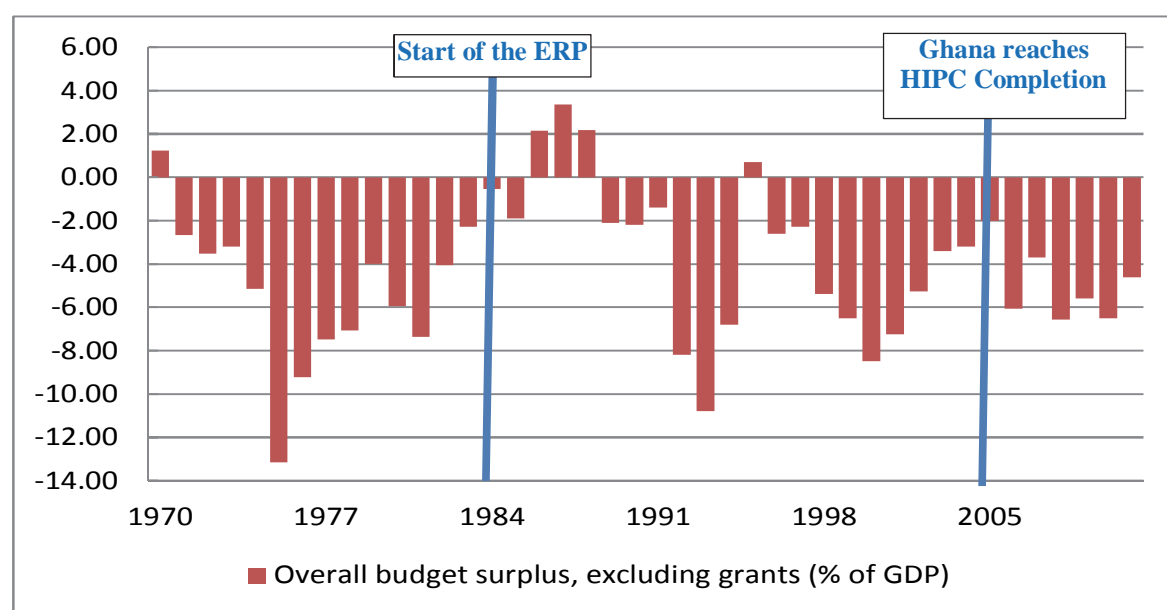
Source: Authors' computation based on Ghana Statistical Services.

3.2 Trends in fiscal and monetary performance

Fiscal balance

Fiscal balance data, as shown in Figure 3, indicates that over the last four decades Ghana governments have mostly run fiscal deficits. The magnitude of the deficits seems to have been smaller over the post-1984 period compared to the preceding one. Indeed the period that saw the best years in terms of government fiscals, coincide with the economic recovery period. As Osei et al. (2005) note, there were only minor differences in fiscal behaviour under the various governments from about the mid-1960s to the early 1980s. The deficits narrowed after 1983 and by the late 1980s the country was recording surpluses. This was however short-lived as by the early 1990s, the country had started recording deficits again. Foreign aid did play a part in the improvement in fiscals over that period (see Addison and Osei 2001; Osei et al. 2005). A notable feature of Ghana's fiscal deficits in more recent times is the improvements observed for the period 2002-05. The improvements came from the strict compliance to the HIPC initiative conditions set for fiscal management. Unfortunately after reaching HIPC completion point, the country's fiscal position worsened again (Figure 3). Another feature that one can observe with the fiscal deficit trends is that the position seems to worsen over electoral cycles. Part of the problem with the electoral cycles comes from the high spending associated with these cycles. In election years, foreign aid becomes very important for the stability of the macroeconomy, as the government would otherwise resort to domestic financing. The foregoing discussion suggests that aid has directly and indirectly helped in maintaining fiscal discipline in the post-reform period in Ghana.

Figure 3: The trend of budget deficit in Ghana, 1970–2011/*rebase years



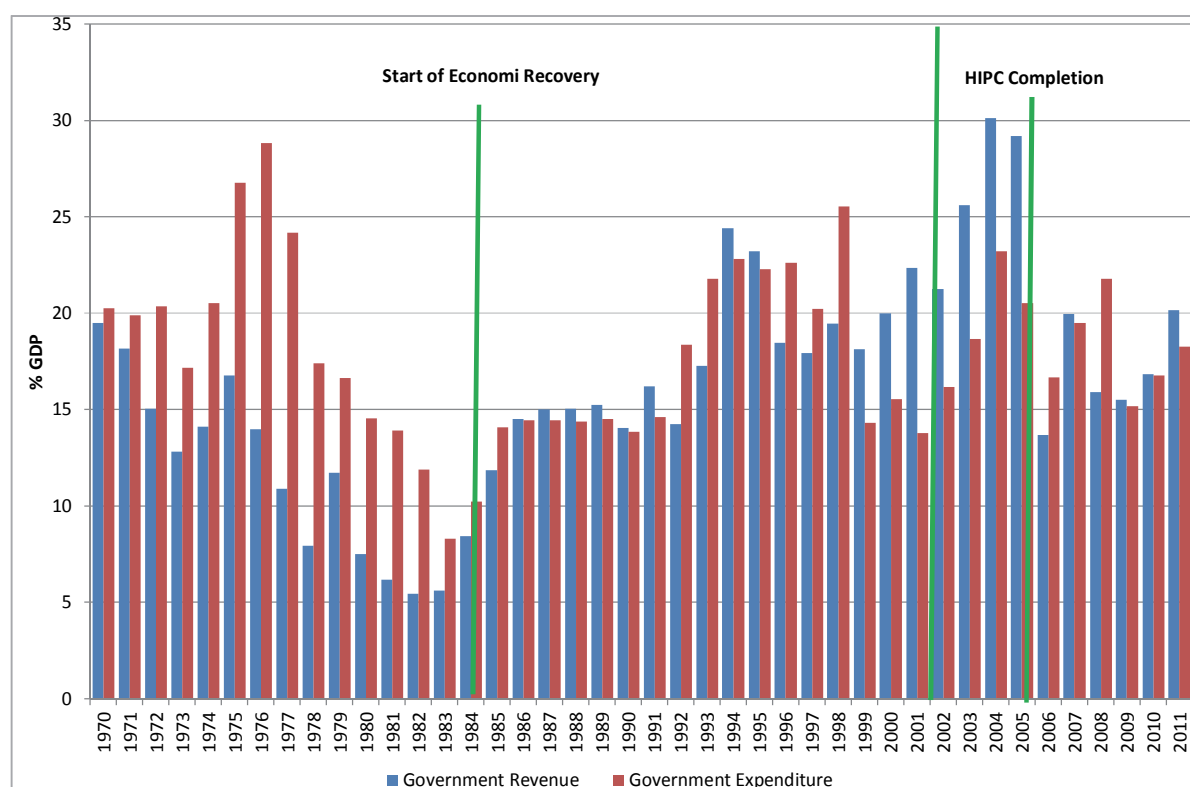
Source: WDI-World Bank (2012).

One notes from Figure 4 that generally, expenditures have consistently exceeded revenue. Even when one takes into account the rebasing of GDP from 2006,¹ one can still observe an

¹ The apparent shift in both revenue and expenditure from 2006 is a result of the GDP, which led to a nominal rise of about 75 per cent

increase in the revenue-GDP ratios over the years (Figure 4). However the expenditure increases have generally matched the revenue increases and so it has been difficult to record a consistent reduction in the deficits. Even when deficits had to be narrowed under the HIPC conditionalities, the expenditure pressures remained strong, almost matching that of revenue. Not surprisingly therefore that upon reaching the HIPC completion point, the expenditure-revenue gap again widened. These patterns reinforce the earlier assertion that aid may have helped to enforce fiscal discipline in Ghana. We explore this hypothesis later in this paper.

Figure 4: Government revenue and expenditure trends, 1970–2010 (% of GDP)



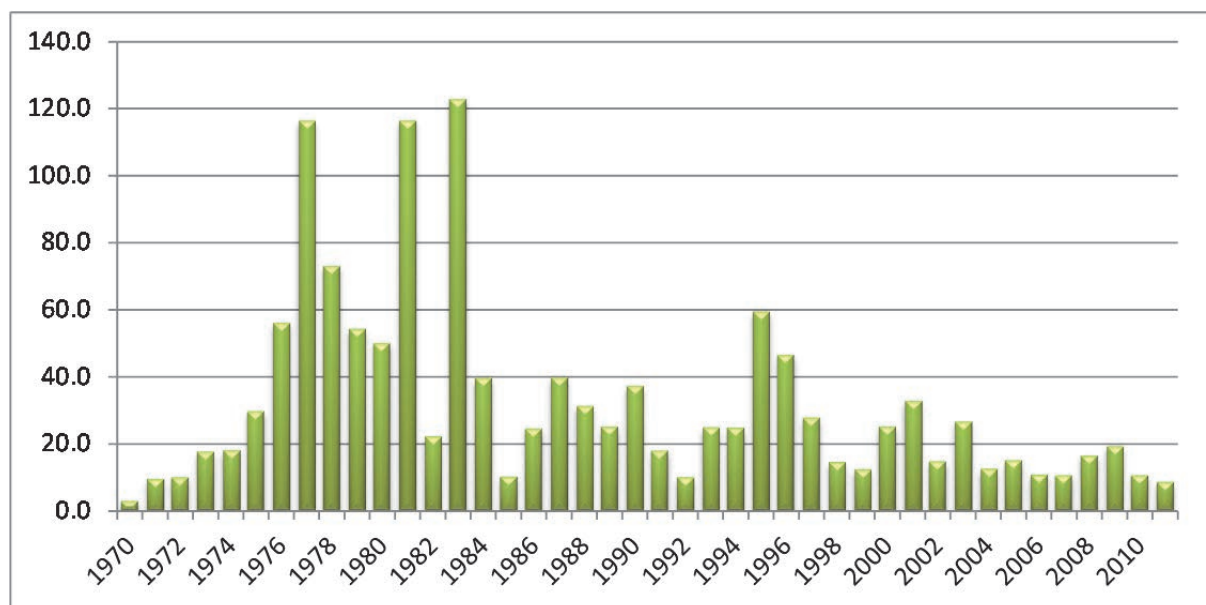
Source: Compiled by authors from various issues of the Government of Ghana Budgets.

Inflation

Inflation has been an intractable problem to the Ghanaian economy. It was especially high between 1976 and 1983 when the country was affected by global oil price hikes, political instability and a severe drought. The adoption of the IMF/World Bank initiated reforms appears to have helped in significantly easing the supply-side constraints and consequently growth in prices, particularly in the second half of the 1980s. The implementation of inflation targeting policy from about 2003 seems to have also helped considerably in the disinflationary process in the last decade (Figure 5).

Amoah and Mumuni (2008) attribute the jumps in 2003 and 2005 to the strong external oil price shocks and the realignment at the onset of and subsequent implementation of deregulation in administered domestic pricing of petroleum products. On the other hand, the jerks in 2008 and 2009 were influenced principally by the developments in the global economy. Ghana, as with many developing countries, was affected by the global food crises in 2007 which was exacerbated by the unprecedented hikes in the global oil prices.

Figure 5: Trend of inflation, 1970–2006

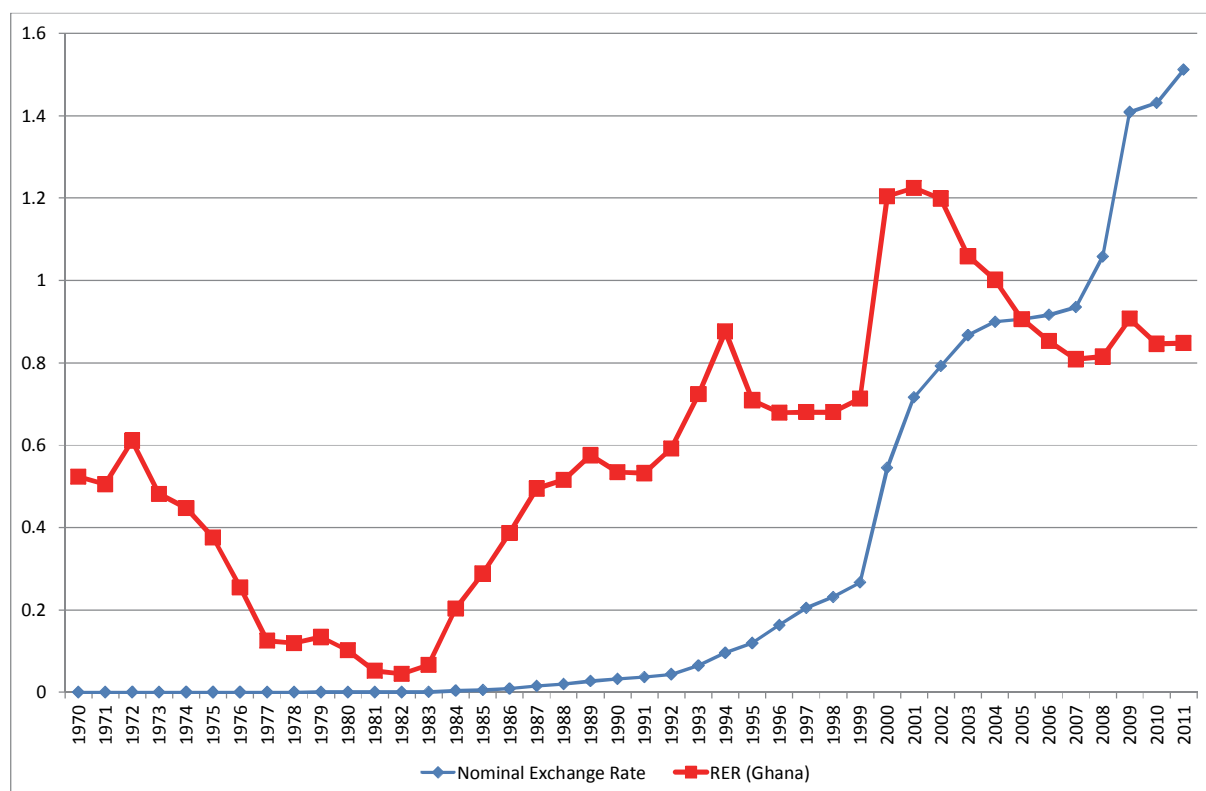


Source: WDI-World Bank (2012) and Ghana Statistical Service.

Exchange rate

The Ghanaian cedi was highly overvalued in the pre-reform era under the fixed exchange rate regime (Harrigan and Oduro 2000). As a result, the cedi appeared to be quite stable against the US dollar and other major foreign currencies (Figure 6). The reality, however, was that

Figure 6: Trend in nominal and real exchange rate for Ghana, 1970-2011



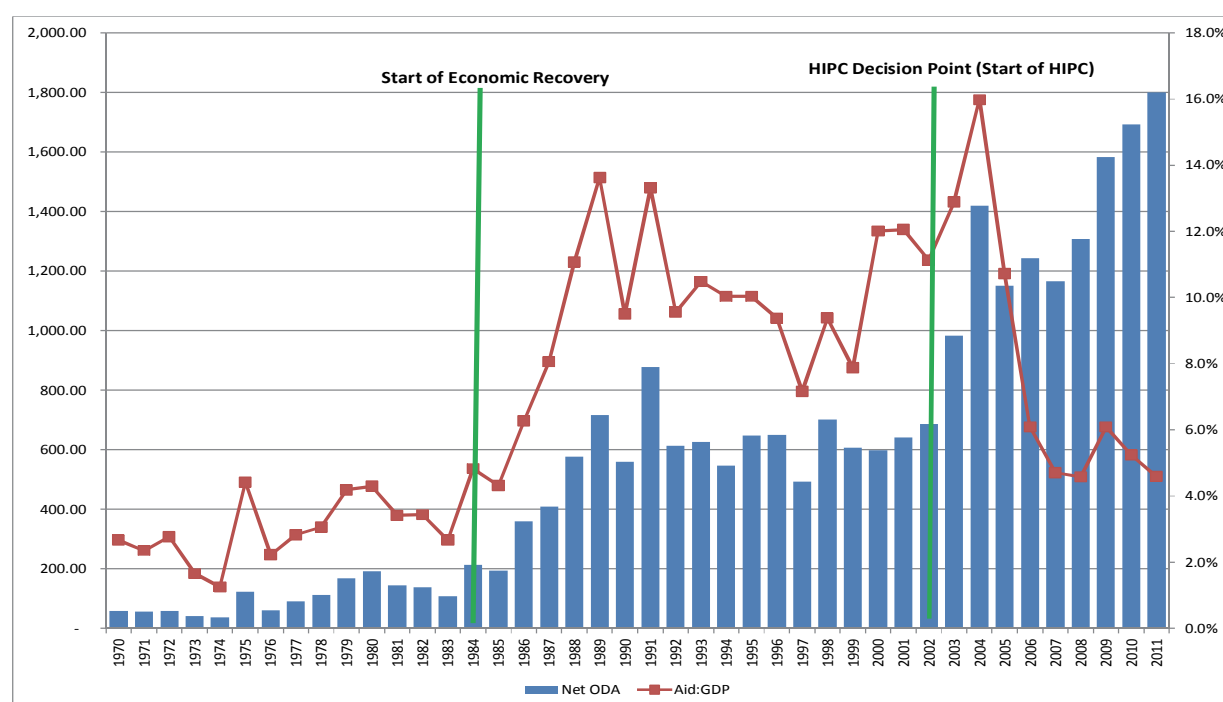
Source: WDI-World Bank (2013) and Ghana Statistical Service.

foreign currency was very scarce and the ‘black market’ became the more ‘efficient’ avenue for foreign exchange transactions. One of the objectives of the economic recovery programme was the abolishment of price controls (see Harrigan and Oduro 2000). In the case of the exchange rate regime, this was started gradually and it was not until 1986 that an exchange rate auction was started with the aim of moving towards a market determined rate. Harrigan and Oduro (2000) show that it was in 1990 that the official rate and the black market premium were unified. We note from Figure 6 that before the economic reforms, nominal exchange rates were fixed. However, the stable nominal exchange rate was at a cost of being uncompetitive as the real exchange rate appreciated over the period. The trend with respect to both the nominal and real exchange rates over the period 1984-2002 has been generally upward, signifying real depreciation in the exchange rates. The period from about 2003 to about 2011 recorded again an appreciation of the real exchange rates.

4 Trends in aid flows to Ghana, 1970-2010

In Figure 7 we show net official development assistance (ODA) to Ghana, over the period 1970 to 2010. The data show a sharp increase in aid inflows from about 1984. Indeed, the annual average ODA to Ghana over the period 1970–84 was about US\$107 million. As a per cent of GDP, this was about 3.1 per cent on average. However from about 1985, there was significant increase in net ODA on the whole: the annual average over the period 1985-2011 was over US\$846 million, almost eight-fold compared to the pre-1984 period average. The increase in aid flows to Ghana during ERP and post-ERP has not been trivial. In fact, Harrigan and Younger (2000) show that aid to Ghana as a per cent of GDP and in per capita terms exceeded the SSA average from about the late 1980s (see also Quartey 2005). The other marked increase in more recent years coincides with the start of the HIPC initiative—between 2002 and 2003, net ODA increased from about US\$686 million to over US\$983 million.

Figure 7: Aid inflows to Ghana, 1970–2010



Source: Authors' calculations based on data from WDI-World Bank (2013).

4.1 Correlates of aid and selected macroeconomic variables

In Figure 8 we plot a scatter diagram for aid flows on one hand and economic growth on the other, over the period 1970 to 2010. We note that for the period before 1985, the relationship between aid and growth was largely negative but insignificant—the fitted linear trend shows a very weak association between aid flows and GDP growth. However, over the period with significant aid inflows (the post-1984 period), one observes a positive relationship between aid and growth. The association between these two variables is also much stronger over the latter period. We do not make any claim of causality here, as that is an empirical issue. However, there is no denying the fact that large inflows of foreign aid to Ghana have been associated with higher and more steady economic growth. We discuss some of the empirical literature on Ghana in the next section.

The relationship between aid and investments-to-GDP share seems to follow a similar pattern as that of aid and growth (Figure 9). Before 1985, the relationship between aid flows and investment shares was weakly negative. However, for the period after 1985, there seems to be a positive and strong association. The annual average gross capital formation figures as a per cent of GDP, were respectively 9.5 per cent and 19.9 per cent in the periods before 1985 and 1985–2010. We note further from Figure 10 and Figure 11 that the positive association for the latter period is mainly driven by private capital formation. As we can see from the correlation between aid and public investment shares remained negative even in the 1985–2010 period. This is interesting, given that aid is mainly given to governments and so the more direct route between aid and investments will be through the public arm of investments. However, in the case of Ghana aid seems to have a positive correlation with private investments. This is consistent with the argument that aid may have contributed to creating a conducive environment for private investment in Ghana (Asem et al. 2013).

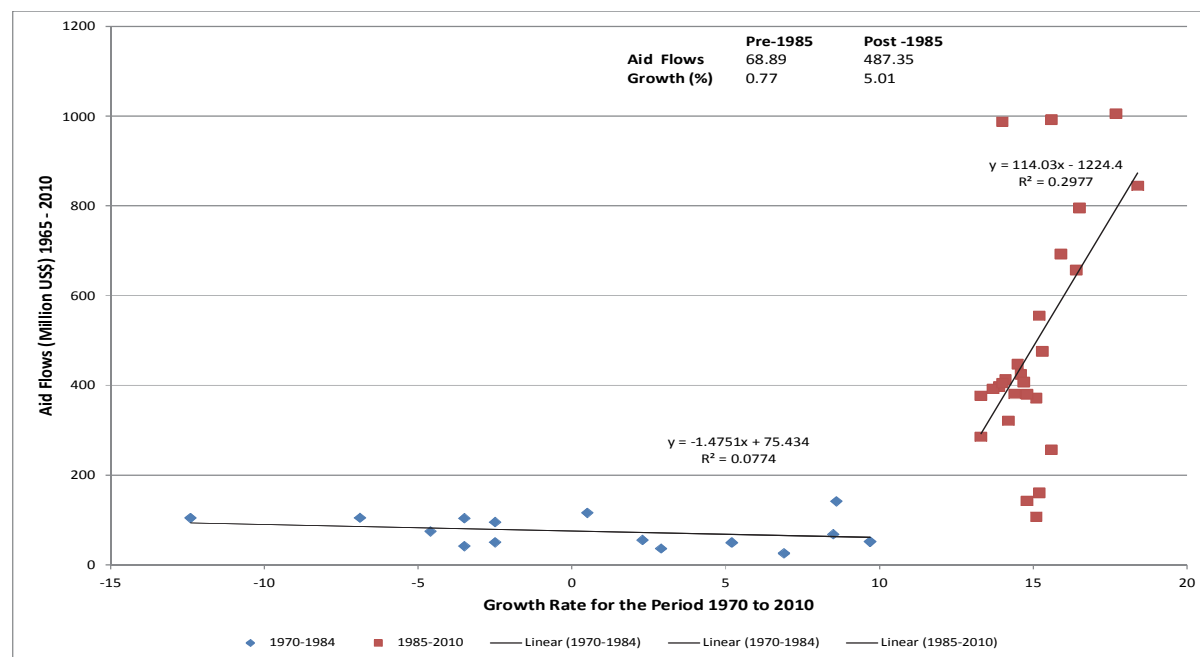
In Figure 12 we show the relationship between Ghana's budget balance and aid flows over the period 1970 to 2010. As noted earlier government fiscals have generally been in a deficit over Ghana's history. However in the period up to the start of the ERP (1970–84), the relationship between the deficits and aid inflows to Ghana was almost non-existent. However for the period 1985 to 2010, one observes a negative relationship between aid flows and fiscal deficits. This suggests that higher deficits have been associated with higher aid inflows. Here again we are not in any way suggesting a cause-effect relationship from one to the other. A plausible explanation may be that aid commitment fuels high budget deficits. If this is the case, then one can argue that aid helps reduce macroeconomic instability in the sense that, countries would otherwise have had to borrow more domestically. In other words, this positive association may be because aid is a cheaper source for financing deficits. In the next section we discuss empirical evidence with respect to aid and government fiscal behaviour.

We observe a somewhat similar relationship between aid and inflation as we did for the aid-fiscal deficits. Here also we note that the correlation between aid and inflation is very weak in the pre-1985 period but negative and strong in the post-1984 period (Figure 13). This reinforces that earlier suggestion that increased aid has been associated with improved macroeconomic stability for Ghana.

We note from Figure 14 that for the pre-reform period, aid inflows were generally low and associated with an appreciation of the real exchange rates. For the reform and post-reform period, however, aid was positively correlated with real exchange rates. In other words aid inflows have been associated with a depreciation of the real exchange rates. The observed correlation in the latter period may be inconsistent with the Dutch disease theory which

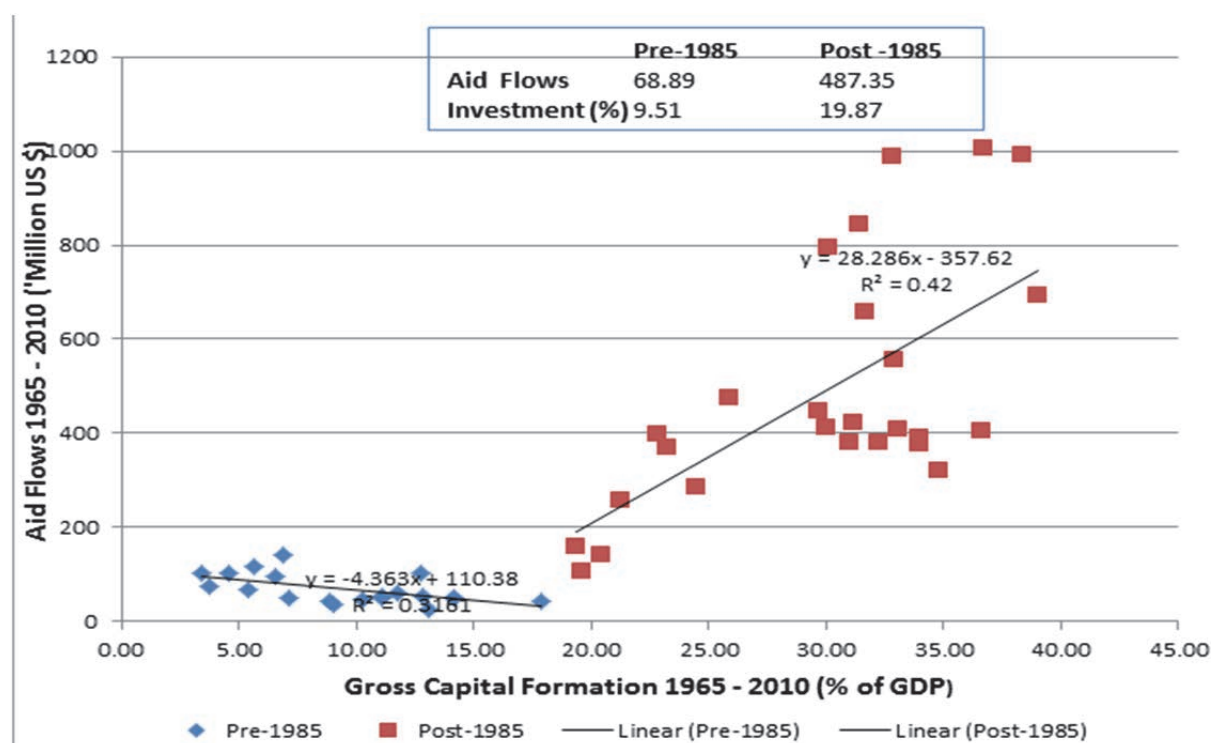
suggests that capital inflows should lead to an appreciation of the real exchange rates. However when one considers the significant misalignment of the exchange rates in the pre-reform period in Ghana (see for instance Harrigan and Oduro 2000; Opoku-Afari et al. 2004), then one could argue that the observed relationship may be as a result of a third variable such as policy. In other words, aid's effect on real exchange rate over the reform and post-reform period was to influence the exchange rate regime, as Harrigan and Oduro suggest (2000: 154–6).

Figure 8: Aid versus economic growth for Ghana, 1970–2010



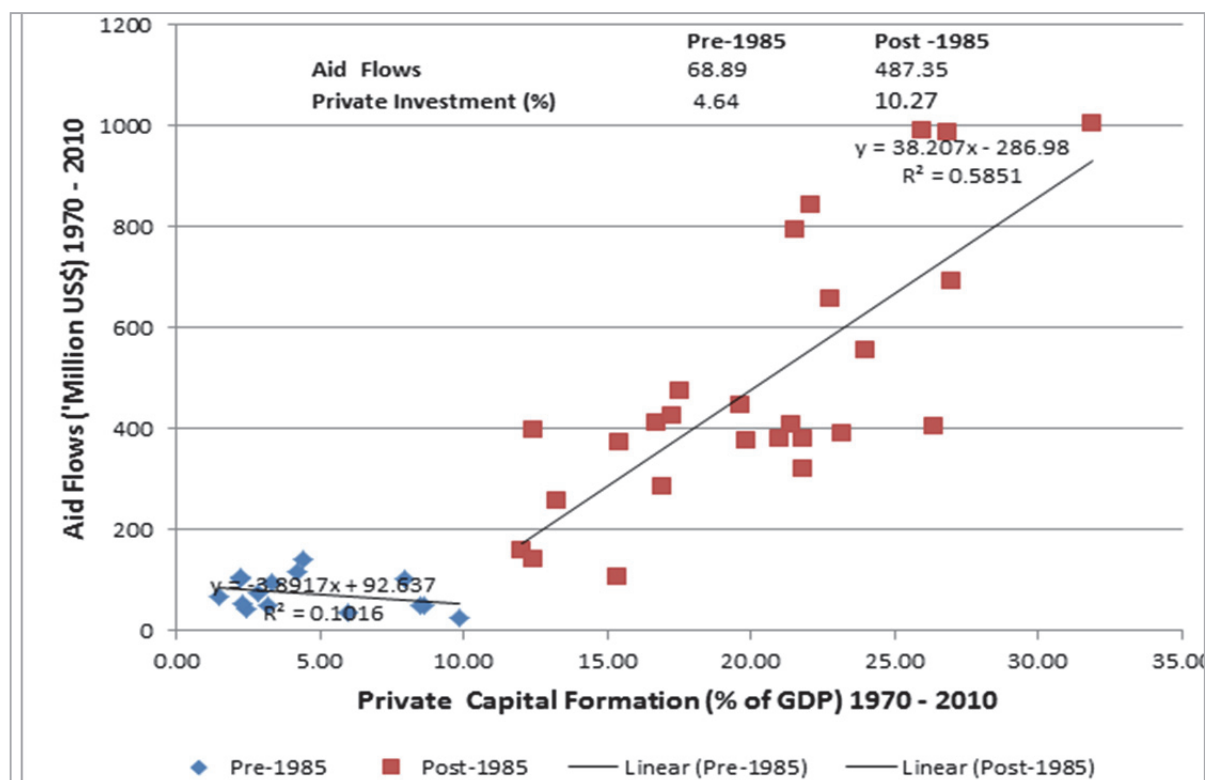
Source: Authors' calculations based on data from WDI-World Bank (2013).

Figure 9: Aid versus gross capital formation for Ghana, 1970-2010



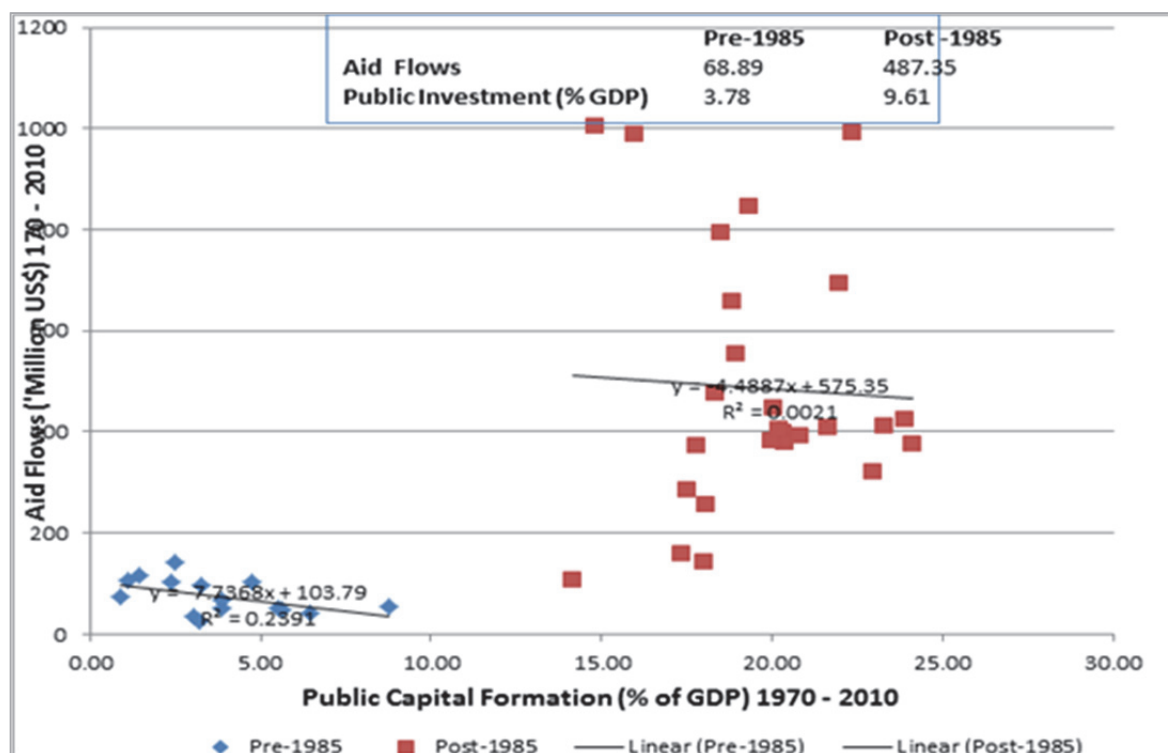
Source: Authors' calculations based on data from WDI-World Bank (2013).

Figure 10: Aid versus gross private capital formation for Ghana, 1970–2010



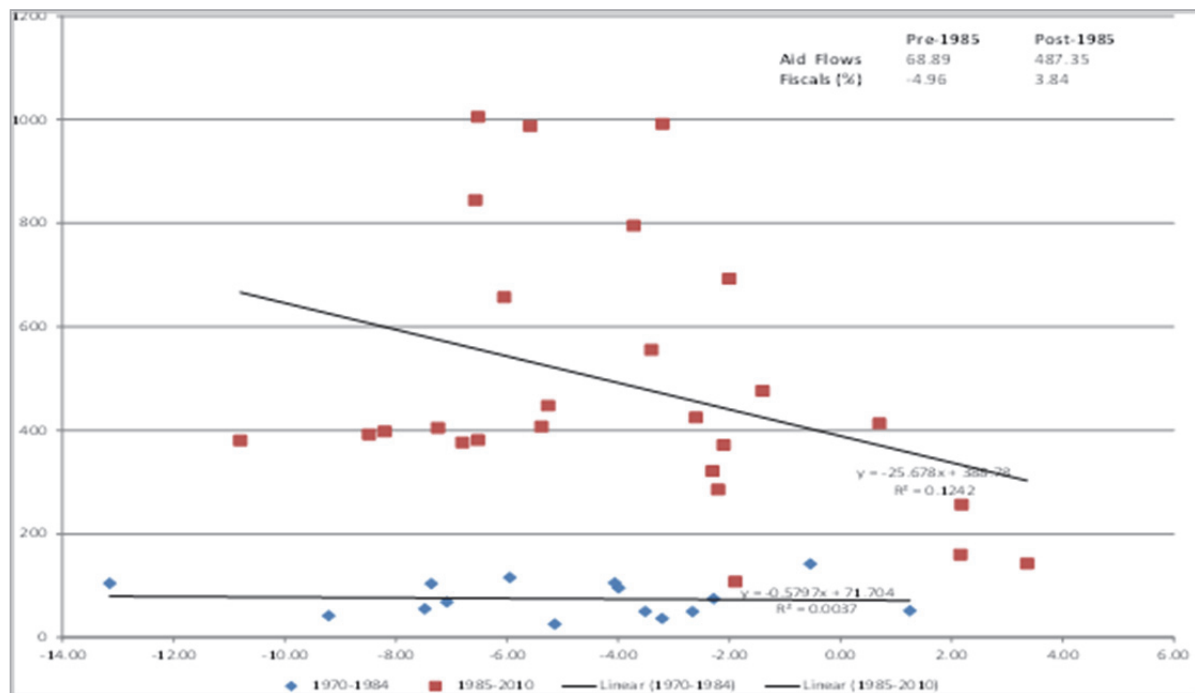
Source: Authors' calculations based on data from WDI-World Bank (2012).

Figure 11: Aid versus gross public capital formation for Ghana, 1970–2010



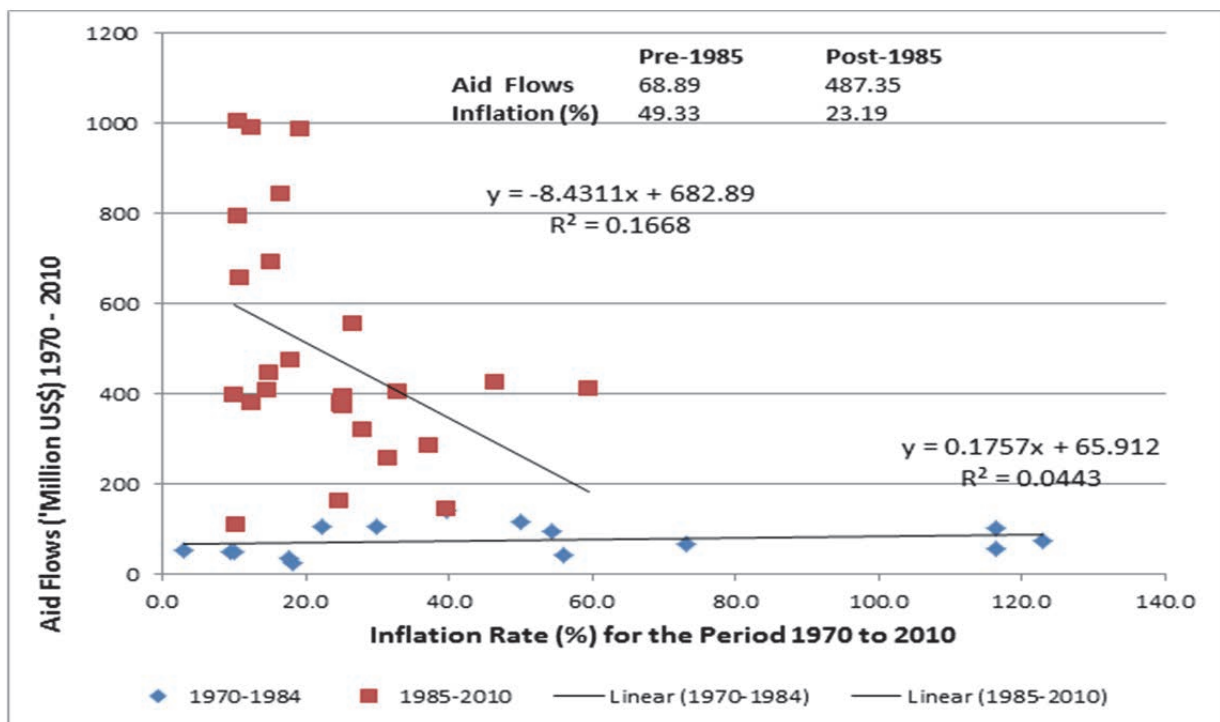
Source: Authors' calculations based on data from WDI-World Bank (2012).

Figure 12: Aid flows to Ghana and Ghana's fiscals, 1970–2010



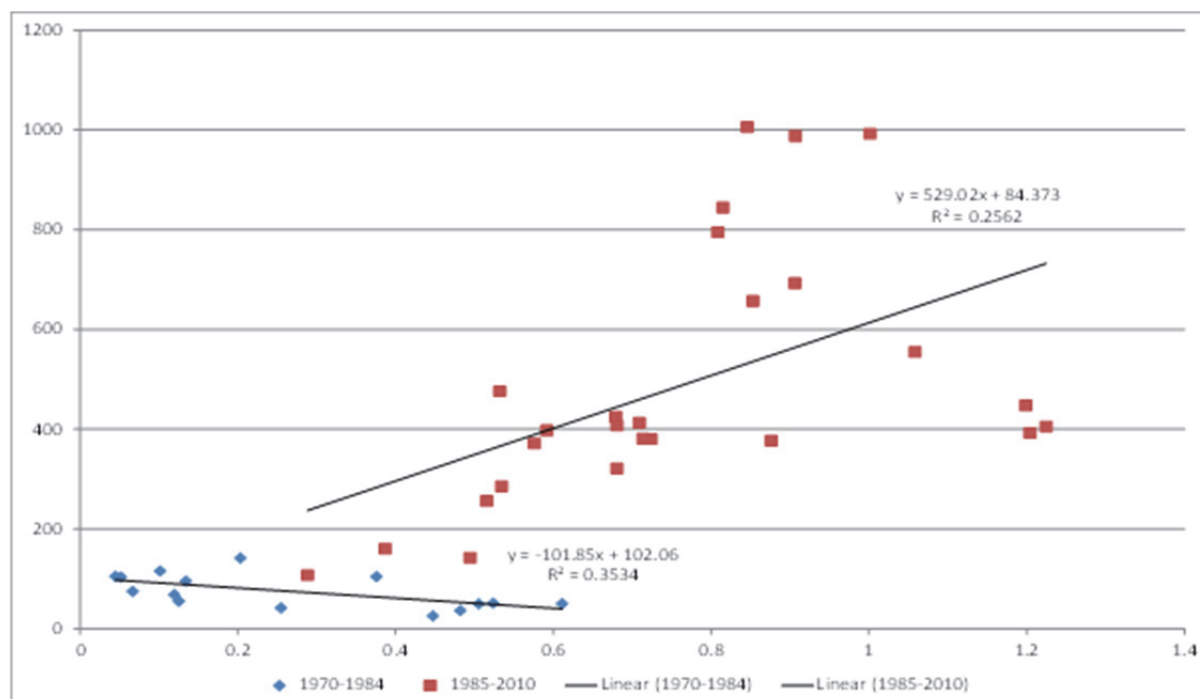
Source: Authors' calculations based on data from WDI-World Bank (2012).

Figure 13: Aid flows to Ghana and Ghana's inflation rate, 1970–2010



Source: Authors' calculations based on data from WDI-World Bank (2013).

Figure 14: Aid Flows versus real exchange rates for Ghana, 1970-2010



Source: Authors' calculations based on data from WDI-World Bank (2013).

5 Aid effectiveness: some evidence for Ghana

Our discussion of the trends and correlations between aid and selected macroeconomic variables generally suggests that aid inflows to Ghana have been associated with improved growth and macroeconomic stability. In this section we discuss some of the econometric evidence on the effectiveness of aid.

The issue of aid effectiveness has been discussed widely in the literature. Generally one can think of two broad views with respect to the evidence on aid effectiveness. First, we have the sceptics who believe that aid has done little or no good for recipient countries and should therefore be discontinued (see Boone 1994). Second, we have those who believe that aid has been largely effective even though the degree of effectiveness may vary from country to country (Hansen and Tarp 2001; Juselius et al. 2011). Juselius et al. (2011) note that the differences in aid effectiveness results may stem from three sources—the econometric approach used; the choice of the data transformation used for the analysis; and exogeneity or endogeneity assumptions. These views are generally consistent with those of Riddell (2007) in his chapter on ‘assessing and measuring the impact of aid’. In this paper we do not attempt to do a general review of the literature on aid effectiveness. Rather we discuss some of the more recent econometric evidence on aid effectiveness for Ghana.

Juselius et al. (2011) provide an analysis on the effect of aid on a set of key macroeconomic variables in 36 SSA countries of which Ghana is one, using the cointegrated VAR (CVAR) modelling approach. Their results show that for Ghana, aid has had a positive and significant impact (long-run) on GDP but a negative impact on investment. The result for Ghana is interesting and raises a number of questions. For instance, does this suggest that aid’s impact on GDP in Ghana is through other channels rather than investment? How does one reconcile the result that aid has had a negative impact on investment with the popular view that aid has

supported many infrastructure investments in Ghana? In what ways has aid led to a decrease in investments in Ghana? Undoubtedly getting answers to these questions is important if the effectiveness of aid to Ghana is to be improved. This result is somewhat consistent with Ackah et al. (2013) who find that aid has contributed to growth in Ghana, at least since the 1980s through supporting policy reforms and also by financing investment.

Osei et al. (2005) provide econometric analysis of the fiscal effects of aid in Ghana. They find that aid has been used as a substitute for domestic borrowing in Ghana. In addition they find evidence that aid led to increased tax effort for Ghana. Ackah et al. (2013) also find that aid to Ghana increased government spending, reduced tax revenue, and domestic borrowing. This supports the assertion that aid to Ghana helped shape policies in a good way (Asem et al. 2013).

The econometric evidence on aid effectiveness for Ghana suggests that there is more to the statistical evidence on the effectiveness of aid. As Riddell (2007: 355) notes, two critical determinants of the impact of aid are the commitment of the recipient; and the capacity to utilize the aid effectively. In other words, the effectiveness of aid is affected by the use to which the recipient puts the aid. Also how a recipient country uses its aid is influenced by the political economy. We therefore discuss the political economy dimensions of policy generally in Ghana and how these have been influenced by aid.

6 So how has aid affected macroeconomic management in Ghana?

There is little debate on the improvement of the political environment in Ghana over the last 30 years. The period over which this improvement has been seen has also been associated with increased aid inflows and improvement in the macroeconomic environment. We have also discussed some of the empirical evidence which generally points to the fact that aid has been effective in Ghana. The quantitative evidence is undoubtedly very informative. However, it does not bring to the fore the other critical dimensions of aid's effectiveness in Ghana. In this section of the paper we discuss the 'softer side' of aid (i.e., political economy dimensions) in shaping the macroeconomic management in Ghana. The discussion here is premised on the view that foreign aid has, on the whole, impacted positively on growth and development in Ghana. Our analysis here is based on Ghana's experiences as culled from different sources, plus in-depth interviews with experts who have been involved with macroeconomic management and research in the country over the years. We identify three main channels by which aid has affected macroeconomic management—filling a savings-investment gap, reducing macroeconomic instability, and shaping the general economic policy direction of Ghana.

There is qualitative evidence for Ghana that aid has impacted on growth through the classical channel of bridging the savings and investment gap. We must admit here that this may not always be consistent with the quantitative evidence as found in Juselius et al. (2011). However, evidence abounds as to how aid has supported both physical, social and institutional infrastructure. Some of the aid-supported investments have been in the provision of critical public goods. In the past one can point to the Akosombo Dam which was built with the help aid² and which continues to this day to be the major source of power generation in

² Of the US\$196 million used for the construction of the Akosombo Dam, US\$47 million was from the World Bank (IBRD), US\$27 million from USAID, US\$14 million from UK government, US\$10 million from Eximbank and US\$98 million was from Kaiser (see Decker 2011).

Ghana. Some of the more recent examples include the infrastructure investments financed under the Millennium Challenge Account programme for Ghana over the period 2007–12. Under this programme, for instance, many rural roads were built to help reduce the burden of carting food from farming communities to markets. Other examples mentioned during some of our interviews included the following:

On arrival at Bosase today, you will see villages transformed, and that is aid at work ... The Kofi Annan International Peace Keeping Training Centre is another example of aid at work... The Ghana Stock Exchange was established in 1991 with a grant of about half a million USD from Canada (Country Director, UNDP Ghana Office 2012).

Speaking on developments around the period when the economic recovery started, Dr Joe Abbey notes that there was a lot of rehabilitation of the productive capital stock that needed to be undertaken then. He notes, for instance, that the 1983 bushfires made it necessary for the perennial tree stock (mainly referring to cocoa and oil palm) to be rehabilitated. This, he points out, was done with the help of aid. There is no doubt therefore that an important channel through which aid has impacted on developments in Ghana is by helping to fill the saving-investment gap. In this light one can argue that aid helped macroeconomic management by supporting economic growth and development.

A second channel through which aid has impacted positively on macroeconomic management in Ghana is by helping to reduce macroeconomic instability over the years. As noted earlier, aid to Ghana tends to impact the extent to which domestic borrowing is undertaken. The consequence of low aid is increased domestic borrowing and consequently a squeeze on private sector borrowing, high interest rates and inflation. Indeed Osei et al. (2005) argue that aid to Ghana tends to be more important in driving recurrent spending than it does with capital spending. Some have argued that aid tends to ease significantly government cash flow challenges which would otherwise have meant a resort to domestic financing with adverse consequences for macroeconomic stability. As noted earlier the early 1980s period was characterized by both low aid inflows and significant macroeconomic instability. Killick (2010: 405) notes that a first priority at the start of the economic recovery programme was a restoration of macroeconomic stability. He goes on to make the point that, ‘This meant, among other things, bringing some rationality to the exchange rate and getting the budget under control’.

This view is also consistent with Harrigan and Young (2000) who argue that during the period of economic recovery, aid helped the government to survive external shocks without resorting to policies that would have compromised sound economic policy at the time. In more recent times an example of how aid has helped macroeconomic management can be told of the experience of 2009. Following fiscal slippages associated with the elections of 2008, the country had to rely on an extended credit facility from the IMF and the World Bank to halt the depreciation of the cedi and reduce net domestic financing as well (World Bank 2011). Of course, one has to be careful here so as not to fall into the trap of inferring causality from an observed correlation. Other factors such as the tightening of government spending (which was partly achieved through the creation of arrears) may have helped solve these short-term cash flow challenges. However, many experts and commentators (including government) agree that the extended credit facility did help in addressing the macroeconomic challenges that faced the economy in 2009.

The third channel through which aid has impacted very positively on macroeconomic management in Ghana have been to help change the general direction of policy. Discussions on the economic recovery programme implicitly point to this assertion that aid did influence policy direction in Ghana (see, for instance, Hutchful 2002: 37–8). Also one expert, who generally thinks that the social cost of adjustment had been very high for Ghana, makes the point that:

...If you are retrenching so many workers, as happened in our case right from the initial stages of the structural adjustment, then the potential market for the economy, within the economy is restricted (Interview with an Emeritus Professor of Political Science at the University of Ghana 2012)

The suggestion here is that as part of the economic recovery programme, certain policies were pursued with adverse implications for employment. Our aim here is not to debate the merits or otherwise of a specific policy such as the retrenchment exercise under the ERP/SAP. Rather we seek to emphasize that aid was a major leverage used in guiding the direction of the general economic policy under the economic recovery programme. In other words, aid did help to change the fundamentals on how the economy was run. As one of the experts note:

The World Bank Economic Recovery programme changed the culture of account management. It is true that ERP systematically put down a new path on which we have been building as a country since 1983. We got out of bureaucratic control of the economy, which was destroying the Ghanaian economy by rewarding retailers to the detriment of producers, through price controls. Before then those who could bribe the bureaucrats were those who could make profits (personal interview with the Executive Director of the Centre for Policy Analysis [CEPA] 2012)

This view is also consistent with others in the literature. For instance, Herbst (1993) as cited in Killick (2010: 407) notes:

The intellectual and financial clout of the World Bank and the IMF had a profound effect on Ghanaian politics at the time. First, the positions of those favouring stabilization and adjustment were strengthened because they could point to the *availability of real resources* (our emphasis)... The multilateral organizations were crucial in providing support so these officials could forcefully advocate within the government the policies they had designed. At the same time, the fact that the Ghanaian could argue that at least part of their reform programme was locally developed may have helped somewhat in convincing the public to swallow the IMF bitter medicine.

Generally therefore one can argue that aid has played a part in shaping the general macroeconomic policy direction of Ghana. The result, we believe, is a relatively more efficiently functioning market today. Indeed there is little disagreement among economic commentators that Ghana has relatively more effective and functioning markets today than it did in the mid-1980s. The market imperfections that existed in the 1980s were corrected with the help of aid.

7 Conclusions

This paper contributes to the debate on aid effectiveness by exploring the political economy dimensions of macroeconomic management in Ghana. In particular it assesses in more detail what role aid has played in shaping policy in the country, going beyond the usual two-gap type arguments. To do this we first discussed the empirical question of whether aid to Ghana, a major aid recipient in SSA, has been effective. The discussion with respect to this question is essentially based on econometric evidence from the literature. We then went on to discuss in some detail how aid has affected macroeconomic management in Ghana. The main findings in this paper can be summarized as follows.

First, we note that aid inflows to Ghana have been positively associated with economic growth and investment shares, from about the mid-1980s to date. In the case of investment shares, the paper notes that this positive association is mainly driven by private investments as opposed to public investments. The paper therefore argues that if aid did spur investments in Ghana, it was mainly through the creation of an enabling environment which engendered private investments.

Second, we note that aid has been associated with improved macroeconomic stability for Ghana. The two variables which were used to capture macroeconomic stability were fiscal deficits and inflation. For both these variables we do find evidence that periods of relatively high aid inflows have been associated with reduced deficits and inflation.

Third, the econometric evidence for Ghana that was reviewed finds evidence which is generally consistent with the correlates. The evidence points to the general result that aid to Ghana has impacted on GDP growth. The likely channels have been through increased private investments and improved competitiveness through realignment of the exchange rates. In addition, there is evidence that aid has helped in the macroeconomic management in Ghana. This, it is argued, comes from the absorptive role that aid has played with respect to fiscal shocks. Finally the study identifies three key channels through which aid has supported macroeconomic management in Ghana. First is that aid has helped general macroeconomic management by supporting both physical and social investment and therefore growth. The second channel is by directly helping to reduce the instability that is induced from government fiscal balance. Here the argument is that the structural nature of government fiscals means that its transmission to macroeconomic instability is determined by how it is financed. Without foreign aid, government resorts to domestic borrowing and this has consequences for availability and cost of credit to the private sector and consequently on inflation. In the light of this, aid plays a major role in helping to stabilize the macroeconomy. The third channel that is discussed in this paper relates to aid helping to shape the general policy direction. It may be true that this aid-induced policy drive has not always been without some opportunity costs particularly on the social dimensions of households' welfare. However it is our view that, on balance, the aid-induced policy direction has helped secure a more effective and efficient market system in Ghana today.

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