

**MACROECONOMIC EFFECTS OF FOREIGN AID IN THE  
MIRAB ECONOMIES OF THE SOUTH PACIFIC**

by

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I certify that the substance of this thesis has not already been submitted for any degree and is not currently being submitted for any other degree or qualification.

I certify that any help received in preparing this thesis, and all sources used, have been acknowledged in this thesis.



Patrick Laplagne

*A ma grand-mère, Louise*

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## ABSTRACT

The macroeconomic effects of foreign aid have long been a matter of interest to economists specialising in the South Pacific. In contrast to small island economies in other parts of the world, South Pacific countries do not appear to have reaped long term benefits from the generous amounts of overseas assistance they receive. This thesis draws on both the MIRAB hypothesis and the findings of the international aid literature to examine the effects of aid in five South Pacific microstates—Kiribati, Tuvalu, Niue, Tokelau, and the Cook Islands—which are thought to form a distinct class of economies, within the South Pacific region.

After confirming that the phenomena originally described in the MIRAB hypothesis continued in the 1980s, the various avenues through which aid is thought to affect an economy are investigated in detail. These include possible undesirable effects on domestic saving, on fiscal policy, and on economic structure. Particular attention is paid to the latter type of effect, also known as the ‘Dutch Disease’ or ‘booming sector’ effect. Further to the empirical investigation of these phenomena, stylised models of ‘typical’ MIRAB economies are constructed, in an attempt to identify more clearly any positive or negative macroeconomic effects of foreign aid. Finally, numerical parameters are attached to some of the models, so that the impact of aid may be quantified.

The results reveal a somewhat multi-faceted picture of the impact of aid. However, two generalisations appear warranted: (i) foreign aid has been able to foster real economic growth in the economies considered and, in some cases, this growth has been sufficiently strong for income per head to increase; (ii) aid has led to some of the negative effects evoked in both the MIRAB and the international aid literatures. In particular, it appears to diminish the incentive for public saving, and to induce a relative decline of the tradable goods sector. In all models, foreign aid is shown to be an effective source of domestic employment creation and output growth. However, its capacity to increase average labour productivity—and hence output per capita—is found to depend crucially upon a number of factors, such as the degree of external labour mobility and sectoral labour intensities. Depending on the environment into which it is injected, the impact of foreign aid on the marginal product of labour could be positive, negative or nil. Finally, numerical simulations indicate that the chances of avoiding the relative decline of the tradables sector which aid causes are low.

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## LIST OF ACRONYMS, ABBREVIATIONS AND SYMBOLS

ABS	Australian Bureau of Statistics
ADB	Asian Development Bank
AGR	Aid–Growth Relationship
AIDAB	Australian International Development Assistance Bureau
AM	Assymetrical Mobility
APF	Absorption Possibility Frontier
ASR	Aid–Saving Relationship
CGE	Computable General Equilibrium
CIA	Central Intelligence Agency
CPI	Consumer Price Index
CRS	Constant Returns to Scale
EEC	European Economic Community
EEZ	Exclusive Economic Zone
FSM	Federated States of Micronesia
GDP	Gross Domestic Product
GDS	Gross Domestic Saving
GE	General Equilibrium
GNP	Gross National Product
GNS	Gross National Saving
ICOR	Incremental Capital–Output Ratio
ILO	International Labour Organisation
IMF	International Monetary Fund
IOCR	Incremental Output–Capital Ratio
LHS	Left Hand Side
MIRAB	Migration, Remittances, Aid, Bureaucracy
MURAB	Migration, Urbanisation, Remittances, Aid, Bureaucracy
MIRAGE	Migration, Remittances, Aid, Government Employment
NCDS	National Centre for Development Studies
NT	Non-Tradables
NZ	New Zealand
ODA	Overseas Development Assistance
OLS	Ordinary Least Squares
PNG	Papua New Guinea
PPF	Production Possibility Frontier
RCC	Reference Currency Country
RER	Real Exchange Rate
RERF	Revenue Equalisation Reserve Fund
RHS	Right Hand Side
RPI	Retail Price Index
SDR	Special Drawing Right
SIDS	Small Island Developing States
SIN	Small Island Nation
SPC	South Pacific Commission
SPD	South Pacific Economic and Social Database
SPR	South Pacific Region
T	Tradables

TTF	Tuvalu Trust Fund
UK	United Kingdom
UNDP	United Nations Development Program
ZM	Zero Mobility
'000	Thousand
Exp.	Exports
Imp.	Imports
Is.	Islands
M	Million
St. Dev.	Standard deviation
n.a.	not applicable
..	not available