

# Three Essays on Foreign Aid Effectiveness in a Small Open Economy

## Dissertation Abstracts for Completed Chapters

### *Chapter 1 Abstract – Foreign Aid and Macroeconomic Performance*

Using a non-scale growth model framework, we examine the effects of the allocation of foreign aid on growth and welfare in a small, open economy. We contrast the effects of both extremes, when foreign aid is ‘tied’ and ‘untied’ to public investment, as well as other aid scenarios on key macroeconomic variables. Initial results suggest that tied aid is growth enhancing as agents respond to the increased productivity of the private factors. When aid is allocated to public infrastructure, the effect on the private sector is that agents accumulate wealth (in the form of private capital) in the long-run, and benefit from a higher levels of output during transition - which compensates for the short-run welfare losses suffered from their increased work effort, decreased consumption, and debt financing (of that private capital). The effects are the opposite in the case of untied aid, that is, when aid is a pure transfer. In this regard, the long-run effects of aid transfers are not significantly different from the results under an endogenous growth model, when taking into account technological change. However our model does produce some important results. First, the model finds that aid shocks affect growth rates only in transition. Second, we find that aid shocks have permanent effects on levels but leave the long-run growth rates unchanged. Third, our fungibility analysis points out that in some circumstances aid still remains ineffective, even after accounting for level and scale effects. Fourth, we observe that after the aid shock, the economy converges more slowly as it readjustments to its long-run balanced growth path.

*Chapter 2 Abstract – Foreign Aid and Real Exchange Rate Dynamics in a Small Open Economy*

Recent research on foreign aid has focused its attention on finding explanations for why aid, despite best efforts, has not had consistent success in encouraging growth and development in recipient countries. One explanation that has found some traction in the empirical literature has been the adverse effect that aid may have on the real exchange rate in the recipient economy. I explore theoretically this relationship between foreign aid and the real exchange rate in this paper. Using a neo-classical growth model, I explore the effects of the composition of foreign aid transfers on the real exchange rate dynamics in an aid recipient country. We keep the model simple by using a characterization of a two-good, one-sector, small, open economy. The aid transfers that the country receives are denominated in units of the foreign consumption good. Initial results show that there is a net long-run depreciation of the real exchange rate in response to a tied aid shock. In respect of a pure transfer, the currency appreciates in the long-run. There are no transitional dynamics as the currency quickly appreciates to its new steady-state level. This is the expected result as discussed in the literature of the presence of huge capital inflows (such as foreign aid) into an economy - reflecting an anticipated decrease in the country's international competitiveness.