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Sunday, June 11, 2006

VIEW: Pakistan: foreign aid or band aid? — *Ahmad Faruqui*



A former World Bank economist, Easterly says that despite the disbursement of \$2,300 billion of foreign aid over the last five decades, almost half of the world lives in poverty. Aid has even failed to deliver a basic necessity such as mosquito netting costing four dollars to poor families in Africa. When aid agencies hand these out, they are often diverted to the black market

The World Bank has stated its intent to provide up to \$6.5 billion aid to Pakistan over the next four years. This amount, the largest single award ever by the Bank to Pakistan, is more than twice what it has provided during the past four years. In fact, it is almost half of the entire amount that the Bank has lent since Pakistan's independence.

John Wall, the Bank's man in Islamabad, said the country had laid "the groundwork for sustained economic growth and significant poverty reduction. We will substantially ramp up support to Pakistan and focus on the areas that are most critical for the country's poor and most vulnerable." The Bank's director for South Asia, Praful Patel, cautioned that sustained growth in Pakistan is not assured, noting that it "will require continued sound macroeconomic management along with further improvements in the investment climate and faster progress in improving the quality of life for all Pakistani citizens, especially women."

While there is some evidence that foreign aid equivalent to one percent of GDP given to a poor but well-managed country can help increase its growth rate by a sustained 0.5 percent, the economists are divided on the long-term merits of foreign aid.

Advocates maintain that it allows nations to climb out of poverty by overcoming the "financing gap" between domestic savings and investment needs. This position, argued persuasively by Jeffrey Sachs in *The End of Poverty*, harkens back to Walt Rostow's thesis in *The Stages of Economic Growth*. Writing in 1960, Rostow asserted that aid could launch an economy that would otherwise stay trapped in poverty into the stage where it would "take off" towards prosperity. Indeed, Rostow's theorising provided the underpinning for the early work that was carried out at General Ayub Khan's Planning Commission, under the guidance of Harvard economists.

One of the chestnuts in development planning is the incremental capital-output ratio. If the ratio is four and the rate of domestic investment is 20 percent of GDP, then GDP will grow at five percent a year. If the country wishes to grow at a rate of eight percent, it will need an investment rate of 32 percent. Foreign aid can help bridge some of the difference in investment rates, with the rest coming from personal remittances (from expatriates) and foreign direct (private) investment (FDI).

In addition to World Bank aid, Pakistan is expected to receive some \$600 million of US aid annually, split equally between economic and military applications. According to the US Congressional Research Service, Pakistan has received a total of \$15 billion in US foreign aid since independence. Between 2002-05, it also received \$3.6 billion in US aid for counter-terrorism operations, most probably as a grant requiring no repayment of principal or interest. Between 2001-07, Pakistan is estimated to receive \$4.4 billion in US aid, of which 29 percent will be for financing military supplies.

In the coming years, Pakistan is also likely to get additional aid from the Asian Development Bank, the Islamic Development Bank and other sources. All things considered, it is likely to add \$2 billion a year to its foreign debt. Just in the past three years, foreign debt has grown by \$5 billion.

How much will it cost to service the debt? That depends on the terms of the loan. For example, if the term is 20 years and the interest rate is eight percent, every billion dollars of foreign aid will require \$100 million in annual debt servicing. Over the life of the loan, Pakistan will have returned \$2 billion to the lender. For aid to be cost-effective, Pakistan would have to generate productive revenues that far exceed the cost of debt servicing. Can this be assured?

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ZAHOOR'S CARTOON:

Hardly, since Pakistan received 20 "structural adjustment" loans from the World Bank and the IMF with the explicit requirement to lower the budget deficit between 1980 and 1999. But this never happened. Neither did aid eliminate year-to-year fluctuations in the rate of economic growth.

It is lacklustre results such as these that lead critics of foreign aid to argue that it simply represents a waste of resources in the donor countries and promotes dependency in the recipient country. William Easterly lays out this position in *The White Man's Burden*, which builds on arguments that he first marshalled in his 2001 book, *The Elusive Quest for Growth*. A former Bank economist, Easterly says that despite the disbursement of \$2,300 billion of foreign aid over the last five decades, almost half of the world lives in poverty. Aid has even failed to deliver a basic necessity such as mosquito netting costing four dollars to poor families in Africa. When aid agencies hand these out, they are often diverted to the black market or end up being used as fishing nets or wedding veils. Only rarely do they get to the recipients.

Easterly recommends that the West stop "coddling the warlords and kleptocrats" by bestowing them with the gift of foreign aid. At the minimum, it needs to do a much better job of seeing what happens once the big checks are cut.

Since independence, Pakistan has received more than \$30 billion in aid just from the Bank and the US and billions more from other sources. Despite this "embarrassment of riches", it has failed to become an Asian tiger. This is evidenced by the continuing presence of five structural problems in the economy. First, as the economy grows, imports grow faster than exports, leading to rising deficits on the current account. Second, consumer goods rather than capital goods dominate the growth of imports, reflecting a bias towards consumer spending and fuelling inflation. Third, domestic investment rates remain low, thus requiring continuing infusions of foreign aid to bridge the non-vanishing "financing gap". Fourth, as growth occurs, the government begins to rack up rising budget deficits to placate special interest groups, most notably the military. And, finally, despite all of Shaukat Aziz's rhetoric about transparency, Pakistan remains a highly corrupt country according to Transparency International.

As the parliament debates the budget, it should ask the government how it will use the new foreign aid to address these endemic problems. Otherwise, the new money will become a band aid to cloak the ills of military rule. General Musharraf's regime should not be allowed to leave a painful inheritance for future generations of Pakistanis, by saddling them with billions in debt servicing costs.

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