1 Finance for development

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The subject of my chapter is certain aspects of finance for development. The key question is the following: How can developing countries attain finance for development given the high costs of capital and the higher risk premium they face? In other words how can they compete?

All around the world one repeatedly hears countries complaining that they cannot compete. The US, for instance, cannot compete because of cheap wages; small countries are sceptical about their ability to compete with large countries – every country seems to entertain the view that it is disadvantaged relative to others.

But this, as a matter of logic, cannot be true. Every country has a comparative advantage somewhere, and therefore, every country can attract capital. Low wages, for instance, can offset high costs of capital. The key issue is the right exchange rate. If one has the right exchange rate, certain sectors of the economy will be able to attract investment and thus provide the basis for economic growth. Furthermore, the right economic framework can make it easier to attract investment. Consequently it will lead to a better exchange rate and eventually to greater economic prosperity.

I am now going to describe some of the elements of that economic framework. I will argue that the main elements stressed by the Washington Consensus such as macro-economic stability, privatisation and liberalisation are only part of the right framework. If they are taken to the extreme, however, they can impede development. I will argue that there are some other important ingredients one needs to think about as well. For example, attracting capital to developing countries does not lie at the core of the issue. What is really important is the creation of domestic savings.

1 The shortcomings of the Washington Consensus

Economic policy should be oriented towards development and development transformation rather than economic stability alone. The Washington Consensus, however, mainly focuses on macro-economic stability, with a strong emphasis (within macro-economic stability) on inflation control. Furthermore, it stresses the importance of privatisation and liberalisation.
However, each of these measures, when given too absolute or preemptive a weight in policy determination, may have an adverse effect on economic development. An overly narrow focus on macro-economic stability can stifle economic growth and increase inequality. In a large number of countries, an excessive focus on macro-economic stability and inflation control have led to very high interest rates. High interest rates, in turn, have led to increased levels of unemployment and this has been a major source of continuing poverty. Privatisation, when carried out in the wrong way as it was under the sponsorship of the IMF in Russia, can lead to asset stripping rather than wealth creation.

The interaction of misguided policies can have disastrous consequences. High interest rates, for instance, increase the return to asset stripping. As managers in transition countries like Russia realised that they could not afford the high interest rates and could not access capital, they also realised that they could not easily restructure their enterprises into more productive ones. That made it all the more profitable for them to engage in asset stripping. Thus there is an interrelationship between macro-economic policies and the failures of privatisation. Similar problems have been found elsewhere in the developing world.

It is increasingly acknowledged today that what is going on in a country is not independent of the political economy of that country. One aspect of this is the legal structure – the rule of law. The importance of institutions is undisputed. However, macro-economic policies combined with privatisation and resulting in asset stripping in Russia have significantly undermined the political support for the rule of law. There were more people occupying key managerial roles within Russian society who gained from asset stripping and the absence of the rule of law than there were people in such roles who gained from its creation. Thus, if we start thinking about institutions as being endogenous results of the policies themselves, we recognise that some of the policies put into place as part of the Washington Consensus not only ignored fundamental aspects of political economy but also undermined the creation of institutions that might have facilitated the successful transition of countries like Russia. That differs considerably from the view put forward by Andrei Shleifer (Shleifer, 1994; Shleifer and Boycko, 1994; Shleifer and Vishny, 1994; Shleifer et al., 1995; Barberis et al., 1996; Shleifer and Blasi, 1996; Shleifer, Boycko and Vishny, 1996; Shleifer and Vasiliev, 1996), that privatisation by itself could have created political support for the rule of law.

On the whole we can say that the Washington Consensus has not created the kind of framework that is conducive to investment. Focus on particular elements brings this out clearly. One of the central aspects of the Washington Consensus mantra has been that capital market liberalisation will make a country more attractive for the inflow of capital. It has been argued that if a country does not liberalise its capital markets, it will not be able to attract capital. Both parts of this proposition are false.
The country among the emerging markets that has been most successful in attracting capital is China. China has also had the most rapid economic growth within the developing world. The magnitude of its success is reflected in the fact that if one treated the various provinces of China as separate data points, twenty of the fastest growing countries would lie in China.  

Another way of putting it is that if one considers the world’s low-income countries, a disproportionate fraction of the growth among them occurs in China. So if one wants to study economic growth, one should study China. However, China has succeeded in becoming the largest attractor of FDI both in the developing countries and in the developed world even though it has not liberalised its capital markets. Thus the argument that one has to liberalise capital markets in order to attract investment is simply wrong.

In fact, the argument goes the other way. Capital market liberalisation is associated with higher levels of economic volatility. Higher levels of economic volatility make a country less attractive for investment and have adverse effects on poverty. Thus, capital market liberalisation can create an economic environment that is adverse both to domestic and foreign investment.

What I have been stressing is not only the importance of the political risk associated with the change in policy environment and incentives to corruption. More particularly I have been stressing the risks associated with misguided macro-economic policies and forms of liberalisation that are bad for economic growth. There are a number of other elements of an economic framework that are important but have been under-stressed in the Washington Consensus. One of these is the importance of human capital or a good workforce, which has been one of the crucial ingredients to the success of East Asia. But around the world the advocates of the Washington Consensus have put an emphasis on labour market flexibility – a cold term for falling wages and the elimination of worker protections – rather than on improving the work environment for workers that would be likely to lead to higher productivity.

2 Financial institutions

What is important for investment is not just the issue of interest rate policy that I mentioned earlier. What is also crucial is the ability of a country to channel capital to where it is needed – and this requires appropriately equipped and incentivised financial institutions. These financial institutions must be geared to provide capital for small businesses and micro-credit facilities.

Under the WTO regime there is an increasing emphasis on openness to foreign banks. The concern is that these foreign banks are less interested in lending their money to domestic small businesses, let alone to
micro-credit institutions, than to large multinational firms. If that is the case, then small businesses will have to disproportionately bear the risk associated with capital scarcity. In that sense attracting foreign banks may be adverse to long-term economic growth.

This issue is of increasing concern in many developing countries. It was a key issue in the recent sad economic history of Argentina. One of the reasons that Argentina was given an A-Plus rating by the IMF during the period 1996–98, before it fell from grace, was that the country opened up its capital market to foreign banks. Foreign banks took over almost all financial institutions. Unfortunately they were not eager to provide credit to Argentinean firms, particularly to small businesses. The government recognised the problem and tried to set up a special ministry to channel funds to small businesses; however, it did not succeed in doing this effectively. Thus, the opening of the capital market to foreign banks actually contributed to the stifling of economic growth in Argentina and was one of the major factors that pushed the country into economic crisis in late 2001.

Interest rate policy is, of course, still important. High interest rates, as I said before, affect the cost of capital. Firms that cannot access capital cannot grow. Furthermore, high interest rates in a country with open capital markets can lead to higher exchange rates. Many countries have found that these high interest rates combined with high exchange rates have a further adverse effect on economic growth and development.

3 Taxes and tariffs

While appropriately organised and incentivised financial institutions are crucial, concerns about the level and structure of taxes and tariffs play an important role as well. Standard textbooks, like my own textbook in public finance, talk about the virtues of VAT. They praise it as a uniform tax that causes less distortion than others do. They also talk about the disadvantages, such as the fact that VAT is not progressive but proportional and therefore has undesirable distribution consequences. The IMF has been pushing the adoption of VATs in country after country without being too concerned about their negative distribution effects. But it has not understood why VAT is efficient in the developed world. VAT is efficient in developed countries because it taxes all sectors uniformly. However, in developing countries VAT is typically collected on only a fraction of GDP. The reason for that is that much of the GDP in a typical developing country is in the informal sector. This means that VAT is effectively a tax on the formal sector of the economy. But it is precisely the formal sector of the economy that one is trying to encourage in order to promote development.

When VAT is imposed on a global level, one sees some further general equilibrium effects. One of the striking things that has occurred in the past decade is worth mentioning. The prices of the goods exported by develop-
ing countries, particularly agricultural goods, have been decreasing relative to the prices of manufactured goods. There have been adverse terms of trade effects to the developing world. As has been noted, these effects began after World War II and the trend, after a short interruption, has continued. This is surprising because the rate of innovation in manufacturing during the post-war period has been very rapid. With that rapid pace of innovation one might have thought that the prices of manufactured goods would come down relative to the prices of agricultural goods. One reason that explains why the reverse has happened is the following: If the people in developing countries are encouraged to go into the informal sector, they are also encouraged to produce those goods that are used as input to the developed countries and discouraged from producing goods that might compete with the output of the developed countries. Under the WTO regime developing countries are, for instance, discouraged from producing textiles but are encouraged to produce raw materials for consumption by the developed countries.

When VAT is applied across all the countries of the world, it has a similar effect. By distorting the structure of the formal sector of the economy it encourages the informal sector – and the informal sector disproportionately produces the kinds of goods that are production inputs for the developed world.

A similar issue arises with respect to the structure of tariffs. Let me give an example that is likely to illustrate a more general principle. When Intel Corporation was considering investing in Costa Rica it strongly emphasised the importance of getting customs clearance within one hour. So if a part in the factory broke on a Tuesday afternoon, they could call up their US supplier, get the part on the plane on Tuesday night, bring it down to Costa Rica Wednesday morning, get it through customs clearance by 6am and load it immediately into the factory. Thus work could continue before significant delays would occur. Long delays in customs function like tariff-barriers. But they are dissipative tariff-barriers: the country does not get any revenue gre the delays interfere with the movement of goods. Costa Rica not only promised to fulfill Intel’s demand for one-hour customs clearance but also met this promise. As a result it got a ship factory worth $500 million which is now the second largest export industry within the country.

4 Trade liberalisation
It used to be a standard part of the economic dogma expressed in the Washington Consensus that trade liberalisation is good for economic growth. People would cite the statistics from the influential paper written by Jeffrey Sachs and Andrew Warner (1995) to illustrate that countries that liberalised more would grow faster than those that did not. More recently, a book published by the World Bank (2002) talks about how the
'globalisers' — the countries that got more integrated into the global economy — have grown faster than other countries. From this it is inferred that if one wants to grow faster, one should obviously liberalise trade.

Looking more carefully at what those statistical studies actually show, however, will lead one to recognise that things are far more complicated. The so-called 'globalisers' were the countries in East Asia, which have had enormous export volumes. But during their periods of rapid growth these countries were not liberalising quickly, but gradually. It is true that China and most of the other East Asian countries have now taken down their tariffs to a very large extent but this happened over a long period of time.

Rodriguez and Rodrik (2001) have looked at the statistical studies that supposedly support the argument that reduced tariff-barriers lead to economic growth. However, there is simply no compelling evidence for that. We can now work with a decade of data concerning alternative strategies for economic growth. The continent where the debate has been most crystallised is Latin America. For three decades — the 1950s, 1960s and 1970s — the Latin American countries pursued import substitution strategies (ISS). In the eighties these strategies collapsed, largely due to the debt crisis. Towards the end of the eighties debt-forgiveness was followed by a reform of economic policy and strong liberalisation, and in the 1990s Latin America experienced renewed growth. The growth that occurred in the early 1990s was partly the kind of growth one always expects to see after a period of stagnation — but it was not sustained. If we compare the decade under reform with the three decades of pre-reform, the numbers we get are quite startling. During the two decades of the 1960s to the 1980s average growth was 5.6 per cent. In the 1990s it dropped to 3.2 per cent! Apparently growth slowed down significantly during the decade of reform compared to the decades of the 'failed' ISS. I do not doubt that there were very good reasons for abandoning import substitution strategies. But we have to learn from both the failures of ISSs and the failures of reform strategies. We have to try to find out why and when each of these strategies work and why and when they fail.

Tariffs do cause distortions, but all forms of taxation are distortionary. The key question is how to use the distortions associated with taxation to promote development rather than to arrest it. As pointed out before, part of the problem is that VAT strategy that has been pushed by the IMF has actually worked to impede development. It has forced more and more firms to go into the informal sector. Firms that have left the formal sector cannot secure credit from formal financial institutions and thus have difficulties in securing finance. This is — again — exactly what happened in Argentina.
5 Foreign investment

The subject of this chapter is 'Finance for development'. As we have seen, the question that many countries have been focusing on is how to attract foreign investment. This focus rests on two assumptions: a) that which separates less developed from more developed countries is their lack of capital and b) that developing countries can solve the problem of development if they overcome this lack of capital. This view is nicely reflected in the designation of the international institutions providing assistance to developing countries. One is called the World Bank – a bank because the key thing that has been taken to be needed is finance. And that is what banks are supposed to provide.

Thinking about development has changed and with it thinking about the role of finance. Finance is an important factor – but absolutely not the only one – and if it is provided in the wrong way it can actually impede other factors.5

Keys to long-term economic growth include measures like employment creation. But if it is the case that countries in their attempt to attract foreign investment pursue macro-economic policies that make it impossible to create employment, they will not grow economically. Treating the attraction of (foreign) capital as an end in itself is a fatal confusion. Attracting capital needs to be balanced against other development factors if one wants to promote economic growth.

The obsession with attracting foreign investment has partly originated from the observation of the increased importance of private capital flows relative to development assistance. From 1990 to 1997, before the global financial crisis, private capital flows increased by six to seven times. At the same time public capital flows to developing countries were basically stagnant or slightly decreasing. Thus, by the end of the decade private capital flows were five to six times as great as the public capital flows. That led many to the conclusion that if you want to be successful you have to focus on private capital flows. But these data did not stress the fact that only a small number of countries were receiving most of these capital flows and that the capital only went to specific sectors of their economies. Capital flows did not go into education and they did not go into health.

Countries were told that they had to get the right policy mix in place. The right policy mix should include the opening of capital markets, privatisation and the attraction of FDI. But as I mentioned before, the country that attracted the most foreign investment – China – not only did not liberalise its capital market but also did not privatise. It focused primarily on the creation of new firms rather than on restructuring old ones. In the African context we observe that even countries that have put in place sound macro-economic policies, that have reduced inflation rates to zero and that have balanced their budgets and even maintained economic
growth of 3 to 6 per cent have failed to attract FDI. That is, of course, one of the challenges the continent is facing.

There are a few countries that have managed to attract FDI. But if one looks more carefully, one recognises that much of it is not the kind of FDI that promotes sustainable growth. A great part of this FDI has gone into natural resources. But one often finds that countries that are rich in natural resources have, in general, not grown very well. Countries like Nigeria have seen their income fall by two-thirds to three-fourths over the last two decades – $250 billion in oil revenues disappearing into nowhere! Yes it is true – you can attract FDI into natural resources if you give them away, in particular if you give them away at a low enough price and especially if some of the money that you have given away comes back to the politicians engaged in rapid privatisation. But this money does not lead to strong economic development.

It is also necessary to differentiate between FDI and portfolio flows. When FDI is not going into natural resources but into manufacturing, it tends to create employment, brings with it technologies, access to markets, and, if well designed, training. Portfolio investment brings none of these advantages. In fact, it often has deleterious effects. The inflow of funds can lead to exchange rate appreciation. This, in turn, can make exports more difficult, inhibit job creation and lead to higher unemployment rates. This is the well-known phenomenon called 'the Dutch disease'.

Recently, the chief advisor of the Russian President has been discouraging portfolio capital flows on the grounds that it has an adverse effect on the exchange rate and therefore on economic growth. It was only after the lowering of the exchange rate following the 1998 crisis that Russia was able to begin growing at all. Moreover, portfolio investment, particularly short-term portfolio investment, is very unstable and that instability leads to increased risk. That, in turn, leads to lower economic growth.

These problems also arise with longer-term portfolio investment, because longer-term loans themselves eventually become short term. Inevitably, countries that have relied heavily on foreign borrowing have found that they have lost a significant part of economic sovereignty. When the foreign banks that are so anxious to get into the country suddenly turn away and the country has to ask the IMF for help, economic policies begin to be dictated by the financial markets and by the IMF.

The bottom line here is that for countries to rely on foreign borrowing is a mistake. If one looks around the world, one sees crisis after crisis. Banks are fair weather friends; they are willing to lend when the economic situation is good. But the moment that times turn bad, banks want their money back and thereby exacerbate the economic downturn. Many countries in the developing world were told that they had to open up their capital markets in order to achieve greater economic stability, but all the evidence points clearly to the contrary.

The point is of particular importance in the context of East Asia. In
East Asia there was no need to open up the capital market for the reason of needing more money. Countries already had savings rates of 30 to 40 per cent. They were having problems investing this money appropriately. One of the miracles of East Asia is that they succeeded in investing their huge savings reasonably well. What advantage could they have gained from opening their capital markets? They certainly did not need increased capital flows. They were told that they should open their financial sectors because doing so would stabilise their economies: if their economies should decline they would be able to get funds from abroad. But even when that story was told, the evidence was all to the contrary: banks simply do not like to lend to people who are in trouble. I have increasingly come to the view that countries should not rely on foreign borrowing.

They should work to attract FDI that promotes economic development. But they should not try to attract portfolio investment, particularly not the kind of short-term portfolio investment that leads to economic instability. The adverse effects of this kind of portfolio investment are even greater than those I have already described. I would like to highlight this by illustrating my point with respect to short-term capital flows.

One cannot build factories on the basis of money that can flow in and out of a country overnight. The instability associated with such short-term flows has currently led to the view that countries have to hold reserves equal to their short-term foreign borrowings in dollars or euros in order to protect themselves. Countries that hold reserves less than their short-term foreign borrowings face a higher probability of having a crisis. Think about what this means for a poor developing country. If a firm within that developing country borrows $100 million from an American bank at 18 or 20 per cent interest, this means that it has to send to the US $20 million every year. For prudential reasons, the government of that country has to put $100 million into reserves. Typically, the government holds these reserves in US treasury bills. What does it mean to hold reserves in US treasury bills? It means that the country is lending the United States $100 million. But the interest the country gets for lending the United States $100 million is currently a little less than 2 per cent. This means the country is borrowing $100 million from the United States and is lending $100 million to the United States. But it is paying 18 to 20 per cent on what it borrows and gets back only 2 per cent on what it is lending. Thus, it is sending something like 16–18 million dollars net to the United States. That is clearly good for the United States - and as Americans we appreciate the foreign aid from the poor African countries. It is also quite understandable now why the US Treasury is so enthusiastic about capital market liberalisation. However, it is hard to see how that is going to help the African countries to grow. They could use the money they are putting into reserves in far more productive ways.

Let me reiterate. I think that economic policies that are primarily focused on the objective of trying to attract foreign portfolio flows into a
country are likely to stifle economic growth. To encourage economic growth countries should attempt to promote domestic savings.

The success in East Asia was largely based on high savings rates. High savings were secured through a variety of mechanisms such as savings institutions and compulsory savings. The success in East Asia was not based on an attempt to attract portfolio investment but on the promotion of savings within countries and the attraction of job-creating FDI.

6 The outflow of capital and the issue of transparency

Within the context of Africa it is also important to stress the necessity of limiting the outflow of capital. Some of this outflow of capital has to do with corruption. The international community has helped people like Mobutu to move money out of his country by the creation of secret offshore banking centres.

In the aftermath of the East Asian crisis there was a great deal of discussion about the importance of transparency. As the discussion proceeded a consensus was developed in the international community that it had to be comprehensive; it had to apply to hack-funds and offshore banking centres. But amazingly the US Treasury changed its mind. Transparency, according to it, was important in the developing world but not in the developed world. People like Lawrence Summers came forward with arguments saying that if we allow too much openness, then people will not have an incentive to seek information. The OECD fortunately recognised that there was a real problem. They drafted an agreement that would limit secrecy in the offshore banking centres. Until 11 September 2001 the US Treasury vetoed the OECD initiative, claiming that secrecy is obviously good. Only after 11 September did they seem to have made the discovery that secret offshore banking centres have facilitated terrorism, drug trafficking and corruption; now they have changed their tune slightly.

The reason why I am talking so much about this is the following. The secrecy that provides safe haven for terrorists and money laundering is also safe haven for corruption and is to a large part responsible for the capital outflow from the African continent. It is important to do something on the global level to attack the secrecy of these offshore banking centres.

7 Ongoing debates

I am going to talk now about some of the global debates about providing more finance for development. The Monterrey meeting* that was recently held focused on finance for development. This meeting was an important initiative for a number of reasons. It brought home the point that finance has implications not just for financial markets. Issues of finance have an effect on everybody in society. Therefore, the people participating in discussions and decisions about finance should not only include finance minis-
ters and central bank governors. The UN meeting managed to bring together a relatively broad spectrum of leaders from the countries of the world. Doing that was of symbolic importance since it made clear that when we are talking about finance we are really talking about development and that discussions about finance have to involve more people.

One of the big issues was the need for more money. To meet the millennium goals such as reducing poverty by half, increasing education, and improving health, there is a substantial need for more money. Within Europe and most of the other developed countries we find a broad consensus to contribute 0.7 per cent of GDP to development assistance. Some countries even contribute 1.0 per cent of their GDP. It is peculiar that the richest country in the world continues to give only a very pauper amount.2

One of the issues that is currently under debate in the international community is that of grants vs. loans for development. The issue has certainly attracted more attention than necessary. To my mind it should depend to a large extent on the purposes for which the money is to be given and it has to be looked at from the perspective of the overall aid flows.

8 Innovative proposals

A topic that has not been discussed sufficiently has to do with innovative proposals for finance and development. The trend of globalisation brings with it an increased need for global collective action, which requires more finance. One new proposal has come from Finland, suggesting a global lottery whose proceeds could be used for economic development. Another proposal that has attracted considerable attention in Europe is the Tobin tax, sales taxes on currency trades across borders.10

A third proposal is linked to the recognition that there is a large area of global commons, such as the oceans, the sea bed, Antarctica, the atmosphere, etc., that lie outside sovereign boundaries. Managing these global commons is very important and can generate substantial revenues. These revenues could be devoted to the finance of global public goods.

9 SDRs or global greenbacks

There is one more proposal I want to end on. In 1969 the IMF created Special Drawing Rights (SDRs), as a de facto international reserve asset to supplement existing official reserves of member countries. The SDR is neither a currency, nor a claim on the IMF. Rather, it is a potential claim on the freely usable currencies of IMF members. It is allocated to member countries in proportion to their IMF quotas. Today the SDR has only limited use as a reserve asset, and its main function is to serve as the unit of account of the IMF and some other international organisations. However, in the current circumstances, SDRs could and should be put to
expanded use. Regular emissions of SDRs (or ‘global greenbacks’) could greatly help to finance economic development.

The current reserve system is both unequitable and unstable. In order to hedge against the volatility of currency and capital flows that come with increased financial integration, developing countries are forced to hold vast amounts of reserves that are estimated at between 1.6 and 2 trillion dollars — and as mentioned before these reserves are extremely costly to them. The additions to these reserves are a subtraction from global aggregate demand. That is to say that every year roughly between 100 and 200 billion dollars is put into these reserves. This means that the money that these countries have is not spent to buy goods — and that creates a downward bias in global aggregate demand. In a way only the US is allowed to continuously spend beyond its income, but even this may not last.

One way of looking at the problem is that there is a basic proposition that the sum of the trade surpluses has to equal the sum of the deficits. Thus, if China and Japan insist on having surpluses, the rest of the world must be in deficit. This means that if one country decides to reduce its deficit, that deficit has to show up somewhere else — deficits are like hot potatoes. That explains in some sense why we have had one crisis after another in recent years. If Thailand and Korea have crises, they want to get rid of their deficits. They get rid of their deficits by turning them into surpluses. But those deficits have to show up somewhere else, because the sum of the surpluses has to equal the sum of the deficits. Thus another country will face a big deficit, tries to turn it into a surplus and passes the deficit on to some other spot in the global system. So what we have is a system with an inbuilt source of instability. That system is characterised by enormous inequity. While there are great costs of the reserves for the developing world, the US reaps the benefit as developing countries provide them with a continuous flow of low-interest loans.

The proposal I would put forward for financing development is a regular issue of SDRs, which could be used to finance global public goods including development. This also would break the instability nexus of the current system and promote both equity and development. Such a measure would not be inflationary partly because the amounts issued would be relatively small. But it would offset the deflationary bias that the continual push of money into reserves causes. One can think about the proposal as a mutual help arrangement with the reserves representing the amount of goods that a country could acquire from others in times of crisis. If appropriately designed, it could be implemented in a way that would induce all to participate. Not surprisingly, there is one country one could see not liking this idea. How would one get the Americans to go along with it, then? One might, of course, just ignore them. The rest of the world — Europe and Japan — could form a club and let the US go its own way. But that is not the first-best solution. One possibility to induce the United States to join in would be to agree that countries would only hold
the currencies of those who are members of the club in their reserves. That would include those who acknowledge that new emissions of SDRs will be used for the purchase of global public goods. Thus, if the US decides that it does not want to co-operate in this global venture, other countries would have to dump their holdings of reserves of US Dollar bonds. That would clearly be adverse to the interests of the USA and would eliminate their incentive for staying out of the club.

10 Conclusion

Part of the responsibility for improving the flow of funds to finance development lies with the developing countries. Developing countries need to adopt better policies. They should only focus on attracting those kinds of funds that will promote economic development. They should not be led by the shibboleth that all funds promote economic growth. But I also believe that part of the responsibility lies with the global community. More ODA (overseas development assistance) is needed and a better reserve system has to be created. The structure of finance to the developing world needs to be re-considered. Although the general theory of risk bearing says that the wealthier countries should bear risk relative to the poor, at present we have the reverse of this. It is the poor that have to bear the risk of fluctuations in real interest rates and exchange rates.\textsuperscript{12} That is a major market failure and the international community should do something about it.

I have not talked much about trade. The trade agenda has been very unfair. The Uruguay Round left the poorest region of the world – Sub-Saharan Africa – worse off because of terms of trade effects.\textsuperscript{13} However, trade is intimately linked to finance because it is through income generated by trade that countries will be able to create the savings that may enable them to finance development themselves rather than rely on outside funds.

In short: while the provision of finance is certainly an important ingredient of development, we must not focus on it exclusively. If we want to promote economic growth, we also have to keep in mind the broader development objectives. There are economic strategies that can promote finance, particularly domestic finance, and economic development. But these strategies differ widely from many of the strategies that the developing countries have been encouraged to follow in the past.

Notes

1 Most of the provinces in China are larger than most of the countries in Africa.
2 Depending on what period and what numbers are used between 60 and 75 per cent of the total growth of the low-income countries has occurred in China.
3 China’s levels of FDI inflow currently compete only with those of the USA.
4 On average, this is one-third to two-thirds of a developing country’s GDP.
5 One of the other important factors is the disparity of knowledge. It is not only a disparity of capital but also a disparity of knowledge that separates the developed from the developing countries.

6 A case of well-designed FDI policy can be found in Malaysia.

7 Personally I take the view that a lack of transparency was not the cause of the crisis in East Asia. After all the previous set of crises had occurred in Scandinavia – in the countries that were allegedly the most transparent countries in the world. Thus although I consider transparency to be very important it is not going to inoculate a country against a crisis.

8 "Financing for development", 18-22 March 2002. This UN-hosted conference on key financial and development issues attracted 50 heads of state or government and over 200 ministers, as well as leaders from the private sector, civil society, and all the major intergovernmental financial, trade, economic and monetary organisations.

9 As a result of the Monterrey meeting this amount has increased, but it is still only of the magnitude of 0.5 per cent, as opposed to the 0.7 per cent that the European countries have set for themselves. But the increase is a step in the right direction.

10 It should be noted that James Tobin, the Nobel laureate economist who originally proposed the idea, has himself renounced it.

11 Amounts between 100 and 200 billion dollars are relatively small compared to the global economy amounting to 30 to 40 trillion dollars.

12 That is why they suffered in 1980 when the US raised its interest rates to higher levels.

13 It is a good sign that that the new round of trade talks is going to be called the ‘development round’.

References


