Foreign Aid and Export Diversification in Developing Countries

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Abstract
This paper analyzes the effect of foreign aid on export diversification for a sample of developing countries while controlling for the effects of other factors which determine export diversification. We find that foreign aid not exceeding 20% of a country’s GDP significantly promotes export diversification, while foreign aid in excess of 20% of GDP significantly impedes export diversification. The latter result corroborates evidence from related literature which has shown that foreign aid can have an anti-export bias due to a Dutch disease effect. However, our results show that aid as a percent of GDP is below 20% in most low income countries. This implies that in many low income countries, varying amounts of additional aid can be used to enhance export diversification without causing a Dutch disease effect. As in the previous literature, we find that the level of development, infrastructure, transactions costs, and natural resources significantly affect export diversification. Our results are robust to the use of two different export diversification measures and different sub-samples.

Keywords: foreign aid; export diversification; developing countries

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