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Foreign aid and FDI in the presence of good governance have positive impact on the economic growth

Just availability of funds does not necessitate the economic development; it's the institutional infrastructure that matters a lot for development. Developing countries are not only facing the binding revenue constraints but also side by side they are victim to low level of governance quality. Asia is the fastest growing economic region since 1965 and the Asian economy consists of nearly 4.2 billion people (60% of the world population) but it is facing the problems regarding the availability of funds and issues in the governance quality. So there is a need to pin point those issues that create the development difference with in different regions of Asia.

The East and Southeast Asian countries grew rapidly during the last quarter century. The eight best performing economies -- Singapore, Korea, Hong Kong, Taiwan, China, Thailand, Malaysia, and Indonesia – maintained per capita growth rate of over 5.5% per year during 1965 to 1990. On the other hand, growth rate of Central Asia and South Asia was below average or at best average in comparison with the East and Southeast Asian countries. During last decade China and India not only outperformed all other Asian economies but the whole world.

Capital inflows play important role in determining growth. Interest rate and economic growth are among the major determinants of capital inflows in the country. Mostly the capital inflow of developing nations is in the form of official development assistance (ODA), foreign direct investment (FDI) and foreign borrowing that can be used to spur the economic growth process. The supporter of foreign aid in the form of official development assistance argues that the role of foreign aid in promoting economic growth is recognized by many MENA countries which face development challenges such as, volatile economic growth, high unemployment, inefficient public sectors and shortage in domestic saving. External resources in the form of foreign aid can prevent bad governments going bankrupt, as it reduces the costs of reforming and doing nothing.

The successful experience of South East Asian countries and particularly Singapore has motivated many other countries to engage in activities aimed at attracting higher inflows of Foreign Direct Investment (FDI) for economic growth. Within policy circles, there is a common belief that foreign direct investment (FDI) enhances the productivity of host countries and promotes economic development. Competition is very strong as both developed and developing countries are showing great interest in attracting FDI. The thing which matter most in attracting FDI is quality of institutions in the host country. Nevertheless good institutional quality matters a lot to FDI. Without proper emphasis on institutional reform efforts of attracting FDI into countries would be ineffective.

Paper presented by Qayyum and Siftain at the PIDE explores the effectiveness of foreign capital in accelerating the economic growth of Asian developing countries by considering the governance quality. They found that foreign aid and FDI in the presence of good governance have positive impact on the economic growth and hasten the development process while in case of external debt it seems as a burden on an economy. All the results are highly statistically significant; in order to confirm the robustness of our results sensitivity analysis has been performed. On the basis of our findings it is highly recommended that governance can considerably improve per capita growth, hence, can lead a country toward heights of prosperity, expansion and a situation in which everyone will be better off. So, special efforts must be undertaken to improve governance quality in developing countries while FDI and foreign aid can also be used to improve growth. So a country must develop such an environment which can attract FDI and foreign aid. At the same time country must try to depend less and less on foreign debt.

Qayyum, U. and H Siftain (2013), "Governance and the Effectiveness of Foreign Capital" *Forthcoming PIDE Working Paper*