A CRITICAL REVIEW OF AID EFFECTIVENESS WITH A FOCUS ON THE RELATIONSHIP BEWEEN FOREIGN AID AND FOREIGN DIRECT INVESTMENT

By

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THESIS

Submitted to
KDI School of Public Policy and Management
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ABSTRACT

A CRITICAL REVIEW OF AID EFFECTIVENESS WITH A FOCUS ON THE RELATIONSHIP BEWEEN FOREIGN AID AND FOREIGN DIRECT INVESTMENT

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In the current post-2015 era, the global community is faced with dynamic changes such as the establishment of the new Sustainable Development Goals led by the United Nations and the modernization of ODA measurement framework led by the OECD. With such changes taking place, this paper aims to review the three studies (Selaya and Sunsee , Bhavan, Xu, and Zhong , Kimura and Todo) conducted on the relationship between foreign aid and FDI and find the implications that relate to the debate on aid effectiveness. When it comes to examining the impact of foreign aid on development, the paper highlights the importance of considering the composition of aid, country specific differences and donor’s varying ODA policies.

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I. Introduction

The global development community is standing on the brink of the post-2015 era, at a critical juncture where dynamic changes are taking place. The Post-2015 new Sustainable Development Goals (SDGs) were announced at the UN Sustainable Development Summit in September 2015, which will lay a new foundation for achieving the new development goals ranging from the eradication of poverty and hunger to promoting sustainable growth. The 193 countries of the UN General Assembly adopted the 2030 Development Agenda tilted *'Transforming our world'* which includes 17 Sustainable Development Goals and 169 sub targets (UN, 2015). The new set of goals is an improved version of the pre-existed MDGs with a more holistic approach on development. Despite the outstanding outcome achieved from the former MDGs, it is viewed that the former MDGs failed to consider the root causes of poverty, overlooked the issue of gender inequality and in particular, the goals were too much focused on the social sector development that it did not address the economic sector development. Moreover, while the MDGs were generally considered as targets for developing countries with finance from the developed, every country is expected to contribute to achieving the SDGs. The post-2015 SDGs have reflected such shortfalls in the former MDGs framework and have set out greater, universal goals of every sector development.

Figure 1. Sustainable Development Goals

<Source: United Nations, 2015>

In July 2015, the Third International Conference on financing for Development was held in Addis Ababa, Ethiopia to assess the progress made in the implementation of the Monterrey Consensus and the Doha Declaration and to address the current evolving development cooperation landscape including the interrelationship of all sources of development finance (UN, 2015). In the conference, a wide consensus was made on the importance of catalyzing private investment and scaling up domestic resource mobilization and ODA as the main sources of development. In December 2014, at the High Level Meeting of the OECD Development Assistance Committee, high level political representatives including Ministers of Finance, Foreign Affairs and Development Cooperation, as well as all relevant institutional stakeholders, non-governmental organizations and business sector entities have agreed to modernize ODA measurement to reflect the changing landscape of today's development cooperation and established a new concept of Total Official Support for Development which is supplementary to ODA in order to capture various development finance mechanisms not yet reported on to the current measurement framework (OECD, 2014). These new changes led by OECD will be elaborated in detail in the next section of the paper.

The current dynamics in the development cooperation is innovative but this is not the first time the global community has faced with such big changes. At a time when new changes are taking place, it is important to give a moment to the things that were at the heart of the issue throughout the long years of development cooperation history. In this context, these dynamics and new changes are more or less linked to addressing one critical question, 'what is the most effective way to provide support to the developing countries?' In efforts to find an answer to this question, the United Nations established the new Global Development Goals to coordinate the global efforts to the prioritized areas where the resources should be systemically concentrated. The modernization of ODA measurement led by the OECD reflects the global community's strong will to better capture the donor efforts in providing support to developing countries and to provide incentives as well as to scale up such financial support. The Third International Conference on Financing for Development was a meaningful platform to discuss the effective ways to mobilize resources for development cooperation. The active interaction between the innovative development financing methods, modernization of ODA measurement, establishment of new development goals and diversified stakeholders in the development cooperation sheds new light on the very question of 'what is the most effective way to provide foreign aid to developing countries.'

Against this backdrop, the purpose of this paper is to investigate the long debated discussion on the effectiveness of foreign aid with a focus on the relationship between foreign aid and FDI. There have been numerous studies conducted on this topic and particularly many of them examined the impact of foreign aid on the economic development of the aid recipient country. The result differs among the studies due to the fact the foreign aid is a complex interaction between donor countries with different ODA policies and recipient countries with diverging economic situations and ability to manage and absorb the aid inflow into their national system. Capturing the effect of foreign aid is a difficult task as the impact of aid varies depending on the issues such as which type of aid was provided, how the aid was financed and more importantly, one can never be sure when the impact of aid will appear in the long process of national development. With a consideration on those difficulties, this paper will analyze three research papers on the topic of aid effectiveness on its relationship with FDI. Each paper establishes a theoretical statement on the relationship between aid and FDI, after conducting a panel data analysis the outcome of the research is presented. As arranged in the table 1, this paper reviews the three papers with a focus on their methodological weaknesses. Selaya and Sunesen (2012) finds out that aid invested in inputs complementary to physical capital draws in foreign aid however aid directly invested in physical capital crowds out private foreign investments. Although their result provides statistical evidence of aid having a positive effect on FDI, their research failed to consider the composition of foreign aid which is crucial to address the question of varying impact among different aid types. Bhavan, Xu and Zhong (2011) discovers that foreign Aid in South Asian countries can be a vehicle for attracting more FDI into the region with an evidence to prove that aid for human capital and infrastructure development causes FDI in Bangladesh, Sri Lanka and India while aid for physical capital causes FDI only in India. Nonetheless, their result is difficult to be generalized as a regional trait analysis as only four countries were used to represent South Asia region and the result varies even among those four countries. Moreover, the aid dependent ratio differs greatly among the four countries (India only 0.1%. Bangladesh 1.6%), which may have affected their result on the relationship between FDI and foreign aid. Kimura and Todo (2010) argue that the foreign aid does not have a significant effect on FDI and there is no general evidence of vanguard effect (a term used to explain when aid from a donor country promotes FDI from the same donor) except for foreign aid on infrastructure from Japan. Above the reasons Kimura and Todo explained behind Japanese vanguard effect, this paper views that the fact that Japanese aid is concentrated towards middle income Asian countries experiencing dynamic economic growth may have led to such outcome of having the vanguard effect.

The rest of the paper is organized into three sections. The section 2 explains the changing landscape of the development cooperation to deliver the better picture of the current dynamics in the development cooperation field and to emphasize the timeliness of this paper. The section 3 presents the in-depth analysis of the selected papers with critical reviews on methodology. Lastly, in section 4 the paper concludes by presenting the key elements to consider for future researches on aid effectiveness.

Table 1. Key findings of studies on the topic of foreign aid and FDI

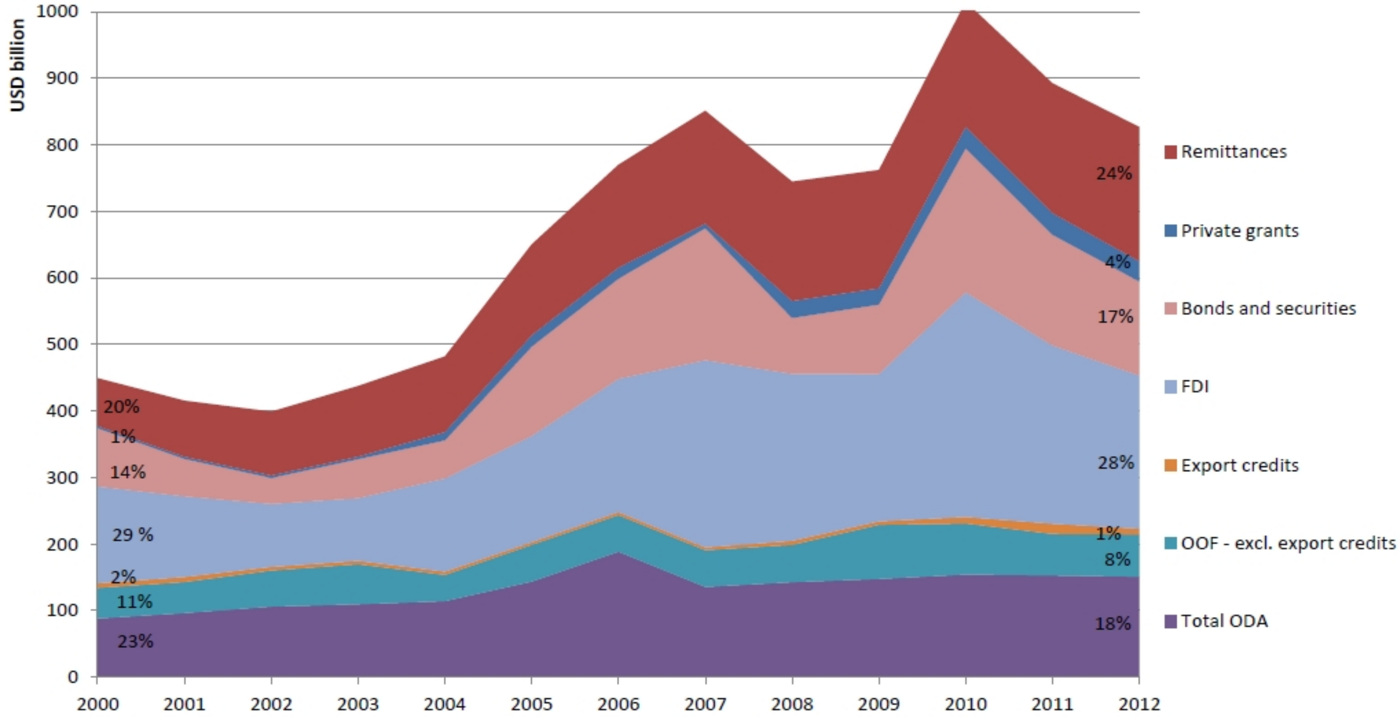
Author	Title	Methodology	Key Findings	Critical Review
Pablo Selaya, Eva Rytter Sunesen (2012)	Does Foreign Aid Increase Foreign Direct Investment?	Panel data analysis: 2SLS, 2SLS+FE, GMM-DIFF, GMM-SYS Dependent variable: FDI per capita Independent variable: total aid for complementary inputs, total aid for physical capital, Savings per capita, Population growth	Aid invested in inputs complementary to physical capital draws in foreign capital Aid directly invested in physical capital crowds out private foreign investments	Although the impact of total aid presents a positive effect, to address the overall level of aid efficiency, *the composition of foreign aid* should be considered.
T.Bhavan, Chansheng Xu, Chunping Zhong (2011)	The Relationship between Foreign Aid and FDI in South Asian Economies	Co-integration analysis: to test the long run equilibrium relationship between FDI and aid Granger Causality analysis: to test the direction of causality between FDI and aid Panel data analysis: FE, IV	Aid for human capital and infrastructure development causes FDI in Bangladesh, Sri Lanka and India. Aid for physical capital causes FDI only in India. Foreign Aid in South Asian countries can be a vehicle for attracting more FDI into the region.	Difficult to be generalized as only four countries were used in a regional trait analysis and the results vary even among those four countries. *Aid dependent ratio differs* among the four countries,

		Dependent variable: FDI per capita Independent variable: total aid for human capital and infrastructure, total aid for physical capital, POP, Population growth rate, Trade openness index, TO, GDP per capita		which may *affect the relationship between FDI and foreign aid*.
Hidemi Kimura, Yasuyuki Todo (2010)	Is Foreign Aid a Vanguard of Foreign Direct Investment?	Panel data analysis: GMM Dependent variable: logarithm of the inflows of FDI from country *i to j* Independent variable: GDP, geographic distance between *i* and *j*, a measure of skilled labor abundance in country *i* relative to *j*	Foreign aid in general does not have significant effect on FDI and no general evidence of vanguard effect (a term used to explain when aid from a donor country promotes FDI from the same donor). Foreign aid on infrastructure from Japan has a vanguard effect.	The Japanese vanguard effect link to the issue of *diverse purposes of practicing foreign aid a*mong donor countries. The fact that Japanese aid is *concentrated towards middle income Asian countries,* may have affected the result.

II. Changing Landscape of Development Finance

The rapid changes in the global finance market in the recent decade have brought enormous impact on the development finance architecture. As shown in the figure 2, the sources of external finance other than ODA such as FDI, remittances and Other Official Flows are becoming more and more prominent resource of inflow in the developing countries. As the new sources and instruments of development finance have become prevalent over the recent years, capturing and leveraging these financing trends will be vital in mobilizing the required financing for the new post-2015 development agenda as well as to provide statistical information of these new flows to the international development community.

Figure 2. Sources of external finance beyond ODA in developing countries



<Source: OECD DAC, The future of development finance, 2015>

Statistics play a pivotal role in planning, managing and ensuring the efficient use of development finance particularly when allocating scarce resources such as ODA (OECD DAC, 2015). With a clarified data, the recipients of resources can anticipate the inflow of external resources and reflect the trends when establishing national development strategy and annual budgets. Likewise, the providers of resources are able to evaluate their performance, identify the trends and financing gaps, set priorities, reallocate spending and thus contribute to increasing the aid impact (OECD DAC, 2015). Acknowledging such trends, the DAC announced the need to modernize the current development finance framework which was established in 1972, to better reflect the new changes in the international development cooperation. Below are the key elements that the DAC aimed to achieve in the revised measurement system:

"- Reflect the increased diversity among developing countries, and be relevant to the different financing needs this creates, not least between LDCs and middle income countries experiencing rapid growth;

- Reflect the broadening of the global development agenda, the convergence of the poverty and sustainability agendas, and the increasing importance of shared global challenges;

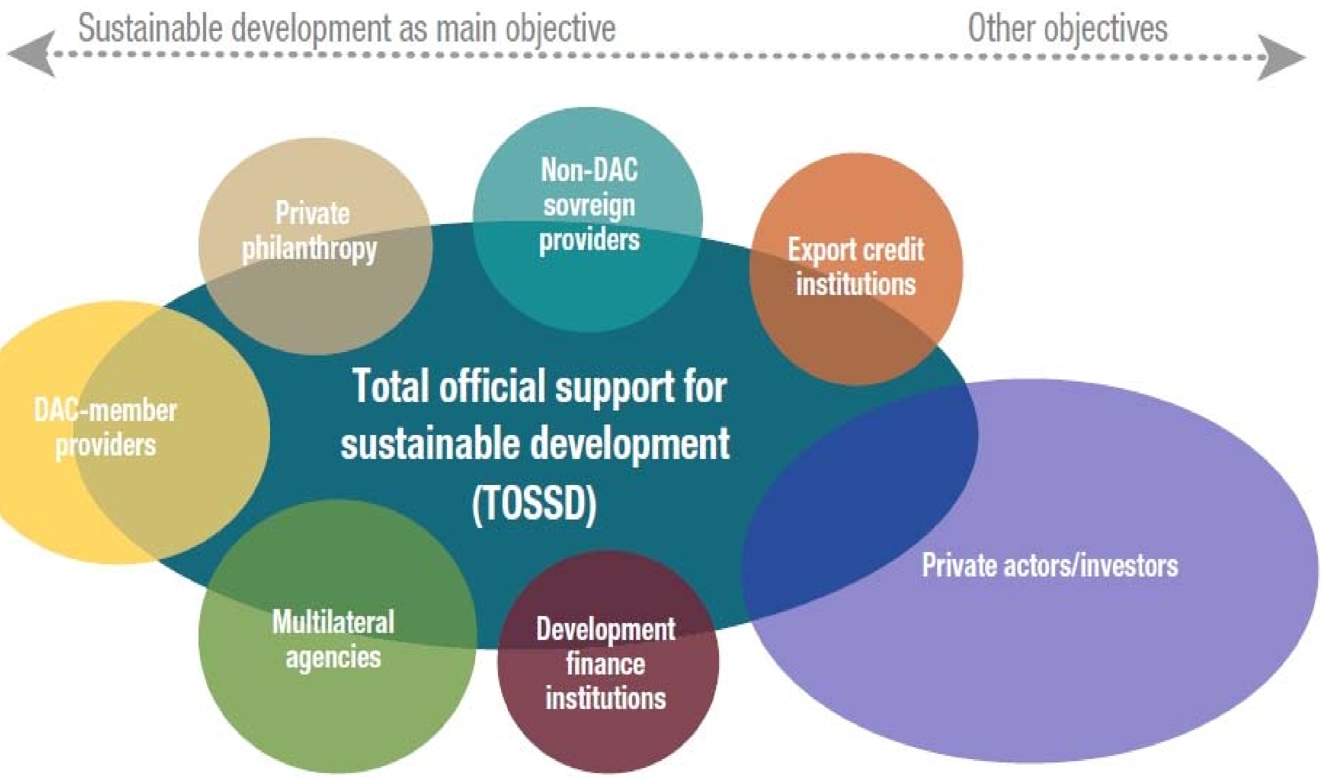
- Reflect the changing development financing landscape, both in terms of new actors and new instruments, and in terms of the changing importance of the different sources of development finance;

- Valorize official efforts that are not included in ODA, thus reducing the near-exclusive focus on ODA, but also clarify the changing role of ODA within this new development financing landscape; and

- Present a more comprehensive picture of external development finance from the recipients' perspective, including finance from longstanding South-South providers, emerging providers and private philanthropy." (OECD DAC, 2014, p.4).

The Monterrey Consensus in 2002 was the very beginning of the debate on finding the effective ways to mobilize private resources for development and to improve the coherence in the international monetary, financial and trading system in support of development. Building on from the Monterrey Consensus, the DAC agreed to "elaborate a proposal for a new measure of total official support development" to complement the ODA measure and has intensified its work to establish a modernized statistical framework that captures the broad range of instruments and complex financing packages that are becoming more and more common in today's development cooperation (OECD DAC, 2012). Such efforts have resulted in a proposal of a new measure: Total Official Support for Sustainable Development (TOSSD). The new proposed concept of measure aims to capture the diversified actors and resource flows to the developing countries. The OECD DAC(2015) highlighted that the new measure, TOSSD could include both concessional and non-concessional finance (e.g. grants, loans, equity, mezzanine finance, venture capital, shares in collective investment vehicles, development-related export credits, etc.). In this way, the new development financing tools will be reported to the DAC for a better coordination of global development cooperation. In short, TOSSD is a new concept encompassing the totality of international public finance extended to developing countries and multilateral institutions in support of sustainable development, regardless of the type of instrument used and the associated terms (OECD DAC, 2015). As it is illustrated in figure 3, the area for TOSSD includes partial areas of various stakeholders ranging from the DAC-member providers to private actors and investors with diverging objectives.

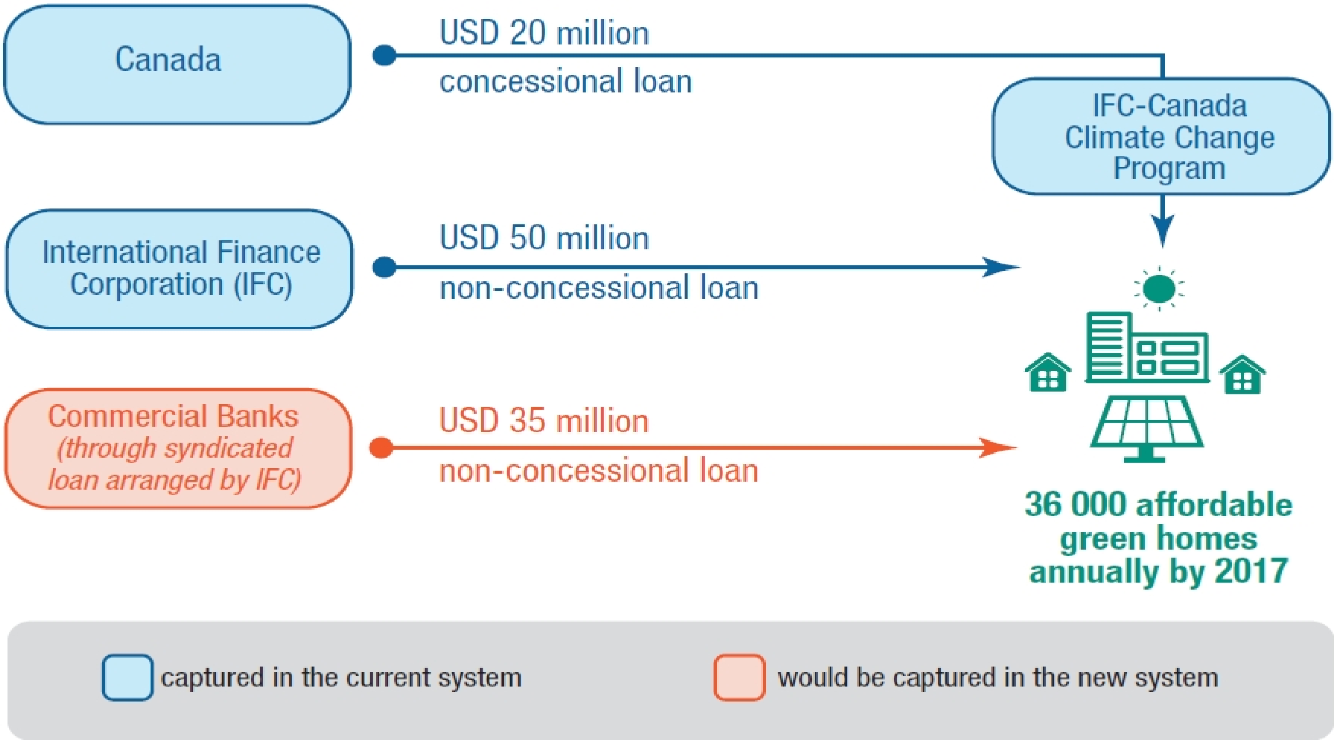
Figure 3. Sources and instruments of finance to included in TOSSD



<Source: OECD DAC, Measuring TOSSD, 2015>

It is important to note that the new TOSSD framework does not aim replace ODA, but to improve the international accountability by increasing transparency and to provide a coherent principle in reporting on development finance beyond ODA. The TOSSD will provide a fuller picture of resource inflows to developing countries ensuring that relevant flows supporting the economic development and welfare of the developing countries are captured under new framework. Below, figure 4 illustrates how a typical infrastructure financing package works in practice and shows where the current OECD statistical system fails to capture all the resources provided (OECD DAC, 2015). As the complex financing packages combined with diverse sources of finance and financial instruments are expected to be increased, it is important to modernize the statistical systems to fully capture these flows. Further discussion on the specific features and parameters of TOSSD measure is still an ongoing process and it is expected to be determined once the post-2015 development framework has been agreed.

Figure 4. Mix of finance for a project for Solar-Powered, low income homes in Mexico



<Source: OECD DAC, Measuring TOSSD, 2015>

Another critical change in the modernization of ODA is clarifying the meaning of "concessionality" of loans. Currently, due to the low interest rate around the world the usage of concessional loans is becoming more common in development finance. The concept of ODA was established by the OECD DAC in 1969, and until the recent modernization process, the definition of what made a loan "concessional in character" - which approves the extent to which loan can be reported as ODA- was open to interpretation (OECD DAC, 2015). To this, issues were raised among the providers as differences existed in the interpretation of this "concessional in character" and how these loans were counted as ODA. The major change of the modernization process is that in the past the face value of both grants and loans was counted as ODA whereas with the new modernized method only grant and the "grant portion" of concessional loans would be counted as ODA (OECD DAC, 2015). The new method will allow a more realistic comparison of loans and grants and use of highly concessional loans is expected to be encouraged. The detailed changes are explained in the table below (Table 2). This new framework promotes accuracy and credibility in measuring ODA loans and also provides incentives for a better allocation of concessional loans. The new system will become the standard for reporting from 2018 on and until then, ODA will be reported using both the new grant equivalent and previous cash-based systems to allow for full data on actual disbursements and repayments of loans collected and published (OECD DAC, 2015). In the advent of such new changes taking place in the development cooperation architecture, it is indeed timely to review the long continued debate on the aid effectiveness. This paper aims to highlight the critical elements in addressing the aid effectiveness with a focus on the relationship between aid and FDI as well as to provide implications when implementing the new development finance methods.

Table 2. The new statistical framework measures for ODA loans

	Before:	After:
	Cash Flow	Grant equivalent
Grant element threshold	25%	45% for LDCs and other LICs 15% for LMICs 10% for UMICs
Discount rate	10% Used for assessing the concessionality of a loan	5% base (current IMF discount rate) + adjustment factors of: - 4% for LDCs and other LICs - 2% for LMICs - 1% for UMICs Used both for assessing the concessionality of a loan (threshold) and for calculating its ODA grant equivalent
Measurement of flows	Counted as ODA when disbursed Subtracted from ODA when repaid	Grant equivalent of loan disbursement (grant element multiplied by amount disbursed) counted Repayment of past loans not subtracted from ODA but data continues to be collected and published More ODA credit for softer terms and conditions loan Grants score more ODA than loans
Debt sustainability safeguard	No explicit measure	Must comply with IMF Debt Limits Policy and

		the World Bank's Non-Concessional Borrowing Policy

<Source: OECD DAC, Why modernize ODA, 2015>

III. Continued Debate on Relationship between Foreign Aid and FDI

When it comes to discussing 'aid effectiveness', one of the most visited topics is the impact of foreign aid on the economic growth of a recipient country. It is a challenging task to compare and evaluate the relationship between aid and economic development as aid is given for many different purposes and in many different forms (Hansen and Tarp, 1999, p.2). It may seem obvious at first, that delivering medicine to poor countries and building hospitals in destructed villages will improve the living conditions of people, contributing to the development of the aid recipient country. However, it is unfortunate to point out that the history presents providing such aid for decades in the most devastated regions around the world did not bring a dramatic economic growth impact in those regions. Aid requires a complex and strategic approach, in the case above, providing medicines and building hospitals address only one side of the problem, consideration on delivering hospital management skill and producing educated doctors to perform qualified treatments is necessary to scale up the impact to the fullest. Eradication of poverty is still the foremost important mission in the global development community and finding the most effective way to achieve this goal is continuously being sought for. In this context, the question whether foreign aid leads to growth is coupled with divergent views.

To find the link between aid and growth, investment can be an effective variable to examine the relationship. There is a wide consensus on the fact that investment is the driving force of economic growth regardless of the choice of growth model (Hansen and Tarp, 1999, p.8). It is viewed that investments stimulate the economic activity of a country and provide resources for expanding the economy. Papanek (1973) proposed that debate on aid-effectiveness should move away from the aid-savings relationships and to focus on investigating the effects of aid on the various elements of investment and growth. The UN's 2002 Monterrey Consensus on International Financing for Development stressed that "ODA plays an essential role as a complement to other sources of financing for development, especially in those countries with the least capacity to attract private direct investment. A central challenge, therefore, is to create the necessary domestic and international conditions to facilitate direct investment flows, conducive to achieving national development priorities, to developing countries, particularly Africa, least developed countries, and also to countries with economies in transition." (United Nations, 2002, p.9). Acknowledging the vital role investment can play in the course of economic development many studies have been conducted to discover the direct relationship between FDI and foreign aid to evaluate the impact of foreign aid on economic growth.

Yet, the literature on this topic that foreign aid can be the catalysis in attracting FDI, or that aid and FDI are complements presents controversial results. The studies on the topic show inconclusive results with no coherent answers. For example, Kosack and Tobin (2006) claimed that there is no evident relationship between aid and FDI as they feature different characteristics in investment. They argued that aid is generally oriented toward the government budget support and finance investments in human capital, whereas FDI is directed toward private sector involvement in economy and tends to be more connected to physical capital (Kosack and Tobin, 2006). On the contrary to this argument, Harms and Lutz (2006) stated that with a control over the regulatory burden in the host country, aid brings positive effect on FDI supporting the idea that aid and FDI are complements. Moreover, they also discovered that the catalyzing effect of aid is maximized in countries under unfavorable institutional environment. Karakaplan and Neyapati (2005) presents insignificant effect of aid on FDI, but interestingly against the findings of Harms and Lutz (2006), Karakaplan and Neyapati highlights that good governance and developed financial markets contribute to a positive effect of aid. Boon (1995) claimed that aid does not lead to increase in investment and growth but may have impact on scaling up the size of the government. According to Kasuga (2007) the impact of aid is closely related to the aid-recipient countries' income level, financial structure, and government infrastructure. Asiedu et al. (2009) argued that aid may reduce the investment risks such as violation on contractual agreements, changes in laws and regulations in the aid recipient countries and thus contribute to attracting FDI. Building on from the literature, this paper will focus on three research papers under the topic of FDI and foreign aid and deliver a critical review of each analysis. The three papers; Pablo Selaya and Eva Rytter

Sunesen's 'Does Foreign Aid Increase Foreign Direct Investment?', T.Bhavan, Chansheng Xu and Chunping Zhong's The Relationship between Foreign Aid and FDI in South Asian Economies, Hidemi Kimura and Yasuyuki Todo's 'Is Foreign Aid a Vanguard of Foreign Direct Investment?' were selected to present diverse opinions on the relationship between FDI and foreign aid. After reviewing each paper's key findings, a more in depth critic will be made to the parts where there remains a room for improvement.

The first paper, Selaya and Sunesen (2012) investigates whether aid and foreign direct investment (FDI) are complementary sources of foreign capital. They examine the relationship between aid and FDI in a framework that distinguishes aid invested in complementary factors of production and aid directed toward physical capital. To elaborate more on this distinction, aid invested in complementary factors refers to aid used to finance social infrastructure such as education, health, and water supply projects and the authors argue that this type of aid increases marginal product of capital(*MPK*) in the recipient country which will contribute to attracting additional foreign resources. This type of aid usage will lessen the budgetary constraints on aid-recipient governments in undertaking investments in public infrastructure and human capital. On the other hands, the authors point out that aid invested in physical capital which refers to aid used to finance productive sectors such as agriculture, manufacturing, trade, banking and tourism projects will compete directly with other types of capital. In consequence, this type of aid will crowd out private investments including the FDI. With a basis on such theoretical approach, the paper presents the result of a panel data analysis of 99 countries over the period of 1970-2001. Selaya and Sunesen (2012) find out that a large and positive effect of aid directed toward complementary factors, while aid invested in physical capital has a negative impact on FDI. Nonetheless, while the two types of aid holds a positive impact, as it was briefly mentioned in the conclusion of the paper, to capture the overall level of aid efficiency *the composition of foreign aid* should be taken into account. To consider the composition of foreign aid, one should start with a notion that there are various types of foreign aid which brings different impact to the aid-recipient country. In short, it is crucial to address how the aid was invested in the selected sectors as this can be done in various forms. Another frequently used term to describe foreign aid is the 'Official Development Assistance (ODA)'. OECD (2015) classifies ODA into broad categories: budget support, core contributions and pooled programs and funds; project-type interventions; experts and other technical assistance; scholarships and student costs in donor countries; debt relief; administrative costs; and other in-donor expenditures. These different types of foreign aid have diverse impact on the development of an aid-recipient country. Moreover, the types of finance used in providing such support also affect the development of the recipient country. Under the OECD (2015) classification, the types of finance include grants, loans, debt relief etc. In general, technical cooperation, development food aid, humanitarian assistance and debt relief are in the form of grants while the non-grant ODA refers to providing concessional loans. The development impact of these diverse types of aid and ways to finance such aid occur in various forms with different time lag. For instance, providing humanitarian assistance and food aid to a country faced with a natural disaster presents an immediate impact by showing improved figures in the number of people suffering from injury or people dying from hunger. However providing technical cooperation to transfer knowhow of operating a power plant or managing a complex tax system requires time to show its impact on the overall development of the aid recipient country. To capture the varying impact of these different types of aid is at the core of today's debate on aid effectiveness. As shown in the figure 5 and figure 6, the breakdown of foreign aid varies within the donor countries as well as within the recipient countries. In figure 5, the composition of aid of United States, the largest donor by volume with net ODA flows of USD 31.5 billion in 2013 shows concentration on using 'Grants' as the main type of aid. In contrast, the composition of aid type of Luxembourg shows concentration on using 'Technical Cooperation' as the main type of aid. In figure 6, Ghana shows 100% concentration on receiving grant type of aid whereas India shows preference for receiving loan type of aid. This implies that the impact of foreign aid may differ to a great degree depending on which type of aid is prevalent in donor country as well as in the recipient country. To fully distinguish the varying impact between these different types of aid and financing methods, a more comprehensive and technical approach is required. Further research can be made by using the data of countries that have similar composition of foreign aid or even to focus on a specific type of aid and investigate the direct impact of the selected type of aid. The result of Selaya and Sunesen's research hold significant meaning in revealing the relationship between foreign aid and FDI however, due to the fact that it failed to address the varying impacts among different types of aid brings to leave a room for doubts on their final statement. In this context, to find a generalized statement explaining the impact of aid to a recipient country *the composition of foreign aid* should be considered.

Figure 5. Composition of foreign aid among donor countries (USD millions, 2013)

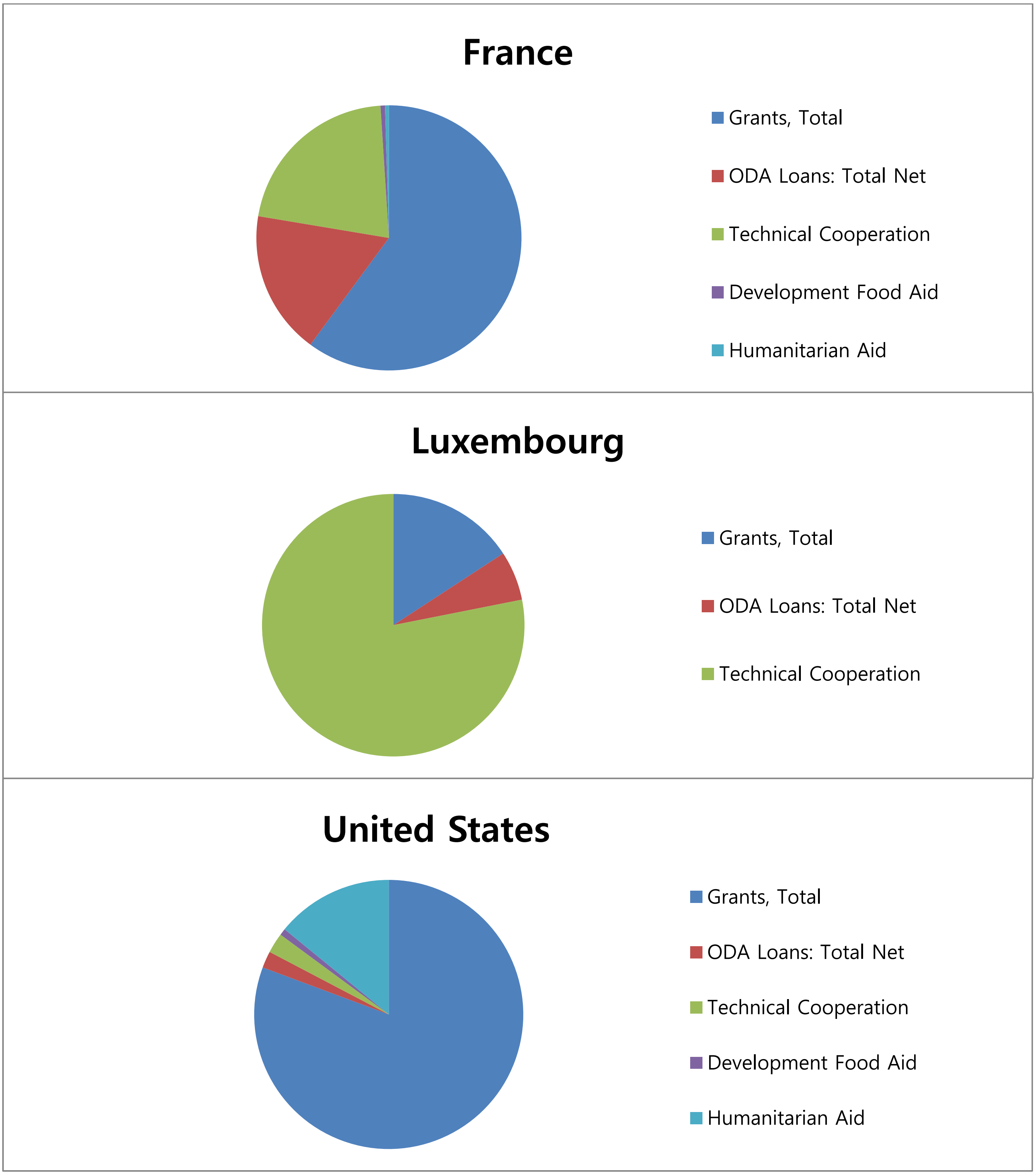
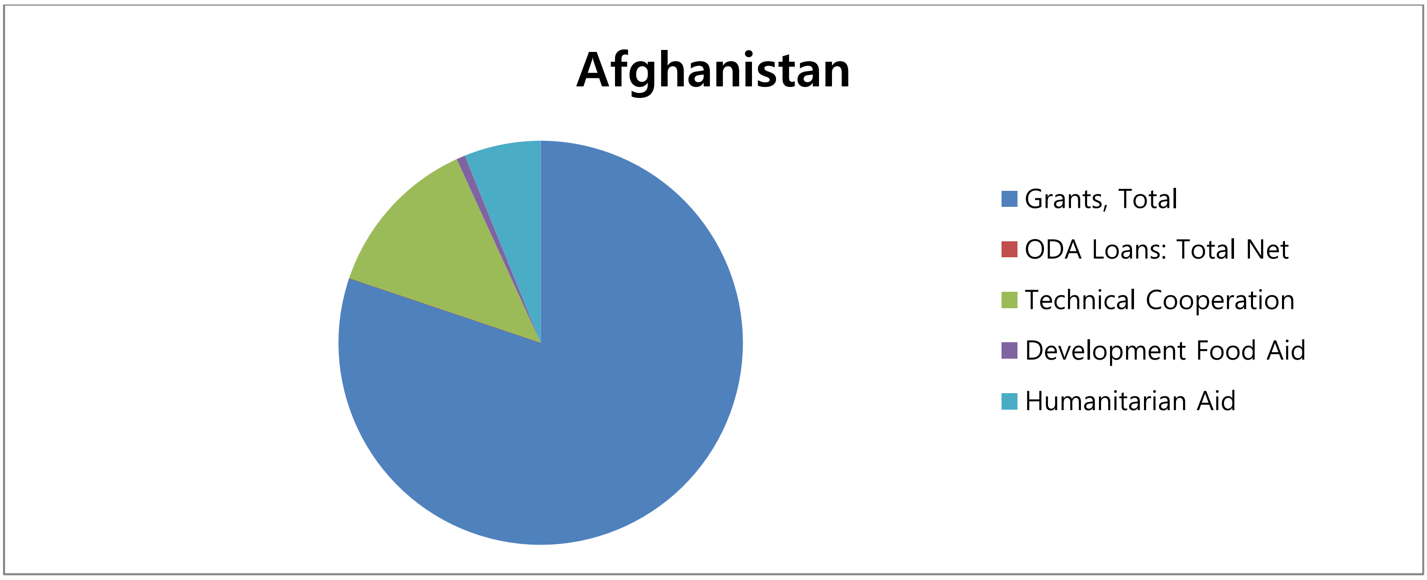
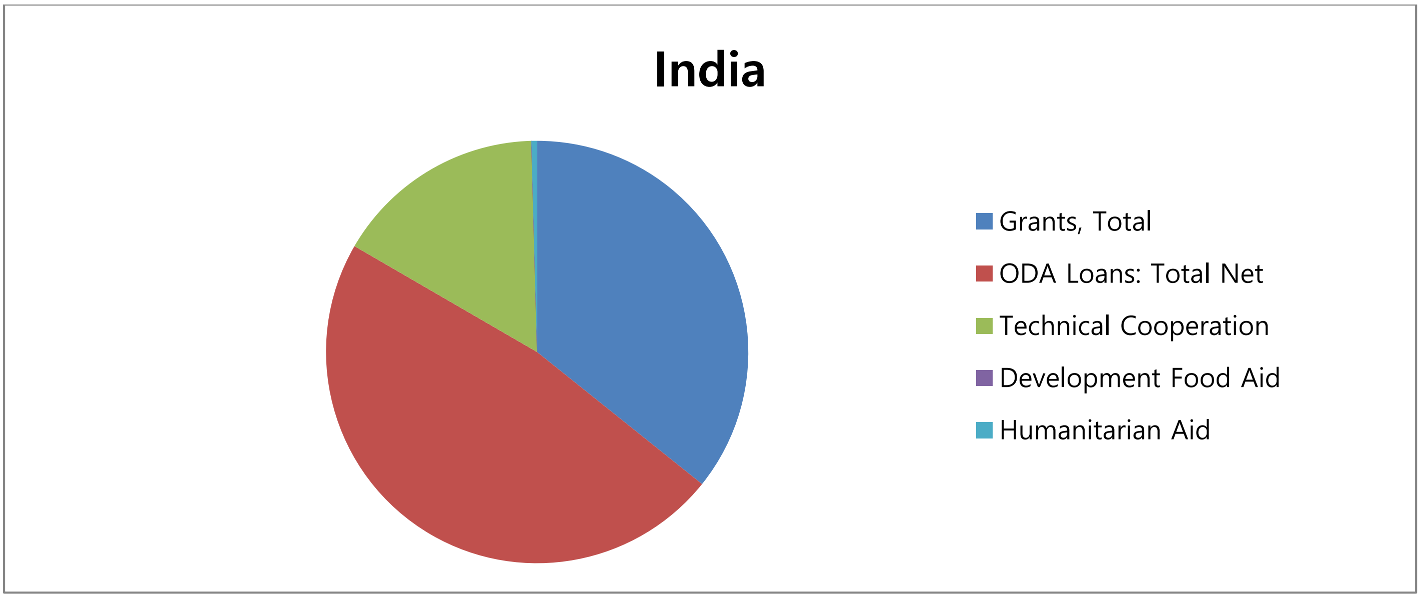
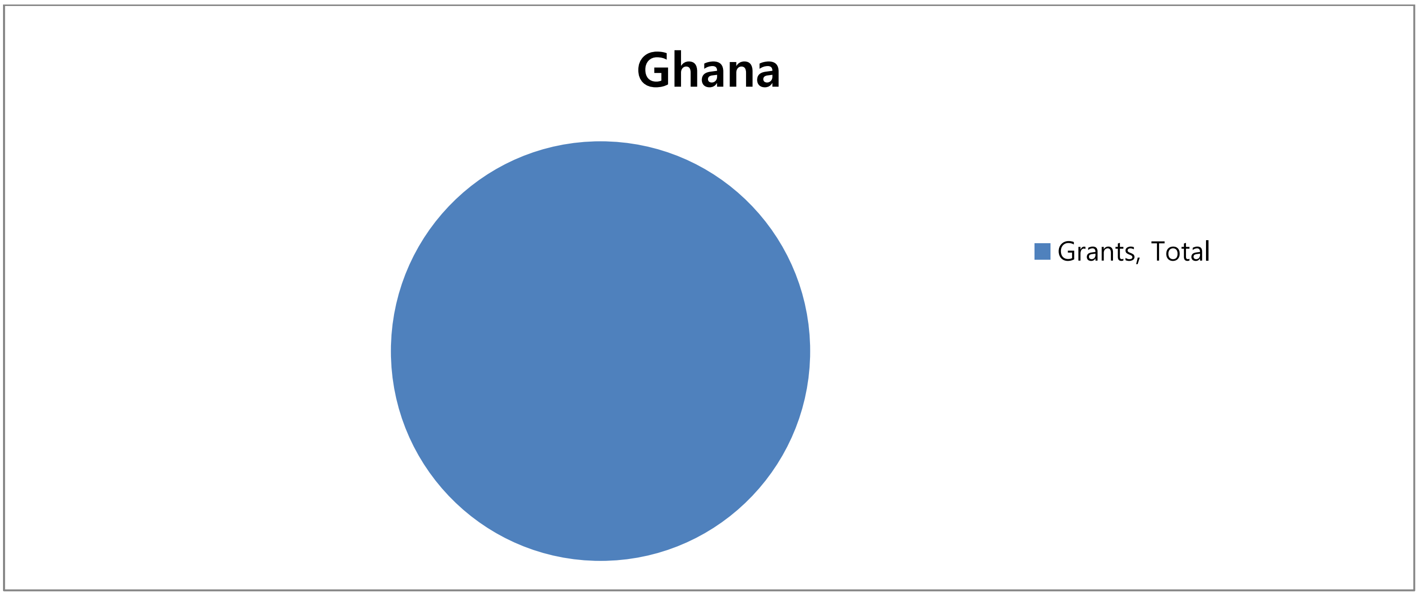


Figure 6. Composition of foreign aid among recipient countries (USD millions, 2013)



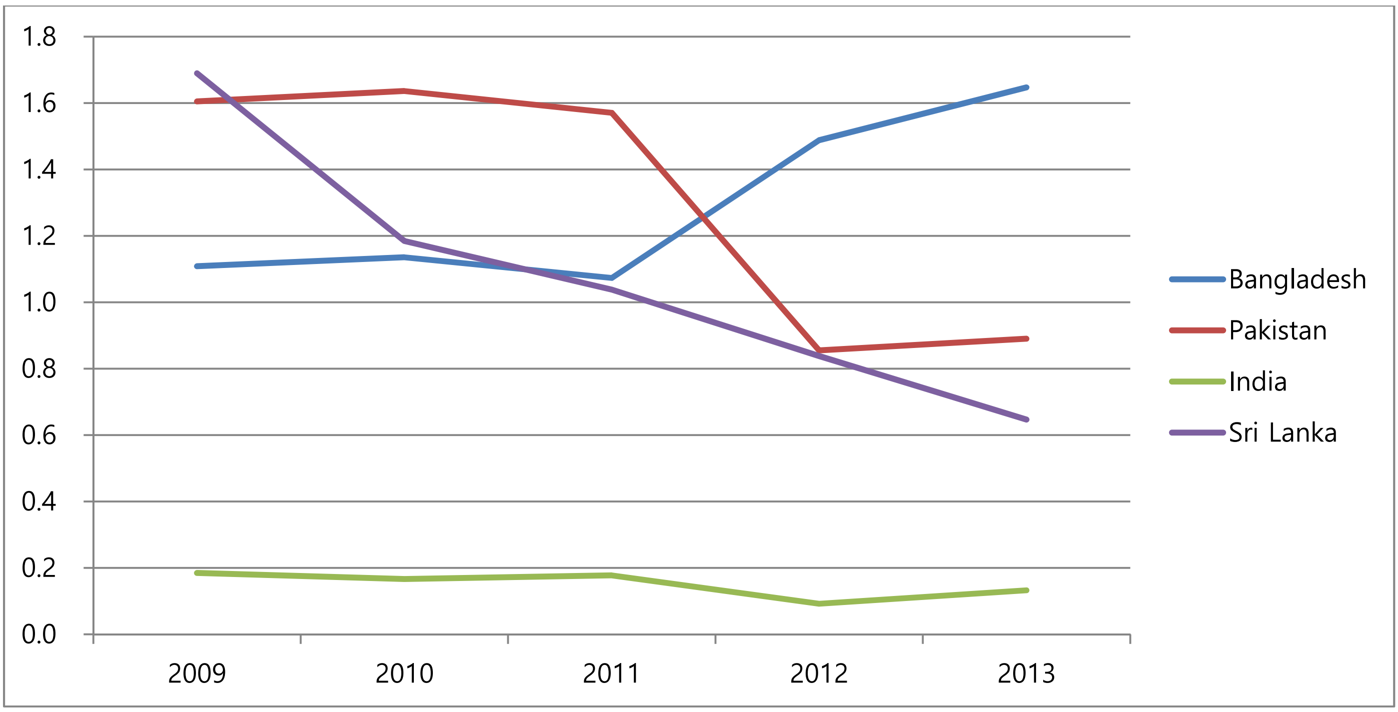




<Source: OECD DAC, ODA Statistics, 2015>

The second paper, Bhavan, Xu, and Zhong (2011) examined whether or not foreign aid draws in additional foreign direct investment (FDI) in South Asian Economies. The authors aim to investigate whether aid directed toward human capital and infrastructure development act as a complementary factor in bringing FDI into the region and whether aid for physical capital development crowds out FDI as substitute factor. With such theoretical approach, the paper presents the result of co-integration, Granger causality, fixed effect and instrumental variable analysis of four South Asian countries: Bangladesh, Pakistan, India and Sri Lanka over the period of 1995 and 2007. Bhavan, Xu, and Zhong (2011) concludes that a long-run relationship between FDI and aid in the shape of physical capital can be found in Sri Lanka, Pakistan and India, but not in Bangladesh, whereas a long-run relationship between FDI and aid for human capital and infrastructure development can be found in Bangladesh, Sri Lanka and India, but not in Pakistan. In terms of the direction of causation, Bhavan, Xu, and Zhong (2011) states that aid for human capital and infrastructure development causes FDI in Bangladesh, Sri Lanka and India whereas aid for physical capital causes FDI only in India. The paper strongly argues that foreign aid in South Asian countries is the catalysis in attracting additional FDI into the region. It is meaningful to discover that a long-run relationship between FDI and foreign aid exist in the examined countries however for the result to be generalized as a regional trait analysis, the methodology of the study holds questionable areas for further improvement. The South Asia is consisted of 8 countries: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka (World Bank, 2015). According to their methodology, Bhavan, Xu, and Zhong (2011) analyzed only four countries of the region over the period of 1995 and 2007 which is relatively small sample size to be generalized as a regional characteristic and the result vary even among the four selected countries. Rather than making the result as a regional statement, the paper could have focused on being an in depth case study of relationship between FDI and foreign aid in those selected countries. Also, it is notable to underline that the dependency on aid among those selected countries differs to a great degree (India 0.1%, Bangladesh 1.6%) which may have affected the varying relationship between FDI and aid among those selected countries. Although the paper concludes by stating the foreign aid in South Asian countries serves as a vehicle for attracting much more FDI into the region, the reason behind increased FDI may not necessarily relate to the role of foreign aid. For example, as seen from the data (Table 3, Figure 7) below India has distinguishably low aid dependency (aid as % of GNI) compared to other three countries while India presents highest FDI inflow over the recent 5 years. This implies that the foreign aid may not have played a significant role among many economical, social and political reasons behind the increasing FDI inflows in India. More importantly, as indicated in figure 8 apart from India the amount of FDI inflow in each country shows no sign of fluctuation while in figure 9, the net ODA received in Bangladesh, Pakistan and India shows an increasing trend since 2012. In short, although there was an increase in the net ODA received, the volume of FDI inflow in Bangladesh, Pakistan was not increased. These records of numbers contrast with the concluding statement of Bhavan, Xu, and Zhong (2011) that foreign aid in South Asian countries can be the driving force in attracting additional FDI into the region. The result among the South Asian countries differed for one reason their difference in aid dependency and considering the case of India, the economic situation was very much different from the rest of the countries in the region. From this one can note that, when investigating the relationship between the foreign aid and FDI, the importance of country specific-difference should not be disregarded.

Figure 7. Aid as % of GNI (Net ODA received)



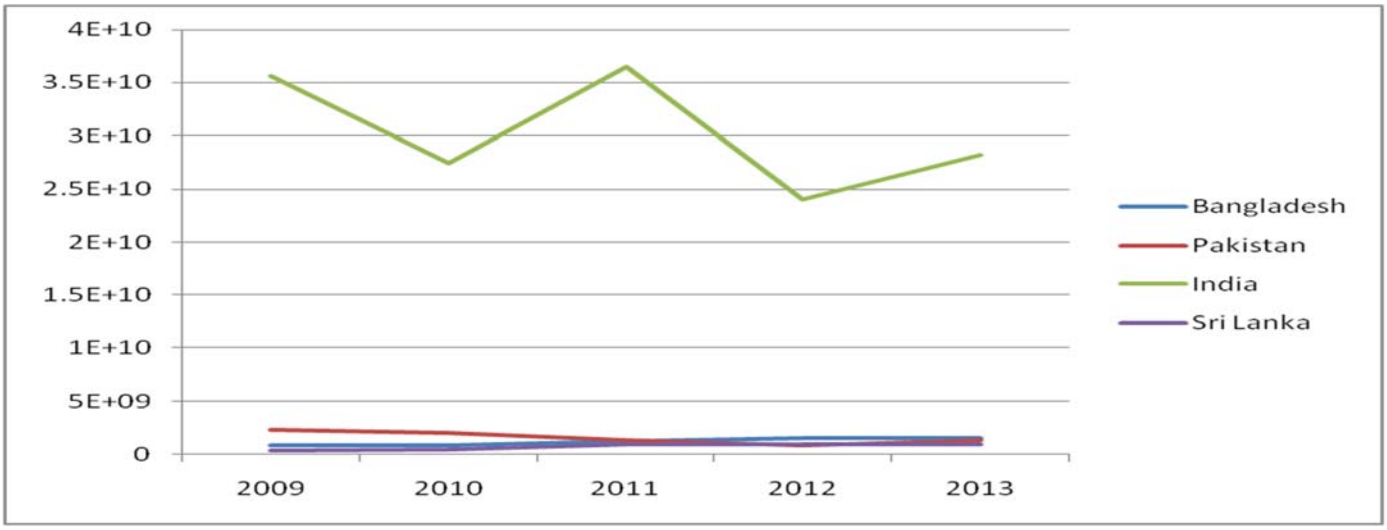
Source: World Bank Development Indicator (2015)

Table 3. Aid as % of GNI (Net ODA received)

	2009	2010	2011	2012	2013
Bangladesh	1.1	1.1	1.1	1.5	1.6
Pakistan	1.6	1.6	1.6	0.9	0.9
India	0.2	0.2	0.2	0.1	0.1
Sri Lanka	1.7	1.2	1.0	0.8	0.6

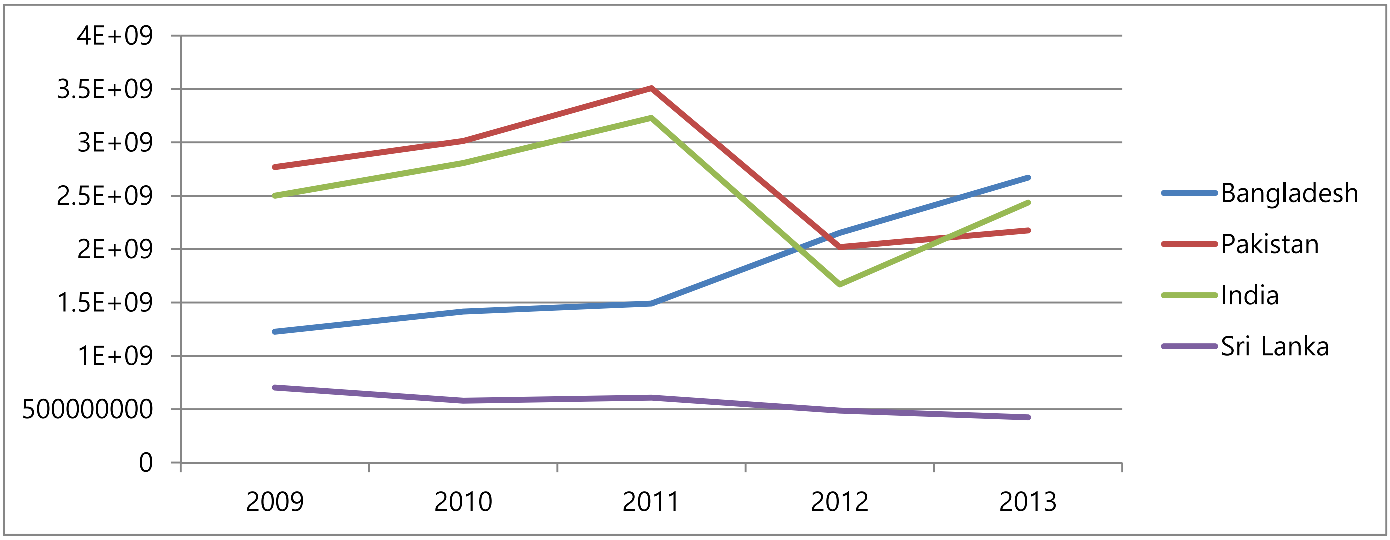
Source: World Bank Development Indicator (2015)

Figure 8. Net Inflow of Foreign Direct Investment (BoP, current US$)



Source: World Bank Development Indicator (2015)

Figure 9. Net ODA received (Current U.S. $)



Source: World Bank Development Indicator (2015)

The third paper, Kimura and Todo (2010) focus on whether and how foreign aid stimulates foreign direct investment flows into the developing countries. The authors conduct gravity equation-type estimation with a large data set of source-recipient country pairs to examine the “vanguard effect”, a term used in the paper to explain the positive effect of aid, through which foreign aid from a donor country promoting FDI from the same donor in particular. Kimura and Todo (2010) illustrate theoretical background of the vanguard effect: (i) foreign aid allows the information on the local business environment of recipient country to be exclusively transmitted to firms of the donor country (ii) foreign aid being provided from the government may reduce the recipient country's investment risks perceived by the firms of the donor country (iii) aid is an opportunity to bring the donor country specific business practices, rules, and institutions into recipient countries. These reasons may allow aid to attract much more FDI from the same donor country but does not affect promoting FDI from other countries. The results of the analysis presents that in general foreign aid does not necessarily promote FDI and the evidence of the vanguard effect was also not found. However, in an expanded examination with a consideration of possible differences in the size of the impact of aid among donor countries, the result showed that the vanguard effect was shown in the case of infrastructure aid from Japan. Kimura and Todo (2010) conclude by stating that infrastructure aid from Japan has a positive effect on FDI from Japan, despite having no impact on FDI from other countries to the recipient. To elaborate their findings, the authors provide possible reasons behind the characteristics of Japanese aid that promote Japanese FDI: (i) the Japanese government intention is to promote FDI from Japan through foreign aid, especially in East and Southeast Asia where Japanese firms have developed production and trade networks (ii) close coordination between the public and private sectors in the process of providing the foreign aid allows more active participation from Japanese firms. Adding on to Kimura and Todo (2010)'s explanation on the Japanese vanguard effect, it is notable to mention that the Japanese vanguard effect link to the issue of *diverse purposes of practicing foreign aid* among donor countries. Although the purpose of providing aid to developing countries among donors cannot be stated under a single factor, the differences in what type of aid is being provided to which countries clearly exists among donor countries as a distinguished characteristic. In the case of Japan, as shown in the figure 10 and figure 11, most of the foreign aid is concentrated in lower middle income countries in South and Central Asia. According to OECD (2015) top five recipient countries of Japanese foreign aid are Myanmar, Viet Nam, India, Indonesia and Afghanistan. As indicated, apart from Afghanistan, the other four countries are one of the fastest growing countries in the current global economy.

Generally, rapid growing economies provide opportunities for profit and tend to draw in financial resources including FDI. Taking this opportunity forward, under the sectoral division, the fact that Japanese aid is concentrated on economic infrastructure (41.0%) explicitly presents the distinguished characteristics of Japanese foreign aid. In the OECD Peer Review of Japan (2014), the review states that Japan provides aid to about 140 countries but most (70%) is allocated to middle income Asian countries and Least Developed Countries (LDCs) received about a quarter of Japan's gross bilateral ODA, compared to a DAC average of 41%. To this, OECD DAC (2014) recommended that Japan needs to pay more attention to where it is spending and continue scaling up its support to countries where assistance is most needed, including LDCs, bearing in mind international commitments. Thus, another possible reason behind the vanguard effect of Japanese aid can be Japanese concentrated aid toward middle income Asian countries.

Figure 10. By Income Group (USD million)

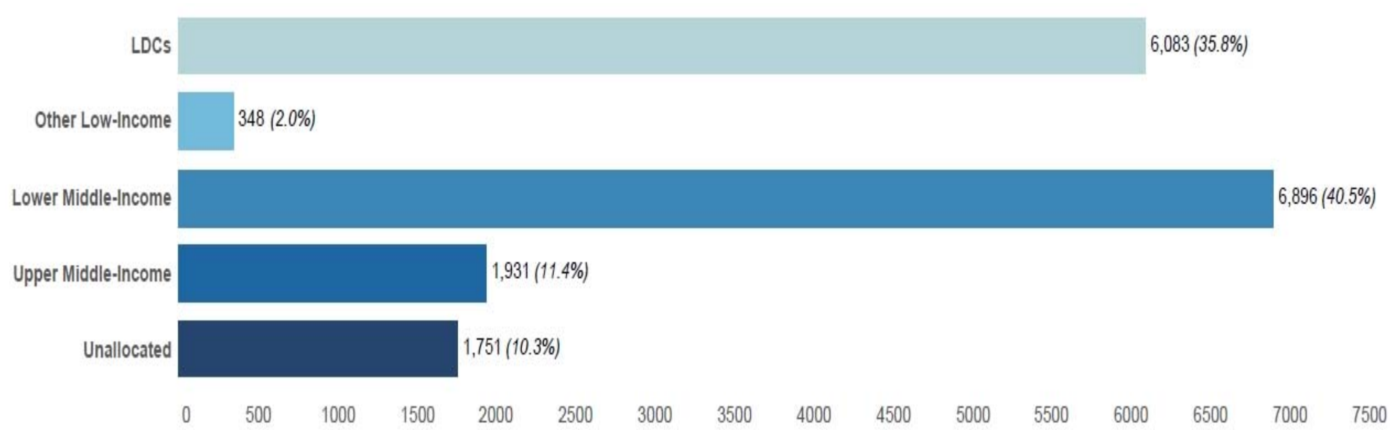
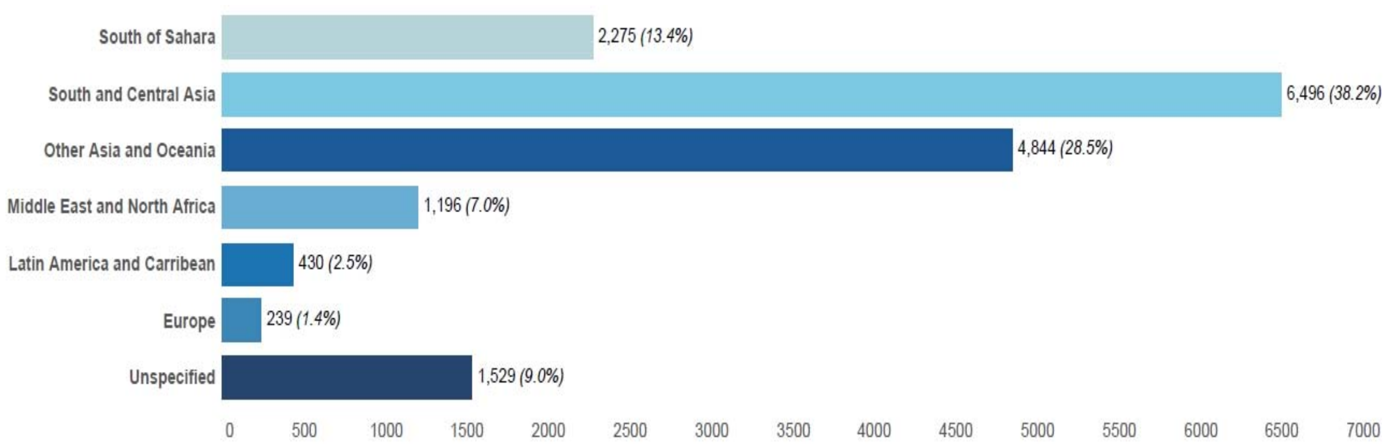


Figure 11. By Region (USD million)



Source: OECD, ODA at a glance (2015)

IV. Concluding Remarks

There is no doubt that FDI contributes to the economic growth of a country. A large scale of FDI inflow is an investment towards a country, a signal for economic growth and an opportunity for economic gains. Investors crowd into good opportunities and this triggers a positive implication that the country is on the right track of development leading to more inflow of resources to stimulate the economy. In this context, the relationship between FDI and foreign aid is crucial. If foreign aid can become a positive signal for development and contribute to attracting FDI then, the debate on aid effectiveness would also gain stronger support. Moreover, if further studies are conducted to find out the specific casual effect of foreign aid on attracting FDI, the global community would be able to promote economic growth in developing countries with leveraging effect from foreign aid. In order to discover the complicated casual effect of foreign aid on FDI, as it was mentioned in the third part of this paper a more holistic and thorough methodology is required. The critical review of the three papers, Selaya and Sunesen, Bhavan, Xu and Zhong, Kimura and Todo indicate the elements that need to be addressed when conducting a study on the relationship between foreign aid and FDI. Those elements are important characteristic of foreign aid that must be addressed when continuing the debate on aid effectiveness.

As noted in the first paper of the review (Selaya and Sunesen's), foreign aid is composed with various types such as humanitarian aid, food aid, technical cooperation, budget support, grants and loans etc. And these aid are directed towards development of different sectors such as infrastructure, education, health and even human rights. With such diversity, the impact of aid is not coherent. Particularly, considering the current dynamics in development finance, it is urgent to find out how the impacts differ between these different types of aid, as the global aid architecture will become more diversified.

If the fundamental principle behind the aid effectiveness debate, a guidance to answer the matter of in what way and in which sector the impact of foreign aid can be maximized is provided, achieving the long-standing goal of eradicating the world's poverty would be one step closer to realization.

The critical review of the second paper (Bhavan, Xu, and Zhong) highlighted the importance of considering the country-specific differences. The impact of aid differs among countries due to differences in economic situations, aid dependency, ability to manage aid resources, level of governance, level of corruption and population may bring varying outcomes. For instance, in Bhavan, Xu, and Zhong's research, the net ODA received continuously increased since 2012 in India, Bangladesh and Pakistan however, the FDI inflow of those three countries did not show similar increase in the volume apart from India. One of the most prominent difference among the four countries were aid-dependency (India 0.1%, Bangladesh 1.6%) which is highly related to the varying economic situations of the countries. This indicates that the effect of aid on FDI differs among the South Asian countries or even the result is close to stating that there is no evident relationship between foreign aid and FDI in the region. The country specific difference is an important factor to consider in aid effectiveness debate and in this regard, the evolving new aid framework should reflect the country diversities.

The critical review of the third paper (Kimura and Todo) handled the relationship between aid effectiveness and donor's divergent aid policies. Although the purpose of providing aid to developing countries among donors cannot be stated under one single factor, every donor country has it main agenda in providing foreign aid to another country. The difference in the agenda is distinguished by whether the purpose of providing aid is based on political reasons, military reasons, historical reasons, economic reasons or humanitarian reasons. Such differences in the agenda affect the allocation of aid. For instance, the agenda in ODA policy decides what type of aid will be provided to which country and this affects the impact of foreign aid in the aid recipient country. In Kimura and Todo's research, the Japanese foreign aid towards infrastructure showed the vanguard effect, attracting more FDI from Japan. The characteristics of Japanese aid policy, such as its high concentration in aid middle income countries and focus on the infrastructure sector may have attributed to having the vanguard effect.

Foreign aid is a complex process between countries with varying purposes and is conducted in diverse forms. Establishing a manifest relationship between aid and FDI may take longer than one can expect. Further, the debate on aid effectiveness may never be solved in this generation. However what is important is, with the new findings and critical reviews on the shortfalls of evolving studies, the global community is getting one step closer in finding the answer to the heart of the issue; discovering the most effective way to provide support to the developing countries.

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