This can lead us to the conclusion that foreign assistance can be an important contributor to reinforcing a growth path for a developing economy, although it may also simply permit the diversion of domestic funding to either government or private consumption (see Figure 2). Traditional neoclassical growth theory argues foreign assistance helps to increase investment and possibly savings in the short term, leading to short-term GDP increases. In the longer term, neoclassical growth theory has a role for aid by transferring new technological "paradigms" which allow a country to move on to the next steady-state growth path. New or endogenous growth theory argues that aid works through improving inputs, particularly labour through better education, learning by doing and technological transfer. Naturally, both sides of the growth theory debate believe that this assistance must be of the right type, and targeted efficiently.

In an accounting framework, where the current account deficit of the balance of payments equals the difference between national savings and investment, the effectiveness of foreign assistance on domestic economic performance cannot be determined in advance. The increase in disposable income resulting from an inflow of foreign assistance could be either invested or consumed (see Boone's empirical findings below), depending largely on the perceived permanence of the higher level of foreign savings. Thus, uncertainty regarding the permanency of aid inflows could discourage private investment. At the same time, the large increases in public sector investment frequently associated with foreign aid, even in the form of grants, can have a negative impact on domestic savings over the medium term by often leading to a deterioration in the fiscal position. In addition, the success of foreign aid, and the absorption of higher levels of aid in particular, is likely to depend to a large extent on the capacity of governments to use the aid efficiently. It is conceivable that once the absorptive threshold of foreign assistance has been reached, additional inflows of foreign aid could become counterproductive.

A branch of the literature on the real exchange rate has noted that foreign aid can sometimes have an undesirable effect on economic performance. When a part of foreign aid is spent in the non-traded goods sector, the ensuing upward pressure on the domestic price of non-traded goods causes the equilibrium real exchange rate to appreciate, thus harming external competitiveness. Moreover, the resulting improvement in the profitability of the non-traded goods sector induces labour to move out of export-oriented activities (such as export agriculture) into service-oriented activities. A fall in labour supply in agriculture puts upward pressure on labour costs in agriculture, thus lowering the profitability of this sector. The resulting decline in external competitiveness hurts export performance and, in