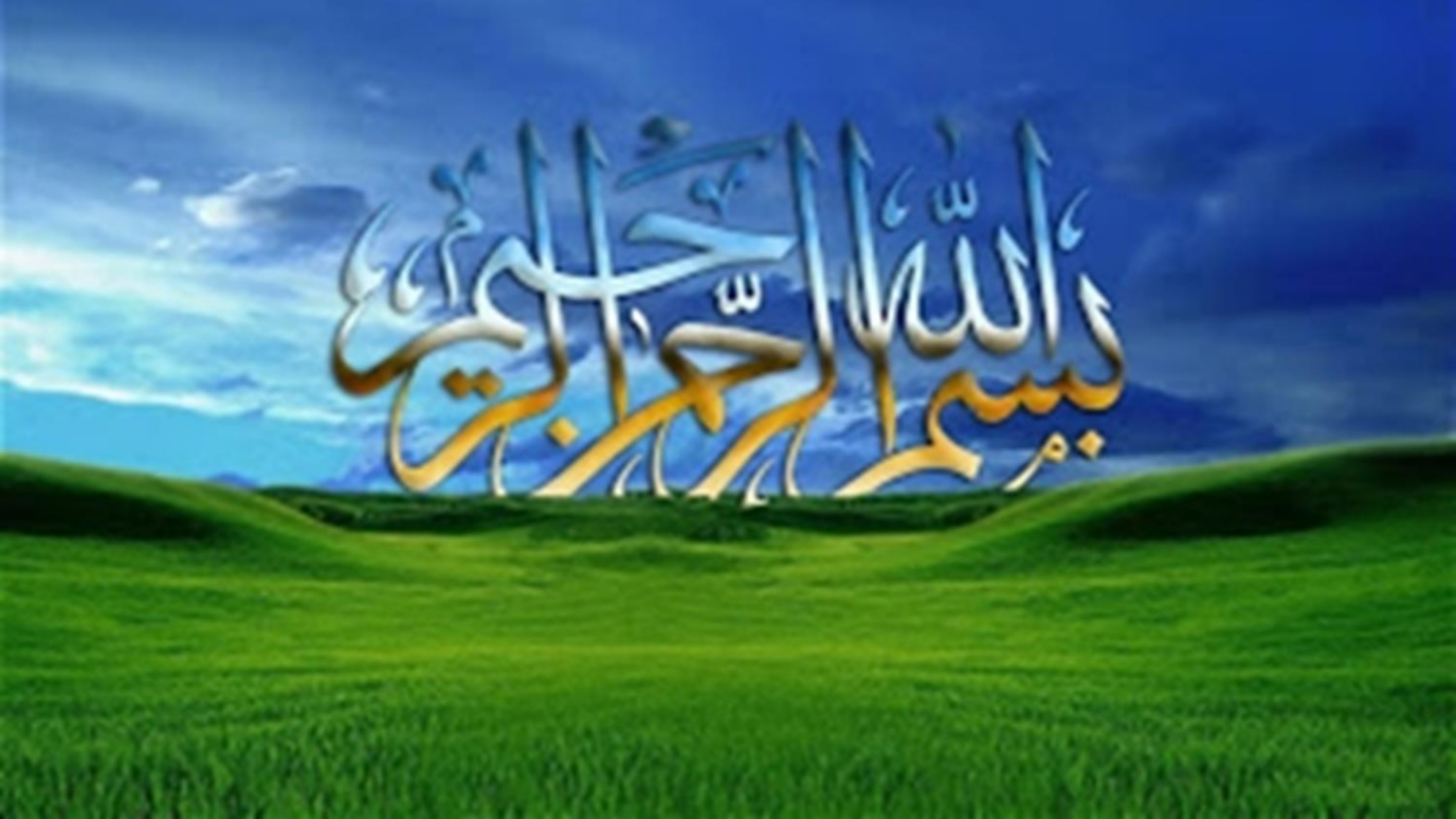
بسم الله الرحمن الرحيم

Effect of Foreign aid and economic policies on Economic growth of the Asian countries.

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Introduction

- In this paper we observed that aid has effect on economic growth of the developing countries and also analyze political stability and role of policy of recipient countries which have effect for aid on economic growth,

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- The effectiveness of foreign aid is a controversial topic in literature. Previous empirical studies on foreign aid and economic growth generate mixed results.

- There is positive impact of aid for economic growth (Gupta and Islam (1983) Dalgaard et al. (2004), and Karras (2006).

- Few find evidence for negative impact of foreign aid and growth (Burnside and Dollar (2000) Brautigam and Knack (2004).

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- While few find evidence to suggest that aid has no impact on growth (Mosley, et al. (1987), Jensen and Paldam (2003).

- Another valid counter argument to the effectiveness of aid is that countries that receive aid just use aid in consumption, effectively becoming aid dependent (Radeletet al 2005 and Ali and Isse 2005).

Objective

- To analyze the foreign assistance is growth promoting
- To analyze the political stability (good governance) of recipient countries has effect for aid on growth
- To analyze the role of policy of recipient countries for aid on growth

Literature gap

- Quite a lot of work has been done to find out the relationship of aid and growth as aid reduce poverty , increase consumption in recipient countries , effect on fiscal behavior of countries, aid fungibility and aid volatility etc.

- There is lack of serious work to explore whether aid promotes growth in the presence of better polices and political stability in developing countries of Asia and this study tries to fill this gap.

Foreign aid to Asian countries

- Foreign aid in less developed countries is primary concern to alleviate poverty, by bridging the domestic resource investment gap for socio economic progress.

- South Asian continues to be the utmost region with 71% of the population, living below poverty line and survived under $2 a day in 2008 (World Development Indicators 2012).
- Funds are needed in form of foreign aid to assist developing the infrastructure requirement, adequate governance and capacity building.

- Among donors countries including European Union (EU),United Kingdom (UK), United States of America (USA), Japan, Saudi Arabia, Germany, France and Australia.

Literature review

RESEACHER	YEAR	RESEARCH
Chenery and Strout	(1966)	They presented the underlying economic rationale of accepting foreign assistance and argued that developing nations are unable to achieve their desired prosperity targets due to lower level financing power. This is mainly because of inadequate level of savings at domestic level.
McGillivray	(2000)	He applied three stage least square procedures to estimate that how aid inflows effect revenue collection in Pakistan. He introduced domestic borrowing to finance both capital and recurrent expenditure and also found that it was also related with expenditure level and not with consumption only.

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RESEARCHER	YERA	RESEARCH
Heller	(1975)	He showed different ways by which foreign aid may affect the domestic savings effort negatively. Also the recipient country reduces its domestic borrowings and revenue generating efforts and also increases the government expenditures on consumption.
Gupta	(1995)	He used ordinary least squares estimator in the first step of his analysis and then he used three-stage non-linear-least-squares estimator for assessment purpose and revealed that nondevelopmental expenditures have increased tremendously due to foreign aid.

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RESEARCHER	YEAR	RESEARCH
Goumanee	(2005)	Found evidence for 25 SSA countries, aid actually supports growth but the contribution of aid is indirect. Aid promotes growth in SSA through its contribution to investment
Lele and Goldsmith	(1989)	They showed that high volatility in assistance inflows results in high turnoff ratio of staff, misunderstandings develop in the relation of donor and recipient countries and also reduced the level of learning opportunities. This fluctuating behavior of foreign aid inflows also leads to design an unpredictable policy environment mainly because of fluctuating disbursement of expenditures by government.

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RESEARCHER	YEAR	RESEACHER
McGillivray, et al.	(2006)	According to him four main alternative views on the effectiveness of aid have been suggested, namely, (a) aid has decreasing returns, (b) aid effectiveness is influenced by external and climatic conditions, (c) aid effectiveness is influenced by political conditions, and (d) aid effectiveness depends on institutional quality.
Burnside and Dollar	(2000)	conclude that the aid-growth effect is positive for good policy countries but negative for countries with bad policies
Islam	(2005)	concludes that a stable political environment is a necessary condition for aid to promote growth.

Theoretical frame work

- The study will mainly focusing on impact of aid on economic growth further it will enlighten the effect of political stability and role of policy for aid on growth.

Economic Growth

- Classical Growth Theory
- Neoclassical model as Solow- Swan model
- Endogenous Growth Theory

Economic growth

- 'Economic Growth' An increase in the capacity of an economy to produce goods and services, compared from one period of time to another. Economic growth can be measured in nominal terms, which include inflation, or in real terms, which are adjusted for inflation.

Foreign assistance (aid)

Aid is a voluntary transfer of resources by individuals, private organizations and governments to support the recipients' economic development.

Financial flows to developing countries take two main forms, aid that comes from foreign governments, often called official development assistance, and investment from foreign private companies, known as private capital flows.

Hypothesis

- We are conducting the study empirically estimate the impact of aid on economic growth of recipient countries. So hypothesis is as follow:

Aid has effect on the economic growth of recipient countries.

Macro economics policy such as trade policy, fiscal policy and monetary policy has effect for aid on growth.

Political stability has effect for aid on growth.

RESEARCH MODEL

- The growth equation is

$$Y_{it} = \alpha_0 + \beta_1 \sum X_{it} + \mu_{it} + \varepsilon_{it}$$

In the vector X_{it} includes the determines of growth, independent variables including physical capital, labor force participation, human capital, trade openness, budget deficit, inflation further the endogenous variables are : aid, political stability (PS), policy (POL) .

Further we have explain aid equation, political stability equation and policy equation.

The Aid Equation:

- $A_{it} = \beta_0 + \beta_1 GDP_{i,t-1} + \beta_2 HK_{it} + \beta_3 logPOP_{it} + \beta_4 POL_{i,t-1} + \beta_5 AID_{i,t-1} + \varepsilon_{it}$

The main independent variable is aid in growth equation. In the aid equation includes lag of GDP, human capital log population, lagged policy index, and the lagged aid variables.

Donor countries usually give aid for reasons linked to their own self-interest. Boone (1996) and Islam (2005) document that the allocation of aid depends on: Political links between donor and recipient countries, Socio-economic climate, Structural vulnerability, Economic policy.

Political stability equation:

- $PS_{it} = {}^{\delta}{}_{0} + {}^{\delta}{}_{1}ED_{it} + {}^{\delta}{}_{2}DEM_{it} + {}^{\delta}{}_{3}GGDP_{it} + \; + \varepsilon_{it}$

The proxies will use to measure them are ED: Education: Primary school enrolment; DEM Democracy: Dummy = 1 if democratic, GGDP for economic Performance,. Political stability or good governance has been found to be a necessary condition for aid to be growth promoting at least for LDCs (Islam 2005). For political stability (PS) we used data from ICRG.

The policy equation:

- $POL_{it} = \gamma_0 + \gamma_1 TO_{it} + \gamma_2 BS_{it} + \gamma_3 INF_{it} + \gamma_4 GDPc_{i,t-1} + \gamma_5 AID_{i,t-1} + \varepsilon_{it}$

In this equation TO is Trade openness, BS is Budget surplus and INF is inflation. To mitigate endogeneity bias of policy in the growth equation, the policy index equation is instrumented by lag of GDP per capita, and lagged Aid.

The effect of policy on growth has enjoyed significant analyses is in the literature with Easterly(2003),Hansen and Tarp(2001),Burnside and Dollar(2001) and Arrellano et al (2005) education training medical care.

Variables

Variable name	Description	Data source
GDP	Growth of GDP per capita.	
AID	Official development assistance as a share of GDP.	World development indicator (WDI)
Population	Log of population.	
EDU	Primary school enrolment	Human development index (HDI)
Democracy	Dummy = 1 otherwise 0	
Trade openness	Export +import (as a share of GDP)	Corruption Perception Index (CPI)
Budget Surplus	Defined as government revenue expenditure	
Inflation	Consumer price index	
PS	Political stability	ICRG
HK	Human capital(average year of schooling)	
PK	Physical capital (gross investment)	

DATA PERIOD AND METHEDOLOGY

- Observed time period is 1984 to 2013
- Asian developing countries including Pakistan, Bangladesh, India and Sri Lanka, Indonesia, Malaysia, Thailand, Philippines and china.
- Panel data estimation technique has been used.

Estimation technique

- Panel data estimation technique is extensively used in this paper.
- . Once panel data is use question arises whether, the individual effect is taken as a common or fixed or random.
- The fixed effect and random effect models are compared based on Hausman test. The Hausman test support fixed effect method over random effect.

Results and discussion: aid, political stability and policy equation.

Variables	Model 1 AID EQ	Model 2 PS EQ	Model 3 POL EQ
Con	0.011*	2.54*** (0.497)	1.28*** (1.70E-10)
IGDP	-0.013		-1.51E-12 (8.43E-12)
HK	-0.009		
LPOP	-0.002*		
EDU		0.0139*** (0.005)	
GGDP		0.0798*** (0.022)	
DEM		0.148 (0.183)	
TO			0.02** (1.06E-12)
BD			-0.02*** (1.11E-11)
INF			-0.18*** (5.14E-12)
IPOL	-0.342^{e-3}		
IAID	0.903***		-5.02E-12* (2.95E-11)

POLICY INDEX

- Policy index = a + aTO +aBD + aINF

- Policy index = 1.28 + 0.02*TO - 0.02*BD – 0.18*INF

Results interaction terms

Variables	Model 1 PS	Model 2 POL	Model 3 AID-GROWTH
Con	-53.39*** (11.83)	-56.4*** (12.718)	-66.4*** (15.5)
Aid	0.107* (0.026)	-20.936*** (8.412)	-0.37*** (2.18)
TO	0.013** (0.010)	0.016 (0.0168)	0.03 (0.024)
BD	-0.211*** (2.042)	-0.241*** (2.053)	-0.26 (-2.06)
INF	-0.188*** (2.04)	-0.173*** (2.04)	-0.0019*** (-2.07)
HK	-1.21 (-0.52)	-1.297 0.469	-1.161 (0.42)
PK	6.620*** (1.441)	7.030*** (1.515)	7.66*** (1.80)
DEM	1.044* (3.66)	0.050 (2.759)	0.789 (4.68)
Aid*ps	5.349* (3.514)		
Aid*pol		2.691 (8.268)	
R^2	0.555	0.494	0.46
Adjusted R^2	0.524	0.462	0.42
F-test	17.830	15.298	13.037
Prob(F-test)	0.000	0.000	0.000

Static and dynamic

Variables	Model 1 static panel estimate	Model 2 dynamic GMM Panel estimate
Con	-59.44 *** (11.3)	-20.6 *** (7.53)
lGDP		-0.479*** (2.16)
Aid^{hat}	0.926* (0.42)	0.153* (0.033)
Pol^{hat}	0.336* (0.037)	0.36* (0.24)
PS^{hat}	0.980* (0.37)	10.38*** (1.57)
HK	-1.800*** (0.508)	-0.053 (0.165)
PK	6.460*** (1.30)	0.76 (0.83)
DDEM		12.8*** (2.24)
Lab	0.052 (0.05)	
R^2	0.40	0.25
Hausman (p-value)	0.13	
Sargan J test (p value)		0.000

Conclusion

- The estimated results of the study highlighted the role of political stability and policy for aid to promote growth.
- Study cannot confirm, Burnside and Dollar (2000)'s claim that aid and growth positive relationship is conditional on good policy.
- Political stability is necessary for aid to efficiently promote growth.
- Aid is growth promoting when state hold political stability.

- Introducing aid, policy and political stability jointly in growth equation and estimated by static FE, aid, policy and political stability coefficients became positive and significant, which support the point that if there is stable government than policy may contribute for aid to promote growth.

Policy recommendations

- countries need to follow proactive policies, strong institution and good governance if they want to get desire outcomes from internal and external resource.
- Governments in developing countries may consider the use of foreign aid for enlightening the sectors like investment, advance education, health, export, which make significant contribution to their growth.
- These countries need to reduce its dependencies on foreign aid, because the dependence on foreign aid does not offer the solution for sustained rapid growth.

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