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**A MACROECONOMETRIC ANALYSIS OF FOREIGN AID IN  
ECONOMIC GROWTH AND DEVELOPMENT IN LEAST  
DEVELOPED COUNTRIES: A CASE STUDY OF THE LAO  
PEOPLE'S DEMOCRATIC REPUBLIC (1978-2001)**

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To the memory of my father,  
*Choulaphonh XAYAVONG*

## ABSTRACT

Despite receiving large quantities of aid, many developing countries, especially the Least Developed Countries, have remained stagnant and become more aid-dependent. This grim reality provokes vigorous debate on the effectiveness of aid. This study re-examines the effectiveness of aid, focusing on the ongoing debate on the interactive effect of aid and policy conditionality on sustainable economic growth. A theoretical model of the aid-growth nexus was developed to explain why policy conditionality attached to aid may not always promote sustainable economic growth. Noticeable methodological weaknesses in the aid fungibility and aid-growth models have led to the construction of two macroeconometric models to tackle and reduce these weaknesses. The Lao People's Democratic Republic's economy for the 1978-2001 period has been used for a case study.

It is argued that the quality of policy conditionality and the recipient country's ability to complete specified policy conditions are the main factors determining the effectiveness of aid. Completing the policy prescriptions contributes to a stable aid inflow. The aid-growth nexus model developed in this study shows that stable and moderate aid inflow boosts economic growth even when aid is fungible. However, failure to complete the policy conditionality owing to inadequate policy design and problems of policy mismanagement caused by lack of state and institutional capability in the recipient country triggers an unstable aid inflow. The model shows that unstable aid flows reduce capital accumulation and economic growth in the recipient country. These empirical findings reveal that policy conditionality propagated through the "adjustment programmes" has mitigated the side effects of aid fungibility and "Dutch disease" in the case of the Lao PDR. Preliminary success in implementing the policy conditions in the pre-1997 period led to a stable aid inflow and contributed to higher economic growth. This favourable circumstance, however, was impaired by unstable aid flow in the post-1997 period. The lack of state and institutional capacity in the Lao PDR and the inadequate policy design to deal with external shocks triggered the instability of aid inflow, which in turn exacerbated the negative effects of the Asian financial crisis on the Lao PDR's economy.

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## LIST OF ABBREVIATIONS

2SLS	2 Stage Least Squares
3SLS	3 Stage Least Squares
ADB	Asian Development Bank
ADF	Augmented Dickey-Fuller
ARDL	Autoregressive Distributed Lag
AusAID	Australia Agency for International Development
CGE	Computable General Equilibrium
CPI	Consumer Price Index
CPIA	Country Policy and Institution Assessment
DAC	Development Assistance Committee
DF	Dickey-Fuller
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FAO	Food and Agriculture Organisation
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross National Product
GSP	General Special Preference
ICOR	Incremental Capital Output Ratio
IDA	International Development Association
ILS	Indirect Least Squares
IMF	International Monetary Fund
Kips	Lao Currency Unit
Lao PDR	Lao People's Democratic Republic
LDCs	Least Developed Countries
LIML	Limited Information Maximum Likelihood
LPRP	Lao People's Revolution Party
NZODA	New Zealand Official Development Assistance
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
OLS	Ordinary Least Squares
PIP	Public Investment Program
PSBR	Public Sector Borrowing Requirement
REER	Real Effective Exchange Rate
RHS	Right Hand Side
SAC	Structural Adjustment Credit
SAF	Structural Adjustment Facility
SIDA	Swedish International Development Authority
SNPA	Substantial New Programme of Action
SOEs	State-Owned Enterprises
SURE	Seemingly Unrelated Regression Estimation
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UXO	Unexploded Ordnance