Interview with Dimitri Demekas

Rethinking what postconflict aid can accomplish

Over the past decade, countries recovering from war and civil unrest have received substantial amounts of postconflict aid designed to address their humanitarian emergencies, rebuild destroyed infrastructure, and restore public services. In a new IMF Working Paper, Dimitri Demekas (Advisor, European I Department); Jimmy McHugh (Resident Representative in Armenia); and Theodora Kosma (Athens University of Economics and Business) examine the impact of postconflict aid on an economy. Demekas talked with the IMF Survey *about the new study.*

IMF SURVEY: What prompted you to develop a new framework for analyzing the impact of postconflict aid?

DEMEKAS: The original idea for the study came from Jimmy McHugh, who was then our desk officer for Bosnia. At the time, I was leading missions to Kosovo, and we had just finished a major joint IMF–World Bank paper on Southeastern Europe after the Kosovo conflict. Our work on that paper, as well as on Bosnia and Kosovo, turned our attention to the amount of aid that went into these countries after the wars. Jimmy originally proposed a paper on the economic impact of an influx of refugees and of refugee-related aid flows. This aid helps host countries deal with the cost of assisting refugees and facilitates the postconflict return of refugees to their countries of origin. The idea quickly led us to the broader issue of postconflict aid. We discussed our outline with senior staff in the European I Department and, in mid-2002, wrote the paper with the indispensable input of our summer intern, Theodora.

IMF SURVEY: Is postconflict aid really all that different from conventional development assistance?

DEMEKAS: Three characteristics of postconflict aid distinguish it from traditional aid. The first and most noticeable is, of course, its size. Look at some of the examples we cite in the paper: Rwanda's aid reached 95 percent of GDP during the first year after the conflict; Bosnia's, 75 percent of GDP; and Kosovo's, 65 percent of GDP. These are huge amounts of money, which drop off very quickly four or five years later, typically down to a range of 10–25 percent. Traditional development aid is a trickle compared with that: on average, the amount of aid that middle- and lower-income countries receive is something like 2.5 to 3 percent of GDP. But then it lasts for 20, 30, or even 40 years in the case of Africa. We felt that these two kinds of aid were essentially different phenomena and decided to develop a new analytical approach because we suspected that the tools developed to analyze the impact of development aid were not really appropriate for postconflict aid.

Another reason the traditional aid literature does not provide appropriate tools for examining postconflict aid is that it basically models aid as a transfer of tradable goods or, in more sophisticated models, a transfer of foreign currency. But this is not the typical case in postconflict countries. In these countries, you instead see a lot of resources allocated toward rebuilding infrastructure—roads, telephone networks, water supply systems, and houses—that has been destroyed. And you also see armies of foreign consultants rebuilding institutions—a ministry of finance, a modern tax system, a central bank—that, of course, are at least as important as physical infrastructure.

Demekas: "Our advice would be to give larger amounts of humanitarian aid over a shorter period of time, instead of disbursing relatively small amounts over a long period of time."

In postconflict situations, there is also a very clear difference between humanitarian aid and reconstruction aid. Humanitarian aid provides a huge burst of money in the first year or two after the conflict. Then, in most cases, it tapers off very quickly, while reconstruction aid continues for several years. That is not the pattern of development aid, where the distinction between these two kinds of flows is much less sharp.

IMF SURVEY: How does your model help in assessing the impact of postconflict aid?

DEMEKAS: I think the main achievement of our model is that it distinguishes the impact of humanitarian aid from that of reconstruction aid. We distinguish between the two types of aid to reflect their fundamentally different objectives: reconstruction aid aims to improve productive capacity, while humanitarian aid is intended to support basic consumption. We also include reconstruction aid in the production function to account for the fact that, by rehabilitating infrastructure and public institutions, postconflict reconstruction directly boosts productivity.

IMF SURVEY: And what did you conclude?

DEMEKAS: Our main finding is that humanitarian aid and reconstruction aid do have different effects. Humanitarian aid has pretty much the same impact as

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traditional development aid: it is a transfer of income that tends to be consumed rather than saved. It gives a boost to consumption in the short term but reduces savings, capital accumulation, and, in the long run, growth.

Reconstruction aid, however, has a completely different impact. In particular, its effect on capital accumulation, which is the key to growth, is ambiguous in our model but, within reasonable constraints, we believe it can be positive. In addition, our model also provides a bit of comfort because it shows that reconstruction aid, when properly designed, does not necessarily lead to "Dutch disease."

A Kosovo family receives humanitarian aid.

IMF SURVEY: What is "Dutch disease," and why is it of concern?

DEMEKAS: If a country receives a transfer of tradable goods (or foreign exchange that makes it possible for the country to buy tradable goods), the relative price of nontradable goods rises. As a result, resources (capital and labor) shift toward the nontradable goods sector and the tradable sector shrinks. This phenomenon is called "Dutch disease" because Holland experienced a contraction in its tradable goods sector after the discovery of large natural gas deposits and the foreign exchange inflow associated with it.

The same thing can happen when a country receives foreign aid: aid boosts consumption but can depress the tradable goods sector and jeopardize the long-term potential of the country. Our paper shows that in postconflict economies, in particular, the design of the aid package has a crucial impact on whether or not postconflict aid will cause the tradable goods sector to shrink.

IMF SURVEY: How should postconflict aid be designed?

DEMEKAS: There are perfectly legitimate reasons for giving humanitarian aid. But from an economic perspective, in the long run, it is "growth-destroying" because people lose their incentive to save and invest. Our advice would be to give larger amounts of humanitarian aid over a shorter period of time, instead of disbursing relatively small amounts over a long period of time. Also, in designing reconstruction aid, which is the component typically disbursed over a longer period of time, channel it toward the tradable goods sector. Spend the money on activities or infrastructure or institutions that help that part of the economy. If you must choose, for example, between rebuilding churches and sports facilities and rebuilding roads and sewer networks, you are better off—from an economic point of view—doing the latter.

IMF SURVEY: What are the broader lessons you would like to see policymakers draw from your study?

DEMEKAS: In the traditional aid literature, there is little agreement on whether aid is beneficial and, if indeed it is, under which circumstances. It is remarkable how disappointing the results of almost 50 years of economic research in this area are. This has been one of the major motivations behind our effort to give a fresh look at how we model aid. Our hope is to stimulate a new trend in thinking about it. The main benefit for policymakers would be the creation of new analytical tools to help them make better choices about allocating the limited aid resources between different uses—for instance, humanitarian and reconstruction aid—and design aid packages more effectively. ■

Copies of IMF Working Paper No. 02/198, *The Economics of Postconflict Aid*, by Dimitri Demekas, James McHugh, and Theodora Kosma, are available for $15.00 each from IMF Publication Services. See page 12 for ordering information. The full text is also available on the IMF's website (www.imf.org).

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
January 6	1.91	1.91	2.44
January 13	1.90	1.90	2.43

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website under IMF Finances.
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