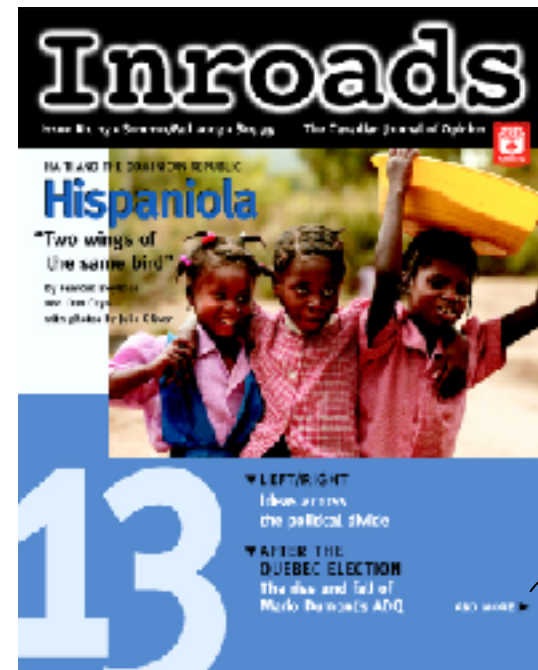


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A WORD ABOUT PRINTING THIS ARTICLE: These pages are intended to print on legal (8.5 x 14 inch) paper, two pages per sheet, in a horizontal landscape. Pages can also be printed onto letter sized paper, vertically, at a reduced size.

Foreign aid and poverty

An exchange on two books

William Easterly, *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics*. Cambridge, Massachusetts: The MIT Press, 2001, 342 pages.

Joseph Stiglitz, *Globalization and Its Discontents*. New York: W.W. Norton & Company, 2002, 282 pages.

by Finn Poschmann and Alvaro Pereira

OUR DISCUSSION OF DEVELOPMENT ISSUES FROM RIGHT AND LEFT perspectives takes the form of an exchange between Finn Poschmann and Alvaro Pereira. Both writers focus their attention on two recent books that have sparked debate on these issues, William Easterly's *The Elusive Quest for Growth: Economists' Adventures and Misadventures in the Tropics* and Joseph Stiglitz's *Globalization and Its Discontents*. After their initial contributions, each writer responds to the other's arguments.

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Photography by Julie Oliver.



For a desperately poor country like Haiti, remittances – the money sent home by people like this Haitian labourer in Santo Domingo, the capital of the Dominican Republic – may be a more important source of income than either exports or foreign aid.

Finn Poschmann writes

WILLIAM EASTERLY AND JOSEPH STIGLITZ have written powerful books extremely critical of the International Monetary Fund–World Bank standard medicine for sickly economies threatening to enter their death throes. The books are profoundly different in tone and tack.

Easterly's tone matches his position as a distressed insider firmly advocating change from within (he was Senior Advisor with the Development Research Group of the World Bank when his book was published). He is saddened, perhaps angered, by the misery that poor-country governments inflict on their citizens, a misery multiplied in scope and extended over time by IMF and World Bank funding that permits tyrants to cling to power when natural events might otherwise have driven them out. Easterly documents the repeated extension of

credit to governments that have steadfastly resisted the reforms that could have prevented their return to the lending window.

By contrast, Stiglitz's tone is arrogant and self-centred. It is a book about Joe Stiglitz's experience dealing with the Bank (where he was Chief Economist) and the IMF, and his fury with the IMF's application – against Joe Stiglitz's considered advice – of its standard prescription for the Asian economies that melted down toward the end of the 1990s. Shock therapy in the Communist transition economies comes under his gun as well. His complaint is that the IMF's brutal insistence on market reforms has greatly harmed the poor populations that the Fund's stabilization program presumably intended to help.

With Easterly and Stiglitz we enter a looking-glass world where, on the basis of the same history, one author laments the failure of the IMF to properly police the promulgation of market reforms, and the

other decries the agency's insistence on those same reforms. Easterly's history is by far the more engaging read; in my opinion, it is also the more accurate reflection of the reality behind the mirror of development policy debates.

Easterly describes the set of conditions that bring a government to seek IMF cash. The proto-

typical borrower is the mismanager of a desperately poor nation: infrastructure is crumbling or nonexistent; education is rotten; corruption is normal (it may be decentralized and uncontrolled, or top-down and more manageable); the government owns major economic enterprises and controls key prices; government spending far exceeds revenue; debt is high and commercial lending to the government has come to a halt; foreign investors are fleeing with whatever cash they can carry out (which may be partly limited by attempts to control the flow of capital); and, owing to a fixed exchange rate, a balance of payments crisis builds.

Meanwhile, senior government officials have become rich, because their position above the law permits them to trade in the marketplace at regulated prices and exchange rates *and* at the black market rate, pocketing the difference. One typical means is to require an export commodity to be sold by local producers to a state trading agency at a regulated price, perhaps determined by the world (U.S. dollar) price expressed in local currency at the official exchange rate. The



agency sells the product in the external market in exchange for U.S. dollars, which are then converted to local currency at the much stiffer black market rate. When one makes the rules, but doesn't have to follow them, there are many opportunities for fun and profit.

Life under these conditions can be quite horrible, as economic misery is compounded by the threats to person and property that typically accompany governmental lawlessness. In this inauspicious environment, the Western taxpayer steps in with World Bank development projects and conditional IMF loans intended to keep public services running – and avoid credit market default – through the hoped-for transition to a properly functioning market economy.

The IMF lays out the conditions it sees as necessary for arriving at the desired end state. This often means backing off on government involvement in the economy – freeing prices, selling state enterprises, easing capital controls, floating or devaluing the local currency (thereby easing the black market squeeze on the economy and providing a release for balance of payments pressures) and taking steps



What looks cute and quaint to Western eyes may not be so funny to the world's millions of profoundly poor people who live without basic amenities. Just keeping clean is difficult for people like this Haitian girl who lives in a crowded shantytown with no running water.

to make government revenues more nearly match spending, so that outstanding debt can be serviced and the commercial market might be tempted to resume lending. The hope is that the country will eventually function passably well without continued infusions of aid.

Take note that the IMF aims directly at government policy failures that in principle can be put right simply by making better choices. Central to these better choices is a more liberal approach to the economy. This is anathema to most self-designated advocates of the poor, who see price controls and high government spending as pro-poor policy.

I may be guilty of caricaturing Stiglitz but I think his book reflects a naive view of how to do good by the poor. For example, Stiglitz writes that “the level of pain in developing

countries created in the process of globalization and development as it has been guided by the IMF ... has been far greater than necessary.” If not IMF “pain,” how does Stiglitz propose to tackle the political fail-

Stiglitz's complaint is that the IMF's brutal insistence on market reforms has greatly harmed the poor populations that the Fund's backers presumably intended to help.

ures that lie at the heart of ongoing poverty in so many developing countries?

On the allegedly damaging role of the IMF, I think Stiglitz is wrong. For the most part, as Easterly shows, IMF prescriptions are routinely ignored, yet the lending window stays open and miserable policy choices survive another day. It is persistently bad economic policy pursued by host gov-

ernments that proximately causes persistent poverty, not persistently bad IMF policy interventions.

Where Stiglitz is right and his critics wrong is in the importance he attaches to civil institutions, which receive little but rhetorical attention in IMF programs. I think specifically of mechanisms for protecting private property and contract – more broadly, institutions that support the rule of law. (I can be more specific: the English common law approach is indicated, in part because it is readily adaptable to local conditions and habits. Developing countries whose colonial legacy left them instead with civil law systems have performed less well than those with a stronger Anglo heritage.) How *can* an economy transit from a state

Life under these conditions can be quite horrible, as economic misery is compounded by the threats to person and property that typically accompany governmental lawlessness.

wherein private property is effectively absent to one where sales and contracts can freely be entered, if the proceeds can readily be confiscated at gunpoint and there is no popularly accepted court or broadly recognized property law for the court to apply in putting things right?

My worries on this front began long ago. When the then newly constituted Russian parliament was pondering its role and the future relationship between the state and voters, I was part of a panel discussing transition issues with a group of new members of the Duma. I asked them how much effort they were devoting to establishing a property and contract (common) law frame-

work. In reply, I received mostly blank looks. I dimly recall one who said that some Western think tank had raised the issue with them, but the parliamentarians had other things to do first.

Absent a popularly accepted legal framework, it was easy to predict what happened, such as bankers exploding with their cars when they sought to collect on outstanding loans. Stiglitz argued that legal institutions should have been more secure before the post-Soviet transition was set loose. He was right. (Beginning in 1993 Stiglitz had a policy role in the process, having joined President Clinton's White House staff as chair of the Council of Economic Advisors).

I had thought these arguments obvious. Maybe not. Some advocates of the so-called Washington Consensus were overly optimistic that the demise of Communism would spontaneously bring forth a well-functioning capitalist economy. I think they were right to be optimistic, but wrong to pay relatively little attention to the civil institutions needed to make markets work.

Taken together, these books have a strong message for the IMF. On the one hand, lenders should ensure that they are not accidentally prolonging the policies and the misery that they set out to change. Sadly for those in badly governed poor countries – and for Joe Stiglitz – this may mean shutting off funds to countries whose populations truly are in a desperate state. Sometimes, no aid will be a better option than misspent aid. On the other hand, there is little point in prescribing remedies where the institutions to implement and enforce them are entirely absent. Sadly for all concerned, this will sometimes mean long, hard and dangerous work on the ground. If that is what it takes to reduce the tyranny of poverty, so be it.

Alvaro Pereira writes

JOSEPH STIGLITZ AND WILLIAM EASTERLY, both with intimate links to the World Bank, have written two valuable contributions to the literature on economic development and reform of the international financial architecture. The writing styles and the underlying messages of these two could not be more divergent, but their objective is essentially the same: what can we do to help the poorer half of the globe's population escape from poverty?

Stiglitz is concerned with reform of the international financial institutions, arguing that the International Monetary Fund and the World Trade Organization have failed the people of the less developed countries. Easterly debates what has comprehensively gone wrong in the last decades in the quest for growth in the developing countries. Stiglitz's book is mostly a political manifesto, whereas Easterly's work is an examination of the causes and consequences of underdevelopment. Stiglitz seems to be on a personal crusade against the IMF and the forces of market fundamentalism, while Easterly attempts a more balanced approach. Stiglitz adopts a quixotic tone in which he presents himself fighting against the windmills of the vested interests and the political opportunism of the Western world, represented by the IMF and the U.S. Treasury ("they" as Stiglitz often calls them). Easterly's tone is more academic, presenting evidence on how growth disasters are often caused by bad luck (wars, HIV/AIDS, a sharp deterioration of the terms of trade, etc.), bad domestic government policies (high inflation, high black market premium, political instability, corruption) and/or inadequate policies by international organizations such as the IMF

and the World Bank (providing aid to corrupt governments, pursuing capital fundamentalist policies).

What are the main lessons of these books?

Stiglitz argues that the disenchantment with globalization is largely caused by the flawed policies of international organizations (especially the IMF) that have disenfranchised poor countries, induced social unrest and neglected the environment. He contends that the IMF has zealously pursued so-called "Washington Consensus" policies of fiscal austerity, privatization and market liberalization. Overly rapid privatization, driven by a "narrow ideological perspective," has aggravated unemployment problems in many countries and led to social instability. The IMF programs of stabilization based on fiscal austerity have also been too contractionary. Furthermore, Stiglitz thinks that the "inflation paranoia" of the IMF led it to impose sharp increases in interest rates on countries seeking IMF aid, dampening aggregate demand and destabilizing social relations. In addition, the "market fundamentalism" of the IMF induced many countries to adopt capital market liberalization, which has led to more frequent crises across the world. Capital market liberalization was, Stiglitz concludes, the most important factor that led to the 1997–98 East Asian crisis.

Finally, Stiglitz blames the IMF for its "colonial mentality" and for neglecting recent advances in economic theory. What Stiglitz has in mind are his own contributions to economic theory which show that governments should intervene whenever there are missing or incomplete markets, which in his view are key to explaining poorly performing economies.

What are the remedies for the maladies of the international economy? Stiglitz argues that the developing countries should be given more voice in the IMF, the World Bank and the WTO. An increase in the representation (and voting rights) of the developing countries in these organizations would go a long way to solving many development problems. In addition, he contends that capital market liberalization should be used sparingly (at most) by developing countries, to avoid the speculation associated with short-term capital flows. Bankruptcies and standstills should also be authorized whenever countries face a debt crisis. In turn, big bailouts should be used less, since they are plagued with problems of moral hazard and provide the wrong incentives. Stiglitz

An increase in representation (and voting rights) of developing countries in the IMF, World Bank and WTO would go a long way to solving many development problems.

also advocates increased banking regulation, improved risk management and better safety nets in the developing countries. As Keynes proposed almost 60 years ago, Stiglitz thinks that the IMF should return to its original mandate by providing funds to countries temporarily needing demand stimulus.

In my opinion, Stiglitz's analysis is unfair, as he gives too little credit to the IMF for its ability to reform, especially after the crises of the late 1990s. For instance, many at the IMF now accept the need for temporary capital controls whenever financial crises hit. The new First Deputy Managing Director of the IMF, Anne Krueger, has proposed the introduction of Chapter 11 clauses for the international finance archi-

ture. Standstills are also on the agenda. Furthermore, Stiglitz's proposals are not themselves without problems. His proposal that the IMF provide funds to restore a country's aggregate demand would be plagued by the same moral hazard problems associated with current IMF bailouts.

However, Stiglitz is correct when he contends that the Western world (and especially the United States) has a double standard with respect to the developing countries. The United States, Europe and Japan have often preached the virtues of free trade to gain access to the markets of the developing countries, only to impose tariffs and other trade restrictions unilaterally whenever their "sensitive sectors" (such as agriculture, textiles and shoes) are at risk from the competition of the developing world.

In the final analysis, Stiglitz fails because he attributes too much blame for the misfortunes of developing countries to the external dynamics arising from the IMF and other agencies, and not enough to dynamics operating within. This is why Easterly's book is so important.

Easterly also argues that the IMF, the World Bank and generations of development experts share some of the blame for the discouraging record of most developing countries. For decades, the IMF and the World Bank insisted on inadequate models of growth, insisting, for example, that foreign aid was essential to finance the gap between the required domestic investment and a country's own savings. For decades, development economists, the IMF and the World Bank preached different variants of "capital fundamentalism," the idea that increases in physical and human capital were the keys to economic growth. For decades, our models stated that capital returns



It's just an irrigation ditch, shallow and muddy, but even modest water sources become a focus of community life throughout poorer regions of the world. People use them for drinking, for washing themselves and their clothes, and as a place to play.

should be substantially higher in the developing countries where capital was scarce, but could not explain why investors continued to invest in the rich developed world (in 1990, the richest 20 per cent of world population received 92 per cent of portfolio capital gross inflows, 79 per cent of foreign direct investment and 88 per cent of private capital gross inflows).

For decades, numerous remedies failed to deliver growth. Investment in physical capital did not bring substantial growth. There was an explosion in schooling throughout the developing world after 1950 but growth stagnated or declined in the last two decades. Population growth was blamed for the ailments of the developing world, but food production in both the rich and poor countries has vastly outstripped the increase in population. Adjustment lending by the World Bank and the IMF has

failed in many countries. Successive rounds of debt relief have not worked.

Why, asks Easterly, did these growth agendas fail? His answer is they failed because people respond to incentives. Giving aid to countries with bad policies does not bring about good policies and proper incentives. If a government allows high inflation, a high black market premium on the currency, high budget deficits or seriously negative interest rates, or if it does not restructure or shut down money-losing government enterprises, how will foreign aid help? If adjustment lending does not discriminate between corrupt and non-corrupt governments, how can we reward governments for good behaviour? How can the IMF and the World Bank be taken seriously if aid is determined by the strategic interests of donors and not by the policy choices of the recipients? How can debt relief work

if a host government's irresponsible behaviour persists after debt relief?

Taking account of incentives would yield better results. Aid should be given only to countries with good policies, and debt relief should be granted only if there has been a proven change in the behaviour of the government. Debt relief should also be a once-and-for-all measure.

Although Easterly's proposals are well intentioned, there are many political difficulties in realizing them. First, it might be difficult to establish whether a government has truly changed its policies. A government could temporarily change policies in order to be granted debt relief or aid, reverting afterward to bad policies. Second, it might be difficult to establish whether bad policy

If long, hard and dangerous work on the ground is what it takes to reduce the tyranny of poverty, so be it.

or bad luck is responsible for growth disasters. In fact, they often go together. For instance, governments are certainly partly responsible for the many of the growth disasters in sub-Saharan Africa. However, the devastation of HIV/AIDS, endemic civil wars, severe droughts and imminent famines imply that foreign aid will remain a vital component for these countries. Removing foreign aid from these countries on the basis of bad policies would certainly be catastrophic. Third, the recent events in Iraq suggest that, in the future, aid could be conditional on certain demands by the donor countries and donor agencies, such as respect for basic human rights or the protection of the rule of law. It is obviously an open question whether or not most developing

countries will agree to implement these demands in return for aid or debt relief.

All in all, these (and other) problems mean that implementing Easterly's prescriptions on foreign aid and debt relief might not be straightforward.

Incentives are important, but expectations and history are also crucial for economic growth. Some of the new theories of growth emphasize the role of increasing returns in the process of development. Unlike labour and capital, which are subject to diminishing returns in the short run, technological knowledge is subject to increasing returns. Knowledge is complementary not only to existing knowledge, but also to the existing technologies. High-skilled people will tend to get together with other high-skilled people. They will also go where technology yields the highest returns. The lesson is that strongly complementary skills and knowledge can create virtuous cycles of growth but can also generate traps. If a country starts with low technology and a lot of low-skilled people, then neither capital nor high-skilled people will go there, and the economy will remain trapped in a low level of income.

Poverty traps can occur as a result of bad government policy, but they can also occur as a result of bad luck. Major natural disasters, wars, famines, substantial losses in the terms of trade or HIV/AIDS can, like governments, create bad incentives, which in turn destroy growth. And, if people expect an economy to remain trapped in poverty, then growth will certainly not ensue.

Governments of poor countries have an important role if their economies are to escape the poverty trap. First, they should stop pursuing the bad policies that kill growth. Second, they should create institutions and



This shed, about one metre by four and lighted only by a doorway into an alley, is both workshop and daycare space for a small group of Haitian artists who paint colourful pictures to sell to tourists who come in droves to the neighbouring Dominican Republic.

the legal framework to protect and secure property rights. Third, they should eliminate incentives for corruption. Fourth, high income inequality is bad for growth, since it abets political instability. Fifth, governments should subsidize research and development as well as technology-promoting policies. This is not an easy agenda for developing-country governments to pursue. Easterly's message is that, without it, nothing enduring will be achieved.

All in all, these two books are a significant contribution to the development literature. There are lessons to be learned from both Stiglitz's egocentric, conspiracy-laden book and Easterly's more carefully written work. Over the next few years, these two books will shape the debate on development economics and reform of the international financial architecture.

Finn Poschmann adds

OBVIOUSLY ALVARO AND I AGREE ON THE central issues: incentives matter, and so do institutions, and Easterly is ultimately the better guide.

On reflection, we have been far too kind to Stiglitz. His looking-glass view of the world has been irremediably distorted by his academic background, which has focussed on the existence of market failures. Wherever Stiglitz looks, he perceives markets failing and an opening for government intervention. This jaundiced view leads him, for example, to refer repeatedly to "hot money" as a symptom of misbehaving markets crying out for capital control. A clearer eye would see investors coolly responding to the incentives governments create, such as the one-way bet they often open up when



Oksidan, a peasant (also depicted on the cover of this issue) in the remote mountains of northeastern Haiti, is immensely grateful to a now-dead priest who "gave" him three or four stony acres to till. In return, Oksidan gives the church half his produce each year.

defending fixed exchange rates that are unsupported by macro fundamentals and bank reserves.

Stiglitz is far too optimistic about governments' abilities and intentions: many of the world's citizens suffer because of their government's choices or their choice of government, not because Western aid agencies have failed to deliver the right medicine. We should bear this in mind when talking about the role of luck: famines and wars are not a matter of fate, as Easterly implies (and Alvaro, above, suggests); they are quite uniformly the result of government policy choices.

These themes twine together in a recent research paper that studies Botswana, an outstanding development success story:

Botswana has had the highest rate of per capita growth of any country in the world

in the last 35 years. This occurred despite adverse initial conditions, including minimal investment during the colonial period and high inequality. Botswana achieved this rapid development by following orthodox economic policies ... Good policies were chosen in Botswana because good institutions, which we refer to as institutions of private property, were in place ... The effect of British colonialism on Botswana was minimal, and did not destroy these institutions ... Following independence, maintaining and strengthening institutions of private property were in the economic interests of the elite ... We emphasize that this situation was reinforced by a number of critical decisions made by the post-independence leaders.¹

I hope these simple lessons hold sway as the rebuilding job in Iraq wends forward.

They will bear more fruit than anything the IMF or the World Bank does or does not do.

Finally, Easterly's message on corruption bears a powerful injunction for aid agencies like Canada's CIDA, a past offender on this front. His figures on corruption's corrosive impact and how it is sustained by foreign aid are terrifically compelling. As CIDA's mandate is reworked, Ottawa ought to keep this in mind.

Alvaro Pereira adds

I AGREE THAT ONE OF THE PROBLEMS with Stiglitz is that his view on market failures can cause many misunderstandings. Markets do sometimes fail, because of externalities, asymmetric information and moral hazard. However, these failures are the exception, while Stiglitz implies that they are the rule. Most growth disasters in recent decades have been caused by government failure, not market failure. The "Washington Consensus" policies are not a panacea, but an outright rejection of these policies can lead many governments to go back to the old protectionist and import-substitution policies that caused so much damage in so many countries.

Good policies are crucial in the process of economic development, and Botswana is indeed an example. In less than four decades, Botswana has transformed itself from one of the poorest countries in the world to a middle-income country. However, other factors besides good policies also played a role in Botswana's success. Ethnic divisions in that country are not exceptionally high. Botswana has a clearly dominating ethnic group (the Tswana or Setswana who account for 79 per cent of the popula-

tion), whereas many of the growth disasters suffer from extreme ethnic polarization. As Easterly points out, more polarized societies have worse government policies (and worse growth records) than more unified societies.

Botswana's case also shows that good policies are not enough. In spite of high growth, Botswana has an extremely high unemployment rate: officially 21 per cent, but unofficial estimates place it closer to 40 per cent.² High inequality also persists in the country, which could threaten future growth. Finally, like many other countries in sub-Saharan Africa, Botswana is vulnerable to the ravages of HIV/AIDS: in 1999, the adult prevalence rate was almost 36 per cent. HIV/AIDS has the potential of reversing gains from past decades' growth.

Although most wars and many famines are the result of bad government policy, bad luck or geographical considerations do sometimes play a role, as David Landes demonstrates in his magnum opus, *The Wealth and Poverty of Nations*.³ The devastation of HIV/AIDS is one of the greatest challenges to the development of many regions in the globe, especially in sub-Saharan Africa. The magnitude of this tragedy may transform some growth successes into growth disasters. To prevent that, a combination of good government policies and a healthy dose of foreign aid is required. ■

Notes

¹ Daron Acemoglu, Simon Johnson and James A. Robinson, "An African Success Story: Botswana," CEPR Discussion Papers, 2003.

² U.S. Central Intelligence Agency, *The World Fact Book 2002* (Washington, 2002), at <http://www.cia.gov/cia/publications/factbook/>

³ New York: W.W. Norton, 1999.