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Question 2
TA: Max. Wed 3:30-4:40
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Question 2: LDC's Dilemma

Less Developed Countries(LDC's) face a dilemma in trying to achieve a higher state of economic well-being. Integration exposes them to a host of economic and political pressures, whereas isolation makes economic development more difficult. By looking at the past solutions that LDCs have attempted it is clear that developing nations are entrapped: they need to be integrated into the world economy in order to develop, however they are faced with strict monetary regulations from international bodies and political pressures which curtail their development. First I will focus on previous solutions that LDC' s have implemented, such as the import substitution industrialization and the Washington Consensus, and examine the reasons why these were not successful. Then I will shift to explaining how developing nations that attempt integration are often forced to abide by strict regulations from international organizations, such as the International Monetary Fund, that actually make the nations worse off economically. Lastly, I will suggest solutions that developing nations should follow in order to have more economic success.

The first strategy that many developing nations, including Brazil, Mexico, India, Egypt, and Turkey, implemented to try to better their economic situation was Import Substitution Industrialization(ISI).[1] This policy developed as a nations leaders became skeptical of their trading negotiations. Leaders believed they needed to become less dependent on foreign capital, technology, and services by developing their own industries at home. This policy was a way of

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[1] Joseph Greico, and G.John Ikenberry, "Developing Nations and the World Economy," In *State Power and World Markets- The International Political Economy*, (New york, London: W.W. Norton&Company, 2003), 255.

industrializing by substituting imports with domestic products. The belief was that internal demand was sufficient enough for nations to sell their own domestic goods and prosper, if only foreign products could be kept out.[2] The government would protect import competing industries in an effort to give them time to become internationally competitive by overvaluing the exchange rate so that needed imports to develop industry are cheaper.

Although this policy sounded good in theory, in reality it was destructive. In order to favor industrialization firms, developing nations discriminated against agriculture in every way. This caused large animosity among agriculture workers who were making no profit because of the restrictions on exports. Labor also suffered a great deal because only capital modes of production were being focused on, causing labor intensive workers to suffer. Lastly, as these firms enjoyed protection from international competition as well as subsidized credit and privileged access to foreign exchange, they had little incentive to become efficient producers and instead became increasingly inefficient.[3] Overall this policy was a failure and demonstrated to developing nations that an isolationist policy would not work in this global economy.

After realizing that integration policies were key for economic success, developing nations looked to the international community for suggestions on the best way to become economically stable.The answer the IMF, the World Bank, and the U.S. government came up with was the Washington Consensus.This advocated that to achieve sustainable growth, countries should pursue macroeconomic stability, rely on private enterprise rather than state-owned firms, and reduce trade and investment barriers allowing international market forces to direct the

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[2] Roger Schoenman, "Development Strategies," Class lecture, Class Lecture from UCSC, Santa Cruz, November 9, 2011.

[3] Joseph Greico and G. John Ikenberry, "Developing Nations and the World Economy," 255.

country to efficiency.[4] The belief was that following these policies will bring economic success. However, the Washington Consensus did not actually provide a set of policies that allowed newly opened economies to cope effectively with the consequences of globalization, especially in the financial sphere.[5] The paradox is that any country capable of meeting such stringent requirements is already developed. The task was too overwhelming and therefore when attempted all at once was not successful.

Not only was the Washington Consensus unsuccessful for developing nations but evidence also shows that developing countries that followed IMF integration policies were worse off economically. Countries that participated in IMF stabilization programs grew at significantly lower rates than countries that were in comparably difficult economic circumstances but elected not to pursue IMF support.[6] In addition, countries that entered into agreements with the IMF do not appear to have grown faster in the years after they completed their stabilization programs than they did before they entered into those agreements.[7] In actuality, the IMF has stunted the growth of many developing countries because it often makes its assistance to nations conditioned on their acceptance and implementation of standby agreements that contain elements that are unnecessary at best and counterproductive at worst. This demonstrates that integration did not always help nations economically, rather it exposes nations to greater outside influence and pressures that can actually impede their growth.

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[4] Ibid, 256

[5] Moises Naim, "Washington Consensus or Washington Confusion", *Foreign Policy* No. 118 (Spring 2000), 67

[6] Joseph Greico and John Ikenberry, *Developing Nations and the World Economy*, 279.

[7] Adam Przeworski and James Rayment Vreeland, "The Effect of IMF Programs on Economic Growth," *Journal of Development Economics 62* (2000),pp.397-403.

An example of this can be seen by the IMF's response to the Asian financial crisis in Thailand in 1997. Jeffrey Sach's argues that IMF arriving in Thailand actually contributed to the crisis by issuing dire public pronouncements and by demanding solutions so drastic that market participants concluded that Asia was contracting.[8] Instead of the IMF appeasing the situation it made the crisis worse by causing panic throughout these Asian nations causing investors to pull out and the economy to crash. IMF intervention is typically a negative symbol to the international community, demonstrating that a nation is in trouble which can damage these developing nations reputation, making economic growth more difficult.

Lastly by the IMF becoming active early in managing financial crises and by imposing costs on the government and public of the borrowing country rather than on the foreign or the local banks lending to that country, it has produced international financial chaos within developing nations- hindering rather than helping. This can be seen with what is currently happening in Greece. The IMF keeps forcing the Greek government to implement austerity packages that focus on cutting wages and pensions as well as thousands of layoffs in the public sectors. The Greek citizens are outraged with these measures, believing that they are being punished for all of these large economic mistakes. This lead to a series of large scale strikes and demonstrations, causing chaos throughout the nation. The IMF is forcing its policies and beliefs on developing nations and these nations are forced to accept, even if the policies are extremely unpopular, because they are in dire need and have no other alternatives. By forcing its policies on a nation, the IMF is no longer helping the nation, rather it is contributing to increased animosity by the population and increased economic destruction throughout. Overall, it is clear

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[8] Jeffrey Sachs, "The IMF and the Asian Flu," *American Prospect 37*(March-April 1998), 2

that the IMF's policies often hinder developing nations who are trying to establish themselves economically.

Looking at the issues that the IMF alone causes, its is clear that developing nations are stuck in an economic conundrum: isolation creates complete economic disfunction and integration policies expose nations to monetary pressures from international bodies that often hinder growth. While there is no clear answer to economic success for developing nations, there are certain key elements that developed nations possess that help them maintain economic stability, that developing nations can learn from. Ideas for solutions can come from looking at the policy of export-led growth that East-Asian countries followed, a form of managed integration. This policy focused on a governed market approach where the state is actively involved in the economy. The idea was that the state purposely created wrong prices, allowing certain industrial sectors to develop comparative advantage that did not have it previously, which then would compete on the international market.[9]

I am not advocating that this policy will be successful for developing nations, however I believe there are things that developing countries can learn from the success of the Asian Tigers.These nations succeeded because they possessed macro-economic stability, heavily invested in social infrastructure, and had a strong state. The first thing that developing nations need to focus on is building a unified state and gaining popular support. The populous needs to support the state and the economy in order to consume and help the economy prosper. Therefore these developing nations should focus on building a strong state with populous support because

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[9] Roger Schoenman, "Development Strategies," Class lecture, Class Lecture from UCSC, Santa Cruz, November 9, 2011.

only with the formation of a stable state can these nations be successful in other aspects such as building social infrastructure and bringing in economic success.

After developing countries have focused on building a solid state with popular support, they can begin to focus on maintaining economic stability. In order to do this, nations will first have to develop a set of institutions and policies that mitigate the impact of the economic shocks when they occur. These institutions need to have the ability to allocate massive resources to these initiatives. This ties back to what was mentioned earlier about the need for a stable state with a strong and efficient public sector. Once these features are in place, nations should focus on both savings rates and foreign investment because these are critical variables in economic success. Even if a high savings rate does not protect a country's economy from crashing, it is needed to develop a strong financial system that can help buffer the economy from external shocks.[10] Lastly, nations should then focus on gaining higher domestic savings and foreign capital because these are needed to fund the huge investments that most reforming countries require to catch up with the demand for infrastructure and social services. There is not one clear path that developing nations should follow, however nations can gain insight from looking at past policies that developed countries have implemented that have helped them succeed.

At the moment, developing nations face a dilemma in trying to achieve a higher state of economic well-being. Integration exposes them to a host of economic and political pressures, whereas isolation makes economic development more difficult. By looking at the failure of ISI it is clear that isolation shuts down economic development and that integration is necessary for economic success. However, integration policies come with pressures from international

[10] Moises Naim, "Washington Consensus or Washington Confusion",71.

monetary bodies such as the IMF. The IMF tries to enforce its beliefs on nations in need, often times hindering these nations rather then helping, which can be seen in the case of Thailand and Greece. Although, the situation seems grim for developing nations and there is no clear solution of how to achieve economic success, hope is not lost. Developing nations can learn from looking at which policies and past situations helped developed nations prosper economically and then structure a unique plan for themselves. This path would be more successful than having the international community dictate which steps to take because the nations would be formulating a unique plan specific to their country.

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