NEAR EAST UNIVERSITY

FACULTY OF ECONOMICS AND ADMINISTRATIVE SCIENCES
DEPARTMENT OF BUSINESS ADMINISTRATION

The Impact of Foreign Aid on the Economies of Developing Nations: Northern Cyprus Economy Analyzed.

GRADUATION PROJECT (MAN 400)

Submitted By: SAJJAD DELAFROOZ (20032227)

Supervisor: DR. AHMET OZYIGIT

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ABSTRACT

Research clearly indicates that regardless of the Foreign aid, Impact of Foreign Aid on Economic Growth, Fungibility and Role of foreign aid. It talks about the whether good policies are important in distribution of foreign aid.

The aim of this study is to find out whether foreign aid have positive or negative affect and it help in development. This study gathers other scientist's studies and shows many different ideas about foreign aid and whether is friend or foe? As an example this paper focuses on North Cyprus as a case study to see the effects of foreign aid.

Key words: foreign aid, foreign aid and developing nations, fungibility

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I. Introduction

Small economies usually import more goods from abroad compared to how much they sell to foreigners. The reason is simple. Smallness determines how much production takes place within an economy. An economy producing limited amount of goods cannot easily take advantage of economies of scale. Larger economies will produce goods cheaply and sell them abroad. Since small economies tend to be open to trade, they face a challenge from outside firms. These outside firms are often large in size and very efficient in production so that they produce more than local demand and also sell abroad at reasonable prices. These reasonable prices are usually lower than the prevailing domestic prices in a small economy so that the consumers prefer cheaper imported goods. Another problem with small economies is that they cannot possibly produce everything they need either because of lack of raw materials or because some production processes are only made possible through large scale capital investment, which is simply not profitable for a small economy. Raw materials can be and are often imported from abroad but these results in higher production costs. As a result, small economies usually find themselves in an awkward position in terms of trade relative to larger nations. Perhaps this is one of the main reasons why obstacles to growth and development are more pronounced in small economies.

II. Foreign aid and Economic Growth

2.1. The Impact of Foreign Aid on Economic Growth

Growth has been analyzed for generations and the concept has been divided into three distinct generational stages. The first generation models often talked about gorwth as development and usually consturcted models that related growth to savings and investment. Such models include the famous Harrod-Domar growth equation which equates economic growth to the domestic savings and capital-output ratios. The model consludes that if domestic savings are short of anticipted growth rates, then foreign borrowing will provide the desired results. In other words, foreign aid will have the same affect as domestic savings and will indeed promote growth.

"In the early literature on aid and growth in less developed countries, foreign aid was perceived only as an exogenous net increment to the capital stock of the recipient country. It was assumed by pro-aid development economists such as Rosenstein-Rodan (1961) that each dollar of foreign resources in the form of aid would result in an increase of one dollar in total savings and investment" (Hansen and Tarp, 2000). Theoretically the main role of aid in stimulating economic growth is to supplement domestic source of finance such as saving, thus the amount of investment and capital stock. The logic is not too difficult to grasp. Foreign assistance aims at helping the developing economy grow, so why shouldn't it be helpful to the receiving economy? However, literature does not agree on the net effect of foreign aid in developing nations. According to World Bank statements, aid is effective at spurring growth in countries with good policies but has little impact in countries with poor policies (Burnside and Dollar, 2000; Collier and Dollar, 2001; 2002, Collier and Dehn. 2001; Collier and Hoeffler, 2002). Good policies refer to ones where the incoming aid is used efficiently in appropriate uses such as improving the existing infrastructure, educational and healthcare systems and other areas which will provide long-term benefits for the society. In other words, the main aim of financial aid should be focusing on problem areas of the developing nation and making sure the aid is used effectively. However, in many cases, "instead of breaking the "endless cycle of poverty," foreign aid has become the opiate of the Third World. AID and other donors have encouraged Third World governments to rely on handouts instead of on themselves for development" (Bover, 1986) (Bover suggests that foreign aid has only helped government bureaucrats and high-ranked officials in the developing world. Aid has helped perpetuate inefficient and corrupt behavior as long as it kept pouring into the country).

On the other hand, many other researchers claim that foreign aid has a positive impact on the economies of receiving countries regardless of the macroeconomic policies used. (Hansen and Tarp, 2000, 2001; Lensink and Morrissey, 2000; Guillaumont and Chauvet, 2001; Dalgaard and Hansen, 2001; Hudson and Mosley, 2001; Lu and Ram, 2001). Perhaps this line of thought is more in line with the earlier views on financial aid. A dollar received in an economy, regardless of the recipient, should have some effect in the economy, at least in terms of stimulation of the economy through increased demand for goods and services.

The International Monetary Fund, an assistance institution itself, released a couple of research statements suggesting that "We need to be careful given the chequered history of aid, that we do not place more hopes on aid as an instrument of development than it is capable of delivering". The research, which looked at duration, type of donor and governance record of recipient, found aid did not boost growth. This conflicts with a World Bank study five years ago that found aid boosted growth in countries with good policy environments. Aid might also have contributed to poor productivity by depressing exports, the IMF research shows. Aid will not lift growth in Africa, warns IMF (Andrew Balls)

2.2. Fungibility:

Fungibility is the problem that money intended for one use can be diverted to another uses. In the first instance aid money goes to the central government's expenditure plans previously included money for the project, the money can then be redirected elsewhere. Examples of wasteful expenditure which have no impact on growth include expenditure on the military, which…can actually have a negative impact on growth. (Feyzioglu et al).

Firstly, if because of fungibility, aid money is used to subsidize domestically produced product such as food stuff then production will fall back. Similarly the receipt of aid may also have the effect of increasing the exchange rate system, again distorting the prices to export and import competing industries. Secondly, if the aid were to fund a large investment project which required considerable unskilled or semiskilled labor, this might result in increased wages being offered pulling workers out of other uses, farms, for example, which then deteriorate. The impact on incentives is additional, although related to, the impact on the price mechanism. Government may be tempted to divert, as the statistics by Feyzioglu et al. suggest, some of aid money is not diverted into other forms of expenditure but into lower taxes. Similarly the satisfaction of part of the demand for finance by aid should lead to shift in the demand for credit, thus reducing the rate of interest and leading people to reduce their saving. There is widespread empirical evidence in support of this (Griffin, 1971; White, 1992). Both the life cycle hypothesis of consumer expenditure and Friedman's permanent income hypothesis would suggest that if consumer in aid recipient countries believes that the aid will raise growth and incomes in future years they will increase expenditure and reduce saving.

2.3. Foreign Aid: Friend or Foe?

In many instances, foreign assistance is provided by international organizations such as the IMF. Majority of developing nations have some sort of relationship with the International Monetary Fund as a means of development. However, as the IMF experiences of developing nations have increased in number, the negative views about this institution have emerged. The IMF often provides funds and assistance, however, in return of certain policy implementations to ensure effective and efficient use of the funds and the advice. Nevertheless, "Capital market liberalization was foisted on these countries, before they were ready, before safety nets were in place, before financial institutions were strong enough to withstand the volatility which hot money flowing into and out of a country overnight could bring" (Stiglitz, 2001). According to Stiglitz, this was done in the name of "good policy" at the expense of instability.

One other point Stiglitz makes is; "if financial markets do not work, and if IMF programs force interest rates up to 15% or 20% or higher, firms cannot get the capital they need to create jobs; and in the absence of new jobs, workers simply move from low productivity jobs to zero productivity unemployment, surely not a recipe for growth. And when unemployment rates are already high, the prospects of finding a new job can be bleak" (2001).

Here the question is whether foreign aid received by developing nations is effective or not. According to Barro and Sala-i-Martin (1995) and Aghion and Howitt (1998) said that the growth process depends on an intricate range of interacting characteristics and lines of influence. Foreign aid has a positive effect on growth in a good policy environment. Boone found that the estimated impact of aid for an observation with average policy is zero. Countries with good policies and significant amounts of aid (3-7% of GDP), on the other hand, perform very well; better than can be explained by other variables in the growth regression.

During the years many studies focus on foreign aid and the role of foreign aid. Most of the researchers agree that the foreign aid bring improvement to countries if the good policies used. But some researchers believe that aid has positive impact on growth even in countries with a poor policy environment (Hadjimicheal et al and Durbarry et al). Sometimes it is possible that aid can have little or no impact on overall economic prosperity in the recipient country. Mosley and Hudson (1996) and Svensson (1996a, 1996b) have shown that when the donor-recipient relationship is modeled as a no cooperative game, moral hazard problems can lead to aid having little impact on the problems it is intended to alleviate. Aid may simply relax the budget constraint of the recipient government, without having much impact on the amount of that budget that ultimately is used to purchase capital. Furthermore, the donor government can also be part of this game for reasons other than benevolence. Donor interest may lead to the suboptimal use of aid and dampen any positive impact that it has. But sometimes aid has no significant positive impact on growth depend to Mosley, Hudson and Horrell (1987) and Boone (1994, 1996) studies.

Aid is given to countries with low income, and aid/GDP is much higher for countries with small populations. Frey and Schneider find evidence that commitment of World Bank assistance is associated with good policies such as low inflation, but no one has examined whether total aid is allocated in favor of good policies.

From the beginning I tried to find the answer whether the foreign aid in good or bad to answer this question we should answer another question that is whether economic development should be undertaken by government or by the private sector Perhaps the best answer was given in 1830 by British historian Thomas Babington Macaulay:

Our foreign aid has made life more pleasant and entertaining for government bureaucrats in poor countries. However, it has done little to promote the production of wealth, or to breed political responsibility, or to encourage people to help themselves. American foreign aid usually only strengthens oppressive regimes, allows governments to avoid correcting their mistakes, and bails out bankrupt state-owned enterprises around the world.

To understand whether aid is helpful for the countries or it has negative affects we have to know the role of foreign aid. During the years many studies focus on foreign aid and the role of foreign aid. In this part we can see the role of foreign in 1950s and 1960s and how its affect the development in countries. Most of the researchers agree that the foreign aid bring improvement to countries if the good policies used. The main economic rationale of foreign aid in the 1950s was to provide the necessary capital resource transfer to allow developing countries to achieve a high enough saving rate to propel them into self-sustained growth. The role of aid was seen principally as a source of capital to trigger economic growth trough higher investment. Household in poor countries –hovering around the subsistence level –were seen to the almost impossible task of raising their saving rate to a level sufficient to generate sustained growth rate. As Ruttan (1996) pointed out, in most cases developing areas lacked the physical and human capital to attract private so that there did not appear to any alternative to foreign aid as a source of capital.

Two other interrelated thoughts made aid attractive as an instrument of growth: first, the faith that governments could plans successfully at the macro level as evidenced by the large number five-year plans formulated during this period and, second, the simplicity of the Harrod-Domar model to calculate the amount of foreign aid required to achieve a target growth rate. In retrospect it was this totally aggregate planning framework and the focus on industrialization-first that led to neglect of the agricultural sector.

Ruttan (1996:104) summarizes the two directions in which development through foreign aid shifted in the 1960s. First, shortages in domestic saving and foreign exchange earning were identified as potentially limiting factor on growth. The counterpart in official policy was to extend programmed-type lending to fill the foreign exchange gap in the less developed countries. A second focus of the 1960s, influenced by the emergence of the dual-economy literature, was on sectoral development and, in the late 1960s, on sector lending for agriculture. As sectoral development process began to be better understood, the importance of investment in human capital and of policies designed to overcome resource scarcities through technical assistance began to be appreciated.

III. The Impacts of Aid on the Economy of Northern Cyprus

3.1. North Cyprus economy

In some aspects, the economy of Northern Cyprus resembles many other small island economies where industrial production is almost nil and there exists almost complete reliance on the service sector for income generation. However, what makes Northern Cyprus unique is the fact that it is not recognized as a separate political entity by the rest of the world. This essentially limits the economic functions of the country since it cannot freely trade with the rest of the world and depends on Turkey, as the only nation to formally recognize Northern Cyprus, for exporting and importing activities.

A certain percentage of the meager light industrial products produced within the country in addition to agricultural products are exported to Turkey, but the amount of exports is in no way comparable to the volume of imports. The following table summarizes the trading activity of Northern Cyprus in selected years:

Table 2: Foreign Trade by Countries in Northern Cyprus in selected years:
(Values are in 1977 million dollars)

Countries	1977		1985		1990		1995		2000		2005	
	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.	Imp.	Exp.
1. Turkey	30.9	6.6	65.1	5.4	153.5	7.9	194.8	20.2	275.1	18.7	817.4	34.2
2. Other Countries	51.1	17.3	77.9	40.9	228.0	57.6	171.3	47.1	149.8	31.7	438.1	33.9
2.1. EU Countries	37.3	15.3	52.9	35.1	131.1	51.0	102.0	36.5	103.2	20.3	264.3	18.6
2.1.1. United Kingdom	20.8	11.8	27.5	31.2	67.1	44.0	49.4	23.8	43.3	18.8	101.4	13.8
2.1.2. Other EU Countries	16.5	3.5	25.4	3.9	64.0	7.0	52.6	12.7	59.9	1.5	162.9	4.8
2.2. Middle East Countries	3.4	1.2	0.8	4.5	6.4	1.6	8.1	1.6	7.5	3.9	42.0	6.8
2.3. Far East Countries	5.1	-	10.7	-	52.3	-	33.5	-	14.1	-	52.0	-
2.4. USA	0.4	0.2	1.4	0.1	5.7	3.3	2.8	0.1	5.2	0.2	8.3	0.1
2.5. Other Countries	4.9	0.6	12.1	1.2	32.5	1.7	24.9	8.9	19.8	7.3	71.1	8.4

Total	82.0	23.9	143.0	46.3	381.5	65.5	366.1	67.3	424.9	50.4	1,255.5	68.1

Source: State Planning Organization (SPO) of Northern Cyprus, Statistical Yearbook of 2006

There are several points worth mentioning in this table. First of all, years selected do not suggest any intentional purpose. They are selected randomly for illustration purposes. As far as the trade figures are concerned, Turkey is the biggest trading partner in both exports and imports. Since the share of trade with other countries is so small, the SPO combines these numbers together. The growing volume of trade with Turkey implies an increasing rate of dependence on Turkey for trade. Furthermore, although the volume of exports sold to Turkey has only increased marginally, the rate of import growth is extremely high. This all happens parallel to real GNP growth in Northern Cyprus. Similarly, Northern Cyprus has experienced a growth in its imports from all the other trading partners as well. One other point worth mentioning is the fact that the level of exports sold to trading partners other than Turkey has followed a declining pattern since the European Court of Justice Decision in 1994 to ban trade with Northern Cyprus since it was not to be recognized. What this means is, although Northern Cyprus has been unable to sell its products abroad, it has continued to increase the volume of imports from abroad. This particular finding has three important implications:

- Trade balance has deteriorated over the years and trade deficit has grown over the years. This deficit has been financed by other sectors of the economy. Therefore, there exist other sectors that allow Northern Cyprus to buy larger quantities of products from abroad every year.

- Although Northern Cyprus has been unable to sell its products abroad, it has continued buying larger amounts from abroad. This implies that effective import substitution or export promotion programs have not been implemented. In other words, failure of growth in the export sectors due to international embargoes was not combat by efficient policies which should have created more efficient production.

- If other sectors are not large enough to compensate for the large volume of import expenditures, there is some sort of foreign assistance so that the balance of payments deficit is corrected.

Perhaps the third point is worth a closer analysis for the purpose of this paper. In terms of financing trade outlays, the Turkish economy extends its generous economic aid packages to Northern Cyprus every year. In a way, the Turkish economy helps the Northern Cypriot economy so that it can continue purchasing Turkish products. The nature of relationship tends to be good-willed and beneficial; however, the pattern of dependence it creates is somewhat burdensome to the TRNC economy.

3.2. Foreign aid in North Cyprus

The observed trade deficit is mostly financed through Turkish economic aid. The table below shows certain aspects of the nature of relationship between Northern Cyprus and Turkey:

Table 3: Certain aspects of the economic relationship between Turkey and Northern Cyprus

Economic Indicator	1977	1985	1995	2000	2005
GNP (Million $)	209.4	240.2	755.7	1039.9	2327.8
GNP per capita (million $)	1444	1498	4167	4978	10567
Exports to Turkey (million $)	6.6	5.4	20.2	18.7	34.2
Imports from Turkey (million $)	30.9	65.1	194.8	275.1	817.4

Foreign Aid from Turkey (million $)	25.6	36.4	28.4	105.5	217.2
Foreign Aid from Turkey As a percentage of GNP	12.2%	15.2%	3.8%	10.1%	9.3%
Foreign Aid from Turkey As a percentage of imports from Turkey	82.8%	55.9%	14.6%	38.3%	26.6%

Source: SPO, Statistical Yearbook of 2006.

The table above shows the trends of growth in national income, exports, imports and foreign aid from Turkey. As revealed by the data itself, foreign aid from Turkey remains very high over the years. More precisely, it makes up a considerable percentage of the Turkish import expenditures. This reliance on foreign aid tends to be parallel to the growth in the volume of imported products from Turkey. As mentioned before, Turkey, in a way, provides financial assistance so Northern Cyprus can keep buying its exports. This way, Turkey not only provides financial assistance to Turkish Cypriots, but also provides an enlarged market for its own export producers.

The existence and the level of foreign aid is obvious. What we are predominantly interested is, whether foreign aid is used effectively or merely as a means of balancing the trade balance. In other words, is foreign aid used in projects that lead to growth and social learning? Or is it being used inefficiently and not contributing to growth at all? Following section will shed some light on this matter.

IV. Regression analysis

4.1 Model

The following equation is used to capture the relationship between economic growth and financial aid. The growth regresion uses GNP growth as the dependent variable and foreign aid as a percentage of GNP, budget deficit as apercentage of GNP. Private and Public investment as ratios of GNP are used as the independent variables.

$\Delta GNP = \beta + B1(forAidGNP) + \beta 2(BudDefRatio) + \beta 3(PrInvRatio) + \beta 4$
$(PubInvRatio) + \varepsilon$

Normally, the expectation is that the variables for aid GNP, Private Investment Ratio and Public Investment Public should be positively related to growth. Budget deficit could be negatively or positively related depending on the nature of public expenditure. Foreign aid should be positive because unless it is used so unwisely that it actually detriments growth, it should have a positive influence even if not significant.

4.2 Results

The regresion results are shown as the table below:

Coefficients

Mode		Unstandardized Coefficients		tandardize Coefficients			Confidence Interval f		Correlations			ollinearity Statistic	
		B	td. Erro	Beta	t	Sig.	ower Boun	pper Boun	ero-orde	Partial	Part	olerance	VIF
1	(Constan	.529	.295		1.794	.089	-.088	1.147					
	ForAidGN	-.004	.008	-.139	-.487	.632	-.020	.013	.032	-.111	-.097	.484	2.066
	BudDefR	-.030	.015	-.527	-1.910	.071	-.062	.003	-.299	-.401	-.379	.516	1.939
	PrInvRati	.001	.020	.008	.036	.971	-.041	.042	.113	.008	.007	.913	1.095
	PubInvRa	-.049	.029	-.382	-1.685	.108	-.110	.012	-.259	-.360	-.334	.765	1.308

a. Dependent Variable: GNPgro

It is interesting that none of the independent variables reach statistical significance of the 5% level, however, budget deficit ratio is statistically significant at 10%. Perhaps the most interesting finding in our analysis is that the rate of public investment has a negative and statistically significant effect on the rate of growth of GNP. This finding should not go unnoticed. The main reason for this tends to be the excessive public employment and public engagement in the economy. High degree of government involvement necessarily creates inefficiencies in resource allocation and production. The negative coefficient of the public investment variable confirms this thought and suggests that public investment is not being directed to efficient uses. In contrast, public investment is so inefficient that it is actually detrimental to growth. Instead of being used as it is currently, if these funds were transferred over to the private sector in terms of loans and incentives, they would probably have higher rates of return to the economy since the coefficient for private investment variable is positive but statistically insignificant. Similarly, foreign aid is also negatively related to economic growth. This finding is very interesting as it is contradictory to the existing literature. Although Burnside and Dollar find that aid may not be a significant growth catalyst, the coefficient is still positive. Here, the negative coefficient simply implies that let alone aid not being a significant aid promoter, it is so inefficiently used that it negatively affects growth.

Model Summary(b)

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.503(a)	.253	.096	.15304	1.532

a Predictors: (Constant), PublnvRatio, PrInvRatio, BudDefRatio, ForAidGNP
b Dependent Variable: GNPgro

The above table shows the Durbin-Watson statistic for this model, which is 1.53, which is in acceptable range, indicating that our model does not suffer from serial correlation.

Perhaps one of the main problems of our regression analysis is the fact that Northern Cyprus is still a young entity and our series only include a limited range of years. However, not much can be done about this since we cannot go back in time and consturct data for years that do not exist.

V. Conclusion

Research clearly indicates that regardless of the Foreign aid, Impact of Foreign Aid on Economic Growth, Fungibility and Role of foreign aid. It talks about the whether good policies are important in distribution of foreign aid. The aim of this study is to find out whether foreign aid have positive or negative affect and it help in development. as it can be seen from the study the in normal case Aid has to have positive affect on Development but in the case of the North Cyprus is different Foreign Aid have negative relationship with GNP.

From the other scientists researches we found that to use Foreign Aid in the way that affect GNP positively many things are important one of the main thing is good policies. In North Cyprus, I have identified that foreign aid does not promote growth and perhaps this is because aid is not wisely used in projects that will result efficient results. The government should be more careful about where it spends the aid money as well as the money it directs to investment as both of these indicators turned out to be negative in the growth regression.

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