Introduction to International Relations
Lecture 16: Development and Foreign Assistance

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Overview. NOTE: this is only the outline.

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1. Why care about underdeveloped countries?
   - ethical concern about poverty
   - negative externalities (disease, refugees, environmental degradation, war)
   - have others contribute to solution of global problems
   - economic growth beneficial to all
   - political stability
2. Can countries escape poverty? Maybe, very rare:
   - Four Tigers (Dragons): Hong Kong—banking and commerce, Singapore—trading city, Taiwan—computers, South Korea—exports of autos, etc.
   - Israel: contributions from diaspora, intensive military and agricultural research
   - Some (Brazil, Malaysia, Indonesia) tried similar policies but failed
3. How can countries escape poverty? By capital accumulation.
   - import substitution: protect local industry and make products instead of importing them. This saves foreign currency and provides employment. However, it is usually economically inefficient because it goes against comparative advantage. Such industries may never become competitive and the country's resources may be better utilized elsewhere.
   - export-led growth: manufacture products that can compete internationally (South Korea is a good example). This requires the government the centralize efforts and channel them into favored industries. Often comes with authoritarian political control to suppress dissent.
   - Generally, countries have to accumulate capital in order to develop manufacturing which needs both capital concentration and a domestic market where to sell the production. Countries need to develop a middle class that can buy the products but they also have to forego short-term consumption in favor of long-term investment. However, cutting consumption can be exceedingly painful for some groups, which leads to social unrest, which leads to authoritarianism that can suppress it. The capitalist approach advocates short-term pain for long-term gain which will eventually make everyone better off. Socialism instead advocates more equitable distribution and slower, but less painful, growth. Socialism has shown to be extremely inefficient and it appears that the only solution is through painful curtailment of consumption. When we say "cutting consumption" we mean the government cutting subsidies on essential products and services. For example, cutting subsidies on foodstuffs. In many countries bread is

an essential commodity and is heavily subsidized by the governments (e.g. Egypt). Should the government cut its subsidy in order to invest the money elsewhere, the price of bread would shoot up, making it too expensive for many. (When the government tried this in Egypt, riots broke out until the government backed down.) This is serious: imagine yourself making $8/hour, or $320/week and a loaf of bread costing $300. You'd be rioting too.

4. What can countries do when capital is not enough? Get it from foreigners who have it:

   - attract foreign investment (about $100 billion in 2001 worldwide); foreigners build factories, hire locals, pay taxes and fees to government; however, this requires relatively stable political and financial environments with low risk, otherwise investors would be unwilling to tie their money in the country; this puts foreign investment out of reach for many of the most needy developing countries which are usually in midst of civil unrest. Also, to attract foreign investment, countries have to compete for it with each other. For example, by offering lower wages and lax working standards. This puts the needy countries in a prisoner's dilemma: they would all benefit if they could commit to demanding somewhat higher pay for their workers but each country has an incentive to undercut the others by offering lower wages and attracting foreign firms. So much of "exploitation" by the rich is really direct result of the competition of the poor among themselves.
   - obtain foreign aid in form of grants (free money) or loans on concessionary terms (easy to repay, low interest, long terms); about $56 billion in 2001. Foreign aid can be bilateral, arranged between donor country and recipient. This usually means it does not really come free but with some strings attached. Recipients usually have ties to donors (e.g. former British imperial possessions), and so not every country can attract this. Because of political strings attached, bilateral aid can be ineffective due to lack of will to spend money wisely. It can be inefficient because of duplication of effort due to lack of coordination among donors. Bilateral aid also looks suspicious because of direct government-to-government interaction. Multilateral aid is mostly channeled through the UNDP (United Nations Development Program), which manages over 5,000 projects. Donors give the money to the U.N., which then disburses it to various recipients according to their needs. This avoids duplication of effort, has a veneer of legitimacy, and is usually more efficient because of competent bureaucracy.
   - borrow from governments and foreign banks; Debt requires constant service and payments of interest and principal can easily reach 15-

30% of GNP, so it's expensive. The idea is to borrow funds, invest well, and then use revenues to service debt and get profits. However, often investments are bad due to corruption (governments arrange for political cronies to get funds who then mismanage or appropriate the money), bubbles (inflated prices, usually real estate and stocks), or crushing debt service requirements from past debts when governments borrowed a lot at a point when money was cheap.

What happens when governments can't service the debt? They can default and refuse to pay creditors. This is really bad for the government (because other lenders would refuse funds in the future or demand excessive interest rates) and the lenders (who lose their entire investment). Both parties have interest in avoiding default, so governments can often renegotiate the terms. Sometimes, they can get some of the debt forgiven outright and they don't have to pay it. More often, they can restructure it by extending the life of the loan so they have more time to repay it, getting more debt at concessionary rate to help repay some of existing commitments, etc. Debt restructuring creates a collective action problem for creditors: they need to commit to present a united front to debtor but each has incentives to strike a private deal and get own debt serviced at the expense of everyone else. Lenders form organizations to help overcome this: Paris Club (for governments) and London Club (for private lenders) where they coordinate policies.

What is the mechanism that can create debt service problems for the government? Investors get nervous about the local economy, so they start selling stocks in it, causing prices to fall. Investors start unloading local currency by exchanging it for foreign currency (dollars). Demand for local currency falls and investments denominated in it fall in value. More investors begin pulling out of by selling these investments, creating a snowball effect. Government tries to stabilize local currency by reducing its supply: central bank buys back local currency by using its reserves of foreign currency and raises interest rates making it more expensive to borrow money. However, process usually happens too quickly and the bank runs out of money, crash then is catastrophic and government's only way out is to devalue the currency. For example, yesterday 1 unit of local currency could buy \$1, and today it can buy only \$0.001. If yesterday you had 1,000 in local currency, you could have bought goods worth \$1,000. Today, your savings can only buy you goods worth \$1. What happens to debt service? If it is denominated in foreign currency (and it usually is), then it also becomes extremely expensive and unaffordable.

Nobody likes devaluations, including lenders. So what does the international community do? During the crisis, the IMF steps in and lends money to central bank so it can continue buying local currency and avoid devaluation (this is what it means to be a lender of last resort). Some of the funds come from governments, some from regional banks, some from the World Bank. Typically, IMF packages are between \$50-\$100 million. However, during the 1990s meltdowns, they reached enormous sizes: the Indonesian bailout in 1997 cost the IMF \$48 billion, the Mexican bailout in 1995 cost \$40 billion, the Russian bailout cost \$22 billion, the Brazilian one cost \$41 billion, and the South Korean bailout (the largest thus far) cost \$57 billion.

What happens to IMF money? Since governments use it to strengthen local currency, most of it goes to investors/speculators who are trying to sell their holdings of the local currency. That is, most goes to foreigners who then spend it in their home countries or invest it in the North. So the IMF money comes back to the rich countries (nice deal). This money, however, is not really free because the IMF usually requires governments to adopt structural adjustment programs (SAP) that are designed, in principle, to improve their economic efficiency and avoid such problems in the future. The IMF conditionality provisions require that countries implement some of these problems before all the funds are disbursed. The SAPs are usually austerity programs devised to tighten fiscal discipline for the government: balance the budget (don't spend more than you get in income), eliminate inefficiencies by liberalizing trade and subsidies, etc. Basically curtail consumption in favor of investment. As we have seen, these measures are socially painful and can cause great unrest, which is why the IMF is so vilified by opponents of globalization. In the end, however, the IMF steps in to help when governments mismanage their own affairs. It is not unreasonable to require that they should improve their economic efficiency in return for this help: why send good money after bad money? If anyone is to blame, it would be the incompetent and corrupt governments that have spent more than they could afford.