

# Is Foreign Aid a Vanguard of Foreign Direct Investment? A Gravity-Equation Approach\*

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## Abstract

This paper investigates whether and how foreign aid facilitates foreign direct investment (FDI) flows into less developed countries. We employ a large data set of source-recipient country pairs and conduct gravity equation-type estimation. Our empirical methodology enables us to distinguish among three effects of aid on FDI: a positive effect through improving infrastructure, a negative effect through encouraging rent-seeking activities, and a positive “vanguard effect” that is specific to the same source-recipient country pair of aid and FDI. We find that foreign aid in general does not necessarily have an infrastructure, rent-seeking, or vanguard effect. However, we find robust evidence that foreign aid from Japan in particular has a vanguard effect, i.e., Japanese aid promotes FDI from Japan, but not from other countries.

Keywords: foreign aid; foreign direct investment; gravity equation

JEL classifications: F21; F35; O11

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