

Aid-Growth Association and Role of Economic Policies: New Evidence from South and Southeast Asian Countries

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Abstract

The present article aims to study the implications of foreign aid on GDP per capita in the seven middle-income countries of South and Southeast Asia from 1990 to 2016. The influence of foreign aid on GDP per capita is studied in a policy-driven environment, for which a policy index using government consumption expenditure, inflation and trade openness is constructed. The outcomes of the study confirm that aid–policy interaction has a significant and positive impact on economic growth in the region. The results are calculated using the two-stage least-squares model, as foreign aid is included as an endogenous variable in the study. This approach enables us to assess the indirect effect of monetary, fiscal and trade policies on GDP per capita, as the constructed policy index is used as an instrument for foreign aid. The results of the study ascertain that besides current aid–policy interaction, the preceding years’ aid–policy interaction also has a positive and significant impact on GDP per capita in the region. The inclusion of a policy index in the analysis enables us to evaluate the effectiveness of economic policies while determining the level of GDP per capita in South and Southeast Asian countries. Therefore, the study proposes that while assessing the influence of aid-financed programmes on GDP growth of a country, the economic policies of recipient countries need to be considered. The bottom line is that foreign aid, economic policies and economic growth of aid-recipient countries are inextricably linked.

Keywords

Foreign aid, economic policy, economic growth, 2SLS, South and Southeast Asian countries