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The real exchange rate, foreign aid and macroeconomic transmission mechanisms in Tanzania and Ghana

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September 2013

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A recent study of 36 sub-Saharan African countries found a positive impact of aid in the absolute majority of these countries. However, for Tanzania and Ghana, two major aid recipients, aid did not seem to have been equally beneficial. This paper singles out these two countries for a more detailed empirical investigation. The focus is now on the effect of aid when allowing external and nominal factors to play a role in the macroeconomic transmission mechanism. We conclude that aid played a significantly positive—but very different—role in the two countries. Due in part to generous aid inflows Tanzania experienced positive investment and GDP growth from the late 1960s to 2007. But, until the mid-1980s, the impact of aid on growth was well below its potential as the large inflows of aid facilitated a serious over appreciation of the real exchange rate. In Ghana, declining aid in the 1970s was associated with lacking growth while the reactivation of aid flows in the 1980s supported an economic rebound. When monetary and external factors are properly accounted for, we find that aid has been pivotal to growth in both real GDP and investment.

Keywords: foreign aid, Africa, transmission channels, unit roots, Cointegrated VAR, Tanzania, Ghana
JEL classification: C32, F35, O11
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The Real Exchange Rate, Foreign Aid and Macroeconomic Transmission Mechanisms in Tanzania and Ghana

Katarina Juselius,1 Abdulaziz Reshid,2 and Finn Tarp3*

Abstract

A recent study of 36 Sub Saharan African countries found a positive impact of aid in the absolute majority of these countries. However, for Tanzania and Ghana, two major aid recipients, aid did not seem to have been equally beneficial. This paper singles out these two countries for a more detailed empirical investigation. The focus is now on the effect of aid when allowing external and nominal factors to play a role in the macroeconomic transmission mechanism. We conclude that aid played a significantly positive - but very different - role in the two countries. Due in part to generous aid inflows Tanzania experienced positive investment and GDP growth from the late 1960s to 2007. But, until the mid-1980s, the impact of aid on growth was well below its potential as the large inflows of aid facilitated a serious overappreciation of the real exchange rate. In Ghana, declining aid in the 1970s was associated with lacking growth while the reactivation of aid flows in the 1980s supported an economic rebound. When monetary and external factors are properly accounted for, we find that aid has been pivotal to growth in both real GDP and investment.

1 Introduction

Recent studies of the impact of foreign aid on economic development tend to find a positive impact of aid on growth. This reflects both better and longer data and more careful methodological choices, and includes work based on the application of modern time series techniques. Such work was not feasible just a few years ago due to inadequacy of relevant time-series information in individual aid recipient countries. Juselius, Møller and Tarp (2013) (henceforth JMT13) is such a study. It provides a comprehensive overview of the long-run impact of foreign aid on a set of key macrovariables (GDP, investment, government expenditure, and private consumption, all in real terms) in 36 Sub-Saharan countries from the 1960s to 2007.

JMT13 relies on a Cointegrated VAR (CVAR) approach, and in the absolute majority of countries (32) aid has clear and positive effects on either GDP or investment, or both. The cases where aid appears to have had no or even negative effects amount to a very small minority of outlying countries. However, Ghana and Tanzania, two major aid recipients,
belong to the latter. They have over the years influenced much of the literature and debate about economic development in Africa, including the role of foreign aid and, therefore, merit attention. The overall scope of the present study is exactly this, i.e. to start from JMT13, dig deeper and try to uncover whether the JMT13 findings as regards Ghana and Tanzania hold up when the implications of the assumptions underlying JMT13 are subjected to careful scrutiny.

The broad selection of variables in JMT13 restricted the analysis to closed economy effects. Accordingly, their results reflect a *ceteris paribus* assumption, where 'open economy' influences are kept constant. In addition, only real variables were included in the JMT13 empirical model, which implies that nominal and real variables were treated as dichotomous. We wish to go further here and also note that, in effect, the *ceteris paribus* assumption in JMT13 comprises a very large number of variables and factors, such as country specific characteristics. Some of these are likely to have had significant impact on the economy. It is for example, well established that structural reforms, other policy interventions, conflicts, and droughts and floods may result in very large changes in the macrovariables under study and, therefore, can be highly influential for the estimated results (Nielsen, 2008). Unless adequately controlled for, they will tend to bias the model parameter estimates.

JMT13 did model extraordinary events such as those mentioned, using step dummies to account for equilibrium mean shifts in the long-run relations, on the one hand, and impulse dummies to account for extraordinary shocks in the equations, on the other. Accordingly, all major events were indeed controlled for. Nevertheless, the large number (36) of countries involved prevented a more detailed analysis of all possible events. The present study fills this gap, paying particular attention to understanding the long- and short-run effects of the series of major political and economic events that affected developments in the two countries, including major structural reforms that have played a key role in both countries.

Finally, while JMT13 focused on uncovering the causal links between aid and the macrovariables and on the long-run impact of a 'shock' to aid (measurable with some simple test statistics and therefore comparable over countries), the JMT13 study did not address the dynamics of the transmission mechanism of aid. This is an econometrically much more complex and demanding challenge, which is better pursued in a two-country comparative case context.

In sum, JMT13 provided an overview based on a number of simplifying assumptions. They were used because of the nature of the very large and comprehensive sample of countries and variables, not because the assumptions were inherently plausible per se. In addition, a series of events were controlled for in a stylized manner. It is on this background of interest to establish whether two major African aid recipients, Ghana and Tanzania, turned out as outliers due to omitted variable effects or whether these two countries are in some sense special. In the latter case, we wish to understand why. More specifically, the aim of this study is to respond to three key concrete questions:

1. What was the effect of major structural reforms on the macroeconomic growth rates in Ghana and Tanzania, do the effects differ, and if so why?

2. Does the inclusion of the real exchange rates (open economy effects) and the inflation rate (nominal effects) significantly alter conclusions regarding the long-run impact of aid on key macroeconomic variables in Tanzania and Ghana?
3. Are the macroeconomic transmission mechanisms in Ghana and Tanzania similar (and if so to which extent) or are they different; and what is the potential role played by Dutch disease?

2 Historical Overview

Given our focus on the role of foreign aid, the real exchange rate and inflation for the determination of real GDP, investment and consumption in Tanzania and Ghana, we provide in Figures 1 - 4 an overview of the historical developments in these seven series over the period of investigation (1968-2009). Figures 1 and 3 describe GDP, aggregate investment, private consumption and government expenditure (all in real terms), and Figures 2 to 4, show official foreign assistance (ODA), and the real dollar exchange and inflation rates. All variables are in logarithmic values. A first observation is that five variables (GDP, aid, consumption, investment and government expenditure) are distinctly trending, whereas the remaining two variables (inflation and the real exchange rate) do not exhibit linear trends, except very locally.

An overriding thesis here is that persistent deviations from long-run trends are very helpful in understanding the historical dynamics of macroeconomic transmission mechanisms and the role of foreign aid. Such deviations from long-run paths usually indicate imbalances in underlying economic structures and are, arguably, very informative in trying to uncover the impact of adopted economic policy and other changes. For this reason we need to study both long-run trends in the data, on the one hand, and deviations from these trends, on the other. The Cointegrated VAR model, to be introduced in the next section, is tailor-made to study such features of the data.

2.1 Tanzania

Tanzania became independent in 1961 and the first period after the transition from colonial rule differs markedly from subsequent periods. The years 1961-67 are therefore unlikely to be informative in our analysis and have been omitted. Accordingly we begin in 1967 where president Nyerere took over as President. The Tanzanian government also endorsed the 1967 Arusha declaration, marking a shift towards a centrally controlled socialist model of development emphasizing self-reliance, nationalization of key economic sectors, villagization of production (known as Ujamaa) and public provision of health and education (Rotarou and Ueta, 2009). In 1973 a National Price commission was established to facilitate price control; a managed exchange rate system was introduced; rural marketing cooperatives were abolished and replaced by a monopoly marketing board; over 7 million people were resettled forcefully under the Ujamaa villagization programme; and the Basic Industrialization Strategy (BIS) introduced state-led investment programmes which were largely financed by foreign aid (Potts, 2005 and Bigsten and Danielsson, 1999). As public expenditure increased and due to a growing bureaucracy, the government became increasingly dependent on donor support, and foreign aid financed nearly half of Tanzania’s import bill in this period (Van Arkadie, 1995). During 1973-75, net ODA more than doubled from USD 441 to 1,044 million annually according to OECD/DAC.

Figure 1(a) shows that real GDP grew along a stable path until the end of the 1970s, but behind the seemingly stable growth rates there were signs of mounting structural problems.
Figure 1: The time path of Tanzanian (a) log real GDP, (b) log real investment, (c) log real private consumption and (d) log real government expenditure. The log scale can be translated to relative changes over the period as follows: real GDP increased 5.7 times, real investment 8.2, real private consumption 4.5 times, and real government expenditure 7.3 times.
Policies undertaken after 1973 had increased the role of the state beyond its administrative capacity leading to inefficiency and under-utilization of resources (Potts, 2005). High mark-ups in government marketing monopolies and a strongly overvalued exchange rate reduced the returns from exports, and state-led government investment programmes and import substitution strategies increased the structural dependency on imported inputs and foreign aid (Van Arkadie, 1995). A temporary coffee boom and substantial donor support helped postpone the crisis (Bigsten and Danielsson, 1999), but the ensuing crisis at the end of the 1970s was aggravated by external factors such as the 1979 oil price rise, the Uganda conflict (1978-79) and a serious drought (1981-82).

Foreign aid was exceptionally high from 1972-1981, more than twice its long-run trend value. Thereafter aid inflows started declining (Figure 2a). The original generosity by donor countries was to a large extent associated with the president Nyerere, a well educated and charismatic leader. In particular the Nordic countries were prepared to give Nyerere’s socialist experiment a realistic chance. Because of the mounting structural problems in the economy, IMF and the donors increased their pressure for more drastic liberalization measures in the early 1980s. As the government initially refused to cooperate on these reforms, aid inflows started declining. As a result, Tanzania experienced a shortage of imported inputs and a declining GDP, but in spite of tensions between donors and the government, aid remained above its long-run trend until mid-1990s.

The large inflows of aid during the Nyerere era did not result in proportional growth in income. Figure 1a shows that GDP closely followed its long-run growth path although foreign aid had doubled. An important reason why real GDP did not grow more can be related to the very strong appreciation of the Tanzanian shilling in the Nyerere period (Figure 2b). That the Tanzanian shilling was seriously overvalued can for example be inferred from the black market rate which shows that the dollar was traded at prices dramatically above the official rate. For Nyerere maintaining a strong currency was a sign of prestige (and possibly as a way to avoid imported inflation), and he refused to devalue the shilling in spite of strong pressure by the IMF, the donor countries and internal analysts. No doubt, the strong appreciation of the shilling tended to offset the benefits of the generous aid.

At the end of the 1970s, the early promising years were definitely over. Investment declined dramatically as a result of lost competitiveness due to the overvalued shilling and declining aid (Figure 2a). GDP dropped below its long-term growth path (Figure 1a) and so did government expenditure (Figure 1d) albeit less than investment and GDP. As monetary expansion was used to compensate for the declining aid, inflation started increasing (Figure 2c). By insisting on a strong shilling in a period of structural weaknesses Nyerere missed a golden opportunity to exploit the generous aid as a means to putting Tanzania on a high growth path. Instead, Tanzania entered into a prolonged structural adjustment period with GDP growth rates below those of the 1970s.

The first Structural Adjustment Programme implemented in 1983-1985 reflected a home-owned effort to liberalize the economy. It included measures such as (i) import liberalization through an “own fund” import scheme, (ii) depreciation of the Tanzanian shilling, (iii) freezing the budget deficit at the previous level, and (iv) liberalization of the trade with domestic food products (Van Arkadie, 1995 and Wobst, 2001). Although the programme resulted in a (modest) reversal of the negative trends in real output growth and domestic investment, the high inflation and the deteriorating balance of payments continued. Also the
Figure 2: The time path of Tanzanian (a) log aid, (b) log real exchange rate, and (c) log inflation rate. The log scale can be translated to relative changes over the period as follows: aid grew 10 times, the real exchange rate devalued around 4.3 times its value in 1985, and inflation was roughly 35% at its highest.
parallel market economy increased in scope. Yet, the home-owned reform measures signaled a major shift towards economic liberalization.

After Ali Hassan Mwinyi took over the presidency from Joseph Nyerere in 1985, negotiations with IMF resumed. President Mwinyi agreed to implement significant stabilization and structural adjustment policies under the Economic Recovery Programmes (1986-1993) (Agrawal et al., 1993). While economic growth recovered to some extent, per capita growth remained modest and even negative in some years. Not until 1996 was the turmoil of the Nyerere period followed by more sustainable growth (Figure 1a).

After the devaluation of the shilling in 1985, the gap between the parallel and the official market rates narrowed from its peak of 800% in 1985 to only 30% in early 1992 (Bigsten and Danielsson, 1999). The National Investment Promotion and Protection Act of 1990, which provided incentives and guarantees to foreign investors (in particular for gold and petroleum exploration) and two legal acts in 1991 and 1992, which allowed free entry and exit for foreign banks, made foreign investment more attractive, especially in gold mining (Cooksey and Kelsall, 2011). Furthermore, the high inflation rates of the 1980s declined to single digits after 1996 (Figure 2d).

In 1995 Benjamin Mkapa became president, and the government intensified the liberalization process. An agreement was signed with the IMF on an Enhanced Structural Adjustment Facility for the period 1998/99 to 2000/01, and the liberalization of trade and finance intensified. The exchange rate was allowed to float and various reforms affecting the civil service and tax collection were undertaken. These reforms were accompanied by increasing aid. Since then economic performance has been strong, the relationship with donors usually good, and Tanzania has continued to be one of the major recipients of foreign aid.1

It is fairly remarkable that over this turbulent period private consumption did not show much variation around its long-run path (Figure 2c). A possible explanation (in addition to data collection challenges) is that the majority of the population continued to live at or close to subsistence levels without much scope for either increases or decreases in consumption patterns.

2.2 Ghana

Political and economic developments in post-Independence Ghana (see Aryeetey, Harrigan and Nissanke, 2000; Aryeetey and Kanbur, 2008) have been quite different from those of Tanzania, albeit with some similarities. The graphs of the seven time series in Figures 3 and 4 illustrate this. A remarkable feature is that among the variables included only government expenditure exhibited long-term growth over the full sample period (Figure 3d). Real GDP, investment and consumption exhibited growth only after the introduction of structural reforms in 1983 (Figures 3a, 3b and 3c).

The pre-reform period was politically unstable with frequent military coups and counter coups contributing to gross economic mismanagement and a deteriorating investment climate. The economy was “muddling through” with inefficient state owned enterprises operating with excess capacity. The consequence was low productivity, an over-valued currency, high inflation rates, large public deficits, and high interest rates (Leechor, 1994 and Aryeetey and Tarp, 2000). In most of the pre-1983 period, economic policy focused on import substitu-

1See Nord et al. (2009) and World Bank (2001) for further background.
Figure 3: The time path of Ghanaian (a) log real GDP, (b) log real investment, (c) log real private consumption and (d) log real government expenditure. The log scale can be translated to relative changes over the sample period as follows: real GDP increased 3.5 times, real investment 2.7 times, real private consumption 3.5 times, and real government expenditure 4.5 times.
tion, exchange rate and price controls with the State strongly present in most macroeconomic activities (Aryeetey, Fosu and Bawumia, 2001).

Foreign aid dropped quite significantly in the early 1970s (Figure 4a) when President Acheampong (who was later to be executed in 1979) announced that Ghana repudiated its international debts. Thus, in contrast to Nyerere’s Tanzania, Ghana was very far from being a donor darling. But similar to Tanzania, the Ghanaian cedi was allowed to appreciate very strongly during the 1970s and until 1983 (Figure 4b). The long period of persistent appreciation combined with very high inflation rates had a disastrous effect on real investments which exhibited a declining trend until 1983 (Figure 3b). Also private consumption stagnated, and even declined in some years in stark contrast to government expenditures. Annual inflation rates soared reaching more than 100% (Figure 4c) as a result of government deficit financing by excessive expansion of the money supply. Also exogenous factors such as the 1983 drought and the return of millions of Ghanaian workers from Nigeria contributed to the severe economic crisis at the beginning of the 1980s (Fosu and Aryeetey, 2008).

Because of deteriorating terms of trade Ghana was literally forced to change its economic policies and turned to the IMF and the World Bank for assistance in 1983. The result was the IMF Economic Recovery Programme (1983-1985) focussing on stabilization and liberalization of various sectors of the economy by exchange rate adjustments (increasing the dollar price by 250% in 1983), stringent fiscal and monetary policies, trade liberalization, civil service and public sector reforms, and privatization of government owned enterprises.

The programme had impact. The annual rate of inflation declined from more than 100% in the pre-reform period to about 25% in the late 1980s and first half of 1990s after which it finally came down to the present low levels. Foreign aid increased substantially (Figure 4a) easing external financial constraints and promoting a higher economic growth path, and possibly also the relatively high inflation rates during the first reform period, as the aid was mostly spent on the domestic economy (Leechor, 1994).

The economic reforms combined with increasing aid resulted in a strong recovery. The pre-reform period with no real growth was replaced with steady growth in all macro-variables. This success became identified with the long-serving Finance Minister, Dr. Kwesi Botchwey. With his departure in the mid-1990s, the earlier cohesiveness in the Ghanaian reforms seemed to be temporarily affected. The reform process slowed down, and with the introduction of multiparty democracy in the early-1990s, Ghana experienced her first political-economic business cycle. In 1995 the government attempted to introduce a value-added tax reform without sufficiently involving the Ghanaian people. The resulting civil disturbances forced the government to withdraw the tax which, after a broader information campaign, was reintroduced three years later, now at 10% rather than the originally proposed 15% (see Tsikata, 2001). However, since 1996 macroeconomic conditions have overall been relatively stable and real GDP has steadily grown at rates faster than in most other Sub-Saharan African countries. In parallel, Ghana has become one of Africa’s success growth stories.

3  Growth and Structural Reforms in Tanzania and Ghana Compared

Both Tanzania and Ghana experienced a long period of currency appreciation in the 1970s, and both initiated economic reforms in the beginning of the 1980s due to deteriorating eco-
Figure 4: The time path of Ghanaian (a) log aid, (b) log real exchange rate, and (c) log inflation rate. The log scale can be translated to relative changes over the period as follows: aid grew 4.5 times, the real exchange rate devalued around 14 times its value in 1982, and inflation was roughly 120% at its highest.
onomic conditions. A very strong devaluation in the mid-1980s was also as a major step to regain economic growth in both cases. While there are many similarities there are also significant differences between the two cases. In Tanzania the harmful effects of the continuing appreciation in the 1970s were to a large degree compensated by generous inflows of foreign aid. This was not the case in Ghana, which experienced very modest inflows of foreign aid after her 1972 default on foreign loans. As a consequence Tanzania experienced average growth of GDP at around 4-5% per annum with a population growth of 2.9%. In contrast, Ghana’s economy did not expand at all while population grew at 2.6% per annum. Thus, per capita growth was positive in Tanzania and negative in Ghana.

Both countries experienced significant nominal growth in the pre-reform period. Yet, while annual inflation rates in Tanzania stayed at rather moderate levels of around 15%, they reached very high levels of 50-100% and even more in Ghana. Similarly, the annual currency appreciation in Tanzania was only 10% thanks to generous aid, whereas in Ghana it averaged 100%. During the first years of the reform period both countries experienced average inflation rates of around 25% implying increasing inflation rates for Tanzania (possibly due to declining aid) and decreasing rates for Ghana (due to increasing aid) compared to the pre-reform period. Since 1998 inflation rates in both countries have come down to 10% or lower.

We also note that over the full sample period the large appreciation rates of the real exchange rates in the 1970s have roughly been compensated by the equally large devaluations since mid-1980s. Similarly increases in inflation rates in the first period have been compensated by the subsequent decreases in the second period. Overall, the real exchange rate has depreciated somewhat in Tanzania and appreciated in Ghana during the period under study.

Tanzanian real GDP growth in the 1970s was partly driven by state-led industrialization, mainly financed by foreign aid, and by public investment in projects that improved public welfare such as provision of better hospitals, schools and clean water. All this meant higher employment and a more positive attitude towards the government. The widespread skepticism shared by many people in Tanzania against the economic reforms can partly be explained by the stronger legitimacy of the Nyerere government. It had after all provided them with free health care, schooling and relative stability. At the same time, these positive advances had been funded (or made possible) by generous aid flows. So when Tanzania’s donors started to withdraw support at the beginning of the 1980s, output started to decline, in part due to a lack of imported inputs, which resulted in further under-utilization of previously created capacity (Bigsten and Danielsson, 1999). The fact that investment growth was generally higher than GDP growth also suggests that at least some of the investments made did not meet reasonable criteria for economic returns.

In contrast, the population in Ghana suffered significantly under the adverse economic conditions in the pre-reform period where high inflation combined with the strong appreciation of the currency caused investment to decline and consumption to stagnate. This reinforced the commitment to economic reforms in Ghana. When the reform process started in 1983 the macroeconomic picture changed considerably. Output expanded and grew at an average annual rate of 5%, private consumption at an average rate of 5.6%, whereas investment rebounded at an impressive 9% annual growth rate. Only government expenditure declined somewhat from previously 6% per annum to approximately 5%. The latter can

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2See Ndulu et al. (2008) for illuminating background.
be related to the strong devaluation of the real exchange rate and the fact that foreign aid started flowing into the country again.

The economic liberalization reforms no doubt had a positive effect on the macroeconomy in Ghana after 1983 and probably also in Tanzania. However, for both countries the growth rates of investment were higher than those of GDP suggesting that investments may have been characterized by poor quality and low productivity (see Bigsten and Danielsson, 1999; Leechor, 1994; Husain and Faruque, 1994).

Thus, the structural reforms in the mid-1980s changed economic conditions significantly to the better in Ghana whereas growth rates in Tanzania essentially did not recover their pre-1983 levels until around 1996. Why is this the case? Tsikata (2001) argues that one reason was that the reform programme in Ghana was largely drawn up domestically and that this contributed to a larger degree of domestic ownership than in Tanzania where reforms were seen as being imposed from the outside. The slow pace of implementation in Tanzania also reflected the difficulty of undoing the country’s socialist legacy. Socialism was much more embedded in Tanzanian society when reforms began than was the case in Ghana. Tsikata (2001) also argues that domestic analytical capacities appear to have been stronger in Ghana than in Tanzania, although the latter had a strong Department of Economics in Dar es Salaam.

4 Model Specification

As the previous sections demonstrated, the last fifty years have seen turbulent changes and significant reforms in both countries. To obtain reliable estimates of key macroeconomic transmission mechanisms in Tanzania and Ghana is, therefore, a major econometric challenge. Extraordinary events usually result in large changes in the economic variables and can be highly influential for the results (Nielsen, 2008). It is, therefore, crucial that we are able to adequately control for the most important economic and political reforms discussed above. Also, over a period of such turbulent changes it is likely that the economic system has adjusted differently in the short and the long run which adds to the demands on the chosen econometric methodology. As in JMT13 we have chosen the Cointegrated VAR (CVAR) model which is tailor-made for the analysis of short-run and long-run structures in the data and allows for an elaborate use of intervention dummies to control for extraordinary event. Besides, it provides us with an analytical framework within which we can study similarities and dissimilarities between the two countries. One could say that it allows us to study the economic transmission mechanisms of each country through the same magnifying glasses.

The previous section demonstrated that for both countries, we can distinguish between a pre- and a post-reform period during which macroeconomic transmission mechanisms may differ. Such changes in regimes are not easy to reconcile with the assumption of constant parameters in the CVAR model. Yet, if we split the sample there are too few observations to apply the CVAR model. The full sample consists of only approximately 40 annual observations, and even with the full sample, a full-fledged CVAR analysis is barely doable. This poses an analytical challenge, which we address using dummies to account for extraordinary events and broken linear trends for significant changes in growth rates over the two regimes. Some of the structural changes can be accounted for in this way; but at least some of the coefficients to the stochastic variables are likely to measure average effects that in some cases
may not be easy to interpret. In what follows we focus on the broad picture and accept the inherent limitations imposed by our data.

4.1 The Cointegrated VAR model

Our CVAR model is similar to the one used in JMT13 where focus was on the long-run effect of aid on GDP, investment, private consumption and government consumption (all in real terms). Here we extend the analysis by including the real exchange rate and the inflation rate. This allows us to dig deeper and check whether the previous atypical results for Tanzania and Ghana are due to the ceteris paribus assumption that nominal and external factors in the economy are constant (or at least stationary) while in reality they are nonstationary.

Our baseline model is a $p$-dimensional VAR model with two lags:

$$\Delta x_t = \Pi' x_{t-1} + \Gamma_1 \Delta x_{t-1} + \Phi D_t + \varepsilon_t,$$

where $x_t = (y_t, inv_t, c_t, g_t, aid_t, \Delta p_t, rex_t)$, $D_t$ is a vector of $m$ deterministic components (such as constant, trend and dummies), and $\varepsilon_t \sim N iid(0, \Omega)$ is a $p \times 1$ vector of error terms. Among the system variables $y_t$ is real GDP, $inv_t$ is real investment, $c_t$ is real private consumption, $g_t$ is real government expenditure (excluding public health and education services), $aid_t$ is real net ODA, $rex_t$ is the real exchange rate relative to the US$, and $\Delta p_t$ is the inflation rate.$^3$

The real exchange rate is defined as $rex_t = \log(s_t/p_t)$ where $s_t$ is the domestic currency versus the dollar rate and $p^*/p$ measures relative consumer prices between the USA and the domestic country. A rise/decline in the real exchange rate means depreciation/appreciation. Small letters denote logarithmic values of annual observations and $\Delta$ is the first difference operator. The effective sample period is 1967-2009 for Tanzania and 1968-2009 for Ghana.

In its baseline form, model (1) is basically a description of the covariances of the data given as a convenient formulation that allows us to discriminate between short- and long-term macroeconomic responses. The econometric task, called the general-to-specific approach, is to gradually impose statistically valid restrictions on the model parameters. This is a guarantee that the data are allowed to speak as freely and as precisely as possible about the macroeconomic mechanisms during the period in question.

If at least some of the variables $x_t$ are unit-root nonstationary then $\Pi$ in (1) has reduced rank. This can be formulated as the hypothesis of cointegration:

$$\Pi = \alpha \beta'$$

where $\alpha, \beta$ are $p \times r$ coefficient matrices and $r$ is the number of cointegration relations. $\Gamma_1$ is a $p \times p$ matrix of short-run adjustment coefficients, and $\Phi$ is a $p \times m$ matrix of coefficients. If $\Gamma_1 = 0$ the system will adjust back to equilibrium exclusively through $\alpha$ after it has been

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$^3$The ODA data is obtained from the OECD online data base. The data on $y_t$, $inv_t$, $c_t$ and $g_t$ are obtained from the Penn World Table (PWT) online data base (Heston, Summers, and Aten, 2011). The data for the real exchange and inflation rates are taken from the IMF online IFS data base. We spotted some data problems in the PWT data base. In 2005 government expenditure decreased in Ghana by 55% and increased in Tanzania by 200%. These figures are not credible and inconsistent with the records in the WDI and UN data bases. The same seems to be the case with a GDP growth of 14% in 2005 in Tanzania. Such extraordinary changes are likely to be due to changing data definitions and we have have corrected these records based on information available in the WDI database for Tanzania and in the UN statistics database for Ghana.
pushed away from equilibrium by an exogenous shock. When \( \Gamma_1 \neq 0 \) the system also adjusts to lagged changes, \( \Delta x_{t-1} \), so \( \Gamma_1 \) becomes part of the adjustment dynamics.

The advantage of the CVAR formulation compared to a regression analysis in levels is that by transforming the trending variables, \( x_t \), into stationary differences, \( \Delta x_t \), and stationary cointegration relations, \( \beta'x_t \), the usual multicollinearity problem is effectively addressed. For example:

(i) Multicollinearity between the \( x \) variables does not lead to imprecise estimates of the cointegration relations, \( \beta'x_t \). This is because two variables are cointegrated only if they share a common stochastic trend defined as the cumulation of all permanent shocks that have pushed the variables out of equilibrium. While, for example, cointegration between two unrelated random walks will be rejected with high probability, they may have a correlation coefficient close to one in small samples (Johansen, 2012). Also, the cointegration coefficients are "canonical" in the sense of being invariant to increasing the information set, or to changing the direction of minimization.

(ii) The removal of trends, either by differencing or cointegration, is likely to make the multicollinearity between \( \Delta x_t \) and \( \beta'x_t \) almost disappear. When \( x_t \sim I(1) \), \( \Delta x_t \) and \( \beta'x_t \) are stationary, standard inference on \( (\alpha, \Gamma_1, \Sigma) \) applies for a given \( \beta \).

Thus, it is the explicit separation between short-run and long-run effects, made possible by cointegration, that makes inference from a CVAR model reliable. To illustrate, the subsequent empirical models explain 65-80\% of the annual variation of the macrodata for Tanzania and 62-84\% for Ghana. This allows us to answer economic questions of significant interest with a high degree of precision.

4.2 Controlling for Major Structural Reforms

To control for the effect of extraordinary events on the variables that have caused long-run trends to change and growth rates and equilibrium means to shift to a new level, we introduce a number of deterministic terms, \( D_t \), defined as:

\[
D_t = \mu_0 + \mu_{01}Ds_{xx} + \mu_1t + \mu_{11}t_{xx} + \phi Dp_{xx}
\]

where \( \mu_0 \) is a constant, \( Ds_{xx} \) is a the step dummy, defined as \( (0,....0,0,1,1,1,1,....1) \) with the step starting in year \( xx \), \( t \) is a linear trend, \( t_{xx} \) is a linear trend defined as \( (0,....0,0,1,2,3,4,...) \) and \( Dp_{xx} \) is an impulse dummy defined as \( (0,....0,0,1,0,0,0...,0) \), where \( xx \) stands for the year 19xx.

The CVAR captures the long-run and short-run structures in the same model implying that the effect of an extraordinary event will differ between the short-run dynamics and the long-run relations. Hence, the coefficients \( (\mu_0, \mu_{01}, \mu_1, \mu_{11}, \phi) \) have to be decomposed into one part belonging to the short-run structure and another belonging to the long-run relations (Juselius, 2006, Chapter 6). Accordingly, the constant and the step dummy are decomposed as \( \mu_0 = \alpha \beta_0 + \gamma_0 \) and \( \mu_{01} = \alpha \beta_{01} + \gamma_{01} \). The \( \alpha \) components, \( \beta_0 + \beta_{01}Ds_{xx} \), describe a change in the equilibrium mean at the year 19xx and the other parts, \( \gamma_0 + \gamma_{01}Ds_{xx} \), a change in the slope coefficient of the linear trend at 19xx.

The broken linear trend, \( \mu_1t = \alpha \beta_1t \) and \( \mu_{11}t_{xx} = \alpha \beta_{11}t_{xx} \), is restricted to the cointegration relations to avoid quadratic trends in the data. Thus, the long-run relations (the cointegration relations) can be trend-stationary around a linear trend with a changing slope.
coefficient at 19xx. This gives us some extra flexibility to capture features in the data that would as already noted otherwise be difficult to model given the econometric constraint imposed upon us by the limited number of observations over a period of very dramatic changes.

For Tanzania, the graphical analysis suggested that the slopes of the long-run linear trends in GDP, private consumption, government expenditure, and investment were approximately constant over the full period. The long-run trend in aid can also be assumed reasonably constant provided we control for a level shift in the period 1973-1992 (when aid was roughly 100% above its long-run level). Since the increase in aid did not lead to a proportional increase in GDP we have controlled for this expansion through the inclusion of two step dummies, \( D_{s73,t} \) and \( D_{s92,t} \), restricted to be in the cointegration relations. This is to safeguard against a bias of the estimated effect of aid on the macroeconomy, in particular for the second half of the sample when aid was no longer above its long-run trend. Finally, we have included an impulse dummy, \( D_{p85,t} \) to control for the big devaluation of the Tanzanian currency in 1985.

With these additions, the final specification of the empirical CVAR model for Tanzania becomes:

\[
\Delta X_t = \alpha \tilde{\beta}' \tilde{X}_{t-1} + \Gamma_1 \Delta X_{t-1} + \mu_0 + \varphi_1 D_{p73} + \varphi_2 D_{p85} + \varphi_3 D_{p92} + \varepsilon_t \tag{4}
\]

where \( \tilde{X}_{t-1} = (X_{t-1}, D_{s73}, D_{s92,t}, t, t) \) and \( \tilde{\beta}' = (\beta', \beta_{01}, \beta_{02}) \).

For Ghana 1983 defines a separation between a period of a stagnant economy with low growth rates and a reform period with vibrant economic growth. As the graphical analysis showed, only government expenditures exhibited linear growth in the first more controlled regime, whereas linear growth was resumed for all variables in the more liberal, post-reform regime.

To control for the regime shift, we allow for a broken linear trend, \( \beta_1 t + \beta_{11} t_{83} \), in the long-run relations combined with an unrestricted step dummy, \( D_{s83} \). Together they are able to account for the change in the growth rates and the shift in the equilibrium mean of the long-run relations. Except for an unrestricted impulse dummy \( D_{p72} \) to control for a large drop in investment in 1972 due to Ghana’s unilateral repudiation of external debt, the division into a pre- and a post-reform period is sufficient to obtain a reasonably well-specified model. The 1972 event also caused a decline in foreign aid and government investment.

For Ghana the final CVAR specification is:

\[
\Delta X_t = \alpha \tilde{\beta}' \tilde{X}_{t-1} + \Gamma_1 \Delta X_{t-1} + \mu_0 + \mu_{01} D_{s83} + \varphi_1 D_{p72} + \varepsilon_t \tag{5}
\]

where \( \tilde{X}_{t-1} = (X_{t-1}, t, t_{83}) \) and \( \tilde{\beta}' = (\beta', \beta_1, \beta_{11}) \).

Various diagnostic misspecification tests are reported in Appendix A table A.1 and A.2. Normality is accepted for both countries and there is no significant residual autocorrelation of order one or two in either country. With the exception of private consumption for Tanzania, there are no significant AutoRegressive Conditional Heteroskedasticity (ARCH) effects. This is reassuring as the CVAR model seems robust to moderate levels of ARCH effects (Gonzalo, 1994).

After having controlled for the effect of some of the most crucial institutional events the specification of the CVAR model became statistically acceptable as can be verified from
Table 1: The largest characteristic roots and maximum t-values of $\alpha$ for different values of $r$

<table>
<thead>
<tr>
<th></th>
<th>Tanzania</th>
<th>Ghana</th>
</tr>
</thead>
<tbody>
<tr>
<td>$r$</td>
<td>$\hat{\rho}_{\text{max}}$</td>
<td>$t_{\text{max}}$ of $\alpha_r$</td>
</tr>
<tr>
<td>4</td>
<td>0.78</td>
<td>6.6</td>
</tr>
<tr>
<td>$r^* = 5$</td>
<td>0.82</td>
<td>3.9</td>
</tr>
<tr>
<td>6</td>
<td>0.84</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Table A.1 in the Appendix. Except for the inflation rate equation the misspecification tests are in general reasonable. As the inflation rate can be shown to be weakly exogenous, this moderate misspecification should not be of any concern. But, it needs to be emphasized that Tanzania and Ghana were subject to many additional economic and political changes over the sample period and the constant parameter assumption underlying the CVAR model is unlikely to be completely satisfied. Since there are too few annual observations to split the sample into a greater number of homogeneous regimes, it is important to keep in mind that the estimated coefficients describe *average historical effects* between two very different pre- and post-reform regimes rather than deep structural parameters. This is likely to cause large standard errors of coefficients, so we reiterate that some inferences are likely to be imprecise. This is aggravated by data which are in some cases of poor quality.

4.3 Determination of the Cointegration Rank

The choice of cointegration rank determines the division into the $r$ long-run equilibrium relations towards which the system adjusts and the $p - r$ common stochastic trends which push the system away from equilibrium. Formally, the likelihood ratio trace test is used to determine the number of the cointegration rank (Johansen, 2007). However, when the number of observations is as small as in the present study, the asymptotic distribution of the trace test suffers from both size and power problems. While the size problem can be solved using the Bartlett corrected trace test statistics (Johansen, 2002), the problem associated with low power to reject an incorrect unit root remains (Juselius, 2006, Hendry and Juselius, 2000). The latter makes the trace test less useful, in particular when the null of stationarity (rather than nonstationarity) is more relevant from an economic point of view, as discussed by Juselius (2006, Chapter 8.5).

Rather than just using the trace test, we therefore base the choice of rank on the characteristic roots of the model, the significance of the $\alpha$ coefficients, and the graphs of cointegration relations. In addition, and most importantly, we assess the statistical evidence against a plausible economic scenario for the data generating mechanisms over this period: A priori, we expect the system variables to be affected by long-run trends associated with trends in population and productivity proxied by the deterministic trends. We also expect at most two stochastic trends, one capturing the nominal growth over the period, the other describing medium long-run business cycle movements in the data. On this background our preferred rank is five and we shall assess the statistical evidence against this number.4

Table 1, reports the largest unrestricted characteristic root, $\hat{\rho}_{\text{max}}$, for the given rank, $r^* \pm 1$, and the largest t-value of the $\alpha_r$ coefficients, $t_{\text{max}}$, of the $r^{th}$ cointegration relation.

---

4For further methodological discussion, see Hendry and Juselius (2000) and Juselius (2006).
The preferred cointegration rank, \( r^* \), is as noted five in both countries, but as a sensitivity check we report as well the results for the closest alternatives, \( r = 4, 6 \). For Tanzania, the information criteria are rather similar and hence not very informative: the characteristic roots are quite similar in all three cases but the significant error correction coefficients of the 5\(^{th}\) cointegration relation can be used to justify our preferred rank. For Ghana, the choice of rank was more straightforward: both the characteristic roots and the significance of error correction coefficients suggested a cointegration rank of five. This reinforces our final choice of rank five for both Tanzania and Ghana.

5 Pushing Forces

Figures 1 - 4 in Section 2 depicted graphically the decomposition of the macrovariables into long-run deterministic trends and stochastic deviations from these trends. Section 4.3 argued that the latter are in most cases nonstationary implying that they can be treated as medium-run stochastic trends around long-run growth trends. The interpretation is that they describe the cumulated effects of exogenous shocks to the economy that have pushed the macrovariables out of equilibrium for prolonged periods of time.

5.1 The Common Trends Representation

The decomposition of the data into deterministic and stochastic trends is based on the moving average representation of the CVAR model:

\[
X_t = C \sum_{i=1}^{t} (\varepsilon_i + \mu_0 + \mu_0 Ds_{xx,t} + \varphi_p Dp_{xx,t}) + \\
+C^*(L)\{\varepsilon_i + \alpha(\beta_0 + \beta_0 Ds_{xx,t} + \beta_1 t + \beta_{11}t_{xx})\} + \tilde{X}_0
\]

where, \( C = \beta_+ (\alpha_+ \Gamma \beta_+)^{-1} \alpha_+ \), \( C^*(L) \) is a lag polynomial describing impulse response effects, \( \tilde{X}_0 \) is a catch-all for initial values, and

\[
C = \beta_+ (\alpha_+ \Gamma \beta_+)^{-1} \alpha_+ \tag{8}
\]

is a \( p \times p \) long-run impact matrix with rank \( p - r \). The \( p - r \) common stochastic trends are measured by \( \alpha_+ \sum_{i=1}^{t} \varepsilon_i \) and they affect the variables by the loadings \( \tilde{\beta}_+ = \beta_+ (\alpha_+ \Gamma \beta_+)^{-1} \). The shocks \( \varepsilon'_t = [\varepsilon_y, \varepsilon_{inv}, \varepsilon_a, \varepsilon_{rux}, \varepsilon_c, \varepsilon_g, \varepsilon_{\Delta p}] \) are measured by the estimated residuals in the CVAR model.

The coefficients \( \alpha_+ \) allow us to attach weights to the individual shocks that have cumulated to stochastic trends in the data. By focussing on significant coefficients we can get a broad picture of which shocks have been particularly important. For example, was it an inflation shock or a shock to government expenditure that pushed the economy out of equilibrium? It is, however, important to note that the estimated results may be strongly affected by the choice of economic variables and the specification of the deterministic components. Therefore, estimated stochastic trends are likely to change if the specification of economic and dummy variables changes. Different sets of economic variables, \( x_t \), will explain

\[A\text{ detailed discussion of (6) can be found in JMT13}\]
the variation of the system to varying degrees; and different sets of deterministic components, \( D_t \), will change the decomposition into deterministic and stochastic explanatory power. In this sense, a residual is not an estimate of a structural shock, unless the model is complete, something which is seldom the case. This is an important caveat when comparing our results here with the findings in JMT13.

5.2 Interpreting the Two Stochastic Trends

According to the hypothetical scenario discussed in the previous section, the main exogenous drivers in the period under study are, on the one hand, the deterministic trends capturing long-term trends in factor productivity and population, and the stochastic trends capturing persistent medium long-run movements in the economy, on the other. This section aims to give the latter an economic interpretation.

The common stochastic trends, \( \alpha'_l \sum \varepsilon_i \), and their loadings, \( \tilde{\beta}_l \), are reported in Table 2. For both countries, one of the common trends essentially describes cumulated shocks to the inflation rate as confirmed by the test of weak exogeneity in the Appendix, Table A.2. This implies that inflation has not been equilibrium error correcting to the macroeconomic conditions but, instead, has been exogenously determined by factors outside the information set, such as excessive expansions of money supply to finance government expenditures. Ghana, in particular seems to have used this option during the pre-reform period, whereas generous aid to Tanzania during the Nyerere period lessened such a need.

The second common trend captures shocks to income relative to investment and private consumption in Tanzania and to income relative to investment and government expenditure in Ghana. In addition, shocks to private consumption, aid and the real exchange rate are also significant for Ghana. Altogether the second stochastic trend seems to capture medium long-run movements in the real economy.

While the trends are somewhat similar between the two countries, this is not the case with their loadings. In particular, the final impact of an inflation shock on the system has been totally different for the two countries. The coefficients are of opposite signs with the exception of the coefficients to government expenditure, which were negative in both cases. More specifically, an inflation shock had a significant negative final impact on (i) Tanzanian GDP (insignificant in Ghana), (ii) Tanzanian investment (positive in Ghana), and (iii) Tanzanian aid (positive but barely significant in Ghana). It had no effect on Tanzanian private consumption (positive in Ghana), and it caused an appreciation in Tanzania, but a depreciation in Ghana. Altogether these results seem more plausible for Tanzania than for Ghana. One reason is that the estimated final impacts may represent average effects over two regimes, which in the case of Ghana were radically different.

In contrast, the final impacts of a real shock on the system are more similar. For example, the impact is positive for both GDP and aid in both countries and also caused a real appreciation in both countries. Furthermore, a real shock had a negative long-run impact on inflation in Ghana but no significant effect in Tanzania. Regarding private consumption and government expenditure the effects differ in the sense that the former is negative in Tanzania but positive in Ghana, whereas the latter is positive in Tanzania but negative in Ghana. Thus, in both countries there seems to be strong substitutions between private consumption and government expenditure, but in Tanzania it is the government expenditure...
been negative for GDP and private consumption, but positive for government expenditure. For Tanzania, the final impact of a shock to these two variables is mostly insignificant. For both countries the final impact of aid is positive for GDP (and strongly significant in Ghana); and for investment (only borderline significant). While in both countries the final impact of a shock to aid has been a real appreciation of the currency, it has been positive for private consumption and negative for government expenditure in Tanzania. The opposite is the case for Ghana.

For Ghana, the final impact of a shock to the real exchange rate (a depreciation) has been negative for GDP and private consumption, but positive for government expenditure.

5.3 The Final Impact of Individual Shocks

To study the individual effects, Table 3 reports the estimates of the final impact of a shock to each variable, $\tilde{\varepsilon}_x$, on the system. As the inflation rate was found to be weakly exogenous and, hence, a common stochastic trend in itself, the last column of the table corresponds roughly to $\tilde{\beta}_{1,1}$ in Table 2. The remaining columns allow us to study the underlying sources of the real stochastic trend in more detail.

We shall first focus on the final effect of a shock to aid and to the real exchange rate on the system. For Tanzania, the final impact of a shock to these two variables is mostly insignificant whereas for Ghana it is mostly significant. For both countries the final impact of aid is positive for GDP (and strongly significant in Ghana); and for investment (only borderline significant). While in both countries the final impact of a shock to aid has been a real appreciation of the currency, it has been positive for private consumption and negative for government expenditure in Tanzania. The opposite is the case for Ghana.
Table 3: The Long-Run Impact Matrix C for Tanzania and Ghana

<table>
<thead>
<tr>
<th></th>
<th>$\varepsilon_y$</th>
<th>$\varepsilon_{inv}$</th>
<th>$\varepsilon_{aid}$</th>
<th>$\varepsilon_{rex}$</th>
<th>$\varepsilon_c$</th>
<th>$\varepsilon_g$</th>
<th>$\varepsilon_{\Delta p}$</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Tanzania</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$y_t$</td>
<td>0.73</td>
<td>-0.17</td>
<td>0.06</td>
<td>*</td>
<td>-0.27</td>
<td>0.09</td>
<td>-0.53</td>
</tr>
<tr>
<td></td>
<td>[1.85]</td>
<td>[-1.67]</td>
<td>[1.24]</td>
<td>[-1.61]</td>
<td>[1.63]</td>
<td>[-3.09]</td>
<td></td>
</tr>
<tr>
<td>$inv_t$</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>-1.99</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>$aid_t$</td>
<td>1.79</td>
<td>-0.46</td>
<td>0.14</td>
<td>*</td>
<td>-0.69</td>
<td>0.19</td>
<td>-0.83</td>
</tr>
<tr>
<td></td>
<td>[2.33]</td>
<td>[-2.34]</td>
<td>[1.52]</td>
<td>[-2.10]</td>
<td>[1.86]</td>
<td>[-2.48]</td>
<td></td>
</tr>
<tr>
<td>$rex_t$</td>
<td>-1.52</td>
<td>0.14</td>
<td>-0.12</td>
<td>*</td>
<td>0.56</td>
<td>-0.19</td>
<td>1.23</td>
</tr>
<tr>
<td></td>
<td>[-1.72]</td>
<td>[1.52]</td>
<td>[-1.17]</td>
<td>[1.49]</td>
<td>[-1.57]</td>
<td>[3.20]</td>
<td></td>
</tr>
<tr>
<td>$c_t$</td>
<td>-0.89</td>
<td>0.27</td>
<td>-0.07</td>
<td>*</td>
<td>0.37</td>
<td>-0.07</td>
<td>*</td>
</tr>
<tr>
<td></td>
<td>[-2.49]</td>
<td>[3.04]</td>
<td>[-1.54]</td>
<td>[2.41]</td>
<td>[-1.54]</td>
<td></td>
<td></td>
</tr>
<tr>
<td>$g_t$</td>
<td>6.69</td>
<td>-1.83</td>
<td>0.52</td>
<td>*</td>
<td>-2.64</td>
<td>0.67</td>
<td>-1.85</td>
</tr>
<tr>
<td></td>
<td>[2.61]</td>
<td>[-2.81]</td>
<td>[1.68]</td>
<td>[-2.42]</td>
<td>[1.93]</td>
<td>[-1.67]</td>
<td></td>
</tr>
<tr>
<td>$\Delta p_t$</td>
<td>*</td>
<td>*</td>
<td>*</td>
<td>0.10</td>
<td>*</td>
<td>*</td>
<td>0.86</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>[1.21]</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

|          |                      |                      |                     |                     |                |                |                          |

|          |                      |                      |                     |                     |                |                |                          |

| **Ghana**   |                 |                      |                     |                     |                |                |                          |
| $y_t$    | 0.35            | -0.10                | 0.09                | -0.09               | 0.39           | -0.21          | *                      |
| $inv_t$  | *               | *                    | 0.19                | *                   | 1.86           | *              | 1.07                  |
|          |                |                      | [1.23]              | [1.66]              |                |                |                          |
| $aid_t$  | 0.77            | -0.25                | 0.24                | -0.18               | 1.25           | -0.41          | 0.34                  |
|          | [2.68]          | [-1.51]              | [3.55]              | [-2.26]             | [2.52]         | [-1.69]        | [1.68]                |
| $rex_t$  | -0.34           | *                    | -0.12               | 0.07                | -0.75          | *              | -0.27                 |
|          | [-1.83]         | [-2.85]              | [1.45]              | [-2.34]             | [-1.69]        |                | [-2.07]               |
| $c_t$    | 0.25            | -0.09                | 0.09                | -0.06               | 0.52           | -0.12          | 0.18                  |
|          | [2.01]          | [-1.22]              | [3.01]              | [-1.62]             | [2.39]         | [-1.12]        | [2.00]                |
| $g_t$    | -0.39           | 0.12                 | -0.12               | 0.09                | -0.62          | 0.21           | -0.16                 |
|          | [-2.73]         | [1.54]               | [-3.59]             | [2.32]              | [-2.52]        | [1.74]         | [-1.64]               |
| $\Delta p_t$ | -0.70  | *                    | -0.11               | 0.19                | *              | 0.55           | 0.39                  |
|          | [-2.33]         | [-1.59]              | [2.33]              | [2.14]              |                |                | [1.87]                |

In both countries, it has been positive for inflation reflecting the experience of increasing inflation rates together with an appreciating currency in the pre-reform period and decreasing inflation rates together with a depreciating currency in the reform period. The final impact of shocks to government expenditure is mostly insignificant for both countries, except for a positive effect on inflation and a negative effect on GDP growth in Ghana. This supports the interpretation that government expenditures were financed by monetary expansion, hence increasing inflation and lowering growth in the first period, followed by a stricter monetary discipline in the second period and declining inflation rates and higher growth.

To summarize, by including the real exchange rate and inflation to the five variable system of JMT13, the final impacts of foreign aid on GDP growth and investment have now become positive, albeit not all are highly significant. Thus, the negative effects found in JMT13 are no longer present. The results also show that a shock to foreign aid caused the real exchange rate to appreciate, suggesting presence of a Dutch disease effect, and finally that macroeconomic shocks have systematically had opposite effects on private consumption and government expenditure with opposite signs between the two countries.
6 Pulling Forces

This section provides estimates of the role of real exchange rate persistence, inflation and aid in the macroeconomic transmission mechanisms. The idea is to pin down similarities and dissimilarities between the two countries in order to study how the transmission mechanisms have differed and if possible relate the differences to differences in policy. We achieve this by estimating an identified structure of five cointegration relations (Johansen, 1995 and Johansen and Juselius, 1994) and by studying how the system has adjusted when exogenous shocks have pushed the system out of equilibrium (Juselius, 2006).

6.1 Identification of Irreducible Cointegration Relations

An identified cointegration structure consists of \( r \) irreducible cointegration relations, where irreducibility implies that stationarity is lost if one of the variables is omitted from the relation (Davidson, 1998). Hence, they contain exactly the right number of variables needed to make the relation stationary, no less, no more. The results are interpreted with the following five caveats:

(i) There is no reason to expect the number of irreducible relations to be the same as the number of postulated economic relations. This means that a cointegration relation does not necessarily correspond to a hypothetical economic relation. For instance, any linear combination of \( r \) cointegration relations is also a stationary relation. This implies there are many ways of identifying a structure of irreducible relations. For example, if \( x_{1,t} - x_{2,t} \) and \( x_{2,t} - x_{3,t} \) are stationary, then \( x_{1,t} - x_{3,t} \) is also stationary and the long-run structure \((\beta_1'x_t, \beta_2'x_t)\) can be identified by either \((x_{1,t} - x_{2,t}, x_{2,t} - x_{3,t})\) or \((x_{1,t} - x_{2,t}, x_{1,t} - x_{3,t})\) and one of the sets may not be economically interesting.

(ii) Economic identification is generally incomplete without combining irreducible cointegration relations with the short-run adjustment coefficients. This is different from a traditional simultaneous equation model associating a number of endogenous variables with a number of exogenous variables and lagged endogenous and exogenous variables. Identification is then mostly achieved by exclusion restrictions and causality is implicitly assumed by normalizing on a postulated endogenous variable in each equation.

(iii) A generically identified structure of \( r \) irreducible cointegration relations, \( \beta'x_t \), can be thought of as building blocks that can be used to construct meaningful economic relations with the help of the \( \alpha \) coefficients. When interpreting a cointegration relation it is important to keep in mind that cointegration as such does not say anything about causality. It only tells us that the variables have been co-moving over time. For a bivariate cointegration relation the sign interpretation of the coefficient is quite straightforward. For example, \((x_{1,t} - \beta_1x_{2,t}) \sim I(0)\) tells us that the two variables are positively co-moving. When the adjustment coefficient, \( \alpha_1 \), of \( \Delta x_{1,t} \), is negative and significant we know that \( x_{1,t} \) has adjusted to the equilibrium error, \((x_{1,t} - \beta_1x_{2,t})\). If, in addition, \( \alpha_2 \) of \( \Delta x_{2,t} \) is insignificant we can say that the direction of causality is from \( x_{2,t} \) to \( x_{1,t} \), i.e. \( x_{1,t} = \beta_1x_{2,t} + u_t \). When \( \alpha_2 \) is positive and significant there is simultaneous feedback. A cointegration relation among three or more variables is less straightforward to interpret in terms of sign effects. For example \((x_{1,t} - \beta_1x_{2,t} - \beta_2x_{3,t}) \sim I(0)\) can mean that both \( x_{2,t} \) and \( x_{3,t} \) are positively associated with \( x_{1,t} \). But the interpretation can also be that \( x_{1,t} \) is positively related to \( x_{2,t} \) after having corrected for a negative effect of \( x_{3,t} \) on \( x_{2,t} \). This is similar to the difference between a
bivariate regression coefficient and a multiple regression coefficient.

(iv) Most relations contain at least the linear trend or one of the two step dummies. They can generally not be associated with a specific stochastic variable unless the relation is a single variable relation. For example, if a cointegration relation consists of a trend and just one variable, say \( x_{1,t} \), then the trend adjusted \( x_{1,t} \) is stationary. Alternatively if \( x_{1,t} \) and a step dummy are cointegrated then \( x_{1,t} \) is stationary with a shift in the mean. If the relation consists of a trend and several trending variables, say \( x_{1,t} \) and \( x_{2,t} \), then the results are equivalent to cointegration between \( (x_{1,t} - b_{1t}) \) and \( (x_{2,t} - b_{2t}) \) both being nonstationary. If the relation consists of a trend, two trending variables, \( x_{1,t} \) and \( x_{2,t} \), and a nontrending variable, \( x_{3,t} \), then the interpretation is that \( x_{3,t} \) cointegrates with the trend-adjusted variables \( (x_{1,t} - b_{1,t}) \) and \( (x_{2,t} - b_{2,t}) \).

How can we interpret the results when some cointegration relations contain a trend and others do not. When there is no trend in a cointegration relation among trending variables it can often be interpreted as a long-run (neo-classical) economic relation provided it satisfies economic identification (Johansen and Juselius, 1994). On the other hand, when there is a linear trend in a cointegration relation, the interpretation is that of a medium long-run relation describing deviations from the very long run. In a sense it captures a relationship relevant for the economy during long and persistent business cycles, or in the case of developing countries, during different political and economic regimes.

With these caveats in mind we can proceed to interpret the empirical results in the next section.

Table 4: An overidentified long-run structure for Tanzania

<table>
<thead>
<tr>
<th>( y_t )</th>
<th>( inv_t )</th>
<th>( aid_t )</th>
<th>( rex_t )</th>
<th>( c_t )</th>
<th>( g_t )</th>
<th>( inf_t )</th>
<th>( D_{s73} )</th>
<th>( D_{s92} )</th>
<th>( t )</th>
</tr>
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<tr>
<td>( \beta_1 )</td>
<td>1.00</td>
<td>-0.62</td>
<td></td>
<td></td>
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<tr>
<td>( \alpha_1 )</td>
<td>-0.12</td>
<td>*</td>
<td>0.51</td>
<td>-0.36</td>
<td>-0.09</td>
<td>1.00</td>
<td>*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \beta_2 )</td>
<td></td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>( \alpha_2 )</td>
<td></td>
<td>-0.04</td>
<td>-0.28</td>
<td>*</td>
<td>-0.14</td>
<td>0.13</td>
<td>*</td>
<td></td>
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</tr>
<tr>
<td>( \beta_3 )</td>
<td>-1.12</td>
<td></td>
<td>1.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>-1.00</td>
<td>0.54</td>
</tr>
<tr>
<td>( \alpha_3 )</td>
<td></td>
<td>*</td>
<td>*</td>
<td>-0.63</td>
<td>*</td>
<td>-0.09</td>
<td>*</td>
<td>*</td>
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<tr>
<td>( \beta_4 )</td>
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<tr>
<td>( \alpha_4 )</td>
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<td></td>
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</tr>
<tr>
<td>( \beta_5 )</td>
<td>-0.28</td>
<td></td>
<td>1.39</td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>( \alpha_5 )</td>
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</tr>
</tbody>
</table>

Test of over-identifying restrictions for Tanzania, \( \chi^2(7) = 4.69 [0.86] \)
6.2 A Long-run Structure for Tanzania

The results for Tanzania are reported in Table 4 where insignificant adjustment coefficients have been replaced by the symbol * and are not commented on.

*Real GDP* is equilibrium error correcting to the first relation (-0.12). Thus, we interpret it as a relation for real aggregate income:

\[
y_t = 0.62 inv_t + 1.23 \Delta p_t + 0.28 D_{s,92,t}.\]

The results show that real GDP and investment have been positively co-moving when corrected for a negative inflation effect. The coefficient 0.62 is consistent with the fact that investment grew faster than GDP in this period. The step dummy captures a positive shift in the level of GDP in 1992 (alternatively a negative shift in inflation or investment). The \( \alpha \) coefficients show that when GDP was above its equilibrium value, the real exchange rate appreciated (a Dutch disease effect), and aid and government expenditure increased, whereas private consumption decreased (confirming the strong substitution effects between private consumption and government expenditure).

*Investment* is significantly equilibrium correcting to the second relation (-0.28). It is therefore interpreted as an investment relation:

\[
inv_t = 4.03 rex_t + 0.79 g_t - 5.11 \Delta p_t - 2.05 D_{s,92,t},\]

The results show that investment increased when the currency depreciated and when government expenditure increased, whereas it decreased when inflation increased. The 1992 level shift can be associated with any of the variables, for example a downward shift in investment or inflation or an upward shift in government expenditure or any combination of them. The \( \alpha \) coefficients show that the real exchange rate has been error increasing in this relation, implying that, in the short run, the real exchange rate has appreciated when investment has been above its equilibrium value. The latter is in contrast to the longer-run co-movements of investment and exchange rate depreciation. Finally, private consumption has adjusted positively to this relation.

The third relation is equilibrium correcting in aid (-0.63) and is interpreted as an *aid* relation:

\[
aid_t = 1.12 y_t + 1.00 D_{s,73,t} - 0.54 D_{s,92,t} \]

It describes that aid has been increasing with increasing GDP and that the level of log aid roughly doubled in 1973 and halved in 1992. The \( \alpha \) coefficients show that private consumption has fallen when aid has been above its long-run equilibrium value.

Both the *real exchange rate* and the *real GDP* are equilibrium error correcting in the fourth relation suggesting simultaneous feed-back. The real exchange rate is more strongly adjusting which is why we choose to interpret the fourth cointegration relation as a *real exchange* relation:

\[
rex_t = -0.99 \widehat{y}_t - 0.22 \widehat{aid}_t.\]

where \( \widehat{x}_t \) stands for trend-adjusted \( x_t \). Over the long run, the real exchange rate has been appreciating when GDP and aid have exceeded their long-run trend values. This provides
support for the hypothesis that the real appreciation of the exchange rate was possible due to the expansion of foreign aid. Thus, the results provide some evidence for a Dutch disease effect of aid. The simultaneous feed-back suggests that when income has been above its long-run equilibrium, the real exchange has appreciated thus depressing income; lower income has in turn resulted in a real depreciation, boosting income, and so on. Finally, consumption has increased and investment decreased when the real exchange rate has been above its equilibrium value.

*Private consumption* is equilibrium error correcting in the fifth relation, which is therefore interpreted as a consumption relation:

\[
\hat{c}_t = -0.13\hat{g}_t - 0.45\Delta p_t
\]

It shows that trend-adjusted consumption has been negatively related to trend-adjusted government expenditure and inflation. Over the medium run (the business cycle) the results indicate significant substitution effects between private consumption and government expenditure in line with previous results. The \(\alpha\) coefficients show that investment increased and real income decreased when private consumption exceeded its equilibrium value.

### 6.3 A Long-run Structure for Ghana

The results for Ghana are reported in Table 5. The first relation is equilibrium error correcting both to *income and aid* and, hence, describes simultaneous feed-back effects. We have chosen to normalize on income, but could equally well have used aid:

\[
\hat{y}_t = 0.44\hat{aid}_t
\]

\[-0.41\]
Basically, the relation captures that trend-adjusted GDP and trend-adjusted aid were positively associated over the period, both in the pre-reform period when declining aid led to a decade of no growth and in the reform period when aid started flowing into the country in larger volumes and growth resumed. The simultaneous feedback describes a circle of increasing/decreasing aid generating higher/lower income and higher/lower income resulting in higher/lower aid, and so on. The remaining $\alpha$ coefficients show that the real exchange rate appreciated when income was above its equilibrium value. Furthermore, investment increased and consumption decreased when real income exceeded its equilibrium.

*Investment* is error-correcting in the second relation. It is therefore interpreted as an investment relation:

$$\text{inv}_t = 0.44\text{aid}_t + 1.40\Delta p_t - 1.9\text{g}_t,$$

It describes that trend-adjusted investment has been positively associated with trend-adjusted aid and inflation but negatively with trend-adjusted government expenditure. The positive inflation effect is somewhat puzzling and is opposite to what was found for Tanzania. The negative government expenditure effect suggests substitution between investment and government expenditure, also a somewhat puzzling result. The $\alpha$ coefficients show that income and consumption decreased when trend-adjusted investment was above its equilibrium value. Altogether the mechanisms behind the Ghanaian investment relation are somewhat puzzling. The finding in Section 3 that investment grew much faster than GDP in the reform period adds to the puzzle, and we therefore recall our initial caveats.

The third relation is equilibrium error correcting in the real exchange rate but error increasing in aid and inflation. We interpret it as a relation for the real exchange rate:

$$\text{rex}_t = -2.70\text{aid}_t + 1.20\text{inv}_t - 2.44\Delta p_t$$

The negative coefficient to aid shows that increasing aid has been associated with an appreciating currency (a Dutch disease effect of aid), and increasing investment with a depreciating currency. The interpretation can, however, also be that the real exchange rate appreciated when aid relative to investment increased. The negative relationship between the real exchange rate and the inflation rate implies error increasing adjustment over the long business cycles. It describes the vicious circle in the pre-reform period which almost led to hyper inflation. The inflation rate increased and the real exchange rate appreciated, and with an appreciating real exchange, inflation was further stimulated. In the reform period the vicious circle became a virtuous circle with the currency depreciating and inflation falling. The $\alpha$ coefficients show error increasing adjustment in price acceleration, which provides further evidence for how close Ghana was to hyperinflation in the pre-reform period.

That aid is also error-increasing shows that the more the currency appreciated and the more inflation increased in the first period, the less aid was flowing into the country. In contrast, the more the currency depreciated and the more inflation fell in the reform period, the more aid was flowing into the country. This is another way of saying that donors tended to withdraw their aid when things went badly in the 1970s and did the opposite when the economic performance improved in the 1980s. The $\alpha$ coefficients show that in-
come and consumption fell when the real exchange rate was above its equilibrium value (i.e. depreciated)

The fourth relation is equilibrium correcting in private consumption and inflation (but not very significantly so) and is error increasing in the real exchange rate. We interpret it as a private consumption relation:

\[
c_t = 1.08y_t + 0.15\Delta p_t + 0.03re_{xt}
\]

This relation shows that consumption relative to income (roughly proxying the inverse of the savings ratio), is positively related to inflation. When inflation increases so does consumption, implying that the savings rate has been declining with inflation. Consumption relative to income is also positively related to the real exchange rate (savings have been low when the real exchange rate has been depreciating). That the real exchange rate is error increasing is further evidence of the complex role the real exchange rate has played in Ghana over this period. The \( \alpha \) coefficients show that when consumption was above its steady-state level, investment, government expenditure and aid increased.

Government expenditure is error correcting and private consumption is error increasing in the fifth relation, which is interpreted to be a relation for government expenditure:

\[
\hat{g}_t = -1.36\hat{c}_t.
\]

It demonstrates (again) strong substitution effects between trend-adjusted government expenditure and trend-adjusted consumption over this period. The \( \alpha \) coefficients show that aid decreased when trend-adjusted government spending was above its steady-state, the real exchange rate depreciated and real GDP increased.

## 7 Conclusions

Our empirical analysis revealed both differences and similarities between Tanzania and Ghana, which ultimately seem to be associated with the role of the real exchange rate, the inflation rate, and aid for the macroeconomic transmission mechanisms. Both countries experienced a long period of real exchange appreciation in the 1970s and until the mid-1980s. As the strong appreciation was not reflected in a similarly strong macroeconomic performance, both countries suffered from imbalances in various sectors of the economy. In the end, very strong devaluations of the domestic currencies were unavoidable: Ghana in 1983 and Tanzania in 1985.

The fact that Tanzania was fortunate to obtain very large inflows of foreign aid explains why it was possible to maintain a strongly overvalued currency in the pre-reform period without suffering from economic collapse in spite of apparent economic weaknesses. For Ghana the opposite was the case. Foreign aid stagnated after the Ghanaian government repudiated international debt, and the strong appreciation of the currency magnified existing structural weaknesses in the economy. Government expenditure had to be financed by monetary expansion, resulting in very high inflation rates. Declining aid, very high inflation rates, and an appreciating currency was a disastrous cocktail for investment. While real GDP and private consumption stagnated in this period, investment followed a negative growth trend, and
also real per capita income growth was negative. The empirical finding that investment was negatively associated with government expenditure complements the picture of a military government that was unable to promote real growth.

Due to generous aid inflows, Tanzania experienced positive investment and GDP growth both in the first and the second period. In spite of the generous aid the growth rates were not up to expectations which primarily seems to be due to the strong appreciation of the currency. The results show that while real growth was strongly associated with investments it was not a one-to-one relationship. The coefficient to investment (0.63) suggests that some investments were not highly productive. As for Ghana, investment in Tanzania suffered from strong real currency appreciation in the first period and benefitted from devaluation in the post-1985 period and from occasionally quite high inflation rates.

The fact that inflation rates in Ghana soared in the same period, reaching almost hyper inflationary levels, suggests that money expansion went hand in hand with currency appreciation. The fact that only government expenditure showed some growth over the full period suggests that it was mostly financed by expansions in the money supply. All this changed in 1983 and the adoption of structural reforms including a strong devaluation of the currency.

A common feature of the transmission mechanisms is strong substitution between private consumption and government expenditure, but the effects are opposite of each other in the two countries. In the Ghanaian pre-reform period, government expenditure was allowed to grow at the expense of private consumption. In the reform period, private consumption increased while the government sector declined. In Tanzania, government expenditure generally appears to have been given priority over private consumption. For example, a shock to aid was shown to be positive for private consumption while negative for government expenditure in Tanzania, whereas the opposite was the case for Ghana.

We now turn to the opening question whether the inclusion of real exchange rates (open economy effects) and inflation significantly affects our conclusions regarding the long-run impact of aid on the key macroeconomic variables in the two countries as compared to JMT13. For Tanzania aid played the dual role of partly financing imports, and partly facilitating a real appreciation (and inflation). The former promoted growth, while the latter depressed it. This might explain why aid is not very visible in the Tanzanian results. For example, the long-run impact of a shock to aid on the macrovariables was found to be positive albeit only borderline significant. In this sense, aid did not seem to play a strong role as an exogenous driver. This is consistent with the finding that aid was mostly found to be adjusting to the level of real income and the real exchange rate.

For Ghana aid seemed pivotal for real growth in both GDP and investment. The decade of declining aid and essentially no growth in the 1970s and the catch-up after the initiation of the post-1983 structural reforms period, when aid flows started increasing again, are a strong indication of this. For Ghana the long-run impacts of aid were also found to be significantly positive. Altogether, the inclusion of the real exchange rate in combination with an improved specification of the deterministic terms seem to be able to explain the negative Ghana results in JMT13.

The next question is whether the effect of the major structural reforms differed for the macroeconomic growth rates in Ghana and Tanzania. The results of Section 5 clearly suggest that the growth rates in Tanzania remained essentially unchanged after the initiation of structural reforms in the mid-1980s, whereas for Ghana the dismal growth rates of the
pre-structural reform period were replaced by strong macroeconomic growth. As the main difference between the two countries lies in the large inflows of aid for Tanzania and lack of aid for Ghana in the pre-reform period, ultimately the difference in macroeconomic growth seems to be associated with a difference in the generosity of foreign aid giving. At the same time, the results confirm the importance of maintaining a more balanced real exchange rate for the overall transmission mechanisms of foreign aid. To some extent both Ghana and Tanzania suffered from Dutch disease in the period under study.

Finally, the macroeconomic mechanisms during the two sub-periods were somewhat different for Tanzania, but radically different for Ghana. The fact that with only 40 annual observations we were not able to split the sample in two more homogeneous periods produced some puzzling results. This was particularly the case with Ghana where the determination of investment and the long-run impact of inflation shocks were empirically difficult to interpret. Also, the results for Ghana provided evidence of several self-reinforcing feedback loops which produced a vicious circle outcome in the first period, but a virtuous one in the second. In this sense the relative abundance of aid flows in Tanzania and the lack of aid in Ghana over the pre-reform period seems to define the difference between a reasonably stable and an unstable economic performance.

8 References


9 Appendix

Table A.1: Misspecification Tests

<table>
<thead>
<tr>
<th>Bivariate tests</th>
<th>Ghana</th>
<th>Normality</th>
<th>ARCH(2)</th>
<th>Tanzania</th>
<th>Normality</th>
<th>ARCH(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\Delta y_t$</td>
<td>7.85</td>
<td>0.69</td>
<td>3.70</td>
<td>0.11</td>
<td>0.95</td>
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<td>$\Delta inv_t$</td>
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<td>0.87</td>
<td>6.37</td>
<td>0.50</td>
<td>0.97</td>
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<tr>
<td>$\Delta aid_t$</td>
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<td>1.08</td>
<td>3.96</td>
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<td>$\Delta ct$</td>
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<td>$\Delta g_t$</td>
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<td>$\Delta inf_t$</td>
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Multivariate tests

<table>
<thead>
<tr>
<th>Autocorr.</th>
<th>$\chi^2(49) = 63.20$ [0.08]</th>
<th>$\chi^2(49) = 72.18$ [0.02]</th>
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<tbody>
<tr>
<td>ARCH</td>
<td>$\chi^2(784) = 825.36$ [0.15]</td>
<td>$\chi^2(784) = 817.02$ [0.20]</td>
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<tr>
<td>Normality</td>
<td>$\chi^2(14) = 20.46$ [0.12]</td>
<td>$\chi^2(14) = 24.47$ [0.04]</td>
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</table>

Table A.2: Test for Weak Exogeneity and Pure Adjustment

Test for Weak Exogeneity (A zero row in $\alpha$)

<table>
<thead>
<tr>
<th>rank</th>
<th>$y_t$</th>
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<th>$aid_t$</th>
<th>$rex_t$</th>
<th>$ct$</th>
<th>$g_t$</th>
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</thead>
<tbody>
<tr>
<td>Tanzania</td>
<td>5</td>
<td>27.96</td>
<td>21.30</td>
<td>28.48</td>
<td>28.83</td>
<td>40.00</td>
<td>22.17</td>
</tr>
<tr>
<td>Ghana</td>
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<td>25.71</td>
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<td>36.77</td>
<td>18.13</td>
<td>19.90</td>
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</table>

Test for Pure Adjustment (A Unit Vector in $\alpha$)

<table>
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<th>$rex_t$</th>
<th>$ct$</th>
<th>$g_t$</th>
<th>$inf_t$</th>
</tr>
</thead>
<tbody>
<tr>
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<td>5</td>
<td>6.91</td>
<td>8.33</td>
<td><strong>2.09</strong></td>
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<td><strong>1.97</strong></td>
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<td>10.78</td>
<td>12.16</td>
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