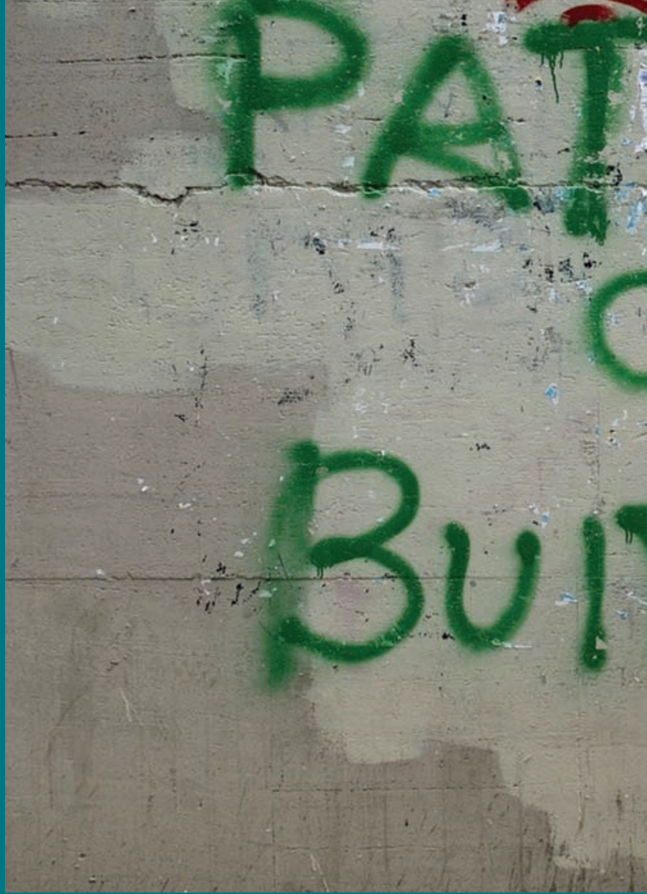


# 8

# International Financial Relations

**THE PUZZLE** *Every year, approximately $5 trillion is invested abroad. Why is so much money invested in foreign countries? And why do relations between foreign investors and the countries in which they invest often become hostile and politically controversial?*

*Above:* Argentina, like many developing countries, has had trouble servicing its loans to private investors. "Vulture funds" brought suit in American courts to try to force Argentina to pay, despite the costs to the Argentine economy. Here, a woman in Argentina is shown walking past graffiti that reads "country or vultures," while the Argentine government was engaged in conflict with such funds in 2014.

The global financial crisis that began in 2008 hit Europe almost immediately with a major debt crisis. Borrowers in a number of eurozone countries had built up large debts and appeared to be unable to service them. The crisis eventually came to be known as the European sovereign debt crisis (sovereign debt is debt owed by governments) and was the most serious sovereign debt crisis since the 1930s, endangering the international financial system and the world economy.

The four principal eurozone debtors were Greece, Ireland, Portugal, and Spain. In Spain and Ireland, households had borrowed heavily to finance a major housing and construction boom. When housing prices collapsed, the two national governments started borrowing heavily from abroad to finance national bank bailouts and to stimulate their economies. Greece, however, had been running budget deficits ever since the creation of the eurozone, with the government relying heavily on foreign borrowing to cover the shortfalls. Portugal was somewhere in between: both households and the government had been borrowing heavily.

The difficulties of the eurozone debtors were not just a problem for them, since major northern European financial institutions and investors were the ones that had made most of these loans. If the debtors defaulted, trillions of dollars in loans on the books of northern European banks, investors, and pension funds would go bad. The weight of so many bad loans and investments endangered the very integrity of the financial systems of even the richest European countries, especially Germany and France. The sovereign debt crisis threatened both the sovereign debtors and their creditors—and, in fact, the entire European economy.

Faced with this looming catastrophe, leaders of the eurozone member states put together a trillion-euro package to shore up the finances of the major debtors and the region's financial system. In return, they insisted that the debtor countries impose severe austerity measures, including raising taxes, cutting government spending, and selling off public enterprises. Mass protests rocked the debtor nations, and there were even talks of leaving the euro.

It took almost ten years for eurozone economic output to return to what it had been before the crisis. In the meantime the region's unemployment soared; in Greece and Spain, unemployment peaked at over 25 percent. The result was widespread dissatisfaction with both national governments and, more generally, the European Union

(EU). Political movements and parties hostile to or skeptical of European integration gained strength, culminating in Britain's June 2016 vote to leave the European Union. All over Europe, it seemed, 50 years of consensus in favor of European integration and a centrist vision of society had collapsed.

The eurozone crisis is an example of how international finance can become a highly political issue. Today, capital flows around the world in unimaginably large quantities. Nearly half of all the world's investment goes across borders—every year about $5 *trillion* in foreign loans and investments. Total international investments in 2014 were about $140 trillion, and *every day* many trillions of dollars in foreign currencies are traded. Even the United States has financed large trade and budget deficits with money from abroad, borrowing more than $5 trillion between 2005 and 2014—increasing its debt to foreigners in those years by more than $40,000 for every American household.[1]

International finance has long been the leading edge of global economic integration. Massive investment flows drove the integrated world economy of the nineteenth and early twentieth centuries; then they dried up during the years between World Wars I and II, when the world's nations turned inward. Since 1960, international finance has revived and is once again the most globalized component of the world economy, dwarfing international trade and migration.

Some analysts regard the emergence of a worldwide market for capital as one of globalization's main attractions. Companies, investors, and borrowers around the world now can tap into an enormous pool of capital. Home buyers in Arkansas can have their mortgages underwritten by investors in Germany; start-ups in India can be financed by Canadian pension funds; shopkeepers in South Africa can borrow money that comes from small savers in Japan.

Yet international finance is also extremely controversial, and critics of global economic integration have long targeted international bankers. Many policy makers in the developing world see international finance as a source of economic and political problems and as a potential threat to their nations' sovereignty.

A series of financial crises, culminating in the global economic crisis, has focused attention on how financial developments in one country can affect others. Problems that started in the market for housing finance in the United States in 2007 ended up causing the most serious international financial panic since the 1930s. Meanwhile, loans gone similarly bad in Europe threatened to tear the European Union apart. Even the world's largest and richest economies seemed highly susceptible to the volatility of international financial markets.

## Thinking Analytically about International Finance

Governments, firms, and individuals sometimes pursue international finance avidly and sometimes attack it mercilessly. This disparity raises questions about why international investment is so controversial. As we will see, within borrowing nations, there are many actors who value access to foreign funds. However, there are others who resent the constraints and burdens that foreign investments sometimes impose on debtors. Similar conflicting interests exist within lending nations.

At the international level, lenders and borrowers have a shared interest in sustaining capital flows, but they may disagree about how the benefits from loans are divided. For example, most Europeans favor allowing capital to flow among EU member countries, but they may disagree profoundly about who should be asked to make the sacrifices necessary to resolve the region's debt crisis. Similarly, international investors and the recipients of investment may enter into conflict. These interactions frequently involve bargaining over the investments, as each side tries to get the best deal.

International institutions, such as the International Monetary Fund (IMF), structure interactions in the international financial realm. Like international finance generally, however, the role of the IMF is very controversial: some analysts think it contributes to the cooperative resolution of financial problems, while others think it takes unfair advantage of struggling debtor nations. In this chapter we take a closer look at these questions.

1. Except where otherwise noted, all data in this section are from M. Ayhan Kose, Eswar Prasad, Kenneth Rogoff, and Shang-Jin Wei, "Financial Globalization: A Reappraisal," *IMF Staff Papers* 56, no. 1 (2009); and the Updated and Extended External Wealth of Nations Dataset, 1970–2011, from Philip Lane and Gian Maria Milesi-Ferretti, "The External Wealth of Nations Mark II: Revised and Extended Estimates of Foreign Assets and Liabilities, 1970–2004," *Journal of International Economics* 73, no. 2 (2007), supplemented and updated from the IMF's International Financial Statistics and the U.S. Department of Treasury.

# How and Why Do People Invest Overseas?

There are many ways in which those with capital can invest in foreign lands. There are two broad categories of foreign investment: portfolio and direct. A **portfolio investment** gives the investor a claim on some income but no role in managing the investment. Loans are portfolio investments. So are shares of a company's stock (equities), for each share of stock represents a minuscule portion of ownership in the corporation.[2]

**portfolio investment**
Investment in a foreign country via the purchase of stocks (equities), bonds, or other financial instruments. Portfolio investors do not exercise managerial control of the foreign operation.

If, for example, an investor buys the bonds of an Indian corporation or the Indian government, or if a bank lends money to an Indian corporation or the Indian government, the Indian debtor commits itself to make interest and principal payments but has no obligation to involve the creditor in figuring out how or when to use the borrowed money. Even if the Indian corporation or Indian government has a bad year, it is obligated to pay off its creditors at the preestablished interest rate.[3] Portfolio investors take little or no part in running their investment; their interest is simply in the rate of return.

A substantial portion of the portfolio investment that goes to developing countries is **sovereign lending**—that is, loans from private financial institutions to sovereign governments. Loans by European or American financial institutions to the governments of Indonesia or Brazil—or to government-owned or -controlled companies or agencies in those countries—are sovereign loans. So too are purchases by foreigners of French or American government bonds, for example. If the government provides a guarantee for loans made to private firms in foreign countries, these too can be considered to be sovereign loans.

**sovereign lending**
Loans from private financial institutions in one country to sovereign governments in other countries.

**Foreign direct investment (FDI)** is made by a company that owns facilities in another country—facilities over which the company maintains control. For example, a Toyota truck factory in Thailand or a Disney theme park in France is an instance of an FDI. FDI differs from foreign portfolio investment most importantly because the investor maintains managerial control—and also bears the risk of the investment. If a Toyota truck factory in Thailand is not profitable, Toyota loses money. Direct investors have full authority to run their investments, but they take most of the associated risks as well.

**foreign direct investment (FDI)**
Investment in a foreign country via the acquisition of a local facility or the establishment of a new facility. Direct investors maintain managerial control of the foreign operation.

2. Equities (stocks) can be ambiguous; an investor who owns enough of the company's shares might, in fact, take control of the company, making the investment direct. But almost all international equity investment is of the portfolio variety, meaning that it does not involve actual managerial control of the firm.
3. This distinction is blurred in instances in which foreigners buy large quantities of corporate equities—so at some point they could, in fact, exercise control over the corporation. Traditional portfolio investors, as discussed here, are not interested in control; they buy equities solely as financial instruments.

## *Why Invest Abroad? Why Borrow Abroad?*

Banks, corporations, and individuals make investments overseas with a clear goal: to make money. Those with capital want to move their money from where profits are lower to where profits are higher. Thus, many international investors want to move money from capital-rich developed countries to capital-poor developing ones. Banks, corporations, and individuals in rich countries invest more than $800 billion every year in developing- and emerging-market nations, about two-thirds of it in direct investment from multinational corporations (MNCs), the other third in loans and investments in equities (stocks).[4] Figure 8.1 illustrates the rapid growth of foreign investment in emerging markets over recent decades.

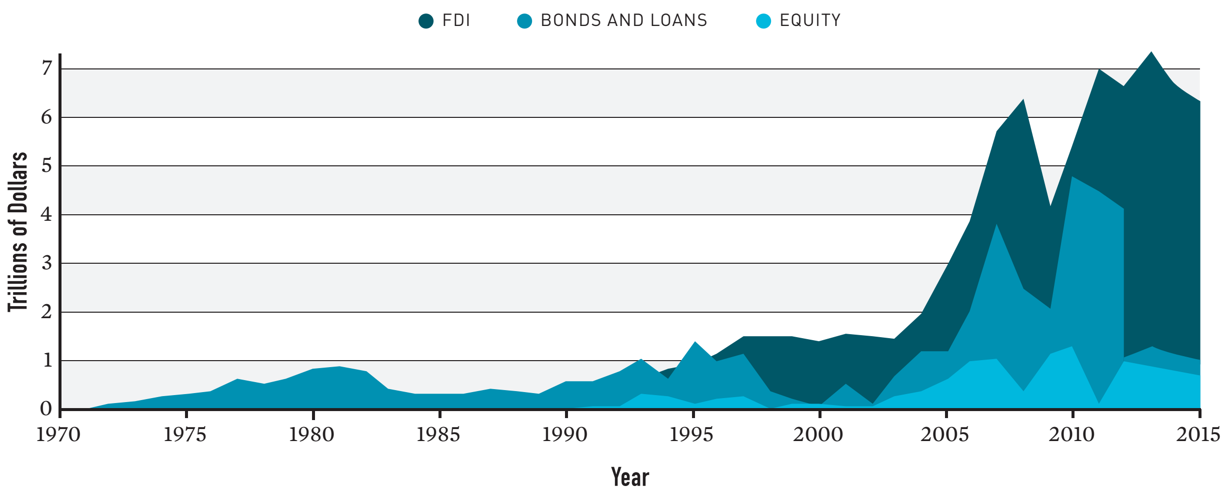
The Heckscher-Ohlin theory presented in Chapter 7 explains why. A country's average profit rate depends on how plentiful capital is. Where land or labor is scarce, it is expensive; where it is plentiful, it is cheap. The same is true of capital, recognizing that the interest rate is the "price" of capital: more expensive capital means a higher rate of return. In a poor country, capital is scarce and therefore expensive: borrowers pay higher interest rates for something in short supply. In a rich country, capital is abundant, so interest rates and profit rates are much lower. For example, in 2014 the prevailing rate of interest on short-term loans in most developed countries was below 2 percent, while in Latin America it was typically 10 percent and often higher.

The greater scarcity of capital, as well as higher interest rates, in developing versus developed countries encourages capital to flow from richer to poorer countries. For example, Mexico is poor in capital, while the United States is rich in

*Figure source:* World Bank, World Development Indicators, http://data.worldbank.org/indicator (accessed 09/07/17).

*Note:* Measures are "net inflows" in current U.S. dollars for low- and middle-income countries as defined by the World Bank. See http://data.worldbank.org/income-level/LMY for countries included.

FIGURE 8.1 ***Foreign Investment in Emerging Markets, 1970–2015***




4. This is an annual average for 2007–2015 based on the data in Figure 8.1.

capital. Thus, profits and interest rates are higher in Mexico, which helps explain why American investors have, over time, accumulated investments worth over $300 billion there.

If the only considerations in international investment were differential rates of return, as in this simple Heckscher-Ohlin discussion, then all foreign investment would flow from capital-rich countries to capital-poor countries. But it decidedly does not. In fact, most international investment is among rich countries, and only a relatively small but growing fraction of international investment in the past couple of decades has gone to the developing world. The reason is the lower risk of cross-border investment in rich countries. International banks, corporations, and other investors care not just about the promised interest or profit rate on foreign investments, but also about the likelihood that they will actually get the money. See Figure 8.2 for a breakdown of FDI by region in recent years.

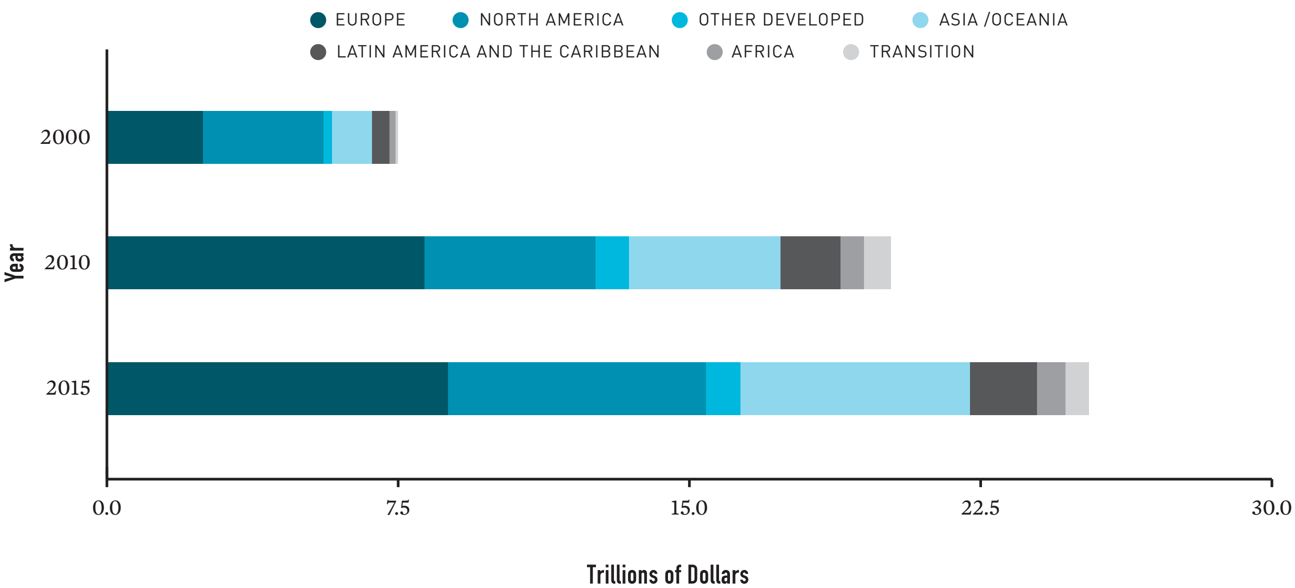
Although all investment is risky, international investment involves a very specific risk: that a foreign government over which the investor has no influence may do things that reduce the value of the investment. This is especially true about loans to a foreign government, which involve a government's promise to pay debt service (interest and principal). Unlike in domestic lending, this promise cannot be enforced by the threat of foreclosure or bankruptcy. For international corporate investment, the concern is that the local government will undertake policies that devalue the investment—up to and including taking over the investment itself.

Investment among rich countries is much less risky than investment in poor countries. After all, the industrialized nations are more economically and politically stable, and they have a longer and more reliable history of treating foreign

*Figure source:* United Nations Conference on Trade and Development, World Investment Report 2016, http://unctad.org/en/PublicationsLibrary/wir2016_en.pdf (accessed 1/4/18).

*Note:* Measures are "FDI inward stock" in current U.S. dollars.

FIGURE 8.2 ***Foreign Direct Investment by Region, 2000–2015***




The United Kingdom presents a low-risk environment for foreign investors because it is stable and rich. Many British brands and landmarks are owned by corporations based overseas, such as the London Taxi Company, owned by Chinese automotive manufacturer Geely.

investors well. For investors to be willing to take a chance on the greater risk in the developing world, they need either higher interest rates and profits or some reason to think that they can effectively manage the investment risks. This need can lead to negotiations, between lenders or investors on the one hand and developing countries on the other hand, to try to ensure a more reliable investment environment. This effort, in turn, draws international investment into international politics.

## *What's the Problem with Foreign Investment?*

International investment is controversial because not only can it provide great benefits to both investors and the countries they invest in, but it can also impose real costs on both sides of the relationship. This is yet another example, discussed in Chapter 2, of how many issues in international politics contain elements of both cooperation and bargaining. Both sets of actors stand to gain by an amicable resolution of their differences, so they have an interest in cooperating, but each side wants to get as much as possible out of the relationship, which leads their interaction down the path to bargaining.

In international investment, there are many common interests among borrowers and lenders, among investors and the countries they invest in. Both sides of the interaction gain from successful international investments and loans. The receiving country gets capital it would not otherwise have. Companies that borrow from abroad can expand their businesses. Governments that borrow from abroad can finance projects that spur development, such as roads and power plants. An inflow of foreign funds can increase the availability of credit to small business owners and homeowners. Meanwhile, the foreign investor who has sent the money overseas gets higher profits than are available at home. Borrowing and lending nations alike gain from the ability of capital to flow across borders.

But there may also be major conflicts of interest between the two sides of the relationship. Each party wants to get as much as possible from the other and to give as little as possible. Lenders want their debts repaid in full, and corporations want to bring home high profits from their foreign investments. Debtor nations, however, would rather pay less of what they owe, and host countries would rather that foreign corporations have less to take away. This situation creates both a commonality of interests in maintaining a flow of capital and a conflict of interests in distributing the benefits of the flow.

Within countries, domestic politics may also contribute to conflict between capital-sending and capital-receiving nations. In most countries, there is little disagreement when money is flowing in. Foreign capital allows the country to consume more than it produces and allows the government to spend more than it takes in through taxes; the foreign capital increases domestic consumption, investment, and economic activity, and this outcome tends to be popular. Eventually, however, lenders must be repaid and profits taken out—an outcome that is less universally popular.

Making debt service payments can require raising taxes, reducing government services, restraining wages and consumption, importing less while exporting more, and generally imposing austerity on the national economy. Debt crises throughout history—including recent ones in both developing and developed countries—have been associated with slow growth, unemployment, cuts in social spending, and general economic hardship. And there is no guarantee that the people and groups who are asked to bear the greatest burden of austerity will be those who benefited most from the capital inflow. Even if foreign borrowing and foreign investment are unambiguously good for a nation, the benefits and costs do not accrue equally to all people in the country. This fact has made international finance a contentious issue within developing—and many developed—countries.

Overseas loans and investments can be controversial within lending and investing nations too. While those making the foreign investments stand to gain, there are also workers and firms that resent money going abroad that could be lent or invested at home. And when debt crises erupt, it is common for creditor-country governments to expend time, energy, and money to try to resolve the crisis. This is partly because a crisis abroad can have grave repercussions at home.

In the midst of the debt crisis of the 1980s, for instance, many Americans were shocked to learn that U.S. banks had lent more money to Latin American governments than the value of the capital base of the entire American banking system. This meant that the Latin American debt crisis could conceivably have bankrupted many of America's largest banks and caused a more general financial and economic crisis in the United States itself. Similarly, northern Europeans were startled to find out after 2008 that their banks, and often pension funds, had invested trillions of dollars in American, Spanish, and Irish mortgages and in the government bonds of Greece and Portugal—and that because these investments had gone bad, their financial systems were under serious threat.

But even if it is in the general interest of creditor nations as a whole to "bail out" their troubled banks and their borrowers, it may not be in the interests of everyone in these nations. So, international investment gives rise to plenty of potential sources of conflict, and these conflicts of interest give rise to complex interactions among the sources and targets of global capital movements.

## *Concessional Finance*

There is another, smaller and somewhat less controversial, part of international finance: money lent to developing countries by government agencies and intergovernmental organizations. Rich countries give to poor countries, or lend to them at below-market interest rates, something on the order of $150 billion a year. Such concessional finance differs from that discussed in the preceding section because it is typically lent at interest rates well below those available in the marketplace; World Bank loans to the poorest nations, in fact, bear no interest.

Many of the countries that borrow these concessional funds would not be able to borrow from private creditors, who are wary of particularly poor and unstable nations. Most countries in sub-Saharan Africa and South Asia have little access to private loans; to the extent that they can borrow, it is from North American, European, and Japanese governments or from such institutions as the World Bank and the Asian Development Bank.

Concessional loans from foreign governments are more a form of aid than of finance. They reflect, as does aid generally, both economic and political motivations of the donors and lenders. The international development banks and related agencies—the World Bank, Inter-American Development Bank, Asian Development Bank, and so on—are somewhat less directly political, as they are controlled by a number of rich countries. Their lending programs emphasize basic development projects, such as economic infrastructure (power plants, dams, highways) and social infrastructure (schools, housing).

As we saw in Chapter 1, the two major international economic institutions established at Bretton Woods after World War II were the World Bank and the IMF. The **World Bank** (officially, the International Bank for Reconstruction and Development) was charged with making loans to promote economic development. The IMF was originally focused primarily on exchange rates and monetary relations, but, as we will see later in this chapter, its focus has shifted to international finance in recent decades.

**World Bank**

An important international institution that provides loans at below-market interest rates to developing countries, typically to enable them to carry out development projects.

Like the IMF, the World Bank is headquartered in Washington, D.C.; in fact, the two international financial institutions are across the street from each other. The World Bank gets most of its money by borrowing on major financial markets—typically at very low rates, as its bonds are guaranteed by the governments of the markets in which it borrows. Funds raised in this way are lent out to developing countries to help them build major infrastructural and other development projects. Because the World Bank can borrow at much lower interest rates than developing countries can, it can relend to them at very attractive rates. The World Bank also receives some money from developed member states that is lent out at extremely low or no interest to the poorest nations. The World Bank is oriented primarily toward financing long-term investments in such things as roads, dams, and power plants, all of which are considered essential for broader economic growth and development.

There has been less political controversy about concessional finance, as loans from individual governments are negotiated directly and, like loans from the World Bank and its related institutions, are relatively cheap. Nonetheless, countries with severe economic problems often complain about the cost of these loans, and for extremely poor nations concessional debt can be a heavy burden—despite the loans' lower interest rates.

This situation has led to calls for debt forgiveness, a measure that would alleviate some problems in very poor nations but that would come at the expense of rich nations' taxpayers. These issues, ethically important as they may be, do not have much impact on private international finance. The amounts at stake are relatively small, and private investors are typically not involved. In any case, much government-to-government concessional debt has been canceled, and the World Bank and IMF are in the process of writing off the debt of the most heavily indebted poor countries.[5] Moreover, the major economic and political issues related to international investment have to do with other, nonconcessional, finance.


Liberian Electricity Corporation workers string electric lines through Monrovia. To help moderate the high cost of electricity generation in West Africa, the World Bank approved a loan to facilitate the construction of an energy transmission network throughout the region.

# Why Is International Finance Controversial?

Historically the most important—and most politically conflictual—component of international investment has been private lending to foreign governments. Shakespeare may have been right about the pitfalls of borrowing and lending when he wrote:

> Neither a borrower nor a lender be;
> For loan oft loses both itself and friend,
> And borrowing dulls the edge of husbandry.
> —Polonius, in Shakespeare's *Hamlet*

Indeed, the parties might end up enemies, and the borrowers could have little incentive to use the money wisely. However, there is nothing economically suspect about borrowing or lending, in principle. In the case of a private corporation, it makes sense to borrow if the borrowed funds are used in ways that increase the firm's earnings by more than the money costs. If General Motors borrows at an interest rate of 10 percent but uses the money to make investments that pay out only 5 percent, it will suffer a loss; but if the investments pay out 15 percent, both the borrower and the lender can benefit. The logic is similar for a government.

5. For further information on the reduction of debts owed by the heavily indebted poor countries (HIPC), see International Monetary Fund, "Debt Relief under the Heavily Indebted Poor Countries (HIPC) Initiative," September 20, 2014, www.imf.org/external/np/exr/facts/hipc.htm.

## *Who Wants to Borrow? Who Wants to Lend?*

From the standpoint of the economy as a whole, it generally makes sense for a country to borrow if the borrowed funds are used productively, in ways that increase the country's output by more than it will take to repay the debt. Loans might be used to raise national output directly, such as to make productive use of a government-owned natural resource (oil or copper, for example). The money could also be used to increase national output indirectly, such as by building new roads that allow the opening or improvement of agricultural lands or by building a hydroelectric power plant that makes national industry more efficient. As national output rises, the government gets more tax revenue and can service its debts more easily. If borrowed funds are used to increase the productivity of the national economy, they can pay for themselves.

Because developing countries are by definition short of capital, most of their governments are eager to borrow abroad. The prospect of using borrowed money to speed growth and increase national output gives developing economies today a powerful interest in attracting loans from international investors, and it makes borrowing relatively uncontroversial within debtor countries—as long as times are good.

But sovereign debts can quickly become a burden to debtor nations, which makes them much less popular. Governments attempting to service their debts often impose unpopular measures. They cut spending and raise taxes in order to earn the money they need to pay off loans. They raise interest rates to restrain wages, profits, and consumption, which in turn reduces imports and increases exports, so that the country can earn more foreign currency to pay its creditors. These austerity measures typically weaken the domestic economy in order to allow the government to continue paying debt service to foreign creditors.

**recession**
A sharp slowdown in the rate of economic growth and economic activity.

**depression**
A severe downturn in the business cycle, typically associated with a major decline in economic activity, production, and investment; a severe contraction of credit; and sustained high unemployment.

Such measures can cause a **recession** and or even **depression**, incurring the wrath of labor, business, and other groups. For example, in the wake of a 1997 debt crisis, the Thai government pushed interest rates to 25 percent, cut government spending by 20 percent, and raised taxes. The economy collapsed, shrinking by 12 percent in two years as unemployment more than doubled.[6] In Thailand, as in many such cases, people regarded debt-driven austerity as doubly unfair: they were being asked to sacrifice to repay borrowed money that did not help them, and their sacrifice was going to enrich huge international financial institutions.

One potential source of debt difficulties is international conditions, which can change in ways that make it harder for governments to pay their debts. Between 1980 and 1982, for example, American interest rates rose by 10 percent as the Federal Reserve attempted to reduce American inflation. Most of the debts owed by developing countries to international banks were at floating interest rates, adjusted every six months in line with American interest rates; as American rates went up, so did the cost of outstanding loans. This was, in fact, one of the causes of the debt crisis of the 1980s.

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6. Joseph Kahn, "I.M.F. Concedes Its Conditions for Thailand Were Too Austere," *New York Times*, February 11, 1998.

Similarly, an international recession that reduces demand for debtors' exports can make it hard to service loans: when the Great Depression of the 1930s drove down prices and demand for debtors' products, it caused almost every debtor nation to **default**. When circumstances, especially conditions beyond their control, make it harder for debtor governments to keep up their payments, some people in debtor nations prefer that their government simply default in order to force a reduction in the debt burden. There are, then, contending interests within debtor countries over whether to service foreign debt. Those who expect to benefit from maintaining access to international loans will disagree with those who have more to lose from the economic sacrifices required to maintain good relations with foreign creditors.

**default**
To fail to make payments on a debt.

Within lending countries, when foreign debts are performing well there is usually little conflict over them. Some local companies and individuals may resent the fact that money that could be lent to them is being sent abroad, but this concern is counterbalanced by the profits being brought home. Overall, creditor countries and their governments tend to support their lenders.

Domestic conflict within creditor nations over foreign debts arises most commonly when the loans run into trouble. In these conditions, creditors and their governments often step in with billions of dollars of new loans and aid to alleviate a debtor country's financial crisis. They do so in the belief that if such a crisis were allowed to broaden and deepen, it could spread to other nations and eventually hurt the creditor nation itself. But many people in North America, Europe, and Japan resent their governments' spending of billions of dollars to "bail out" debtors and creditors whose plight may be the self-inflicted result of greed, venality, and bad judgment.

For example, in 1994, in the aftermath of another Mexican crisis, the U.S. government provided many billions of dollars to the beleaguered Mexican government to try to keep the crisis from spreading and affecting American domestic finances as well. In reaction, conservative Republican political activist Patrick Buchanan charged: "What's going down is not just a bailout of Mexico, but a bailout of Wall Street. [President] Clinton and Congress are rushing to recoup for Wall Street bankers and brokers their enormous losses from the plunderings of [Mexican] ex-President Carlos Salinas and friends."[7] From the Left, the liberal magazine the *Progressive* observed: "It's amazing how our government can find money for . . . bailing out some banks or shoring up some brutal regimes, but not for solving the pressing social needs of our own country, like health care, housing, and jobs at a living wage."[8]

Many people in creditor nations regard the trillions of dollars spent in financial rescue packages over the past 30 years as money doled out to undeserving banks and investors who benefited from their ability to put pressure on policy makers. In the aftermath of the Mexican and East Asian financial rescues, the U.S. Congress enacted a number of measures that limited the authority of the executive

7. From Patrick J. Buchanan, "Congress Saves Wall Street's Bacon," Buchanan.org (blog), April 20, 1995, http://buchanan.org/blog/congress-saves-wall-streets-bacon-172.

8. "Bailout for Whom?" *Progressive* 62, no. 2 (February 1998): 9–10.

branch to use taxpayer money for such bailouts. Supporters of the bills presented the response to these crises as a clear case of Wall Street versus Main Street: bailing out banks while many small farms and businesses were allowed to go under.[9] Many American and European taxpayers were similarly angry with the financial rescues mounted by the governments of the United States and the European Union in the context of the global financial crisis that began in 2008.

Attitudes toward the IMF and other international financial institutions are often related to broader attitudes toward global economic integration. Both supporters and opponents of globalization tend to think of the IMF and its allies as important pillars of the contemporary international economy. Those wary of globalization distrust global finance and the IMF; those who favor globalization support them.

Whatever domestic disagreements there may be, in general the interests of debtor and creditor countries are clear. Both sides of the relationship stand to benefit from continued lending: borrowers get access to foreign money, and lenders get profits. But each side would prefer to gain more from the relationship. Thus, there are incentives to cooperate to keep the lending going and incentives to bargain for the best possible deal. This sets the stage for complex interactions between debtors and creditors.

## *Debtor-Creditor Interactions*

In the modern era, there have been many cycles of lending and debt crises. All through the nineteenth and early twentieth centuries, rapidly growing countries borrowed heavily from the major European financial centers—primarily London, but also Paris, Amsterdam, and Berlin. Foreign borrowing was, in fact, important to the economic growth of the principal developing regions of the day: the United States, Canada, Australia, Argentina, Brazil, and others.

In most instances, debts appear to have contributed to economic development, but that did not diminish the attendant crises and political disputes. The United States, the world's largest borrower throughout the nineteenth century, was not immune: many of its state governments defaulted in the 1840s, and the state of Mississippi, whose banks borrowed heavily from London financiers in the 1830s and defaulted in 1841, has ever since continued to refuse to make payments on its London debt.

Concern about getting embroiled in debt disputes helps explain why today's private international financial flows to the developing world are restricted to the more advanced and successful developing countries. Countries facing severe developmental difficulties, or about which there is little reliable information, are simply unattractive to private creditors. For example, the government of Brazil is able to attract substantial loans from foreign investors (it had over $300 billion in outstanding debt to private creditors in 2015), whereas the governments of Burkina Faso, Nepal, and Yemen must rely overwhelmingly on concessional lending from the World Bank and other aid agencies.[10] Even in the case of well-known

9. J. Lawrence Broz, "Congressional Politics of International Financial Rescues," *American Journal of Political Science* 49, no. 3 (July 2005): 496–512.

10. World Bank, World Development Indicators, http://data.worldbank.org/data-catalog/world-development-indicators (accessed 08/14/17).

This graffiti in Lisbon, Portugal, depicts German chancellor Angela Merkel manipulating the strings of Portuguese leaders. Many Portuguese blamed Merkel for the austerity measures that the government enacted in order to receive an emergency loan from eurozone partners during the crisis.

debtor countries, however, debtor-creditor interactions are inherently complicated by the strategic interactions that are in the relationship.

When debtors and creditors enter into conflict, each side in the interaction has clear interests at stake. For debtor nations in crisis, making prompt and full debt service payments can mean restraining consumption, increasing taxes, reducing government spending, and cutting wages—in a word, **austerity**. So, debtor governments want to reduce the amounts they have to pay so as to reduce the demands on their citizens. On the other hand, creditors' profits depend on the debt service payments they receive. So, creditors want to be paid in full for the loans they have extended. The two sets of interests are, of course, in conflict.

**austerity**
The application of policies to reduce consumption, typically by cutting government spending, raising taxes, and restricting wages.

As we have seen, when two actors have conflicting interests, they engage in a bargaining interaction to determine whether a mutually acceptable deal is possible. Each side has tools in its arsenal that can be used to extract favorable terms. The principal bargaining weapon available to the debtor government is the threat of default, or suspension of payment on the debt.[11] In August 1998, the Russian government responded to national economic difficulties with a default that affected as much as $80 billion in foreign debt; in December 2001, the Argentine government defaulted on $93 billion in foreign debt, and controversy over its repayment continued for the next fifteen years.[12]

11. Legally, a *default* is invoked by the creditor when the debtor misses payments, but the term is used more generally to describe a suspension of debt service.

12. The amounts involved are unclear, especially for Russia. See International Monetary Fund, *World Economic Outlook* (Washington, DC: International Monetary Fund, 1998), chap. 2. On Argentina's most recent default controversy, see Matt O'Brien, "Everything You Need to Know about Argentina's Weird Default," *Washington Post*, August 3, 2014, www.washingtonpost.com/blogs/wonkblog/wp/2014/08/03/everything-you-need-to-know-about-argentinas-weird-default.

Any sensible creditor would prefer to get some money rather than to get no money at all and therefore has an incentive to reduce the burden of debt. But creditors also have financial weapons available: they can cut off debtor governments from future lending, and they may be able to retaliate in related areas, such as freezing debtor governments' bank accounts or taking other government-owned properties. Creditors can also try to get their home governments to use broader foreign policy considerations to induce compliance, such as threatening a cutoff of aid or even military action. In short, each side can threaten to impose costs on the other in order to extract a better deal at the bargaining table. The ability of each side to get concessions from the other depends on how powerful and credible these threats are.

The bargaining between creditors and debtors over existing debt is analogous to the bargaining between countries that we described in Chapter 3, which can sometimes lead to war. Because of the costs associated with default and retaliation, there is usually a bargaining solution to their interaction that makes both sides better off than financial warfare. Both sides would prefer to restructure the debt so that payments can continue to be made; this is what negotiators, arbitrators, and bankruptcy courts do in the case of domestic debt problems.

However, as in the case of security relations, international debtor-creditor interactions are characterized by incomplete information. The debtor may claim not to be able to make payments, but the creditor does not know if the claim is true. Thus, creditors cannot know whether the threat to default will, in fact, be carried out in the face of potentially dire consequences for the debtor, which may simply be bluffing in order to get a better deal. The creditor, for its part, may threaten to retaliate, but the debtor does not know whether the threat will be carried out.

In these circumstances, cooperative relations between debtors and creditors can collapse into bitter conflict. Many debt conflicts drag on for years or even decades and can have a powerful impact on other dimensions of interstate interaction. Debt-related conflicts have even been blamed for invasions, wars, and colonialism. In some instances, the issue is resolved amicably with a negotiated settlement; in other instances, the parties remain far apart.

Of course, cooperation between debtors and creditors is not necessarily a good thing for everyone involved. This is especially the case when debtor or creditor governments pursue policies that impose major costs on domestic groups. Whether an amicable resolution of debtor-creditor interactions is a good thing or a bad thing, it is important to try to understand the conflict and how it develops. One prominent aspect of international debt interactions is that they have come to involve international institutions that can play an important part in debtor-creditor relations.

## *Institutions of International Finance*

During the twentieth century, there were frequent attempts to regulate debtor-creditor relations by creating institutions to mediate their interactions and perhaps facilitate mutually acceptable outcomes. These institutions have, to a certain extent, helped alleviate the problems that can make lending difficult or impossible and that cause conflict when debtors run into trouble. In the interwar period, the League of Nations' Economic and Financial Committee attempted to work with debtors and creditors to manage the financial difficulties of troubled nations in central and eastern Europe, with mixed results.

The **Bank for International Settlements** was established in 1930 explicitly to help oversee relations between one of the world's most problematic debtor nations, Germany, and its international creditors. It too met with mixed results. Nonetheless, by the 1940s there was a common view that some form of international financial institution might be beneficial to the resolution of sovereign debt problems.

**Bank for International Settlements**
One of the oldest international financial organizations, created in 1930. Its members include the world's principal central banks, and under its auspices they attempt to cooperate in the financial realm.

**The International Monetary Fund** Today, many aspects of international financial affairs are overseen by one of the world's most powerful international organizations, the **International Monetary Fund (IMF)**. The establishment of the IMF was agreed on at Bretton Woods (see Chapter 1) in order to manage the international monetary system. After the Bretton Woods monetary regime collapsed in the early 1970s (as we will see in Chapter 9), the IMF gradually took on a more directly financial role. Today, its principal concern is financial crises in developing nations, although it has also played a role during crisis periods in developed countries.

**International Monetary Fund (IMF)**
A major international economic institution that was established in 1944 to manage international monetary relations and that has gradually reoriented itself to focus on the international financial system, especially debt and currency crises.

The IMF's membership includes both borrowing and lending countries. All member states have a vote on its activities, but these votes are proportional to the member's financial contribution to the IMF resources, its "quota." These financial contributions are, in turn, a function of the size of the country's economy and its importance to world trade and payments. As a result, the United States provides nearly 18 percent of the IMF's total resources; the member states of the European Union provide another 32 percent. Because IMF decisions require an 85 percent supermajority, the United States and the European Union (acting as a group) can veto fund actions. This arrangement has led to complaints that the IMF is largely a tool of its richer and most powerful members—to which those members sometimes respond that this is appropriate inasmuch as they are the ones footing most of the bills.

The IMF, indeed, needs substantial funds to carry out its activities. The total of quotas from its members is currently about $650 billion, and the fund can call upon pledges from its members of another $1 trillion. This gives the IMF, in theory, access to over $1.5 trillion dollars, although it has never come close to using all these resources. Nonetheless, one of the things that leads many to regard the IMF as the most important and most powerful international economic institution is that it can mobilize an extraordinary amount of money in a relatively short time. And because debt crises often erupt suddenly, and often involve vast amounts of money, the IMF is uniquely suited to intervene in such crises.

Typically, a country facing debt difficulties turns to the IMF to negotiate a program of economic policies intended to address the sources of the difficulties. The conditions demanded by the IMF are often economically and politically difficult for the debtor government to enact, but in return for implementing a program that meets the IMF's standards, the debtor government receives relatively


When the Indonesian government sought the IMF's help during the 1997–98 Asian financial crisis, it was forced to cut spending on popular programs, and poor Indonesians suffered. These protesters in Jakarta hold a sign asking: "The country's debt—why should the people pay?"

inexpensive loans from the fund. Probably more important, the debtor country is "certified" as being in compliance with IMF norms, which makes it more attractive to creditors. This certification is meant to encourage private lenders to renegotiate with the debtor government and perhaps to extend it new loans to help it overcome temporary difficulties.

For example, during the debt crisis of the 1980s, the IMF signed dozens of agreements with troubled debtors, typically requiring policies of economic austerity and adjustment in return for assistance with working out their debt problems. The IMF's agreement with Indonesia in the midst of the 1997–98 Asian financial crisis obliged the Indonesian government to cut subsidies to—and therefore raise the prices of—sugar, wheat flour, corn, and soybeans, as well as fuel and electricity. All these factors imposed hardships on Indonesia's poor and working people. The IMF also required the government to shut down 16 banks controlled by relatives or cronies of the country's dictatorial president, Suharto. This move may have been less objectionable to ordinary people, but it was, of course, unpopular with the Indonesian government.[13]

While the IMF dealt mainly with developing debtor nations from the 1970s until the 2000s, the financial crisis that began in 2008 drove many industrialized countries to the fund. Over the course of the crisis, the IMF negotiated very large loans and austerity programs with Greece, Ireland, and Portugal, as well as with Ukraine, which experienced a severe crisis in 2014–15. The IMF's operations in these instances were similar to those in other debt crises, although in the European cases it worked in concert with EU authorities.

13. Stephan Haggard, *The Political Economy of the Asian Financial Crisis* (Washington, DC: Institute for International Economics, 2000).

The IMF, like other international institutions, can facilitate cooperative interactions among actors in a variety of ways. It provides a set of financial and macroeconomic standards, and a wealth of other information, that can be used to assess the behavior of debtor nations. By increasing the likelihood that debtor-creditor relations will be iterated (repeated), the fund can make cooperation more attractive. The IMF can also help verify a debtor government's compliance with commitments to pursue economic policies that creditors want to see. And the IMF can act on behalf of the collectivity of creditor nations, which might otherwise have difficulties working out common decisions about how to deal with financial crises.

In one sense, though, the IMF is unusual. While many international institutions act primarily to facilitate bargaining among nation-states, the IMF negotiates agreements directly with an individual country's government. And, perhaps even more unusual, the IMF's involvement is typically closely tied to relations between the debtor government and private international creditors. While the IMF does not represent foreign creditors, there is normally an understanding that an agreement with the IMF will facilitate agreement with private lenders, and sometimes the IMF, member governments, and private creditors make this connection explicit. In this sense, the IMF plays a major part, directly or indirectly, in negotiations between sovereign governments and private financiers. This unusual relationship has also led to charges that the IMF is biased in favor of creditors and against debtors (see "Controversy" on p. 364).

Supporters of the IMF believe that it plays an important role in managing the international financial system, allowing for an orderly resolution of debtor-creditor problems. They focus on the informational difficulties endemic in sovereign debt, as well as the need for reliable monitoring of compliance with agreements. Supporters emphasize how the IMF can help debtors and creditors arrive at cooperative arrangements. They believe that the IMF's power comes from its central role in resolving financial problems in ways that are beneficial to both debtors and creditors.

However, opponents see the IMF as a tool of international financiers. They regard the IMF as a biased agency whose actions reinforce the subordinate position of debtor nations and do little to assist them in achieving economic growth and development. Similar conflicts arise over the involvement of the home governments of creditors, primarily from North America, Europe, and Japan. Debtor nations often resent political pressure from these powerful governments, which they regard as unduly concerned with insisting that "their" bankers get repaid. Creditors can be politically influential at home, and defaults can threaten to bankrupt major financial institutions in industrial nations, which would, in turn, destabilize their own financial markets. This situation leads creditor governments and the IMF, in the eyes of many opponents, to serve as debt collectors for international banks.

## *Borrowing and Debt Crises*

Lending to developing nations has been an important part of the international economy since the mid-1960s. At the same time, there have been many debt crises since international financial markets reopened to developing countries. The first

CONTROVERSY

# Is the IMF Biased against Developing Countries?

In February 1989, facing a protracted fiscal crisis, Venezuela's president, Carlos Andrés Pérez, negotiated a loan with the IMF. Going back on preelection promises he had made only weeks earlier, Pérez adopted market-based reforms recommended by the IMF as part of the loan deal: liberalizing trade, privatizing state companies, restricting state spending, relaxing price controls, and deregulating exchange and interest rates. Almost immediately, Caracas erupted in violent protests that eventually led to two failed coups, the impeachment of Pérez, and the rise of coup leader Hugo Chávez to the presidency. Chávez and the supporters of his "Bolivarian Revolution" became some of the strongest critics of the IMF, and in 2007 Venezuela pulled out of the IMF and the World Bank.

The IMF's supporters argue that its actions are in the interests of developing countries like Venezuela: the IMF assists nations in financial difficulty, and helps them maintain access to foreign capital that is vital to their development. But this claim is controversial. Why?

**Applying the Concepts**

The IMF typically is called upon when a country runs into debt trouble. These situations inevitably involve a conflict of **interests** between debtors (who want debt relief) and creditors (who want to be paid back). As an international **institution**, the IMF is charged with the task of safeguarding global financial stability, which it often interprets as demanding substantial economic reforms from debtor nations. Many people in the debtor nations see the IMF's demands for economic reforms as a threat to the important institution of national sovereignty. The **interactions** among the IMF, debtor countries, and creditors vary greatly in their nature: in some cases, they are cooperative and therefore not controversial; in other cases, they collapse into acrimonious conflicts. The IMF may facilitate international financial cooperation, but critics claim that it distributes the benefits and burdens of that cooperation unevenly across member nations.

The chief criticisms that Chávez leveled at the IMF reflect both conflicts of interest and institutional concerns. Chávez's first main criticism derived from the "conditionalities" routinely attached to IMF loans. For decades, the IMF has required that countries requesting financial assistance commit to "structural adjustment programs" and economic austerity measures designed to address debtor nations' fiscal and financial problems. Critics argue that these conditions are not in the interests of debtor nations and often impose hardship on their poorest citizens, who face higher taxes, wage cuts, unemployment, and reduced social services.

The second charge is that the IMF as an international organization violates the institutional integrity of sovereign nations. This charge derives from the fact that IMF programs may include conditions associated not only with economic reforms, but also with changes to specific national political institutions. Pérez, for instance, was asked to institute direct elections of state governors in Venezuela in place of presidential appointments.

The IMF's critics also point out that the interaction between the IMF and debtor nations is highly unequal. Acceptance of IMF conditions is supposedly voluntary, but the high price of refusal—ineligibility for an IMF program—creates an impression of coercion. Indeed, debtor countries that turn to the IMF are typically in very weak bargaining positions; they are desperate for the IMF's financial assistance and the access to private loans it can help ensure.

Defenders of the IMF respond to these criticisms by stressing that both debtors and creditors have an interest in mutual gains from cooperation. The IMF's policy recommendations help debtor nations ensure economic recovery and restore access to foreign credit, and the benefits over the long term outweigh the temporary costs to the nation's citizens and the diminishment of a nation's sovereignty. Once these longer-term effects are taken into account, it becomes clear that it is in the interest of debtor nations to participate in the IMF.

*Riots overtook Caracas in 1989 after the Venezuelan government imposed austerity measures recommended by the IMF. Here, people stand in line to buy food, looking on toward a victim of the violence.*

Supporters further argue that the IMF provides essential institutional support to the international financial system, whose smooth functioning is equally in the interests of both debtor nations and creditors. If the IMF were not there to help guarantee creditors of good debtor behavior, creditors would not lend. Member states *voluntarily* go to the IMF because they want its seal of approval in order to gain access to global financial markets. Typically, governments have gotten into trouble because they pursued unsustainable policies, and the IMF can help them get back on track and regain access to international finance. Without the IMF, there would be little or no international lending, and poor nations would be far worse off.

Critics counter that the IMF worries primarily about the interests of creditors, even at the expense of social progress, economic growth, and equity. There is little moral justification for subjecting the people of a country to terrible austerity measures solely to pay billions to foreign banks and investors. Many IMF programs fail even on their own terms, providing little economic relief. The allegedly "voluntary" nature of IMF programs is a fiction; a developing country that does not "voluntarily" subject itself to IMF dictates will be punished. As a result, critics argue that the IMF is a tool of the creditor nations and their investors, and its policies benefit only the rich and powerful.

The plausibility of these arguments depends on how well the IMF, in fact, delivers on its promises. If standard IMF measures actually rectify debtor nations' economic problems and contribute to economic growth, and this growth benefits the poor, then its operations may be regarded as fair and the bargains worth the cost. At this point, the evidence is mixed: while IMF programs may improve a nation's balance of payments, their record on economic growth and poverty reduction is unclear.

## Thinking Analytically

1. How and why do the IMF's activities in the developing world lead to conflicts of interest?
2. As an international institution, what is the goal of the IMF? How does it try to achieve this goal?
3. Why might interactions between the IMF and debtor nations sometimes go smoothly, while ending up in acrimonious disputes at other times?

such crisis started in 1982, with the Mexican default. Like most financial crises, this one had a self-reinforcing nature. As in a bank panic, because lenders worried that developing-country governments might not repay them, they stopped lending. This left developing-country governments without a financial cushion, and in desperation they stopped making payments to their creditors—thereby scaring international bankers even further. The more the developing countries ran out of money, the less bankers lent; the less bankers lent, the more the developing countries ran out of money. In the space of weeks, some of the most rapidly growing economies in the world were suddenly cut off from the bank lending they had relied on for 15 years.

One after another, the major debtor governments struggled to generate the foreign currency and government revenue needed to pay their creditors, until eventually their economies collapsed. By 1983, as many as 34 developing and socialist countries were formally renegotiating their debts, and a dozen more were in serious trouble. Latin America was spending nearly half of its export earnings to pay interest and principal on its foreign debt, leaving little to buy the imports it needed. Most debtor economies remained depressed for years, and the crises were not fully resolved until 1990. Austerity programs and economic reforms in debtor nations, coupled with concessions from lenders to reduce the debt burden, gradually allowed the problems to be worked out. (See "What Shaped Our World?" on p. 367 for details about this debt crisis.)

Eventually, lending resumed, but debt crises continued to occur. In 1994, Mexican finances once again collapsed. In 1997–98, combined debt and currency crises hit a series of East Asian countries from Indonesia and Thailand to the Philippines and South Korea. This was a particularly startling shock, as these nations had long been regarded as models of developmental success. Their apparently endless potential had drawn in considerable amounts of foreign money: Thailand's foreign debt tripled, from $30 billion to $90 billion, in the three years leading up to 1996, while Indonesia's doubled from $25 billion to $50 billion. During the early 1990s, about $50 billion a year flowed into East Asia from global financial markets, with tens of billions more in direct investment from multinational corporations.

Once the crisis hit in the summer of 1997, however, money ran out of the East Asian debtor countries as fast as it had run in. The $50 billion annual inflow of the early 1990s turned into an outflow of over $230 billion between 1997 and 1999. After years of extraordinary growth—10 percent a year was common—the economies of Indonesia, Thailand, and Malaysia contracted by 15, 12, and 8 percent, respectively, in a matter of months. It would be years before they would recover their pre-crisis levels.

The East Asian crisis was followed by crises in Russia and Brazil in 1998–99, Argentina in 2000–2001, and others since then. In all these cases, intervention by the IMF alone was not sufficient; the debt problems were so large that creditor governments also stepped in, to the tune of over $50 billion for Mexico, almost $120 billion for the three principal Asian crisis nations (Indonesia, South Korea, and Thailand), and another $70 billion for Russia and Brazil. Critics charged that taxpayers were being forced to bail out foolish investors and dissolute governments, but financial leaders insisted on the need for a quick response to avoid financial contagion.

WHAT SHAPED OUR WORLD?

# The Latin American Debt Crisis

In the 1960s, the governments of Latin America discovered a valuable resource: foreign loans. International investors had not lent money to developing countries since 1929, having been burned during the Great Depression when most countries stopped paying their debts. But by 1965 memories had faded, and international banks resumed lending to governments in the developing world.

**Interests** Latin American governments needed the money to build factories and roads, power plants and steel mills, schools and houses. For 15 years loans poured in, public and private projects lined up for money, and economies expanded. In the 10 years from 1973 to 1982, the region's total debt grew from $40 billion to $330 billion. The borrowing boom came to a crashing halt late in the summer of 1982. In August, the Mexican government announced that it could not pay the interest and principal on its $100 billion debt to foreign banks. International banks panicked. If Mexico, a major oil producer, couldn't or wouldn't pay its debts, perhaps other nations couldn't or wouldn't either. Investors stopped lending within weeks, and heavily indebted developing nations around the world were thrown into crisis. Within four months, about 40 countries had fallen behind on their debt payments.

**Institutions** The debt crisis that began in 1982 led to an economic collapse that was, for many countries, the most catastrophic in modern history. The crisis had dire effects on domestic political institutions. Latin America spiraled downward into recession and depression, unemployment, and hyperinflation (price increases of more than 50 percent a month). Governments collapsed all over the region.

At the international level, the governments of creditor and debtor nations, as well as the world's principal international financial institution, the IMF, all were important. The IMF orchestrated a multibillion-dollar bailout package even as it played an intermediary role between the creditor banks and the debtor nations. Debtor countries typically found themselves forced to enter an IMF program if they wanted to work out a better deal with their bank creditors.

**Interactions** The interplay among creditor governments, creditor banks, debtor governments, and the IMF made the politics of the debt crisis particularly complex. Lengthy and often bitter negotiations ensued over who would make the major sacrifices needed to address the accumulated debt burden. Most of the costs were borne by debtor nations. After decades of rapid growth, income per person in Latin America declined over the 1980s by 10 percent, real wages fell by at least 30 percent, and investment fell even further; inflation in many nations rose above 1,000 percent.[a] The 1980s became known in the region as the lost decade. Eventually, in 1989, creditor governments and banks offered some debt relief, governments began adopting new policies, and the region began growing again.

Domestically, throughout the developing world, protests erupted over the debt crisis and the unemployment, inflation, and government cutbacks it had brought. The economic and political crisis eventually drove most of Latin America's military dictatorships from power. But this advance was overshadowed by the fact that the debtor nations had fallen even further behind economically as they struggled to shoulder their debt. What had originally seemed a golden opportunity—readily available foreign loans—now seemed a terrible burden.


*Banco de México, Mexico's central bank.*

a. Eliana Cardoso and Ann Helwege, *Latin America's Economy: Diversity, Trends, and Conflicts* (Cambridge, MA: MIT Press, 1995).

The international politics of developing-country debt is a striking example of how actors with different interests interact strategically in a highly institutionalized context. The parties have not only clear conflicting interests, but also clear interests in common. Even though creditors want to be repaid and debtors want to pay as little as possible, both sides have an interest in continuing their relationship: the creditors to earn profits, the debtors to maintain access to foreign finance. This mix of cooperative and conflictual motives leads to complicated strategic interactions. And the role of the IMF highlights the role of international institutions—seen by some as effective at helping resolve conflicts, by others as tools of the powerful.

These debt crises in developing and transitional economies were dwarfed by a financial collapse that hit the advanced industrial economies in 2008. Some of the aspects of this crisis were familiar from previous debt crises—although it had been decades since an industrialized country had been so affected—while other features were very novel. Together, they plunged the world into the most serious economic downturn since the Great Depression of the 1930s.

## *A New Crisis Hits the United States—and the World*

The 2008 financial crisis originated in the United States, the world's largest economy and most developed financial system. The country had embarked on a major foreign borrowing spree. In 2001, substantial tax cuts drove the U.S. federal government into a large deficit. Much of the deficit was financed by borrowing from abroad. Government borrowing spurred the economy, reinforced by a monetary policy of very low interest rates; in turn, these low interest rates encouraged American households to borrow heavily. Much of the borrowing went for housing, as many Americans refinanced their homes or bought new homes. Foreigners eager to buy American investments that they regarded as safe and profitable provided large portions of the lending directly or indirectly.

From 2001 to 2007, the United States experienced a traditional borrowing boom. Every year, the country borrowed between a half-trillion and a trillion dollars from the rest of the world. A significant portion of the debt went to finance the government budget deficit; much of the rest went into the flourishing housing market. As financial markets grew at a dizzying pace, banks developed ever-more-complex ways of investing, borrowing, and lending.

Some observers warned that not enough of the new debt was going into productive investments that would increase the efficiency of the U.S. economy, such as new factories or new technologies. Other observers were concerned that American regulators were inadequately supervising the freewheeling, increasingly complex financial system. However, the U.S. government resisted stricter financial oversight, especially given its general commitment to deregulation. Meanwhile, most Americans were happy to enjoy a dramatic expansion in consumption, reduced taxes, increased government spending, and a striking increase in housing prices—all made possible by foreign borrowing.


Between 2001 and 2007, Americans enjoyed increased consumption, reduced taxes, and more government spending, all made possible by foreign borrowing. When the debt-fueled expansion became unsustainable, the economy went into recession.

America's debt-fed expansion eventually became an unsustainable bubble, especially in the housing market. In some parts of the country, housing prices doubled in the space of four or five years. Much of the lending was predicated on the unrealistic expectation that housing prices would continue to rise at this pace. For example, financial institutions extended mortgages to borrowers who would otherwise not have qualified, because they expected that the homes being bought would rise in value. Both borrowers and lenders were thus gambling that housing prices would continue to go up.

Eventually, housing prices stopped soaring and began to fall. Overextended mortgage holders could not pay their debts; overextended lenders faced massive losses. During 2007 and 2008, financial difficulties spread, as hundreds of billions of dollars' worth of mortgages and related financial assets went bad. Fear spread from bank to bank, culminating in September 2008, when Lehman Brothers, one of the world's leading investment banks, collapsed. This was the largest bankruptcy in American history, and it caused near panic in financial markets.

Within a few months, the crisis was transmitted around the world, eventually coming to be known as the *global financial crisis*. Soon, virtually every economy was in decline. Some countries faced circumstances much like those of the United States: the United Kingdom, Spain, Portugal, and Greece. Also hard-hit were some developing and transition economies that had been borrowers over the course of the decade. When the U.S. spiraled downward into crisis, so did the other debtor nations. But the damage was even more widespread, because the collapse of the debtor economies affected the creditors who had extended trillions of dollars in loans to them. As the crisis spread from debtor to debtor, and from debtor to creditor, it became the first truly international financial crisis since the 1930s, resulting in the deepest global economic downturn since that decade.

Individual governments attempted to stem the decline. The U.S. government stepped in with trillions of dollars to bail out affected financial institutions and to try to get financial markets working again, taking over some of the country's largest financial corporations in order to avoid their collapse. And the U.S. government enacted a massive deficit-funded spending package to attempt to stimulate an economy in its steepest recession since the 1930s.

Within the United States, political battles broke out over the response to the financial crisis. The principal question confronting the nation was who would pay for the country's financial follies. Many Americans were furious that the government was spending taxpayer dollars to bail out imprudent banks and corporations. Others argued that attempts to stimulate the economy were simply throwing taxpayer money at the problem without any guarantee it would work. As in other debt crises, many felt that the interests of working-class and middle-class Americans were being sacrificed to address problems created by wealthy financiers. As the recovery stalled, political battles heated up, and the country became increasingly polarized over how best to confront the aftermath of the debt crisis and how best to distribute the burden of economic adjustment among Americans.

A similar dynamic played out in Europe, with the added complication that the problem divided the eurozone, the group of EU member countries that had created a common currency in 1999. As with the world at large, eurozone countries were divided into those that borrowed heavily during the decade before 2008, and those that lent heavily. The big borrowers were largely in southern Europe—Greece, Spain, Portugal, and Cyprus—but also included Ireland. They borrowed for different purposes: Greece to fund an overgrown public sector and huge budget deficits; the rest, like the United States, largely to fuel a consumption and housing boom. The big lenders were the northern Europeans, especially Germany.

Internationally too, the global financial crisis caused tension among contending interests. Governments everywhere scrambled to protect their economies, even at the expense of other countries. For example, the U.S. Congress insisted that government spending to stimulate the failing economy be used preferentially to buy American goods; trading partners insisted that this strategy was protectionist and violated the rules of the World Trade Organization (WTO). Developing countries complained that the heavy borrowing by industrialized-country governments to deal with the crisis was making it impossible for poor nations to get the funds they needed to confront their dire problems. The European Union was torn by conflicts among member states with widely different views as to the appropriate response to the crisis.

As the crisis unfolded, many observers wondered whether the deep recession that began in 2008 might spiral downward into a global depression similar to that of the early 1930s. It did not, in part because eventually, the world's major economic powers engaged in enough macroeconomic policy cooperation to limit the damage.

Nonetheless, the debt crisis in the eurozone dragged on for 10 years without a definitive resolution. And the crisis eventually fed into widespread dissatisfaction with domestic and international economic trends—dissatisfaction that had a profound impact on both domestic and international politics around the world. The global financial crisis once more demonstrated the potential for political controversy inherent in international financial affairs.

# Foreign Direct Investment: What Role Do Multinational Corporations Play?

FDI is another important form of international capital movement. It differs from foreign lending because it is carried out explicitly by corporations that maintain control over the facilities they establish overseas; the corporations involved have come to be known as **multinational corporations (MNCs)**.[14] FDI occurs when Volkswagen sets up an auto factory in Brazil, or Telefónica de España buys the Czech telephone company, or ExxonMobil drills for oil in Angola. In all these instances, what is involved is far more than a simple transfer of capital. Volkswagen could export cars to Brazil but chooses to build them there instead; individual foreign investors could buy shares in the Czech telephone company, but instead a global telecommunications corporation adds the Czech system to its network; the Angolan government could borrow money to drill for oil but instead gives a concession to an American company.

**multinational corporation (MNC)**
An enterprise that operates in a number of countries, with production or service facilities outside its country of origin.

## *Why Do Corporations Go Multinational?*

It is not easy for a corporation to set up facilities in a foreign country. As noted, Volkswagen could simply build cars in Europe and export them to Brazil rather than building them in Brazil, and one might imagine that a local company could run the Czech telephone system better than a Spanish company could. There must be a reason for firms to invest abroad rather than exporting, and for a foreign firm to have some advantage over a domestic one, despite the inherent difficulties of doing business abroad. What makes it attractive for a corporation to establish or purchase subsidiaries across borders, and what gives the host country an interest in permitting this foreign investment?

Corporations may want to establish overseas affiliates to gain access to the local market or to take advantage of local resources—in both instances presumably because doing so through trade is less attractive or impossible. Some FDI is driven

14. Some observers prefer the term *transnational corporation* to indicate that many of these firms transcend national boundaries. Most such corporations, however, maintain a clear national identity despite their global operations. In any event, both terms are commonly used and are largely interchangeable.

by resource location: American and European oil companies, with ample experience in exploring for oil, may be more effective at getting Angola's oil out of the ground than local entrepreneurs could be. The case of Volkswagen in Brazil illustrates that there are often advantages to producing in the local market: cheaper transport costs, or the ability to avoid trade barriers, or better access to market information. In the decades right after World War II, most FDI was by American manufacturers and was motivated by trade protection in Europe and developing countries. Ford, GE, and other big U.S. corporations faced tariffs and other restrictions imposed on their exports to Europe and the developing world. To get around these barriers, they established local affiliates.

As trade barriers were reduced in Europe and, eventually, in many developing countries, other motivations surfaced. MNCs today often place different components of their production network in different countries: the labor-intensive work is done in countries with cheap labor, such as Vietnam, while the work that requires more skilled labor and technicians is done in countries with ample skilled labor, such as Ireland. Other types of FDI, such as that by Telefónica de España, are in service sectors in which companies may have substantial experience or a famous brand name—banking or entertainment, for example. What ties all FDI together is that the corporations involved believe that overseas direct investment is profitable.[15]

Within the home countries of MNCs (that is, the countries in which they are headquartered), there is often support for their foreign activities. After all, American corporations are constituents of American politicians, and it is part of the job of the government to support their constituents, corporate or otherwise. So the U.S. government, like all governments, usually acts to promote and protect the interests of American corporations abroad.

However, FDI can be controversial in the countries from which it originates. Groups and people in North America and western Europe often fault MNCs for not investing at home. Labor unions in North America and western Europe often criticize MNCs, especially for "outsourcing" jobs to countries with lower wages. For his part, President Donald Trump has threatened American corporations that outsource with a 35 percent tax on the goods they try to sell in the American market: "If you go to another country," he told American corporate executives, "we are going to be imposing a very major border tax."[16]

The American labor federation, the AFL-CIO, has also complained: "In the global economy, multinational corporations move capital and jobs half-way around the world with the click of a mouse. These companies—many of them American—seek out the lowest possible labor costs and weakest worker protections. Even if the jobs are not moved, corporate executives use the threat of moving to coerce concessions from their U.S. workers."[17] Labor unions and others have demanded stricter controls

15. For more on the economics of FDI, see Richard Caves, *Multinational Enterprises and Economic Analysis*, 3rd ed. (Cambridge: Cambridge University Press, 2007).

16. C. E. Lee and D. Paletta, "Donald Trump Focuses on Trade and Jobs; President Withdraws from TPP Agreement, Promises Tax on Firms That Move Operations Overseas," *Wall Street Journal*, January 24, 2017.

17. From www.aflcio.org/issues/jobseconomy/globaleconomy/workersrights (accessed 10/07/11).

on “sweatshop labor” in the developing countries, reflecting both working-class solidarity and a more prosaic desire to reduce competitive pressure.

Some human rights activists and environmentalists also eye MNCs with apprehension. Just as corporations can seek lower wages, they can look for pollution-friendly regimes, dictatorships that allow violations of human rights, and other ethically lax governments. In the words of a European campaign to “clean up” the world garment industry: “Incentives for foreign investors include not only low wages, but also the suspension of certain workplace and environmental regulations. If a government does attempt to strictly enforce these regulations, you can bet that many investors will quickly pack their bags for another country that is even less strict and is more accommodating.”[18] And there is a cultural component to some complaints about MNCs, arguing that MNCs reduce diversity and encourage the homogenization of world culture. Nonetheless, in general, home-country governments see their interests as closely tied to those of their corporations.

A factory worker in Shenzhen, China, inspects a motherboard in a manufacturing plant that supplies parts to Apple. Abundant cheap labor in countries like China makes it profitable for companies like Apple to invest in factories there.

## *Why Do Countries Let Foreign Multinationals In?*

Most countries that host FDI have some interest in allowing MNCs to operate within their borders—otherwise, of course, they would keep the corporations out. Certainly, in the nineteenth century it was common for such rapidly growing nations as the United States, Canada, Argentina, Russia, and Australia to rely on foreign companies to build up such important industries as railroads.

Today, most governments welcome foreign corporations. This is because MNCs bring in managerial, technological, and marketing skills that might not otherwise be available, as well as investment capital. Some less developed countries (LDCs) lack the trained personnel and capital necessary to access and develop their own natural resources; without foreigners, they might not be able to profit from their resources. However, if they allow foreign companies to pump oil or to mine copper, the government can then tax some of the profits. Other poor nations with weak or small private sectors may welcome foreign corporations to provide jobs for their citizens and to gain access to world markets for their products.

Most nations are eager to attract the technological or other expertise that MNCs can mobilize. This may especially be the case in high-technology industries, where such multinationals as IBM or Siemens can be the sole source of crucial modern technologies. When Intel opened production facilities in Costa Rica in 1997,

18. From www.cleanclothes.org/intro.htm#7 (accessed 08/21/04).

it transformed that country's economy. The firm soon accounted for one-third of total exports, with Intel's sales alone surpassing the country's traditional banana and coffee exports. Overall, Intel invested about a billion dollars in a country of 3.5 million people, and it employed about 5,000 people directly or indirectly; it had a network of almost 500 local supplier companies; and its presence spurred the creation of a high-technology cluster with over 50 other companies. There were years when Intel's activities alone accounted for more than half of the growth of the Costa Rican economy.[19]

Yet host countries—the countries in which MNCs invest—do not always have such positive views of FDI. There is always scope for disagreement over the division of the benefits. Conflict can arise over how much in taxes an oil company should pay to the local government or over the wages an automobile factory should pay to local workers. Local competitors may complain about foreign firms' presence in the domestic market. Some people may be concerned that foreign managers will be insensitive to national social, cultural, and political norms. Developing-country governments have had particularly fraught interactions with MNCs. Many developing countries have gross domestic products (GDPs) smaller than the sales of the MNCs they host, which can make it difficult for them to adequately monitor the activities of these enormous corporations.

Even where there is agreement when the investment is made, views may change over time. One common pattern is that when countries are very poor, they are eager to attract FDI to bring natural resources and other national products to market. Over time, however, as the local economy becomes more sophisticated, local investors become better able to undertake the activities dominated by the MNCs. As the LDC develops, its government may want its own citizens to get more of the benefits of the investment. National businesses may come to resent the foreign competition, and local managers and technicians may feel they no longer need the MNC.

Even the case of Intel in Costa Rica is hardly clear-cut. Just as Intel's expansion spurred the country's economy, its difficulties have held it back: in 2000, when the firm's growth slowed, Intel's problems depressed Costa Rican growth to half of what it would have been otherwise. And in order to attract Intel, the Costa Rican government had exempted the company from all taxes for eight years and from half of its taxes for another four, and had freed it from many regulations that apply to other domestic and foreign firms. In 2014, Intel announced that it would close its main assembly facility in Costa Rica and move these operations to Malaysia, Vietnam, and China.[20] Costa Rica certainly gained from having Intel invest there; but the presence of this huge firm—whose total worldwide sales are larger than Costa Rica's GDP—also imposed real constraints on the small Central American nation, and the closure of its assembly plant caused job losses and economic contraction. In this context, there is plenty of scope for conflict between MNCs and host governments.

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19. World Bank, Multilateral Investment Guarantee Agency, *The Impact of Intel in Costa Rica* (Washington, DC: World Bank, 2006).

20. See "Intel Outside," *Economist*, April 19, 2014, www.economist.com/news/americas/21600985-chipmaker-shuts-factory-slicing-away-one-fifth-countrys-exports-intel-outside. The company maintains a smaller research and development facility in Costa Rica, but the country lost some 1,500 jobs.

## *Host-Country Interactions with MNCs*

Like debtors and creditors, foreign corporations and host-country governments have some common interests and some conflicting interests. This mix defines the scope of interactions between national governments and MNCs. As with foreign debt, each side has reasons to work to ensure that the investment can take place. But, again as with foreign debt, each side has strong incentives to bargain for a greater share of the benefits from FDI.

This bargaining can involve negotiations over tax rates, or the company's training of local citizens for more skilled jobs, or the MNC giving some of its business to local suppliers. The host country's weapons include its ability to regulate and tax companies within its borders, up to and including nationalizing them—essentially, forcing them to sell out to local investors or to the government itself. The MNC's weapons include withholding its capital, its technology, or its expertise and ultimately pulling out of the local economy.

Interactions between host countries and MNCs have gone through many phases. Among the most conflictual have been relations over FDI in the raw-materials sector. Before World War I, most FDI was in mining, agriculture, or utilities. These investments, which may have been popular at the outset, eventually became controversial. The case of the United Fruit Company in Central America (see Chapter 4) is a good example: many people in developing nations came to see plantation and raw-materials investments as exploitative. Indeed, after the 1920s, more and more LDCs tended to buy out, take over, or limit foreign investment in these sectors, favoring their own investors instead. One study of forcible takings of MNCs in developing countries between 1960 and 1976, for example, found that while FDI in extractive industries (agriculture and raw materials) and utilities was just one-fifth of the total, these sectors accounted for more than half of the takings.[21]

Political considerations about the role of FDI have added to purely economic concerns. Especially during the 1960s, LDC governments began to believe that large foreign corporations could have a powerful and unwelcome impact on local politics. The activities of the U.S.-based International Telephone & Telegraph (ITT) Corporation in Chile demonstrated the threat. ITT first tried to keep Socialist Party candidate Salvador Allende from being elected president in 1970, for fear that his government would nationalize its investments. When this attempt was unsuccessful, ITT participated in a series of plots to try to overthrow President Allende. The story ended with a coup that destroyed one of Latin America's sturdiest democracies and brought the murderous dictatorship of Augusto Pinochet to power. The notion that American companies could be complicit in such matters, long derided by Westerners as feverish imagining, was soon proved to be accurate by a congressional investigation, and this finding fueled sentiment against MNCs.[22]

21. Stephen J. Kobrin, "Foreign Enterprise and Forced Divestment in LDCs," *International Organization* 34, no. 1 (Winter 1980): 65–88.

22. Paul Sigmund, *Multinationals in Latin America* (Madison: University of Wisconsin Press, 1980).

For both economic and political reasons, many countries began restricting MNCs in the 1960s. This was even true of some developed nations: Canada monitored and controlled new investments, while both France and Japan limited foreign companies. But the most sweeping efforts were in the developing world, where foreign corporations were excluded from many industries, and foreign ownership was strictly limited, often to a minority share. Many developing countries nationalized foreign corporations, transferring ownership to local private companies or to the government. Others allowed FDI only if the foreign company did not compete with local firms, shared ownership with local investors, or agreed to reinvest most of its profits in the host country. The turn away from MNCs in the 1960s and 1970s went hand in hand with the turn toward foreign borrowing: by borrowing, developing countries could get foreign capital without allowing foreign ownership of the projects.

But the debt crisis of the 1980s, along with the increased acceptance of global economic integration in the 1990s, eroded resistance to multinationals. Developing countries were desperate for foreign capital, especially after loans dried up. And it appeared that attracting foreign corporations was important to ensuring a nation's integration into global markets. Previous restrictions on FDI were loosened or removed, and many LDCs actively sought to encourage foreign corporations to locate production facilities within their borders. The amounts involved were enormous: while MNCs invested about $2 billion a year in the developing world in the early 1970s, they have averaged over $450 billion a year since 2000. Even accounting for inflation, this is more than a 30-fold increase. As most developing countries have opened their economies to world markets, FDI has become less politically sensitive and more broadly desired.

This does not mean that MNCs are not controversial. Indeed, many people in the developing world continue to regard foreign corporations as economically, politically, or culturally undesirable. Restrictions persist on their activities in developing nations. In industrialized countries too, there are continuing concerns about the exporting of jobs, and in some quarters, about the possibility that foreign investors might compromise national sovereignty. Contemporary controversies over globalization are emblematic of the politically controversial nature of foreign direct investment.

## *Why Aren't There International Institutions Related to FDI?*

There are no effective international institutions associated with FDI. This is in striking contrast to international lending, where there are both regional and global multilateral institutions: the IMF, the World Bank, the Inter-American Development Bank, and so on. One possible reason is that there are fewer (if any) widely accepted truly global concerns associated with FDI than with international finance. In the latter area, it has been generally agreed for over a century that there is a risk of financial crises in one country affecting other countries. This risk creates incentives for countries to find ways, including institutionalized ways, to cooperate to avoid such financial contagion, and international institutions facilitate cooperation in pursuit of these types of common goals. Such incentives are not as strong in the case of FDI.

Nor is there a particularly strong demand for cooperation among countries in bargaining with MNCs. Individual countries that wish to limit or regulate MNCs can do so on their own, and it is not clear that IMF-style international institutions would help with this effort. The role of international institutions in providing information or establishing standards seems less relevant in the case of FDI, where each investment has different characteristics and where host governments are often well equipped to supervise foreign companies.

There have been occasional suggestions that some international agreement or organization might help to create a common set of standards for FDI. Codes of conduct have been proposed, and there has been an increase in private voluntary compliance with such codes of conduct, but this falls far short of an organized intergovernmental institution. Initiatives to institutionalize and regularize relations between MNCs and host nations have made little progress. Thousands of **bilateral investment treaties** have been signed between two countries, providing protection for each other's investors, but nothing even remotely similar to an IMF has emerged.

**bilateral investment treaty**
An agreement between two countries about the conditions for private investment across borders. Most of these treaties include provisions to protect an investment from government discrimination or expropriation without compensation, as well as mechanisms to resolve disputes.

Despite the absence of any multilateral institution, since the 1980s interactions between foreign corporations and nation-states have generally been less conflictual than they were before then. FDI today leads to much less debate than sovereign lending does. To be sure, in rich countries there remain concerns about the role of MNCs in exporting jobs, while many people in developing countries worry about the economic and political impact of large foreign corporations. Nonetheless, today FDI is widely accepted as an important component of an integrated world economy and as a generally positive factor in economic development.

# International Migration: What Happens When People—Rather than Capital—Move across Borders?

Like capital, labor is a factor of production that moves across borders. In fact, international movements of labor and capital can be thought of as responding to similar economic factors and having similar economic effects. Capital can leave one country so that workers can be hired in another; this is what happens when a corporation sets up production abroad. Alternatively, labor can leave one country in order to work for capital in another; this is what happens when workers migrate to a new country to be employed by a corporation there. Whether GM moves a factory to Mexico to hire Mexican workers, or Mexican workers move to Detroit to work for GM, the effect is similar. It therefore makes sense to think about the politics of immigration as part of the broader integration of the world economy.

Of course, the movement of people raises complex social, cultural, and political issues that are typically not present with most other cross-border economic relationships. In addition, there is a substantial difference between migration for economic reasons and the movement of refugees and asylum seekers. We address the noneconomic factors that drive the international movement of people in Chapter 14. For now, we focus entirely on the economic implications of immigration, analyzing it as simply another example of the movement of factors of production from country to country.

International migration has long been a feature of a globalized world economy. In the nineteenth and early twentieth centuries, international labor migration occurred at much higher levels than it does today. During the decades before World War I, some 100 million people left their homelands in Europe and Asia for other parts of the world. The cities of such rapidly growing countries as Canada, Australia, Argentina, and the United States were full of foreign-born workers. For the most part, before 1914 Europeans could move and work wherever they pleased, without complicated legal proceedings or documents (Asian immigration was much more heavily restricted). While international labor movements in recent years have been very large, they are proportionally smaller than those of the nineteenth and early twentieth centuries. However, labor migration has been significant—and also politically controversial.

Today, about one American resident in seven was born in a foreign country, approximately half of them in Latin America. The immigrant share of the population of other developed countries is generally similar to that of the United States (15 percent). It is a bit lower in some countries (10 percent in Italy, 12 percent in France) and substantially higher in some others (20 percent or more in Canada, New Zealand, and Switzerland).[23] Table 8.1 shows the countries with the largest number of immigrants. In almost every developed country, immigration is a politically contentious issue, with some residents favoring more open borders to immigrants and others wishing to limit immigration.[24] What explains these controversies over immigration?

The movement of labor from one country to another is similar to the movement of capital in many ways, and it can be similarly analyzed. Labor, like capital, responds to differential rates of return: higher wages in rich countries attract workers from poor countries. This is true of both unskilled labor and skilled labor, which is typically called human capital because its "owners" have invested in advanced skills. Unskilled workers from El Salvador or Morocco migrate to the United States or Germany in search of higher-paying jobs, just as unskilled workers from Italy and Sweden migrated to the United States and Australia a hundred years ago. Skilled

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23. United Nations Population Division, "Trends in International Migrant Stock. The 2017 Revision," http://www.un.org/en/development/desa/population/migration/data/estimates2/estimates17.shtml (accessed 1/3/2018).

24. A useful resource on this highly controversial topic is the Migration Policy Institute, www.migrationpolicy.org (accessed 01/25/11).

**TABLE 8.1** ***Countries with the Largest Number of International Migrants, 2017***

| | TOTAL MIGRANTS | AS % TOTAL POPULATION |
|---|---|---|
| **United States** | 49,776,970 | 15.3 |
| **Saudi Arabia** | 12,185,284 | 37.0 |
| **Germany** | 12,165,083 | 14.8 |
| **Russia** | 11,651,509 | 8.1 |
| **United Kingdom** | 8,841,717 | 13.4 |
| **United Arab Emirates** | 8,312,524 | 88.4 |
| **France** | 7,902,783 | 12.2 |
| **Canada** | 7,861,226 | 21.5 |
| **Australia** | 7,035,560 | 28.8 |
| **Spain** | 5,947,106 | 12.8 |

*Source:* United Nations Population Division, "Trends in International Migrant Stock. The 2017 Revision," http://www.un.org/en/development/desa/population/migration/data/estimates2/estimates17.shtml (accessed 1/3/2018).

workers from India or Argentina too move to Europe or North America in search of higher incomes.

In this sense, immigration can be explained in terms of the Heckscher-Ohlin theory discussed in Chapter 7. Countries with abundant unskilled labor will export unskilled labor; countries scarce in unskilled labor will import it. Differences across countries in labor endowments (and, consequently, wages) mean that there are economic incentives for a labor-rich country such as Mexico or China to export both labor-intensive goods and labor.

The economic impact of labor migration can also be understood in terms of the Heckscher-Ohlin theory. An inflow of unskilled labor from abroad will tend to reduce the wages of local unskilled workers, while an inflow of skilled labor will tend to reduce the wages of local skilled workers. Thus, for example, unskilled workers in developed countries are likely to be harmed by the immigration of unskilled workers from countries with lower wages. Concerns about this labor-market competition are one source of unease about immigration in developed countries (see "How Do We Know?" on p. 380).

This is not a new phenomenon. In the century before 1914, immigration probably also exerted downward pressure on wages in migrant-receiving countries: two scholars have estimated that in such countries as the United States, Australia, and

HOW DO WE KNOW?

# Explaining Public Opinion on Immigration

Immigration is one of the most politically controversial issues in developed countries. Both the Brexit movement in the United Kingdom and the Trump administration in the United States, along with many populist parties in Europe, have emphasized concern about immigration in their campaigns, and surveys suggest that immigration policy is an important issue for many voters. How do voters decide whether they favor or oppose immigration?

To answer this question, some scholars begin with the same frameworks used to analyze international trade. The Heckscher-Ohlin model, introduced in Chapter 7, demonstrates that the relative abundance or scarcity of factors of production (land, labor, and capital) are critical for understanding trade patterns. For example, countries that have abundant labor are likely to export labor-intensive products. The related Stolper-Samuelson theorem assumes that trade protection benefits the scarce factor of production.

The same logic can explain patterns of immigration and its distributional consequences. Labor-abundant countries, such as India, the Philippines, and Mexico, are likely to experience the largest out-migration of residents, and relatively labor-scarce rich economies, such as Britain, the United States, and Saudi Arabia, are likely to experience the largest inflows of people (see Table 8.1). By the same logic, restricting immigration benefits labor in the receiving country when it is scarce.

Political scientist Kenneth Scheve and economist Matthew Slaughter used the logic of the Heckscher-Ohlin model to explain American voters' responses to surveys about immigration policy.[a] They measured these preferences by responses to a question that appeared in successive American National Election Studies nationwide surveys in 1992, 1994, and 1996: "Do you think the number of immigrants from foreign countries who are permitted to come to the United States to live should be increased a little, increased a lot, decreased a little, decreased a lot, or left the same as it is now?" The authors assumed that respondents believed that U.S. immigrant inflows increase the relative supply of low-skilled workers, which


is a reasonable assumption given that nearly one-third of U.S. immigrants lack a high school diploma or equivalent.[b] The survey also asked respondents about their wages and years of education, which serve as useful proxies for respondents' skill levels.

Scheve and Slaughter analyzed the survey data using a statistical model and found that public opinion toward immigration reflects the logic of the Heckscher-Ohlin framework: respondents with lower skills prefer a more restrictive immigration policy, whereas high-skilled respondents prefer a more open policy. In their interpretation, domestic labor competition is key: unskilled workers—who constitute a relatively scarce factor in the United States—fear that low-skilled immigrants will cause a drop in their wages.

Scheve and Slaughter's findings caused considerable controversy among political scientists, some of whom were skeptical that voters could correctly calculate the income effects predicted by the Heckscher-Ohlin model. Other scholars were skeptical that wages and education actually measure skill level rather than noneconomic attributes like open-mindedness and experience with foreign cultures.[c] Public opinion toward immigration remains a very active research area, with political scientists devising new experiments to determine which economic or noneconomic factors drive individual preferences toward this highly politicized issue.

a. Kenneth F. Scheve and Matthew J. Slaughter, "Labor Market Competition and Individual Preferences over Immigration Policy," *Review of Economics and Statistics* 83, no. 1 (February 2001): 133–45.

b. See Pia M. Orrenius and Madeline Zavodny, "Immigrants in the U.S. Labor Market," Working Paper 1306, Federal Reserve Bank of Dallas, September 2013, www.dallasfed.org/assets/documents/research/papers/2013/wp1306.pdf.

c. See Jens Hainmueller and Michael J. Hiscox, "Attitudes toward Highly Skilled and Low-Skilled Immigration: Evidence from a Survey Experiment," *American Political Science Review* 104, no. 1 (February 2010): 61–84.

Argentina, unskilled wages were between one-eighth and one-third lower with immigration than they would have been without it.[25] While this outcome may have been bad for unskilled workers, it was probably good for the countries' economies as a whole, supplying them with much-needed labor.

Immigration benefits people in receiving countries in several ways. Employers gain from the lower wages they can pay. This is especially true for those who hire a lot of unskilled labor; in parts of the United States, sectors such as agriculture, restaurants, and construction have come to rely on cheaper immigrant labor. The economy as a whole profits from having a larger labor force and from the lower cost of production that lower wages can provide. As usual, the benefits for some are counterbalanced by costs to others: if immigration lowers the wages that employers have to pay, it also lowers the wages paid to native workers who compete with immigrants.

The domestic distributional effects of immigration, coupled with national political institutions, help explain changes in policies over time. In the nineteenth century, there was substantial anti-immigrant sentiment among workers in such countries as the United States, Canada, and Australia. But in the 1800s, employers were far more politically powerful than labor; after all, unions were barely organized. So, while there were some restrictions on immigration, especially from Asia, most countries remained open. As the political influence of labor grew, restrictions on immigration expanded and, until the 1960s, were very stringent. During the 1960s, labor shortages began to develop in industrialized nations, and pressure to permit more immigration grew. The result was a loosening of restrictions; this may also have been due to the rising influence of skilled workers in rich countries, who were less concerned about competition from unskilled immigrants.

The 1990s saw the rise of political movements that were less enthusiastic about, or downright hostile to, immigration. Concern about the economic impact of immigration rose with the financial crisis that began in 2008. In the United States and Europe, many people worried that immigrants from less developed countries were taking jobs away from native workers and driving wages down. A dramatic refugee crisis that grew out of civil war in Syria and unrest elsewhere in the Middle East and North Africa compounded these anxieties. The European Union, which had received about 200,000 requests for asylum in 2008, received 1.3 million in both 2015 and 2016, and many Europeans were concerned that their countries were being, or would be, flooded with refugees.[26] Concern about immigration was central to the rise of right-wing populism in Europe, to the Brexit campaign in the United Kingdom, and to the presidential campaign of Donald Trump in the United States (for more on these developments, see Chapter 14).

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25. Kevin O'Rourke and Jeffrey Williamson, *Globalization and History: The Evolution of a Nineteenth-Century Atlantic Economy* (Cambridge, MA: MIT Press, 1999), Tables 8.1 and 8.3.

26. Eurostat, "Asylum and First Time Asylum Applicants—Annual Aggregated Data (Rounded)," http://ec.europa.eu/eurostat/tgm/table.do?tab=table&init=1&language=en&pcode=tps00191&plugin=1 (accessed 08/14/17).

The political economy of immigration involves additional economic considerations. One such concern is the potential cost of social programs that immigrants may use disproportionately, inasmuch as they tend to be poorer than natives. However, immigrants typically pay taxes, so the overall (net) effect may be hard to distinguish.[27] In some contemporary American and European debates, opponents of immigration express particular concern about the fiscal effects of large-scale immigration. Supporters and opponents of immigration often raise noneconomic issues as well, which we will discuss in more detail in Chapter 14.

Certainly, immigration is one of the more prominent and visible features of contemporary globalization. Today, there are many countervailing economic interests at play that drive opposing viewpoints: workers who would compete with immigrants and workers who would not, taxpayers concerned about the cost of immigrants and those who see them as beneficial, employers who depend on immigrant labor and those who do not. The topic promises to continue to be controversial.

# Conclusion: The Politics of International Investment

International finance is the most globalized portion of the international economy. People and governments worldwide try mightily to attract foreign corporations and to qualify for loans from foreign lenders. There are substantial advantages to having access to the world's enormous pool of capital. This benefit gives governments powerful reasons to try to collaborate with foreign investors to smooth the path of capital as it moves from country to country.

However, international finance is not an unmitigated blessing. Foreign loans can be a boon to a developing nation, but they can become an oppressive burden that forces the population to make huge sacrifices in order for their government to keep up interest payments. Foreign investment by MNCs can bring a country valuable technology and expertise, but it can also impose severe constraints on how much room the host nation has to maneuver. Governments have many interests in common with international financiers, but they also have many conflicting interests.

International finance is inherently political because powerful private actors, governments, and international institutions all come together to bargain over the terms of international financial relations. Such negotiations—over foreign loans, debt bailouts, IMF packages, the role of MNCs, and other financial issues—can be

27. Like many other aspects of immigration, the fiscal costs and benefits of immigrants are hotly debated, even among scholars. For two contending views, both from conservative think tanks, see Robert E. Rector, Christine Kim, and Shanea Watkins, "The Fiscal Cost of Low-Skill Households to the U.S. Taxpayer," *Heritage Foundation Special Report* 12 (April 4, 2007); and Daniel Griswold, "The Fiscal Impact of Immigration Reform: The Real Story," *Free Trade Bulletin* 30 (May 21, 2007).

contentious. The policies associated with them are also often very controversial within nations, adding to the problems' politicization.

Many countries, past and present, have used foreign capital to finance rapid economic growth and development. And many individuals, groups, and companies have benefited from their access to international finance. However, when things go wrong in the international financial system, they can go spectacularly wrong in ways that can profoundly impact international politics—and the lives of billions of people.

# Study Tool Kit

## Interests, Interactions, and Institutions in Context

- Within borrowing nations, there are many actors who value access to foreign funds. However, there are others who resent the constraints and burdens that foreign investments sometimes impose on debtors. Similar conflicting interests exist within lending nations.
- At the international level, both lenders and borrowers, like investors and recipients of investment, have a common interest in sustaining capital flows, which benefit both sides. Nonetheless, they may enter into conflict—especially over how the benefits from the loans or investments will be divided.
- Lenders and borrowers, and investors and recipients, bargain over the investments that tie them together. There is frequent disagreement over debt payments to foreign creditors and profit payments to foreign corporations.
- An array of important and influential international institutions structure interactions in the international financial realm. The most prominent is the IMF, which has often played a major role in managing the problems of heavily indebted countries. Like international finance generally, the role of the IMF is very controversial: some analysts think it contributes to the cooperative resolution of financial problems, while others think it takes unfair advantage of struggling debtor nations.

## Key Terms

**portfolio investment,** p. 349

**sovereign lending,** p. 349

**foreign direct investment (FDI),** p. 349

**World Bank,** p. 354

**recession,** p. 356

**depression,** p. 356

**default,** p. 357

**austerity,** p. 359

**Bank for International Settlements,** p. 361

**International Monetary Fund (IMF),** p. 361

**multinational corporation (MNC),** p. 371

**bilateral investment treaty,** p. 377

# For Further Reading

**Chinn, Menzie D., and Jeffry A. Frieden. *Lost Decades: The Making of America's Debt Crisis and the Long Recovery*. New York: Norton, 2011.** Analyzes the politics and economics of the biggest financial crisis since the Great Depression.

**Copelovitch, Mark. *The International Monetary Fund in the Global Economy: Banks, Bonds and Bailouts*. Cambridge: Cambridge University Press, 2010.** Analyzes the politics and economics of the role of the IMF in resolving international debt conflicts.

**McDowell, Daniel. *Brother, Can You Spare a Billion? The United States, the IMF, and the International Lender of Last Resort*. Oxford: Oxford University Press, 2017.** Analyzes the role of the United States and the IMF in addressing debt and financial crises.

**Mosley, Layna. *Labor Rights and Multinational Production*. Cambridge: Cambridge University Press, 2011.** Assesses the impact of FDI on the rights and opportunities available to workers in developing countries.

**Obstfeld, Maurice, and Alan Taylor. *Global Capital Markets: Integration, Crisis, and Growth*. Cambridge: Cambridge University Press, 2004.** Provides a detailed description and analysis of the history and contemporary nature of international financial markets.

**Pandya, Sonal. *Trading Spaces: Foreign Direct Investment Regulation, 1970–2000*. Cambridge: Cambridge University Press, 2014.** Analyzes the politics and economics of national responses to foreign corporations.

**Singer, David A. *Regulating Capital: Setting Standards for the International Financial System*. Ithaca, NY: Cornell University Press, 2007.** Analyzes the economics and politics of international financial regulation in a world of global financial markets.

**Tomz, Michael. *Reputation and International Cooperation: Sovereign Debt across Three Centuries*. Princeton, NJ: Princeton University Press, 2007.** Explores the politics and economics of private lending to governments historically and in the present.

**Walter, Stefanie. *Financial Crises and the Politics of Macroeconomic Adjustments*. Cambridge: Cambridge University Press, 2013.** Explains the causes and consequences of financial crises, and government responses to them, with both historical and contemporary applications.