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FOREIGN AID, INTERNATIONAL TRADE, POLITICAL UNCERTAINTY AND ECONOMIC PERFORMANCE: A COMPARATIVE POLITICAL ECONOMY ANALYSIS OF SRI LANKA AND PAKISTAN

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ABSTRACT

The purpose of this study is to explore the link between foreign aid, trade openness, political uncertainty and economic performance using a comparative study of Sri Lanka and Pakistan. Aid inflows and trade liberalization are often considered key factors in the growth of developing economies yet their results have shown to be different over time and across countries. The study suggests that the degree of economic performance is influenced by a conditioning factor of political uncertainty, which in turn influences the role of aid and trade. The analysis, based on political economy theory and a comparative case-study approach, examines the links between political stability, policy continuity and institutional credibility with development outcomes in the two countries using secondary macroeconomic and governance data. The results indicate that economic impact of aid and trade is more positive in relatively politically stable periods in which policies are more credible and implementation more stable. On the other hand, high political uncertainty is a drag on investment incentives, delays policy implementation, and diminishes the lasting impact of external support and linkages to trade. Another comparison demonstrates that while political and economic uncertainties existed in both countries, the quality and duration of the uncertainty were different, and as a result, the growth path was different. The study concludes that the role of aid and trade as engines of growth is not fully understood if political environments in which they operate are not taken into consideration.

Keywords: *Foreign aid; Openness for trade; Uncertainties in the political; Economic performance; Sri Lanka; Pakistan; Comparative political economy*

1. INTRODUCTION

Foreign Aid and international trade have played a pivotal role in Development strategies in the low- and middle-income countries since a long time ago. Aid inflows and trade liberalisation have been assumed to have the power to boost growth, productivity and poverty alleviation by the

policymakers and international institutions alike. Empirical studies, however, suggest that similar policies of aid and trade often have different economic results in different countries. This split has implications for the conditions in which aid and trade can effectively influence economic performance, and poses important questions.

There is increasing evidence that political uncertainty, as represented by government instability, policy instability, conflict, and poor institutions, can be an important factor in shaping economic outcomes. In high political uncertainty countries, investment decisions are postponed, policy implementation is reduced, and economic reforms are undermined. This study aims to explore these dynamics by comparing Sri Lanka with a South Asian country with structural similarities, but diverging political paths and economic outcomes, Pakistan.

Before discussing the importance of the comparison of the two cases, it's best to provide an overview of the situations. Before describing the two cases that are being compared, it would be helpful to describe the circumstances surrounding them. Aid and trade do not exist as inputs which can be converted into growth in the same way as mechanical inputs. They delve into the policy decision-making process, institutional capacity, and private-sector expectations. However, as long as politics isn't assumed, they can be fragile or fail, and the same policy tools can have very different impacts in two otherwise-alike countries (Alesina et al., 1996; Rodrik, 2001)..

a) Background

Despite Sri Lanka and Pakistan being both recipient nations of foreign aid and trade since independence, there are important differences in their growth experiences and macroeconomic stability. Whereas both states were starting the post-colonial era with similar constraints on development: shortage of domestic savings, foreign exchange difficulties, lack of infrastructure, and the need to develop productive capacity. In these settings, foreign aid is typically seen as a means to ease capital and foreign exchange limitations and enable investment, and trade openness as a means to boost productivity, export growth, and technology transfers (Chenery & Strout, 1966; Rodrik, 2001). Yet the potential of aid and trade to produce these advantages are very dependent on policy stability, credible governance and stable domestic economic expectations.

This is complex and Sri Lanka's development trajectory is a reflection of this. The country has been described as having relatively high social indicators for people in his country, despite experiencing some times of economic difficulty and irregular economic growth. One is because of the legacy of internal conflict and post-conflict governance policy issues in Sri Lanka. Conflict has a number of impacts in the economy such as: costing the government money on security expenditures, eroding investor confidence, harming tourism, and limiting the ability to plan long-term and make structural changes. Where there is still enough funding for assistance and external contact, the political climate can shape how resources are spent – either on productive investment or on crisis management and stabilization in the short term (World Bank, 2023).

Meanwhile, political uncertainty and economic volatility is another pattern in Pakistan. The nation has been hit by a series of episodes of macroeconomic stress, which have frequently been associated with external imbalances and budget restrictions. In these contexts, foreign assistance may serve as a stabilizing force, but it can also be part of a recurring adjustment cycle in which reforms are promised, but not necessarily executed, due to political changes and the change of policy priorities. But economic performance is also influenced by political instability and policy reversal, as it indicates to households and firms that they should postpone investment if they expect a sudden policy change, unpredictable taxation, and inconsistent policy on trade and industry (Alesina et al., 1996). This is one of the reasons that the same level of trade liberalization or aid receipt can lead to reduced growth performance in politically turbulent countries.

The uncertainty over the political landscape also has direct impacts on trade performance. Rules have to be predictable such as tariff, exchange-rate policy, customs administration, investment policy, and enforcement of contracts, and these rules must be in place when trade is integrated. As these conditions shift, companies may find it difficult to plan, exporters will have to accept greater risk, and the economy may not be able to shift into higher-value economic sectors even as nominal openness expands (Rodrik, 2001). In both Sri Lanka and Pakistan, therefore, the issue is not just if trade expanded, but if there was a political environment conducive to a dynamic export competitiveness and constant export policy.

Importantly, the political uncertainty in both is not the same. In Sri Lanka, uncertainty has been linked to conflict dynamics and the governance needs of post conflict reconstruction. In Pakistan, uncertainty has more often been linked to instability in the structure of governance, frequent changes in the government and discontinuity in policy. These differences are important because they influence the way uncertainty is passed on to the economy through investor confidence, the credibility of reforms, the effectiveness of institutions and the capacity of the state to put in place long term development strategies.

b) Statement of the Problem

The impact of foreign aid and trade liberalisation on growth is highly controversial. Studies also differ in their views on the role of aid in supporting growth; some contend that aid helps to relieve financing constraints and allows for public investment (Chenery & Strout, 1966), while others believe that aid fosters dependency, erodes accountability, and can even be counterproductive if it fails to be spent on productive projects (Easterly, 2003). Likewise, increased trade openness has often been linked to greater growth by means of enhanced productivity and technology transfer, but results have been mixed, and liberalization has not always led to lasting development benefits in developing low-income countries (Rodrik, 2001). This is mixed evidence and indicates that aid and trade do not necessarily ensure growth. The impact of their use seems to be highly context specific.

One major limitation of much of this literature is the manner in which political aspects are incorporated in the empirical and comparative analysis. The background controls for political instability, governance weakness, conflict risk and policy volatility are often not regarded as core factors driving how aid and trade affect economic performance. This is a very restrictive analytical method. A weakened effectiveness of external finance and trade integration is an indirect impact of political uncertainty on growth, as is also the impact of political uncertainty on the level of investment and on macroeconomic management. In the face of uncertainty, governments may not be able to credibly commit to reforms, consistently implement aid projects, or maintain and sustain trade policies over a long enough period for firms to adapt and grow exports. This uncertainty drives investors and producers to postpone long-term investments, cut investment and divert resources to short-term or defensive investment activities (Alesina et al., 1996). If these dynamics are treated as secondary, the literature can fall into the mistake of missing out on the explanation of why the same kind of development strategies can have varying results.

The present gap becomes more significant in the context of comparison, for example Sri Lanka and Pakistan. The two countries have had significant external support for a long period and have implemented differing levels of trade liberalisation. However, their economic paths have varied with regard to their growth stability, the likelihood of a crisis and the effectiveness of the policy response. Existing research has offered micro or macro-economic explanations or country specific political history explanations for these differences, but little systematic comparative analysis has been conducted that explicitly examines political uncertainty as a conditioning factor in the aid–trade–growth relationship. That is, it remains to be seen whether aid and trade are indeed ineffective, or simply hampered by political uncertainty that prevents their channels of expected growth from functioning.

Furthermore, research on the effectiveness of aid has often highlighted the significance of policy and institutional contexts, and aid is more likely to be effective in countries where governance and policy are conducive (Burnside & Dollar, 2000). However, even among this body of work, the role of political uncertainty as an interactive mechanism affecting the impacts of aid and trade over time has been neglected. Research on trade also shows that openness is not enough if domestic institutions are weak or policy credibility is low (Reda 2001), but comparative research seldom extends beyond a (less formal) connection between policy uncertainty and trade results and growth performance.

This paper, therefore, seeks to explain the growth impact of foreign aid and trade openness in a focused and comparative manner, given their influence by political uncertainty. While political uncertainty is not the main subject of analysis, this remains a hard question to explain why sometimes aid and trade is pro-growth and at other times anti-growth, especially in countries with a high frequency of political upheavals. With this in mind, the objective of this study is to compare and contrast Sri Lanka and Pakistan, in order to understand the mechanism that acts as a substitute between the relationship between aid, trade, and economic performance.

c) Research Objectives

- To examine the relationships between foreign aid, trade openness and economic performance in Sri Lanka and Pakistan
- To explore the effects of policy uncertainty on foreign aid, trade openness and economic performance

d) Research Questions

1. What is the impact of foreign aid and trade openness on the economy of the countries such as Sri Lanka and Pakistan?
2. How does political uncertainty influence or dampen the effectiveness of foreign assistance, trade openness and economic performance in Sri Lanka and Pakistan?

2. LITERATURE REVIEW

2.1 Foreign Aid and Economic Growth

Foreign aid–economic growth interactions is one of the most discussed topics in development economics. In the early theoretical models, aid was seen as a key tool in boosting growth in capital-constrained countries. Chenery and Strout (1966) postulated that assistance would act to allow greater investment and growth by correcting the savings and foreign exchange deficits. This view also had a profound impact on post-war development policy and served as a justification for the transfers of large amounts of resources to developing countries.

Later empirical studies, however, found conflicting results. Critics since have raised questions about the ability of aid to provide long-term growth because of poor incentives, resource misallocation, and rent-seeking. In his argument, Easterly (2003) argued that aid can reduce accountability at the national level and foster dependency, especially in a poorly-governed world. Other studies argued that the effect of aid is not necessarily measured in terms of its absolute size, but also in terms of how it affects domestic policy and institutions.

A counterview to this was the conditional view of the effectiveness of aid. Burnside and Dollar (2000) have shown that in countries where targeted countries have sound macroeconomic policies and institutional stability, aid has a positive effect on growth, but in countries that fail to have such policies and stability, it has a negative effect. This result is important, but has been disputed by some later studies, which found it was not as robust as it seemed and that there were methodological flaws. As a whole, literature indicates that aid is not per se effective, and not detrimental, but its effect on growth depends very much on the political and institutional contexts.

This ties in with the second dimension of trade openness, that of economic performance.

2.2 Trade Openness and Economic Performance

Trade openness is seen as one of the major sources of economic growth, for example via efficiency gains, specialization and technology transfer. On

the other hand, the neoclassical and endogenous growth theories argue that the competitive pressures and utilization of larger markets give advantages to open economies. Empirical evidence has shown that there is a positive correlation between trade openness and growth, especially in export-dependent economies.

However, there is also a considerable range of results reported in the literature. Rodrik (2001) contends that trade liberalization is not sufficient to ensure the growth in future and the outcomes are determined by the domestic institutional structure, the governance capability and policy credibility. Too much liberalization in politically unstable places has sometimes created de-industrialisation, external vulnerability and social instability, instead of continued growth.

Recent studies suggest that the advantages of trade become apparent over time, and must be supported by other policies, such as investment in infrastructure, regulation stability and credible exchange-rate management. With political uncertainty, this may lead to greater openness to trade, but not necessarily to gains in long-term productivity. This perspective reinforces the need to think of trade as a component of a broader political economy policy process, rather than as an exclusive policy approach.

2.3 Political Uncertainty and Economic Outcomes

There has been a good deal of literature about political uncertainty and economic outcomes. Research in political economics demonstrates that policy reversals, frequent government changes or instability due to conflict increases uncertainty of future returns, thus reducing private investment and growth. Early empirical evidence that political instability negatively affects economic growth is available from Alesina et al. (1996), who show that it lowers investment and weakens policy implementation.

Political uncertainty also has indirect economic consequences, in the form of a loss of policy credibility. Political instability or contestation of power in a government affects the durability and credibility of long-term fiscal discipline, trade reforms and investment incentives. As a result, there is a delay in investment or a reallocation of resources into short-term or speculative investments for firms and households. This is especially important in economies that are highly dependent on aid, where the continuity of policy is crucial to the successful implementation of projects and sustainability of the reforms.

2.4 Political Uncertainty as a Conditioning Factor in Aid and Trade

The literature on aid, trade, and political instability is rich; however, it has largely been dealt with in isolation. Political factors are often introduced as controls in studies of the effectiveness of aid, but they do not usually form an integral part of the process by which aid works. Likewise, studies on trade openness have grasped the role of institutions but seldom go beyond simply linking to the political uncertainty.

While Burnside and Dollar (2000) indirectly recognize the political nature of the effectiveness of aid, the uncertainty and ambiguity of the political is not often explicitly examined. Similarly, the critique of trade fundamentalism offered by Rodrik (2001) highlights the importance of governance, but cannot be more explicit in terms of a comparison of political instability between countries. Consequently, there is little systematic research which explicitly addresses the political uncertainty and the relationship between aid and growth, especially in comparative country studies.

2.5 Identified Research Gap

The above literature review shows that there is a gap in the literature. Foreign aid and trade openness have been extensively researched, but their impact depends on the context and is not well understood in politically unstable settings. Although political uncertainty is clearly known to be detrimental to growth, it is not often considered as one of the fundamental explanatory variables that shapes the functioning of aid and trade. Furthermore, comparative analyses around countries that have comparable development challenges with different political development paths continue to be limited.

To fill this gap, this study has synthesized the lessons learnt from the literature on aid, trade and the political economy and its applications to a comparative study of Sri Lanka and Pakistan. The study aims to make political uncertainty the central focus of analysis to better explain the reasons for contrasting economic results in different countries in response to similar development strategies.

3. THEORETICAL FRAMEWORK / CONCEPTUAL MODEL

This study is based on the political economy theory which suggests that the economic results are not only driven by the market forces, but also by the political institutions, governance mechanisms and political system's stability. Hence, foreign aid and openness to trade are not a political neutral process. They can be effective if policies are believable, if institutions can enact change and if the political environment in which the economic agent operates is predictable.

According to the standard theories of economics, foreign aid can induce growth by augmenting domestic savings, alleviating foreign exchange problems and funding public investment in infrastructure, health and education (Chenery and Strout, 1966). Likewise, trade openness should improve economic performance in its ability to increase market access, incentivize specialization, increase competition, and promote technology transfer (Rodrik, 2001). The mechanisms, however, depend on a level of political stability which enables policies to be enacted in a consistent and sustained way for them to have an impact.

Political economy theory says otherwise, noting that political uncertainty changes the incentives and constraints for firms and households, and the incentives and constraints of governments. Political instability, as a result of frequent government changes, conflict, reversal of policy and weak institutional enforcement, raises the transaction costs and uncertainty about future returns. In such cases, private investment may be postponed, long-term planning is discouraged, and economic actors may start to behave in the short term or in a risk-averse way (Alesina et al., 1996). Such reactions reduce the avenues by which aid and trade are likely to be seen as growth drivers.

In this context, political uncertainty has two related impacts on the performance of the economy. In this context, political uncertainty produces two interrelated impacts on economic performance. First of all, it affects growth directly, as it deters investments, lowers productivity and creates macroeconomic volatility. More significantly for the purposes of this study, political uncertainty has an indirect or conditioning effect: it influences the effectiveness of aid inflows and trade integration to translate into economic gains. Delays, misallocation or poor monitoring can occur in aid projects in situations where political control is contested or policies change. Likewise, if the firms' perception of the stability of the trade policy, that of exchange rate policy, or the regulatory regimes is unstable or reversible, then trade reforms will not lead to persistent export growth.

In this way, the framework sees political uncertainty as a 'modifier' and not as a 'causing' factor alongside aid and trade. Aid and trade are more likely to contribute to growth via investment, productivity and structural transformation in times of stability. However, the opposite applies when the political context is uncertain: the same amount of aid and trade liberalization can lead to a less effective or less stable result, due to the lack of credibility of political institutions and the lack of effectiveness of the political institutions themselves. This view is in line with conditional views of the effectiveness of aid, which suggest that the best aid occurs in the context of domestic policy and institutional environments (Burnside & Dollar, 2000).

Interestingly, here political uncertainty is not seen as a one-size-fits-all situation. There are a lot of different sources and expressions as to its origin and appearance over time and across countries. Uncertainty can also be caused by situations of conflict or post-conflict governance problems, or by high levels of political turnover, civil–military tensions, or sudden policy shifts. The differences

are important because they have implications for the mechanisms whereby uncertainty affects aid and trade. This is why it is essential to provide a comparative approach that will capture the similarities of economic instruments operating in different political contexts.

The model of this research could be summarized as follows: foreign aid and openness of trade affect the economic performance either directly by means of investment or indirectly through productivity and market access channels, while the latter are dependent on political uncertainty. The growth benefits of aid and trade are undermined by high political uncertainty, which lowers the credibility of policies and institutional capacity. These mechanisms, however, work more efficiently in times of lower political uncertainty.

The study features political uncertainty as its core theme which allows the approach to go beyond the narrowly economic explanations of growth and results in a politicization of the analysis of development outcomes. This kind of approach offers a common ground for comparing Sri Lanka and Pakistan and it helps to understand the causality that underlies the empirical analysis in the following sections.

4. HYPOTHESES

In light of the above political economy framework, this study proposes the following hypotheses for empirical tests. These hypotheses are based on the belief that the impact of foreign aid and trade openness on the economy depends on the political climate in which it is applied.

During times of relative political stability, foreign aid acts positively on economic performance.

This hypothesis suggests that in low-political uncertainty environments and credible policy implementation, the flow of aid could lead to investment, increase productivity, and help achieve long-term economic growth.

The second effect of trade openness is positive for economic growth with a dampening trend as political uncertainty rises.

This idea is that whereas trade integration can provide incentives for firms to grow because of trade market access and efficiency, political uncertainty and policy volatility can limit firms' responsiveness to trade incentives, thereby lowering the growth effect of openness.

5. DATA AND METHODOLOGY

A comparative case-study approach using secondary macro-economic data is used to analyze the interactions between foreign aid, trade openness and political uncertainty with respect to Sri Lanka and Pakistan economic performance. A comparative design is suitable because the study aims to interpret divergent results between two countries that have a few similar political and economic structures (including those of dependence on aid, openness to global trade, and recurring political difficulties) but vary in terms of political trajectories and economic performance over time.

5.1 Research Design

The study design is comparative political economy and descriptive quantitative assessments. This study is not based on econometric modelling to estimate a single causal effect, but focuses on the importance of contextual interpretation and cross-country comparison. This can enable a more complex analysis of the effects of political uncertainty on the success of aid and trade in various institutional and historical contexts. Comparative case studies are especially helpful for recognizing patterns, mechanisms, and differences that are not apparent in any large cross-country regressions, such as Mahoney & Rueschemeyer (2003).

5.2 Data Sources

The study is based on secondary data only, taken from the reliable and comparable international sources. The indicators for economic performance include GDP growth rates and if relevant per capita growth in income. Foreign aid data cover net official development assistance (ODA) inflows, and measures of trade openness include the typical indicators such as the ratio of total trade (exports plus imports) to GDP.

Political uncertainty is measured based on a quantitative and qualitative list of indicators of

instability and policy unpredictability. These are indicators of government stability, the incidence of conflict and policy volatility, which are commonly employed in political economy research (Alesina et al., 1996). Governance and political stability indicators from international sources (where available) are used to highlight periods of increased uncertainty.

5.3 Operationalization of Key Variables

Economic Performance: Measured mainly in terms of GDP growth, as a measure of overall economic growth and short to medium-term performance.

Foreign Aid: Net ODA as a percentage of GDP: Scale of external financial support.

Trade Openness: Trade/GDP. A measure of globalisation.

Political Uncertainty: refers to a multi-faceted phenomenon, including political instability, risk of political conflict, rapid government turnover, and policy shifts. The study does not use just one indicator; it looks at trends on several indicators to reflect the wider political environment.

The multidimensional approach fits into the theoretical framework where political uncertainty is not seen as one independent variable, but as a conditioning variable.

5.4 Analytical Strategy

The analysis is stepped in two phases. First, descriptive analysis is conducted to analyse the trends over time in a country of inflows of aid, openness to trade, political uncertainty and economic performance. This can be used to determine relative periods of stability and instability, and the relationship to growth outcomes. Second, comparative trend analysis is used as a method to compare Sri Lanka and Pakistan, while highlighting the economic results of comparable levels of aid and trade exposure within different political environments.

The analysis focuses not on the individual influence of political uncertainty, but on the interplay and progression of political uncertainty and aid and trade policies. Such an approach supports the political economy arguments that development is not a reflection of policy inputs but of the combination of economic instruments and political context (Rodrik, 2001).

5.5 Validity and Limitations

In order to improve its validity, the study uses several indicators of political uncertainty and also uses several sources of data to triangulate. However, it has its weaknesses. The results are not meant to be statistically generalizable to all developing countries, as a comparative case study. Instead, the aim is to offer analytically oriented observations on the link between aid, trade and economic performance in two revealing cases in which political uncertainty is a factor.

Although these are limitations, the methodology is appropriate for the study's purposes. The comparative analysis and contextual interpretation approach enables a deeper understanding of how similar development strategies can have varying impacts in politically divergent contexts.

6. RESULTS / FINDINGS

Sri Lanka's experience shows that the political climate determines the economic impacts of foreign aid and openness to trade. Thus, a comparative analysis of Sri Lanka and Pakistan demonstrates the strong political context in which foreign aid and trade openness play out. In both situations, times of relative political calm go hand in hand with better results for growth and better absorption of aid and trade benefits. On the other hand, higher levels of political uncertainty have always been followed by lower growth, less policy effectiveness and more macroeconomic volatility.

6.1 Aid, Trade, and Growth under Relative Political Stability

The results suggest that aid receipts and trade liberalisation had better economic consequences for both Sri Lanka and Pakistan in the years of relative peace. During these times, policy continuity was enhanced, investment responses more robust, and more likely to be implemented as intended, and aid-funded programs more likely to be implemented as intended.

In Sri Lanka, better governance capacity after the conflict was ended, was matched by economic growth and policy predictability. In these periods, external support helped in the reconstruction, infrastructure investment and stabilization while trade integration helped in export growth and sectoral recovery. Despite the presence of structural constraints, the effects of peace, conflict avoidance, and better policy coordination enhanced the growth effect of aid and trade (World Bank, 2023).

There is also an indication from Pakistan that aid and trade had a positive and more positive impact on economic performance in more politically stable and in more stable environments for the implementation of economic reforms. The better policy clarity and less political turmoil were correlated with better growth and external balances. In such settings, inflows of aid alleviated financing pressures, and trade liberalization facilitated export activity and economic growth, but not necessarily in a sustained manner.

6.2 Political Uncertainty and Weakening of Aid Effectiveness

The second big result is that, in both countries, the effect of foreign aid on growth was considerably dampened by political uncertainty, albeit via different channels. Post-conflict political instability due to conflict dynamics and the attendant governance issues in Sri Lanka affected the efficiency of public investments and made long-term planning more challenging. But in times of instability aid inflows continued, but were not able to support sustained growth due to delay in implementation, changing priorities and institutional tensions.

Political uncertainty in Pakistan had a constraining impact on the effectiveness of aid more persistently. The credibility of reform was diminished by the frequent change of government, by the contestation of authority, and by policy changes. Aid frequently served a stabilizing function for a limited period of time, but did not have the same impact on long-term structural change. The results indicate that over time, political instability has led to greater reliance on cycles of adjustment, limiting the potential of aid to boost growth (IMF, 2025).

The hypothesis that aid has a more positive impact on economic performance under conditions of political stability has been supported by these patterns, as political uncertainty reduces the effectiveness of the aid by undermining institutional capacity and policy continuity.

6.3 Trade Openness, Political Uncertainty, and Growth Outcomes

The study also finds that none of the other variables are associated with sustained growth when political stability is absent. While there was a clear relationship between growth of trade-to-GDP ratios and long-term productivity growth in low political uncertainty countries, this correlation was not always observed in high political uncertainty countries in both.

Performance in trade sectors has been better in the more stable years, especially if accompanied by governance reforms and coordination of policies to promote export competitiveness in Sri Lanka. But periods of political turmoil led to investor uncertainty and thereby constrain firms' reactions to trade opportunities. Political uncertainty had a greater impact on trade outcomes in Pakistan. The benefits of greater openness for growth were blunted by policy volatility, exchange-rate instability and inconsistent trade strategies, which shortened the planning horizon of exporters, even as they increased their participation in world trade (Rodrik, 2001).

The results are in line with the second hypothesis: the positive impacts of openness to trade on economic growth become smaller with higher political uncertainty. The advantages of trade seem to be multifaceted, not only the openness of trade but also the stability and credibility of the policy framework within which firms grow and develop.

6.4 Comparative Differences in Magnitude and Persistence

Political uncertainty hindered development results in both instances, but to differing degrees and for varying durations. In Sri Lanka, the disruptions were more intense but more intermittent, and in

many cases associated with conflict or governance issues after the conflict. Where uncertainty was reduced, the economy was less hampered in its ability to rebound and take advantage of aid and trade.

Political uncertainty, on the other hand, was more enduring in Pakistan, as several instances of instability and policy discontinuity were observed. The result was greater continuity of negative impacts on aid and trade outcomes and recurring macroeconomic volatility and uneven growth performance. Partly this contrast is responsible for the more lasting effects of similar development instruments on Sri Lanka in more stable times than on Pakistan.

6.5 Summary of Key Findings

Overall, these findings suggest that uncertainty in the political landscape plays a pivotal role in the relationship between aid, trade and economic performance in Sri Lanka and Pakistan. Political circumstances were at their best when they enabled policy continuity and institutional credibility, and this was most effective for aid and trade. As uncertainties became greater, the growth-promoting properties of these instruments diminished greatly. The results confirm the notion that development strategies must be analysed within political contexts.

7. DISCUSSION

The results of this research support some key conclusions of the theory on political economy of economic policies and external development instruments: economic policies and external development instruments are not independent of political context. Political conditions affecting incentives, expectations and institutional performance are closely connected to foreign aid and trade openness. The comparisons with evidence from Sri Lanka and Pakistan show that the extent to which aid and trade are effective in bringing lasting economic benefits is heavily influenced by political uncertainty.

As previous studies have found, the results indicate that political uncertainty has a negative impact on economic performance, by reducing policy credibility and long-term investment. In a government in which leadership changes often, the authority of the government is challenged, or when the country is experiencing disruption due to conflict, the credibility of the commitment to economic reforms is decreased. To this uncertainty, firms and investors react reducing their capital formation, by shortening planning horizons, and by making risk-averse choices, which slow growth (Alesina et al., 1996). In this context, large aid inflows or high levels of openness of trade can turn out to be insufficient to produce lasting economic benefits.

The results also shed light on the mixed results of the empirical literature on the effectiveness of aid. Optimistic studies of the impact of aid tend to focus on the importance of good policy, and institutional stability, which implicitly highlights the importance of political conditions (Burnside & Dollar, 2000). This conditional view is further supported by the Sri Lanka/Pakistan comparison which indicates that aid was more effective during relatively politically stable times. Aid was more likely to provide short-term stability in circumstances where the situation was uncertain, and less likely in circumstances where it was possible to contribute to long-term structural change. This indicates that it might be wrong to question whether or not aid "works" if those questions ignore political uncertainty as a conditioning factor.

The same trend is observed for the trade openness. The results suggest that, although trade integration is usually linked to growth-promoting effects like gains in efficiency and technology diffusion, these benefits require high levels of policy predictability and institutional credibility. Political uncertainty dampened firms' ability to adjust to trade incentives in both Sri Lanka and Pakistan, as uncertainty on the exchange-rate policy, regulatory regimes, and market access conditions grew. This helps to explain the arguments that trade liberalization is not enough to produce growth if the political and institutional environment is unstable (Rodrik, 2001). In politically uncertain settings, openness to trade might lead to higher vulnerability to external

shocks and not provide long-term productivity improvements.

That political uncertainty is not an 'undifferentiated phenomenon' is reinforced by the comparative dimension of the analysis. Uncertainty was more episodic in Sri Lanka, with periods of uncertainty associated with the dynamics of conflict and the difficulties of post-conflict governance. As uncertainty receded, economic resilience increased, and the ability to use aid and trade to recover and build up increased as well. Political uncertainty in Pakistan was more entrenched and institutionalised and had seen several political changes and policy reversals. This persistence lowered the cumulative growth effect of aid and trade, by failing to maintain the reform process. These differences illustrate the need to consider both the nature and the form of political uncertainty, as well as its institutionalization and its duration.

In particular, the results highlight that political uncertainty cannot be considered a background variable or statistical control in development research. Rather, it acts as a central mechanism that influences the activities of economic policies and their external resources. This study makes a contribution to understanding development outcomes that integrates economics and politics by putting political uncertainty as a moderating variable in the aid – trade – growth nexus.

All in all, the discussion indicates that development policies based on aid and trade need to be assessed in the political system in which they are to be conducted. Political stability, institutional credibility and policy continuity are important that cannot be overlooked even for well-designed economic measures to have the desired effect. This knowledge is relevant for the academic study as well as policy design in politically volatile contexts.

8. CONCLUSION

This paper aimed to investigate the effect of foreign aid and trade openness on economic performance with political uncertainty being a conditioning factor and not a background factor. The comparative analysis of Sri Lanka and Pakistan shows that political uncertainty is a key determinant to the effectiveness of development strategies. It was determined that aid and trade had a more positive impact on economic performance when relative political stability prevailed, and that increased political uncertainty undermined policy credibility, induced investments to be more diverted and reduced the persistence of growth results.

The comparative evidence indicates that the political environment can yield very different economic outcomes from similar development instruments. Sri Lanka experienced stronger growth sensitivity to aid inflows and trade integration during less conflict and more policy continuity in the country, although the country was still structurally vulnerable. In Pakistan, the more enduring types of political instability and policy volatility reduced the long-term effects of aid and trade, and helped to push macroeconomic stress and uneven growth into a recurring pattern. These patterns illustrate the main conclusion of the study that the way in which aid and trade affect economic performance depends on the uncertainty in the political sphere.

The study is a political economy analysis of aid and trade that adds to the ongoing debate on effectiveness of development. It can account for the apparent variation in empirical results with regards to aid and trade across countries and over time. The results indicate that neither aid nor trade is, in and of itself, good or bad, but rather that it is how political institutions can sustain policy commitments and manage uncertainty that matters. This is a position that is similar to conditional approaches to aid effectiveness and institutional critiques of trade liberalization and an extension of these in a focused comparative framework (Alesina et al., 1996; Burnside & Dollar, 2000; Rodrik, 2001).

The findings of the study have also significant implications for policy towards development. The outcomes make clear to donors, trade partners and national policy makers that the technocratic solutions without taking account of political context are limited. When negotiating aid allocation and trade agreements, not fully

considering the political uncertainty can lead to short-term stabilization and no long-term growth. Thus, there is a need for policies that enhance economic performance to be complemented by measures that boost political stability, institutional credibility, and policy continuity.

Finally, this study highlights the importance of comparative political economy studies to the explanation of development outcomes. The study is mostly on Sri Lanka and Pakistan, but the findings are applicable to other nations grappling with similar issues of aid dependency, trade integration and political instability. The framework could be expanded to include the analysis of other cases, or use econometric techniques to test the conditioning effects of political uncertainty in general. This study's emphasis on politics in the analysis of economic development provides a more nuanced and realistic understanding of what works and what doesn't in terms of growth strategies.

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