28 FOREIGN INVESTMENT, AID, TRADE AND DEBT

28.1 The meaning of FDI and MNCs

Learning outcomes

- Describe the nature of foreign direct investment (FDI) and multinational corporations (MNCs).

Foreign food aid being delivered.

Foreign direct investment

As you now know, countries can become trapped in the poverty cycle. In its simplest form, the poverty trap shows how limited income makes it difficult to accumulate savings. Without savings, there is little available capital to grow the economy. To break free, many countries seek out foreign injections of money and capital goods. These injections take the form of foreign direct investment (FDI) and foreign aid (Figure 28.1, overleaf). Countries often incur significant foreign debt in the process. This chapter describes each strategy and explores its effectiveness.

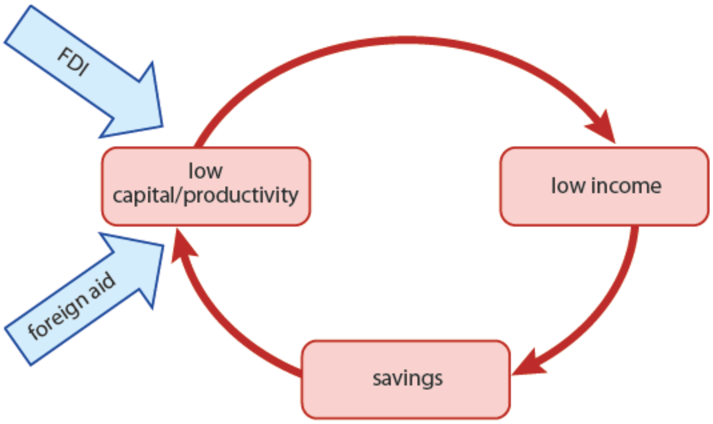


Figure 28.1
Aid and FDI can break the poverty trap.

FDI refers to the long-term investment by a company into the market of another country. Inward flows of FDI to a country are when foreign companies invest in the domestic market of that country. Outward flows of FDI are when domestic companies do the same in foreign markets.

Foreign direct investment is the long-term investment by foreign firms into the domestic markets of other countries.

Typically, FDI occurs when foreign companies purchase productive assets, such as factories, mines and land. These private companies are, by the act of FDI, multinational corporations (MNCs) that are seeking profits by moving or expanding operations to new countries. FDI can be classified as either greenfield investment (when companies construct new facilities from scratch) or brownfield investment (when investors purchase or lease existing facilities).

28.2 Conditions that favour MNC investment

Learning outcomes

- Explain the reasons why MNCs expand into economically less developed countries.
- Describe the characteristics of economically less developed countries that attract FDI, including low-cost factor inputs, a regulatory framework that favours profit repatriation and favourable tax rules.

MNCs and developing countries

There are tens of thousands of multinational corporations, with hundreds of thousands of branch affiliates all over the world. A multinational corporation is typically a large company with trading, manufacturing or service operations across several countries. They are also called trans-national corporations (TNCs). Their initial growth happened in the 1950s as the US moved company offices and factories to Europe at the end of World War II and the start of the Cold War. After steady growth for several decades, FDI exploded in the 1990s.

A multinational corporation is a large company with trading, manufacturing, or service operations across several countries.

While trade has increased four times more rapidly than GDP, FDI has increased even more quickly. This is partly due to the liberalization policies of many developing countries during the 1980s and early 1990s, as well as to the newly emerged transitional economies moving from central control to market-based systems. Table 28.1 shows the 10 largest multinational corporations, ranked on the basis of their foreign holdings.

TABLE 28.1 TOP 10 MULTINATIONAL CORPORATIONS (NON-FINANCIAL), BY FOREIGN ASSETS.				
Corporation	**Home**	**Industry**	**Foreign assets / millions $**	**Foreign employment**
General Electric	US	Electrical and electronic equipment	401 289	171 000
Royal Dutch / Shell	Netherlands	Petroleum expl. / ref. / distr.	222 323	85 000
Vodafone Group	UK	Telecommunications	201 570	68 747
BP	UK	Petroleum expl. /ref. / distr.	188 969	76 100
Toyota	Japan	Motor vehicle manufacture	169 568	121 765
ExxonMobil	US	Petroleum expl. / ref. / distr.	161 244	50 337
Total	France	Petroleum expl. / ref. / distr.	141 442	50 858
E.On	Germany	Utilities (electricity, gas and water)	141 168	57 134
Electricité de France	France	Utilities (electricity, gas and water)	133 697	51 385
Arcelor Mittal	Luxembourg	Metal and metal products	127 127	239 455

UNCTAD, *World Investment Report*, Annex Table 26

Clearly, the largest MNCs come from developed countries. Inflows are expected to total more than 1.1 trillion USD in 2010, and potentially up to 2 trillion USD as soon as 2012. Currently, much FDI flows back and forth between developed countries. However, in 2010, nearly half of FDI inflows went to developed countries, with the other half going to developing countries. Flows of FDI dropped in 2001 and again, because of the recession, in 2008–09 but, in each case, the rebound of FDI has been due to increased flows to developing countries. This suggests that future growth of FDI will be in developing countries.

Figure 28.2 shows the flows of FDI by developed nations and developing regions. A few items stand out. First, China receives more FDI than nearly all of Latin America, more than all of its East Asian neighbours combined, and more than all of South and Southeast Asia, which includes India. Also, note that FDI inflows for Asian countries are nearly double that of the rest of the developed world, including Latin America, the Caribbean, and North and South Africa.

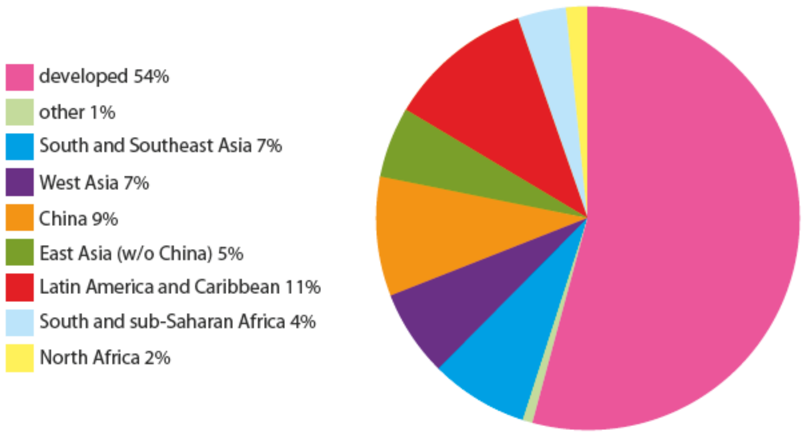
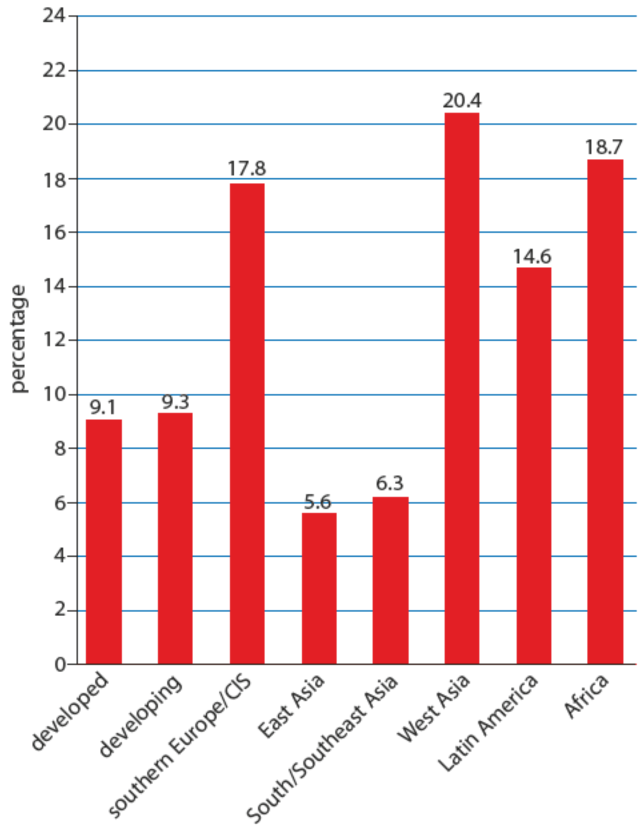


Figure 28.2
FDI inflows by economy type and region.

based on UNCTAD, *World Investment Report*, Annex Table 1

Assuming that developed countries continue to invest in developing ones in the future, which regions will benefit most? Already some regions are rather reliant on FDI as a percentage of their overall investment. Figure 28.3 (overleaf) shows selected regions and the percentage of total private investment that is made up of FDI.

Figure 28.3
FDI as a percentage of private investment.



FDI makes up roughly the same percentage of investment in developing and developed countries. But there is wide variation in the importance of FDI to different regions. For East, Southeast, and South Asia, private investment is not especially dependent on FDI. West Asia, Africa, Southern Europe/CIS, and Latin America all depend more heavily on FDI for investment.

It is also relevant to compare the size and power of the largest MNCs to the economies into which they are investing. In 2009, the sales of the top 10 MNCs (Table 28.1) nearly equalled the GNI of all of South America, and were nearly double that of all of African countries combined. These MNCs are quite large when compared to the countries in which they are investing. This amplifies their importance and influence and, as FDI is expected to grow in the coming years, this is an important factor in developing sound policies for the attraction and retention of FDI.

Why MNCs are attracted to developing countries

The gap between investments in different regions suggests that MNCs are seeking particular characteristics in a host country. Whether the aim is to produce locally and export back to the home country, or to produce and sell in the host country, all MNCs are seeking profitability and stability. The chief attractions of an LDC as an FDI host are discussed below.

Low-cost labour

Many MNCs choose to relocate production to countries where the per-unit labour costs are much lower. This lowers overall costs of production for these goods, even when transport costs are included. In labour-intensive industries, such labour costs are critical and, as wages rise in one country, MNCs seek out lower-wage production elsewhere.

Natural resources

Access to natural resources – be they mineral, metal, timber, or fossil fuel – can draw the interest of many foreign investors. Some countries in Africa and Southeast Asia have recently been recipients of attention from China, in the form of aid and foreign investment. Typically, these countries are resource rich, reflecting China's need to create new supply lines for its growing economy.

Political stability

MNCs generally cannot afford to make substantial investments in areas where the political order is not clear. They prefer countries where the political environment (democratic, autocratic, single-party state, or otherwise) is stable.

Large domestic market

Part of the attraction of emerging markets is that the MNCs' products can be sold to the local population as well. Thus, for some MNCs, the attraction of foreign investment is to export to the rest of the world (and perhaps back to the home country) and to expand the market for the MNC's goods by direct presence in the country. This explains the natural advantage that China and India possess, having huge domestic markets and major growth potential as incomes rise.

Relaxed regulatory environment

Developing countries may relax their regulation of markets in the hopes of garnering more FDI. This deregulation can take several forms.

- **Profit repatriation.** Relaxing of rules on the repatriation of profits, so MNCs can more freely redirect profits to the home country.
- **Tax rules**. Tax rules for corporate profits may be reduced to entice investment. Ireland, which has one of the lowest corporate tax rates in Europe, has resisted increasing this rate, despite a major budget deficit, because it attracts FDI.
- **Property rights**. A respect for property rights, so that firms are not dissuaded from investing by the fear of government takeover or the confiscation of assets through corrupt practices.
- **Health and safety regulations / pollution control**. MNCs may be drawn to a country because the reduced health, safety and pollution regulations mean lower production costs for the firm.

Liberalized free market conditions

Firms also want to see markets open in the general sense. This means they want to see the following conditions.

- **Free trade**. Foreign firms that need to secure imported factor inputs will want open trade, free of tariffs and other protectionist measures.
- **Privatization**. Some MNCs see opportunity in countries that are in the process of privatizing their state industries. Privatization theoretically means new opportunities for outside firms whether their presence is as a purchaser of the industries, or as a supplier of services.
- **Tradable foreign exchange**. Firms prefer to convert domestic currency profits into their home country currency. Exchange controls that limit the amount of foreign capital flow discourage investment.

28.3 Evaluation of FDI

Learning outcomes

- Evaluate the impact of foreign direct investment (FDI) for economically less developed countries.

Because the expansion of FDI is expected to continue, it is critical for developing countries to assess the value of FDI for their own development plans. Keeping in mind the variety of developing countries, as well as the differences between types of FDI, it is still possible to make some generalizations about the desirability of foreign investment.

Advantages of FDI

Capital improvements

- Capital injections can help to break the poverty cycle by injecting much-needed capital goods and finance.
- The foreign purchase of domestic assets brings money into the capital account of the balance of payments, enabling more imports of foreign consumer and capital goods.
- Foreign investment can induce LDC governments to invest in infrastructure to support the new firms. This may have spin-off benefits to the country at large if the works projects have other useful applications.
- Some forms of FDI provide opportunities for enhanced research and development, which may expand technical capital in the greater economy.
- FDI can stimulate domestic industry when the MNC buys locally produced capital goods and services.
- Technology transfer improves the country's capital stock. As foreign firms bring in new and more advanced technology, domestic rivals and suppliers are inspired to adapt technologically as well.

Income, employment and training

- Employment is increased:
  - where foreign firms hire significantly from the domestic workforce; this increased employment increases incomes and tax revenues
  - where firms improve the skills of workers; here FDI can increase human capital through training.
- The increased income accruing to workers and to the MNC is subject to taxation. These increased tax revenues might be used for development purposes such as improved healthcare and education.

Market efficiency and choice

- MNCs may compete with complacent domestic industries. The added competition should lower prices and increase market efficiency domestically.
- If MNCs help a country realize its comparative advantages, world trade is enhanced and lower prices result.
- For domestic consumers, the arrival of foreign firms may initiate meaningful choice in the market for goods and services.

Disadvantages of FDI

Muted effects on employment

- Foreign firms may choose to bring large amounts of management personnel to launch and administer the company. In this case, the employment growth only comes to the low-skilled and low-wage labour force.
- Where foreign management stays in place, the expected training and skills transfer effect is limited.
- Some industries do not hire workers extensively as they are capital intensive. Thus, some FDI companies that earn large revenues have relatively few domestic workers.

Limited income benefits

- **Repatriation of a foreign firm's profits limits the income growth benefits of FDI.** For example, the Swedish house-goods firm IKEA sends its profits home to Sweden. Thus, the impact of IKEA's presence in any country is limited to employment, input sourcing, and perhaps infrastructure benefits.
- **Foreign firms use accounting methods to avoid taxes.** To pay less in tax in a high-tax country, firms try to show that they are making smaller taxable profits. The method used is called transfer pricing: firms show that they pay for resources from affiliates with prices higher than actually paid. For example, Company X in India might claim that it bought an input resource like steel from the Company X factory in Korea at $500 a beam. In reality, the Korean branch of Company X produces the beam at a much lower cost. This makes Company X in India appear less profitable, and thus pay lower corporate taxes in India. It is in this way that LDCs gain less tax revenue than they might otherwise hope.

Limited capital injections

- Countries like China sometimes require that the foreign affiliate be paired with a domestic company in a joint venture, in the hope that some transfer of managerial and technical skills will take hold. In other instances, domestic companies are bought through transfers of share ownership in the new foreign parent company. In either case, the benefit of supposed capital injections is lost. Rather than receive cash for their shares, domestic owners are merely tied to the fate of the new parent firm.
- There is no guarantee that the investment spending from FDI companies comes from outside the domestic economy. In reality, many firms borrow from local financial markets. This pushes up borrowing costs and crowds out domestic firms who are seeking credit. It also limits the expected benefits of external credit injections.

MNC power

Some MNCs earn more in revenue than the GDP of many small LDCs. They come armed with highly skilled lawyers, accountants and political lobbyists, seeking the best return on their investment. Many development economists, politicians and non-governmental organizations have concerns that this presents opportunities for predatory behaviour by MNCs.

- **Influence over regulatory environment**. Through the reduction of tax revenues, environmental degradation and exploitation of workers, it is believed that governments may achieve 'uneconomic growth' in the race to attract FDI. This process is known as the 'race to the bottom': companies seeking the lowest possible costs pressure the governments of LDCs to relax their regulatory policies over taxes, and over environmental and worker protection.

- **Taxes.** Attempting to lure investors, countries often compete to reduce tax burdens for foreign firms. They may also create special investment zones with discounted land purchase and other financial enticements such as easy repatriation of foreign exchange profits.
- **Environment.** It is suspected that MNCs seek out countries where environmental rules are relaxed. This allows companies to pollute in a variety of ways, without making recovery efforts. A clear example of this is the business of selling the rights to dump rich-world garbage in poor countries. Whatever is salvageable in this waste, particularly hi-tech products like computer parts, is often highly toxic to extract and expensive to do properly. It is shipped to cities like Guiyu, China, where it is broken down cheaply but dangerously. However, it should also be said that some evidence has emerged that the movement of MNCs to China, for example, has coincided with a reduction in pollution levels because of enhanced production technology.
- **Worker rights.** It is often argued that MNCs move production to low-wage countries where it is difficult to organize unions, and where workers' rights are not valued. While the employment offered by MNCs increases incomes above what was previously available, the common practice of subcontracting (outsourcing) means that large MNCs can practise 'deniability' when their subcontractors exploit workers by withholding wages or creating poor work conditions.
- **Overwhelming competition with local industry.** Large multinationals already enjoy many of the benefits of economies of scale. With their production, marketing, inventory control, and distribution systems already established, they often have an enormous competitive advantage over domestic firms. This may kill local industry and eliminate the possibility of domestically owned firms.

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CASE STUDY

Big sporting events: real investment or all flash?

Just how much international sporting events such as the World Cup contribute to human development is debatable.

Poor and middle-income countries hoping for a taste of international prestige must have been inspired by South Africa's hosting of the World Cup in 2010. Millions of visitors streamed into the country, injecting large amounts of foreign cash and cachet. The games went off without serious incident or technical problems or violence and were, to most observers, a shining success. But to others, the allure of major competitions like the World Cup and the Olympics are more mirage than substance. Hosting such tournaments offers up all the glitter of foreign direct investment, with few of its benefits and all of its drawbacks.

Such events promise large amounts of foreign exchange, but this is usually a one-time injection. Rather than receiving foreign capital, countries typically go deeply into debt, diverting local capital away from local needs to build the necessary infrastructure to host these events. In poor countries, this may result in some new roads and mass transit links, but it also requires expensive stadium projects that are luxurious by regional standards. These hulking 'white elephants' are often barely used again, and live on as ugly memories of an expensive party the country hosted years before: Greece's white elephants from 2004 are famous, and as early as 2009 the glorious 'Bird's Nest' in Beijing was falling into disrepair from lack of use. Suspicions about the predatory nature of some FDIs were further bolstered when it was revealed by the Dutch government that FIFA, the World Cup governing body, pressed it and other bidding countries to implement special laws for the World Cup – including blanket tax exemptions for FIFA and FIFA sponsors, as well as limits on workers' rights.

If this can happen under the public spotlight of a major sporting event, critics wonder, then what kind of deals and exemptions might apply during the routine approval of more mundane investment projects in more remote places? Better to win on the pitch, it is said, than to play a losing game off of it. South Africans, who spent $5.1 billion on the games, are prepared for a spending hangover, but appear to be pleased with the results. And it is expected that the quest to host such events will continue. The cost, it is argued, is well worth it in the name of enhancing a country's 'brand.' At the same time, it could be said that such tournaments are rarely justified economically, unless one counts the losses as 'psychic income,' and believes that LDCs should have the same opportunities to misspend their money that rich ones have.

EXERCISES

1. To what degree is the comparison between FDI and the hosting of a major sporting event a valid one?
2. If we assume that staging these events is a net loss for the countries involved, to what degree is this economically justifiable? In what ways is it not?
3. How might developing countries protect themselves from the abuses and waste these events typically see?

28.4 Foreign aid

Learning outcomes

- Explain that aid is extended to economically less developed countries either by governments of donor countries, in which case it is called official development assistance (ODA), or by non-governmental organizations (NGOs).
- Explain that humanitarian aid consists of food aid, medical aid and emergency relief aid.
- Explain that development aid consists of grants, concessional long-term loans, project aid that includes support for schools and hospitals, and programme aid that includes support for sectors such as the education sector and the financial sector.
- Explain that, for the most part, the priority of NGOs is to provide aid on a small scale to achieve development objectives.
- Explain that aid might also come in the form of tied aid.
- Explain the motivations of economically more developed countries giving aid.
- Compare and contrast the extent, nature and sources of ODA to two economically less developed countries.

Official aid

Foreign investment is one way to inject capital into the poverty cycle experienced by many countries. Foreign aid is another. It can be defined as financial, technical and in-kind assistance to other countries. Aid can be given by foreign governments – when it is called official development assistance (ODA). Or it can be given by non-governmental organizations (NGOs). Aid flows are tracked by the Organization for Economic Cooperation and Development (OECD).

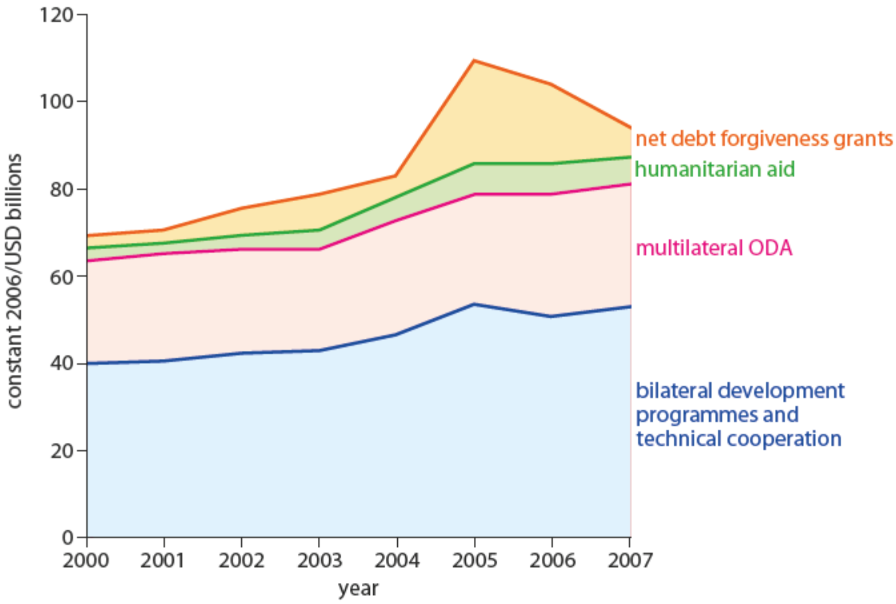
Development aid is the name for long- or short-term loans, grants, and technical assistance for the purpose of increasing the living standard of another country.

Development aid tends to have a longer-term focus and consists of outright grants or concessional long-term loans. It includes project aid that could involve support for schools and hospitals. It can involve programme aid that supports continuing efforts to build whole sectors such as education, healthcare and finance.

Government aid

Donor country governments can give directly to another country – this is called bilateral aid. Alternatively, donors can contribute to multilateral organizations like the United Nations, World Bank, IMF, or regional development banks like the Inter-American Development Bank. Subgroups with specific goals (e.g. UN Children's Fund) can also be the focus of specific giving. These organizations administer the flow of aid according to their aims and goals. In 2007, about two-thirds of ODA was bilateral aid. Figure 28.4 shows the flow of aid according to these distinctions.

Figure 28.4
Sources and types of aid, 2000–07, shown cumulatively.



OECD, *Aid targets slipping out of reach?*, 2008

ODA flows are concessional in nature: they are required to consist of at least 25% grant money, and the rest in long-term loans with relatively easy terms. These loans can be in some combination of local currency and the currency of the donor. In reality, up to three-quarters of ODA funding is grant money, the rest is loans.

Types of aid

Foreign aid takes many forms, but can generally be classified as follows.

- Debt relief grants to heavily indebted LDCs.
- Technical assistance to LDCs such as engineers, doctors, agricultural experts.
- Development assistance in the form of aid to whole sectors such as education or healthcare or specific institutions such as hospitals, schools, and economic cooperatives.
- Humanitarian aid given for emergency relief in disaster areas after tsunamis, earthquakes and famine. This can consist of emergency help, medical aid and food aid.
- Commodity assistance such as the purchase of seeds, fertilizer, equipment, building materials or other essential commodities to encourage the smooth operation of some markets as well as to prevent economic or health sector shocks.

Aid from NGOs

Aid provided by NGOs typically has a more specific purpose or operates on a smaller scale than ODA. Oxfam, which is dedicated to poverty relief and the advocacy of fair trade, is one of the more famous NGOs. Also well known is *Médecins Sans Frontières*, which sends medical relief to areas of emergency and long-term need.

NGOs focus on areas that official aid may not reach. Poverty relief, accomplished by working closely with desperate communities, is a major emphasis. Many NGOs focus specifically on women's issues, in particular prenatal care, abuse prevention, childcare, and women's healthcare.

A non-governmental organization is typically a non-profit group that is created for a set of specific, public-action purposes, including development work.

Donor motivation for giving aid

Political and strategic

In some instances, previous colonial powers might provide aid to their former colonies, in part because of business and political relationships stemming from the colonial years. In general, Cold War calculations motivated most of the post-World War II assistance thinking. The US justified expensive reconstruction efforts in South Korea, Japan and Western Europe based on Cold War strategy. An extension of this tendency in modern aid is the fact that bilateral aid, where one country gives directly to another, is perhaps more likely to be politically or strategically motivated. Table 28.2 shows the top 10 recipients of foreign aid by country.

TABLE 28.2 TOP RECIPIENTS OF FOREIGN AID, BY COUNTRY, 2008

Country	Aid / billions of dollars
Iraq	9.8
Afghanistan	4.8
Ethiopia	3.3
Palestine	2.5
Vietnam	2.5
Sudan	2.3
Tanzania	2.3
India	2.1
Bangladesh	2.0
Turkey	2.0

Money spent on Iraq and Afghanistan is given with the stated objectives of securing peace, preventing conflict and building stability, democracy and economic growth through military and development means. The large amounts given to Palestine, Sudan, India, Bangladesh and Turkey could arguably be considered in the same light.

Economic

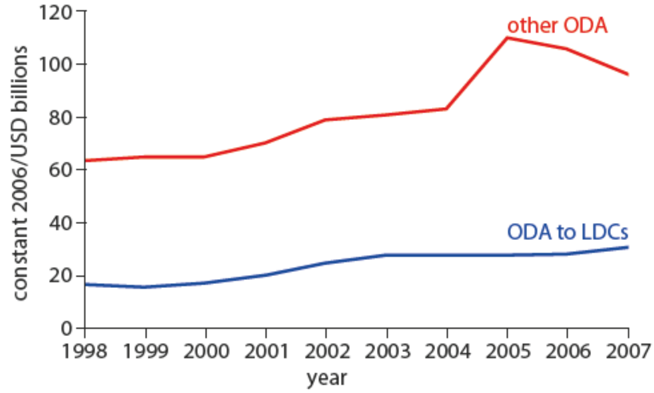
Countries may provide aid as a means of conducting good business in countries where business relationships are valued and perhaps natural resources are coveted by the donor country. Australia, for example, gives substantial aid to Indonesia and other nearby Asian trading partners when other countries have greater need.

In other instances, aid given to countries without special economic ties to the donor country may be linked to the commercial interests of the donor. Called tied aid, this can take the form of sending equipment and materials from the donor country. This may have the benefit of stimulating demand in the donor country, but probably limits the effectiveness of the aid, particularly when the donations are of goods inappropriate to the recipient country's level of technology (e.g. sophisticated tractors in lieu of simple farm equipment). On a per-dollar basis, the receiving country receives less value and derives less benefit from such transactions.

Humanitarian

Emergency assistance to disaster-stricken areas after tsunamis, earthquakes and hurricanes all qualify as short-term humanitarian aid. Other, more enduring aid efforts are aimed at the relief of long-term poverty in much of the developing world. For instance, the United Nations Development Programme has championed the refocusing of growth policies towards development goals. This effort culminated with the UN Millennium Goals for 2015. Nevertheless Figure 28.5 (as well as Figure 28.4) suggests that political and economic interests form most of the motivation for donor aid. If the needs of the poorest countries were a priority, one would expect ODA funding to go predominantly to LDCs. But this is not the case. Less than one-third of ODA funding goes to LDCs.

Figure 28.5 Proportion of ODA given to LDCs and non-LDCs.



CASE STUDY

Afghanistan and Uganda

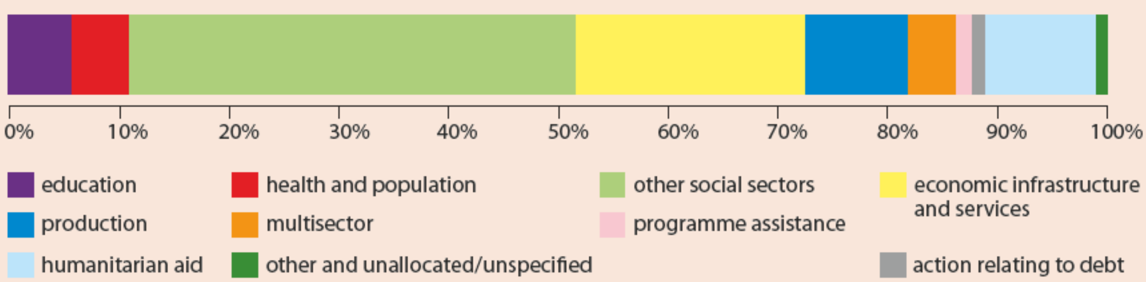
OECD statistics make it possible to see more clearly the differences in the scope and nature of aid in different countries. The OECD 'at a glance' files give information about the donor sources of aid, amounts, and areas where aid is directed within a recipient country. Figures 28.6 and 28.7 show the situation in two countries at similar levels of development. On the 2010 HDI, Afghanistan is 155th, while Uganda is ranked 141st. However, they are in different parts of the world, with rather different aid profiles.

Afghanistan

Receipts	2006	2007	2008
net ODA (USD million)	2956	3965	4865
bilateral share (gross ODA)	84%	79%	86%
net ODA / GNI	36.1%	39.0%	..
net private flows (USD million)	19	13	37

Receipts	2006	2007	2008
population (million)	no data available		
GNI *per capita* (Atlas USA)	no data available		

Top ten donors of gross ODA (2007-08 average)	(USD m)
1 United States	1816
2 EC	328
3 United Kingdom	296
4 Canada	277
5 Germany	256
6 IDA	251
7 Japan	155
8 Norway	112
9 Turkey	107
10 Netherlands	100



OECD

Figure 28.6 Afghanistan ODA 'at a glance'.

Uganda

Receipts	2006	2007	2008
net ODA (USD million)	1539	1737	1657
bilateral share (gross ODA)	61%	58%	61%
net ODA / GNI	15.8%	14.9%	11.7%
net private flows (USD million)	20	38	112

Receipts	2006	2007	2008
population (million)	29.7	30.6	31.7
GNI *per capita* (Atlas USA)	340	370	420

Top ten donors of gross ODA (2007-08 average)	(USD m)
1 United States	327
2 IDA	277
3 EC	210
4 United Kingdom	116
5 AfDF	116
6 Denmark	97
7 Netherlands	77
8 Ireland	73
9 Norway	72
10 Sweden	60

bilateral OAD by sector (2007-08)

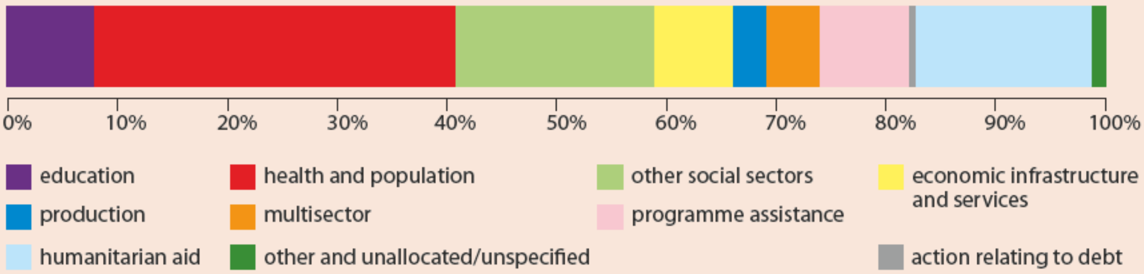


Figure 28.7 Uganda ODA 'at a glance'.

OECD

The two countries have similar population numbers – roughly 30 million people. Both have extremely low GNI *per capita*. Afghanistan's GNI is not listed in Figure 28.6 because reliable statistics are hard to come by; it is estimated to be about $1100 per year. Uganda's GNI *per capita* is much less, between $340 and $420 per year. It would seem that Uganda is significantly poorer in income terms, although roughly equal in development terms. However, the developed world sent Afghanistan between 3–5 billion dollars per year between 2007 and 2009, while Uganda received from a half to a third of that amount.

We can infer reasons behind this discrepancy. Afghanistan, a centre point of conflict against the terrorist group Al-Qaeda, is likely to be receiving much more aid because of its perceived strategic importance. The recent discovery of more than $1 trillion of mineral deposits has added economic incentives to the motivation for aid giving. Although Uganda has also been made aware of significant oil deposits, it does not possess the strategic 'advantage' of Afghanistan.

Who is donating to each country? If we look at the bilateral share of ODA, we can determine how much aid is bilateral compared to how much is from multilateral organizations. Most of the aid in each case each is bilateral; Afghanistan's bilateral ODA is over 80% while Uganda's bilateral share is 60%. On the individual country donor list, it is clear that the US gives nearly $1.5 billion more to Afghanistan than Uganda. This makes up a large portion of the discrepancy between the two countries, and can be understood in terms of the US role in counter-insurgency efforts in Afghanistan since 2002.

Other differences emerge when the areas receiving aid money are compared. While the percentage of aid spent on education is similar, less than 10%, Uganda spends much more on health and population issues than Afghanistan. Afghanistan spends far more on the category called 'other social sectors,' which includes water and sanitation, other population and health spending, government and civil society, and conflict, peace and security. One might guess that the last several categories are particularly important in Afghanistan, as the members of the North Atlantic Treaty Organization (NATO) – including the top five donors to Afghanistan – have attempted to rebuild the country's institutions and government in the wake of the attacks on the Twin Towers (11 September 2001), several years of destructive Taliban rule, and nearly 20 years of guerrilla war against the USSR.

In other areas, spending on infrastructure is higher in Afghanistan, while programme assistance is a priority in Uganda. At the same time, aid in Uganda goes somewhat more directly to humanitarian efforts. Finally, it appears that ODA forms a larger share of total national income for Afghanistan (shown by the net ODA/GNI figure). Afghanistan relies on foreign aid for nearly a third of national income (or more), while for Uganda the figure ranges from about 12% to 15%.

As these two case studies suggest, every country's development story is different. With regard to foreign aid, some countries may receive significant international attention and resources for reasons that are quite separate from need. Uganda appears, with its lower income and greater use of resources on humanitarian efforts, to be more desperate in terms of poverty than Afghanistan. However, it may also be that the requirements of some countries, particularly conflict zones which have difficulty maintaining stability, cost quite a bit more for some periods. For our purposes, the above examples do illustrate the tendency of the developed world to focus on areas of strategic or economic importance. But they also serve as a caution to regard each development tale as one that requires more insight and information for a proper assessment.

To learn more about ODA and the countries it is given to, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 28.2.

EXERCISES

4 **a** Use the link in the hotlinks box (left) to find ODA information 'by country.' Pick two countries that share some characteristics but have some differences to their profiles as well.

b List the similarities between the two aid profiles.

c List the differences between the two aid profiles.

d Make inferences and attempt to draw conclusions about the similarities and differences you have identified.

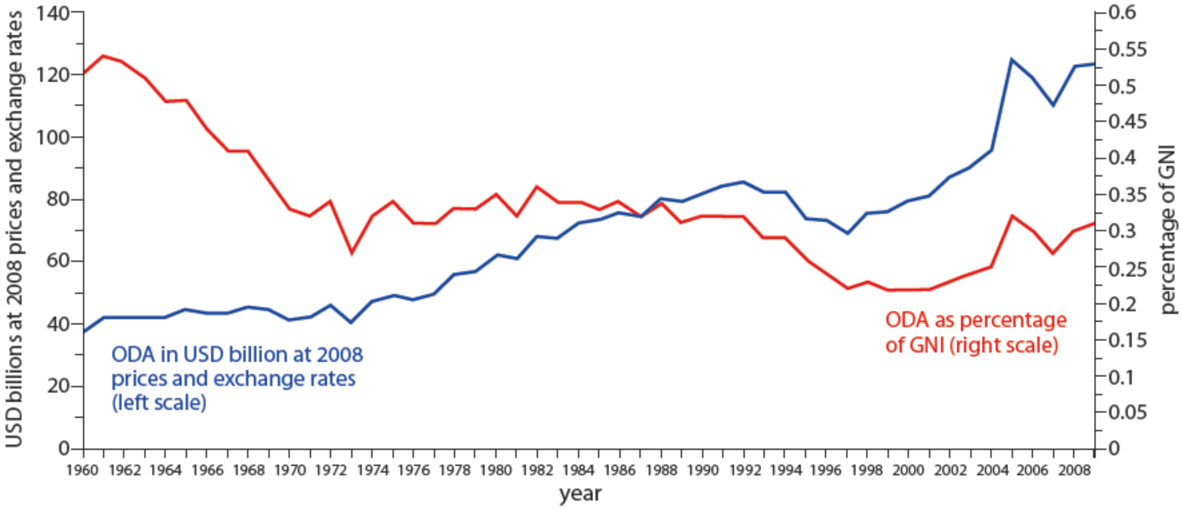
Trends in foreign aid

Is giving going up or down?

In global terms, rich-country giving to poor countries has grown, from just under $40 billion in 1960 (constant dollars) to nearly $120 billion in 2008. However, this growth in absolute terms masks the relative decline in giving observed when aid is measured as a percentage of rich-country income.

Figure 28.8 shows that aid totals have increased steadily, but not at a rate that keeps pace with income growth. Rich-country giving was about 5% of GNI in 1960. That percentage grew slightly, but then declined rather steadily until just after the start of the new millennium. Current aid levels are at nearly 0.3% of GNI, still significantly less than the early commitments of aid in the 1960s.

Figure 28.8
Net ODA by total and % GNI, 1960–2008.



OECD

EXERCISES

5 Why do you think that aid has decreased in relative terms since 1960?

6 Suggest several reasons why it may have increased recently.

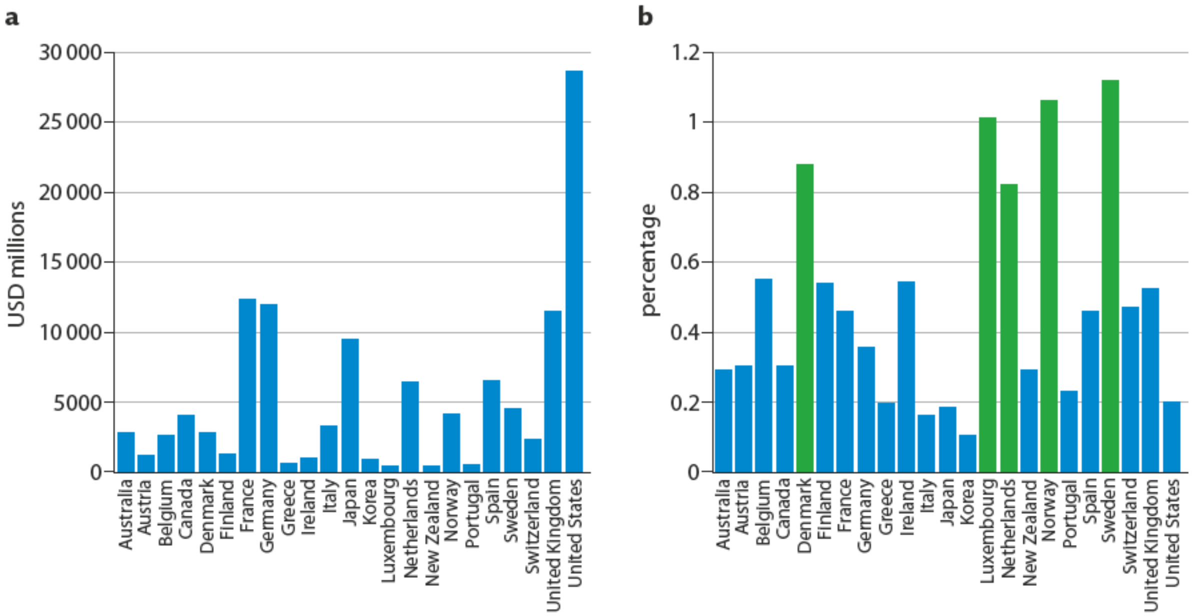
7 Is it possible that factors other than aid have contributed to development? If so, what factors?

Who gives foreign aid?

The OECD also keeps track of the countries donating foreign aid. This can be viewed in absolute or relative terms (Figure 28.9). In terms of total contributions, the US clearly gives more than any other country; France, the UK, Japan and Germany all contribute less than half the amount from the US. However, when considered as a percentage of GNI, the largest contributors are Sweden, Norway, Luxembourg and Denmark, along with the Netherlands. Only these five countries (shown in green) have reached the OECD guideline of 0.7% of GNI to be donated as aid. Several OECD countries, chief among them the US, fall well below the 0.7% level.

W To learn more about aid, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 28.3.

Figure 28.9
a Net ODA in 2009; **b** ODA as % GNI in 2009.



OECD

28.5 Evaluation of foreign aid

Learning outcomes

- Evaluate the effectiveness of foreign aid in contributing to economic development.
- Compare and contrast the roles of aid and trade in economic development.

Is foreign aid effective?

There are several factors that limit the effectiveness of aid. Aside from the dwindling quantity of aid, several objections are levied against the continuance or expansion of foreign aid among rich countries.

The government of Ethiopia depends on foreign aid for over 90% of its budget.

Writer Timothy Garton Ash argues that the world now has more economically secure and politically free people than ever before, nearly 1 billion of us. That leaves 5 billion who do not enjoy such security and freedom. Globally, that makes 1 in 6 people free and independent. What responsibility do those 1s have to the other 5s? To what degree do the 1s have the power to help the other 5s?

Criticisms of aid

Aid is inefficient

Too often, aid money is set aside for large-scale showcase projects that embellish the reputations of the project administrators and donors, despite the fact that smaller or medium-scale projects would do the job at a lower cost. Large infrastructure projects like dams and airports have the attraction of tangible outcomes, but may well be redundant or extravagant.

Corruption squanders aid

In many instances, enormous amounts of money and resources are diverted by corrupt leaders. The money can be stolen, rerouted through friendly political organizations, or kicked back to decision-making officials. Humanitarian goods can be withheld and sold off for profit, or passed around to government officials and the military.

Aid rarely gets to those who need it

Figure 28.5 (page 600) shows that most aid money goes to relatively well-off countries. Among poor countries receiving aid, some evidence suggests that assistance money is concentrated in more affluent urban areas rather than poorer rural ones.

Aid displaces local investment and markets

LDCs are notoriously poor at tax compliance (i.e. the degree to which society pays taxes on its income). Foreign aid discourages governments to enforce the tax code and generate revenue for itself. Furthermore, some kinds of commodity aid may depress local markets and reduce incentives for domestic production.

Aid fosters dependency

For some of the poorest countries, aid accounts for a majority of government revenue, a situation that is chronic rather than temporary. Rather than raise revenue by collecting taxes, countries come to expect aid to fill the gap in government budgets.

Arguments for foreign aid

Nevertheless, part of the Millennium Development Goals Project is a push to encourage governments to step up and meet the stated goal of 0.7% of GNI. Economists and the UN are therefore encouraging more aid, rather than less.

Delivery of aid is the problem

Champions of development point out that aid programmes are relatively new areas of social policy, and attempt to solve very complex problems. Some argue that with the advent of new NGOs, which are applying many new ideas, the quality of aid work will improve.

Aid addresses areas where growth alone will not

Many pro-growth policies can create significant negative externalities (Chapter 26, pages 542–545). Income inequality is one area where aid can redress and support vulnerable populations. Technical assistance can improve health services or help guide environmental policy.

Successes not celebrated because the need is still great

Improved malaria treatment has lengthened lives and enhanced quality of life in many countries; the Millennium Development Goals Project has made progress on a number of fronts. Most of this work has been supported by aid-funded policies, through the UN, the

World Bank and many NGOs. However, by advertising success, aid agencies and the UN risk reducing the sense of urgency that might motivate countries to give more. Promoters of aid must balance the desire to know that aid is working against the desperate need for aid that still persists in much of the world.

Trade *vs* aid

Led by the EU and the US, the rich world spends nearly $1 billion per day on agricultural subsidies and at the same time has protective tariffs on agricultural goods. These policies have been protected under WTO rules for decades. The subsidies and trade rules have two, mutually reinforcing and harmful effects on poor countries. For most LDCs, agricultural commodities are their most likely source of comparative advantage, yet rich-world subsidies artificially build up the competition when rich-world agriculture already has competitive advantages in capital and technology. Furthermore, the subsidies often result in overproduction and the dumping of rich-world produce on world markets. This drives world commodity prices downwards, reducing the income of LDCs that are dependent on agricultural goods, which is to say most of them.

To access Worksheet 28.1 on the bottom billion, please visit www.pearsonbacconline.com and follow the onscreen instructions.

The case for trade

Reducing or eliminating rich-country subsidies and trade barriers would expand the market for poor-country agricultural goods. With larger export markets, the farming industry in these countries could grow and build up capital, and perhaps begin to take advantage of some economies of scale. More efficient and mature agricultural sectors would earn more foreign exchange for the country itself. This might also allow countries to diversify into other areas of production, reducing their dependency on a few staple goods. The increased income might, in fact, reverse the trend in the poverty cycle (Chapter 26) and stimulate more savings and investment. At the same time, the increased income might reduce dependence on foreign aid.

Limitations of trade

Some economists have noted that while poor countries produce food, many also import it. Net food-importing LDCs could be hurt, they argue, if rich-country agricultural subsidies are rapidly eliminated. A major cut in subsidies could cause a rise in food prices, which could cause instability. As food prices soared in late 2007 and early 2008, food riots broke out in parts of Asia and Africa, lending credibility to this claim.

Even fair-trade advocates like Oxfam are wary of the bargain that might be struck in order to obtain open agricultural markets. They worry that, in the name of trade liberalization, rich countries would demand that LDCs further reduce the exceptions to free trade rules allowed by the WTO. This could result in the swamping of LDC infant industries under a deluge of established foreign competitors, mostly the developed world's MNCs.

To learn more about fair trade, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 28.4.

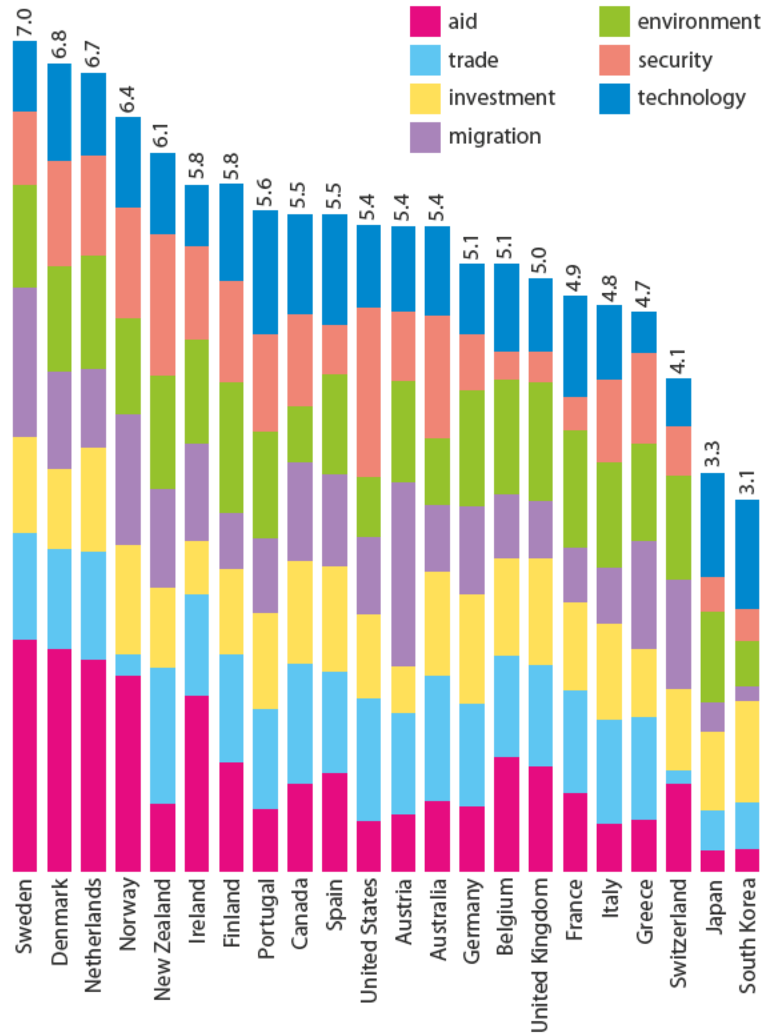
Still others argue that the trade *vs* aid argument presents a false trade-off. The prominent development economist Jeffrey Sachs, for instance, consistently rejects the idea that trade and aid are mutually exclusive. Trade and aid are both necessary for the poorest countries to break the poverty cycle and make large strides in development. Trade is necessary for income growth and self-sufficiency. But aid, he argues, will go where trade does not reach.

To learn more about micro-finance, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 28.5.

Beyond aid?

Economists are increasingly looking for new ways to measure the degree to which countries are supporting development efforts around the world. One policy research group, the Center for Global Development (CGD), has created the Commitment to Development Index (CDI). This composite measure is based on the premise that aid itself is insufficient, and that policies of rich countries in many different areas will influence development as well. The ranking adds trade policy, immigration, investment, technology, security, environment, and technology contributions as well (Figure 28.10).

Figure 28.10
Commitment to development index, 2010.



Center for Global Development

While the results are rather similar overall to the ODA/GNI figures (Figure 28.9, page 603) the CDI provides more specific insight into the nature of rich-country contributions to overall development. Its creators hope that the CDI will refocus rich-country perspectives on development in the same way that the Human Development Index altered the way we assess what constitutes a better standard of life. Interesting further research by the CGD indicates that there is a high correlation between indicators of donor country democracy and the level of commitment to development.

EXERCISES

8 To what extent is the CDI a superior measure of a country's devotion to development than just ODA?

9 What accounts for some of the differences between some countries' ratios on this ranking?

10 How might development officials use this ranking as a means of advocating development-friendly policies?

28.6 Major institutions in development

Learning outcomes

- Examine the current roles of the IMF and the World Bank in promoting economic development.

The World Bank

The World Bank is an international development assistance organization that was created with the purpose of enhancing economic development and structural change. The Bank was created at Bretton Woods, at the same conference as the system of international exchange rates, the International Monetary Fund (IMF) and the General Agreement on Tariffs and Trade (GATT), which later evolved into the World Trade Organization (WTO). These institutions were developed as a system of economic order that would prevent further economic collapses like the Great Depression of the 1930s, which created the conditions for World War II.

The World Bank was initially made up of a handful of countries, with the former Allied countries forming its core. It has since grown to 187 members. Membership influence is directly related to the amount of donor money given to the bank. In 2010, the bank revised voting rules to allow a greater voice from developing countries. Currently the largest voting shares go to the US (15.8%), Japan (6.84%), China (4.42%), Germany (4.00%), the UK (3.75%) and France (3.75%).

A brief history of the World Bank

1947 to the 1960s

In the early years, a sort of fiscal conservatism dominated the Bank's thinking and lending. Making safe loans with an emphasis on projects that would repay the loans easily, the Bank focused on infrastructure projects that would directly increase economic growth. This approach established the financial credibility of the Bank but limited its impact on broader development issues.

1970s

Under new leadership from 1968, the Bank changed priorities to emphasize the meeting of basic needs in poor countries. Spending on social programmes increased significantly, including healthcare, education and poverty alleviation. Lending increased significantly, as did the debt levels of many LDCs, during this period.

1980s

The Bank revisited its fiscally conservative roots under the leadership of AW Clausen. During this period, the increasing debt loads of LDCs inspired the bank to create significantly restrictive conditions on the granting of new loans. The comprehensive economic reforms required, called Structural Adjustment Programmes (SAPs), required major changes in macroeconomic and international economic policy for the countries that took loans at this time. A typical SAP required the liberalization of exchange rates and capital flows, reduced protectionism and open markets. SAPs normally required significant spending cuts by governments (in order to repay the loan), cuts that reduced levels of education, healthcare and support for the poor or unemployed. These policies were later criticized for being harsh and anti-development in practice.

1990s to the present

The Bank responded to criticism of its SAPs by expanding the focus of its lending and assistance activities. The Bank now emphasizes sustainable development methods as opposed to pure economic growth. It supports poverty alleviation and debt relief for poor countries as well. With these aims in mind, the Bank has supported the work of the UNDP to reach the Millennium Goals of 2015.

Evaluation of the World Bank

The influence and role of the World Bank has received regular criticism, especially after the introduction of the SAPs in the 1980s. What follows is a discussion of some of the more common complaints about the Bank.

Conditionality

Conditionality refers to the macroeconomic requirements made by the World Bank (and the IMF) before the granting of loans.

World Bank loans come with conditions attached. Recipient countries must follow the often strict guidelines to receive the funding. The cutting of budget deficits, in particular, in order to pay back the loans, force large cuts in social welfare spending on unemployment relief, medical services and education subsidies. These cuts hit the poorest and most vulnerable rather hard, critics say. These policies may be mixed with compulsory liberalization of domestic industry and trade. Privatization may be causing increased unemployment, with fewer resources available (because of budget cuts) to help the jobless. Increased foreign competition may also cause domestic industries to fold, creating more unemployment and suffering. While this criticism of the World Bank has softened in recent years, as the Bank has adapted its conditions to more specific circumstances, it remains probably the chief complaint of borrowers and critics.

Loss of sovereignty

A related issue to World Bank conditionality, separate from the effectiveness of the conditional requirements, is that these loan terms may dramatically reduce a country's economic sovereignty. The scope of the change can be all-encompassing. When monetary, fiscal and international trade policies are all apparently dictated by non-elected international officials, the borrowing country's people will question the legitimacy of the policies.

Dominance of rich countries

The voting procedures of the Bank give heavy weight to donor countries, most of them highly developed countries, and chief among them the US. Such countries, it is argued, know little of the choices faced by poor countries, and thus World Bank policies are disconnected from poor-country needs. More worrisome is that policy prescriptions too often resemble the harsh medicine that is easier for a doctor to give than to take. During the most recent crisis, when the US and European budget deficits began to soar, the World Bank and IMF were demanding fiscal austerity from its borrowers. Such disparities, if not completely validated by the evidence, do perhaps undermine the Bank's legitimacy.

Mixed results

The free market emphasis of the World Bank's approach has, according to some economists, led to rising inequality in a number of recipient countries. Even further, the resulting cuts in social spending have potentially lowered some countries' performance on the HDI, in effect worsening the quality of life in those countries. More pointed criticism has come from a former chief economist of the Bank, Joseph Stiglitz. While serving for three years in the late 1990s, Stiglitz reported dismay at the results of the 10-year studies of World Bank policy towards former communist countries. He left the Bank, and has since advocated a much greater government role in creating economic growth and development.

To Stiglitz, the timidity of poor-country businesses and individuals to spend or invest results in a lack of growth that can be compensated for only by governments. However, such a role is practically impossible when World Bank/IMF conditionality forces austere fiscal and monetary policy, as well as compulsory liberalization. In part as a reaction to these lingering critiques from Stiglitz and many others, the Bank has refocused its efforts on a broad array of specific development issues that are designed to more directly target development goals. These include sustainable development through carbon-trading funds, conservation efforts and water–sanitation initiatives. The Bank has sought to fortify institutions by working against corruption, and for the promotion of legal reform and property rights. It spends on human development by funding childcare projects, malaria treatment, and HIV/AIDs projects worldwide. Thus the World Bank appears to be changing tactics and strategy as the development consensus changes, even if these changes are occurring rather slowly.

The International Monetary Fund (IMF)

The International Monetary Fund is an organization of 187 countries, whose dues go towards funding IMF activities. Among the stated aims of the IMF are to be working towards fostering global monetary cooperation, securing financial stability, facilitating international trade, promoting high employment and sustainable economic growth, and reducing poverty around the world.

Role of the IMF

Created alongside the World Bank and GATT (page 607), the IMF's initial purpose was to act as the overseer of the Bretton Woods fixed-exchange rate system. The IMF was to monitor the balance of payment situations of member countries and when necessary, act on behalf of those countries to solve current account problems. Typically, this involved the risk of some kind of rapid currency depreciation. The IMF would then loan the country money (an inflow on the financial account) to finance the current account deficit that is a symptom of the depreciation. Without this financing, countries with current account deficits might need to devalue their currencies and upset the fixed-rate system.

The IMF, to some extent, still plays this role, as the international lender of last resort. In the 1980s, the IMF expanded its role beyond management of exchange rates to a form of debt relief. Many LDCs experienced crippling debt crises, and the IMF worked with these countries and the countries and banks that had lent to them. By acting as a final guarantor of privately loaned funds, the IMF provided a backstop for many debt crises. Furthermore, most countries avoided defaulting on IMF loans because this would eliminate their financial safety should any future crisis arise. However, complying with the IMF's loan rules proved challenging for many countries. The stabilization policies associated with these rules could be far-reaching. This resulted in most of the criticism directed at the agency.

Stabilization policies

The recent economic crisis has demonstrated that IMF repayment policies will continue to be debated. The agency may well be the world's 'financial fire department' but it does not work for free, nor is it considered a kind of public good. The policies, according to the IMF, are justified because they are aimed at:

- paying back the IMF so that funds will continue to be available for countries in need
- enabling the IMF to impose unpopular policies that would have prevented the crisis in the first place.

The policies include a range of market-oriented reforms that, depending on the country in question, could have enormous impact.

Government budget austerity

In order to pay back loans, governments need to cut their spending. This nearly always results in significant cuts to social programmes, often in times of crisis, when the need is greater than usual.

Supply-side policies

The IMF may insist on the reduction of minimum wage laws, the privatization of industries, and the cutting of state subsidies to firms.

Inflation control

To establish stability and to reduce the drag downwards of exchange rates, governments may be urged to control inflation with significantly higher interest rates. These high rates could reduce investment and consumption and usher in a period of recession, with all the unemployment and social dislocation that goes with it.

Currency floating

Since the ending of the Bretton Woods system, currencies are encouraged to float to avoid over- or under-valuations. For many, floating rates could lead to a painful depreciation of the currency.

Trade liberalization

This includes reductions in protectionist tariffs, quotas and subsidies, as well as ending restrictions on foreign direct investment.

Evaluation of the IMF

Because countries in need of IMF help have such poor credit reputations, the IMF's willingness to lend offers a hard-won seal of approval, a kind of stamp of credit-worthiness. This makes countries ever more desperate to land IMF help when international consensus determines it is necessary for foreign credit and investment to return to the country. Nevertheless, many of the same criticisms levelled at the World Bank have been applied to the IMF, including the following.

Rich-country dominance

Voting is done according to IMF rules, with the percentages of votes being, in line with those of the World Bank, heavily dominated by rich countries. Rather than one country – one vote, the rules dictate that monetary donations determine the percentage of voting power.

Moral hazard

IMF lending, it is argued, frees countries from fiscal responsibility, and allows them to mismanage their monetary and fiscal policies. With the IMF around to help, the consequences of poor management are one step removed from short-run concerns.

Harsh policies

IMF stabilization polices have a reputation for hitting hardest when the population is most vulnerable. The decreased spending on merit goods, the cutting of already low wages, cuts on food and medical subsidies, and reduction in unemployment benefits at times of greater unemployment, all these have been cited as extraordinary and inhumane policies, especially when applied to developing countries where the reserves of savings and private help are low to begin with.

IMF today

IMF lending surged in 2008, as the world financial crisis hit many countries hard. As of 2010, the IMF was committed to lending nearly $200 billion. The largest outstanding loans from the IMF are to Romania, Ukraine, and Hungary. This highlights the role of the IMF as primarily a financial institution, lending where crises arise rather than with a specific development focus. It also underscores the concerns with IMF stabilization policies, as the politicians and people of each country have railed against the forced spending cuts that are a condition of IMF loans. As each country laid off public-sector employees such as doctors and teachers, and cut by 30% the salaries of the remaining government workforce, there has been the usual talk of defaulting and protesting and even defaulting on the IMF loans. In early 2011, Ireland, a country with one of the highest *per capita* incomes, agreed to accept an IMF/EU bailout worth $85 billion. Its government collapsed the following day.

W To learn more about the International Monetary Fund, visit www.pearsonhotlinks.com, enter the title or ISBN of this book and select weblink 28.6.

28.7 Foreign debt and its consequences

Learning outcomes

- Outline the meaning of foreign debt and explain why countries borrow from foreign creditors.
- Explain that in some cases countries have become heavily indebted, requiring rescheduling of the debt payments and/or conditional assistance from international organizations, including the IMF and the World Bank.
- Explain why the servicing of international debt causes balance of payments problems and has an opportunity cost in terms of foregone spending on development objectives.
- Explain that the burden of debt has led to pressure to cancel the debt of heavily indebted countries.

How indebtedness happens

A country's level of international or external debt determines the level of its indebtedness. This refers to the total amount of external debt, both public and private. Poor-country

International debt comprises short- and long-term loan obligations owed to foreign governments, NGOs and private sources.

debt tends to be more public than private. When a country borrows internationally, it is recorded as an inflow of funds in the financial account (Chapter 23). This foreign borrowing, with the influx of foreign income it provides, can help to balance out deficits of the current account. So, when a country incurs a trade deficit by spending greater sums on foreign imports, foreign borrowing helps to balance the books.

This money can be an important source of investment income, as it represents an injection into the poverty cycle. Normally, a poor country's low income results in low savings, which reduce the pool of money to be borrowed. With access to international loans, a poor country can bridge the savings gap and borrow for investment and capital growth.

The foreign debt, however, only helps in the short term. These debts must be repaid, both the principal loan amount and the interest. Paying interest (called servicing the debt) can be among the most debilitating long-run costs of debt, and is the problem that the most severely indebted countries now face.

Origins of the debt problem

LDCs have not always had a reputation for being heavily in debt. In 1973–74, the petroleum-exporting countries of OPEC put in place an oil embargo that drove oil prices to new highs. The inelastic demand of oil resulted in large export revenues for the oil producers, and massive import expenditure increases for many oil importers.

Large amounts of the 'petrodollars' from OPEC countries were deposited in rich-country banks, which sought to reinvest them. These banks were seeking to make loans, and many oil-importing LDCs were in need of the foreign exchange to shore up their capital accounts and finance their newly inflated trade deficits.

What followed was a rush of lending and borrowing from rich-world banks to poor-country governments. However, the flood of petrodollars blinded banks to the risky nature of many of these loans. In hindsight, it seems clear that many of the countries involved were not financially capable of paying back the loans. Additionally, the loans transacted during this period were not made on the traditionally concessional terms. Instead, countries were borrowing at higher, private market interest rates that would be more difficult to repay. Even in good times and with the funds being spent wisely, these debts would have been a significant burden. In the event, many of the funds were poorly used, and did little to help grow the economies of their recipients.

Consequences of indebtedness

Countries trapped in the poverty cycle may find that large foreign debt acts as an anchor to their development hopes, keeping them in one place. Resources that could be devoted to economic growth and development are instead diverted to the paying down of old debts. Heavily indebted countries suffer from many of these related problems.

Figure 28.11 shows the flow of consequences for many LDCs burdened by massive debt. First, the large loans with market interest rates incur larger than usual debt repayments. The LDC is likely to struggle with repayment, which could jeopardize its credit rating. This makes future borrowing more difficult, as new lenders want even higher interest rates, and are less likely to make loans.

This slows the flow of investment funding in both the private and public sector. Private entrepreneurs find it difficult to borrow for expansion or capital formation. This slows down economic growth and makes debt repayment harder. For governments, debt service and

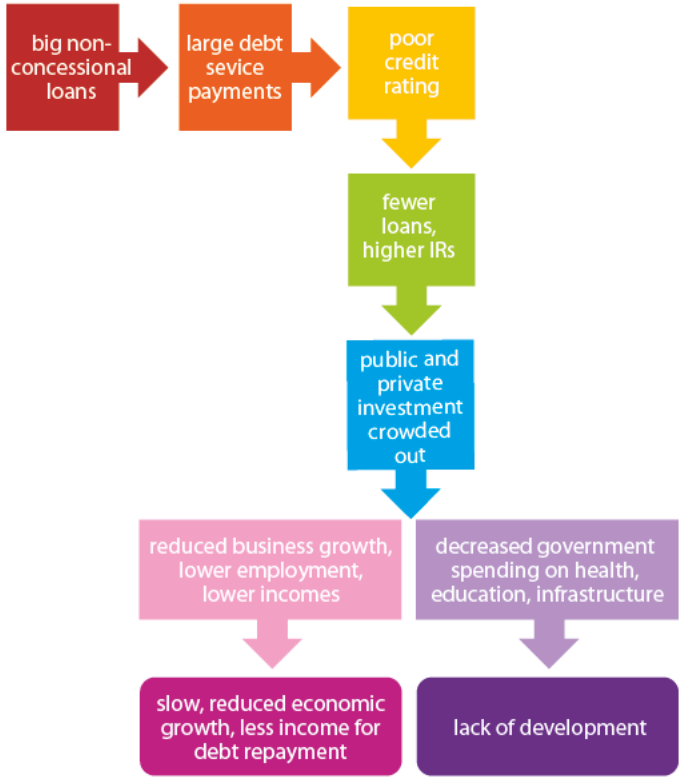


Figure 28.11
The debt trap.

the lack of new funding requires a reduction in spending on merit goods such as education, healthcare and infrastructure. This, in turn, reduces opportunities for development.

Attempted reform: HIPC initiative

Debt burdens reached crisis levels in the 1990s. A combination of NGOs, economists and missionary organizations mounted a campaign for debt relief to poor countries. In 1996, with debt burdens in poor countries threatening the stability of poor nations throughout the developing world, the World Bank and the IMF created the Heavily Indebted Poor Country (HIPC) Initiative. This marked a change in the approach by what had been considered traditional and conservative lending institutions. Countries that qualify are eligible for special assistance in the form of concessionary loans and direct debt relief.

By early 2010, 36 countries had qualified and received at least partial debt relief and low-interest loans. To qualify, countries have to prove that their debts are unsustainable, as measured by their exports-to-debt ratio and other income-to-debt measurements. It also must be shown that the debt cannot be handled by the normal methods. Finally, countries must meet certain macroeconomic stability targets to be eligible for relief.

Early implementation of the programme earned criticism because of the time it takes to fully qualify for relief, on the basis of the sometimes challenging macroeconomic limitations placed on countries that are already in trouble in development terms. After adjustments to the programme to address these problems, the IMF/World Bank have reported the following results:

- nearly \$102 billion debt relief spread across 40 HIPC countries
- reduction of the debt stocks of HIPC countries down to \$21 billion
- reduction in the debt-to-export ratio of 457% in 1999 to 127% in 2010
- reduction in the debt-to-GDP ratio from 114% in 1999 to 29% in 2010.

Additionally, the HIPC programme has created initiatives that attempt to ensure that the savings from reduced debt service and repayments get channelled back into poverty-relief areas. Nonetheless, in recent years some very public campaigns have been waged by NGOs and celebrities who have argued that the HIPC initiatives have not gone far enough to relieve the morbid debt under which many poor countries labour.

Arguments against debt relief have focused on the inefficacy of the above initiatives, as well as the moral hazard issue. Critics say that debt-relief savings will be recycled into the banking system or will go towards expensive prestige public spending projects, with the benefits going to the upper-income classes. Moreover, they argue that debt relief encourages the taking on of more debt. Poor-country governments can borrow freely, they say, immune to the risks of heavy debt because the HIPC will soften the pain of repayment later on.

The ethicist Peter Singer has argued that the injustice of some people living in abundance while others live in poverty is morally indefensible.

Evaluate the validity of this viewpoint using your own knowledge of economics and your understanding of morality.

One view of the indebtedness problem suggests that it was a unique set of circumstances that led to the debt explosion of the 70s and 80s, and that a repeat is unlikely. But the financial crisis of 2008 suggests that financial bubbles like the petrodollar years are still possible. Thus, indebtedness cannot be written off as a one-time event. Furthermore, it appears that the IMF and World Bank have, if belatedly, developed some skill at handling this relatively new and complex problem. If measured by the results published by the IMF and World Bank, it would appear the HIPC has made significant strides in the reduction of debt levels for member countries. The conditions of stability have, at times, rather harshly reduced the level of social services in already strained countries. But more countries that need debt relief have struggled to meet the terms, and so still face significant growth and development stagnation.

To access Quiz 28, an interactive, multiple-choice quiz on this chapter, please visit www.pearsonbacconline.com and follow the onscreen instructions.

PRACTICE QUESTIONS

1 **Crisis in Africa**

Item 1

i The World Bank and the International Monetary Fund have played a major role in Africa's development through their Structural Adjustment Programmes. The stated aim was to bring export-led recovery and a reduction in poverty.

ii However, Africa has suffered a worsening debt crisis, with looming bankruptcy. Increasingly, the IMF has assumed responsibility for national budget policies, and has insisted on **strict deflationary targets**. At the same time, the World Bank has overseen moves towards **trade liberalization** and deregulation of agricultural markets.

iii The IMF and the World Bank now have a chance to resolve the debt crisis which is destroying lives across sub-Saharan Africa and other developing regions. However, a new policy course will need to be charted in which reform of the heavily indebted poor countries is undertaken, along with an abandonment of the almost religious faith in the power of market forces to generate development and reduce poverty.

adapted from various newspaper articles

Item 2

	Guinea-Bissau	Sierra Leone	Singapore
Debt service ratio (debt service as a % of exports of goods and services)	67	60	Not applicable
Adult literacy / %	54.9	31.4	91.1
Real GDP per capita / $	811	625	22604
% labour force in agriculture	85	67	0
Terms of trade (1987 = 100)	89	92	89
Current account balance before official transfers / $ millions	−41	89	15 093

Human Development Report, UN, 1998

a With reference to Item 1, briefly explain the following terms indicated in bold in the text:

i strict deflationary targets (paragraph ii) (2 marks) [AO1]

ii trade liberalization (paragraph ii). (2 marks) [AO1]

b With reference to Item 2, briefly explain why the adult literacy rate of Sierra Leone will make it difficult for the country to grow and develop. (4 marks) [AO2]

c Use your knowledge of economics to explain two of the significant problems faced by Sierra Leone and Guinea-Bissau (other than the literacy rate problem). (4 marks) [AO2]

d Using information from the text and your knowledge of economics, evaluate the effectiveness of the IMF/World Bank's market-based Structural Adjustment Programmes toward Sierra Leone and Guinea-Bissau. (8 marks) [AO3]

2 **Fighting poverty in Africa**

Item 1 There are those, not least in Africa, who fear this massive debt relief will produce the same circumstances that have followed smaller debt write-offs. Incompetent governments will run-up large new debt, spend the money on unrealistic projects and place spare cash into Swiss bank accounts.

Arab News, Editorial, Saudi Arabia, 12 June 2005

Item 2 Doubling official aid, even if it is **tied aid** and cancelling Africa's debt are theoretically very attractive proposals. They fail because they are based on a misguided faith that you can rely on human unselfishness to end human misery. Tony Blair and his partners would do the continent a lot of good if they promoted trade, removed agricultural subsidies and encouraged investment relationships, rather than offering kindness and generosity through more aid and debt relief.

Andrew M Mwenda, *Sunday Monitor*, Uganda, 12 June 2005

Item 3 If we are serious about addressing Africa's poverty, far more money and effort will be needed as well as freeing these countries from debt repayment, which then allows them to invest in economic development and improve the health and education of their citizens. Africa has 11% of the world's population, but accounts for only about 1% of the world's economic output. Export-led growth is needed. Without more help from the developed countries, the future looks bad.

Seattle Times, Editorial, US, 12 June 2005

Item 4 Africa is not poor. As the Africa commission report has noted, while it lacks **infrastructure**, Africa is rich in human and natural resources. The problem is that Africans have been forced to live in countries that have not wanted to enrich the lives of people within them, but rather to transfer resources abroad. The struggle of Africa is to be part of the world economic order based on mutual respect, not exploitation.

Ken Wiwa, *The Observer*, 12 June 2005

a Define the following terms indicated in bold in the text:

i tied aid (Item 2) [2 marks] [AO1]

ii infrastructure (Item 4). [2 marks] [AO1]

b Using an appropriate diagram, explain how domestic farmers would be affected by the removal of their subsidies. (4 marks) [AO2], [AO4]

c Using an AD/AS diagram, explain the effect of a successful export-led growth policy. [4 marks] [AO2], [AO4]

d Using information from the text and your knowledge of economics, evaluate the effectiveness of increased aid and debt forgiveness policies. [8 marks] [AO3]