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Should Easier Access to International Credit Replace Foreign Aid?

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Abstract:
We examine the interaction between foreign aid and binding borrowing constraint for a recipient country. We also analyze how these two instruments affect economic growth via non-linear relationships. First of all, we develop a two-country, two-period trade-theoretic model to develop testable hypotheses and then we use dynamic panel analysis to test those hypotheses empirically. Our main findings are that: (i) better access to international credit for a recipient country reduces the amount of foreign aid it receives, and (ii) there is a critical level of international financial transfer, and the marginal effect of foreign aid is larger than that of loans if and only if the transfer (loans or foreign aid) is below this critical level.

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