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Systemic Factors and Economic Development in Islamic Countries

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Paper for the Islam Program of the Center for Strategic & International Studies; December 2003

I. INTRODUCTION

Development economists have struggled for decades with the question whether, and to which extent the international economic system is to blame for poor economic performance of numerous countries in the Third World. Whenever a crisis hits, e.g., the Latin American debt problems of the 1980s or the financial and currency crises in various emerging market economies since the mid-1990s, the debate crops up again whether the reasons are mainly to be sought in systemic, i.e., exogenous factors or, rather, in internal factors for which the afflicted countries themselves are responsible. As concerns longer-term development trends, the predominant view in the Third World had been for long that attempts to catch up economically to advanced industrialized countries were bound to fail unless a New World Economic Order was agreed upon. This fatalistic view has changed with some developing countries recording – sometimes fairly spectacular – processes of catching up.

Yet, it is for good reasons that the role of systemic factors remains on the agenda, considering that most developing countries have fallen further back, in terms of per-capita income, in the era of economic globalization. Successful catching up has been a particularly rare exception in the Islamic part of the world (Section II). Against this backdrop, we discuss the role of systemic factors in several respects: First, we draw on the relevant literature to figure out which characteristics of the international economic system may have hindered Third World development. Second, we tentatively assess the empirical relevance of these characteristics for a broad set of developing countries. Third, we evaluate whether these characteristics are relevant in particular to Islamic countries and could, thus, help explain their relatively poor economic performance.

The subsequent analysis has clear limitations in all three respects. The discussion of systemic factors is limited to some, though potentially the most important aspects. Moreover, we do not even attempt to assess the relative importance of these factors compared to internal determinants of economic performance. We leave it to other contributions to this volume to discuss internal factors as possible determinants of the vastly different economic performance between Islamic countries. The empirical evidence related to systemic factors refers to data for as many countries as possible. Due to data constraints, however, the sample of Islamic countries as well as the control group of all developing countries varies between the different steps of our analysis and is fairly small in some instances.

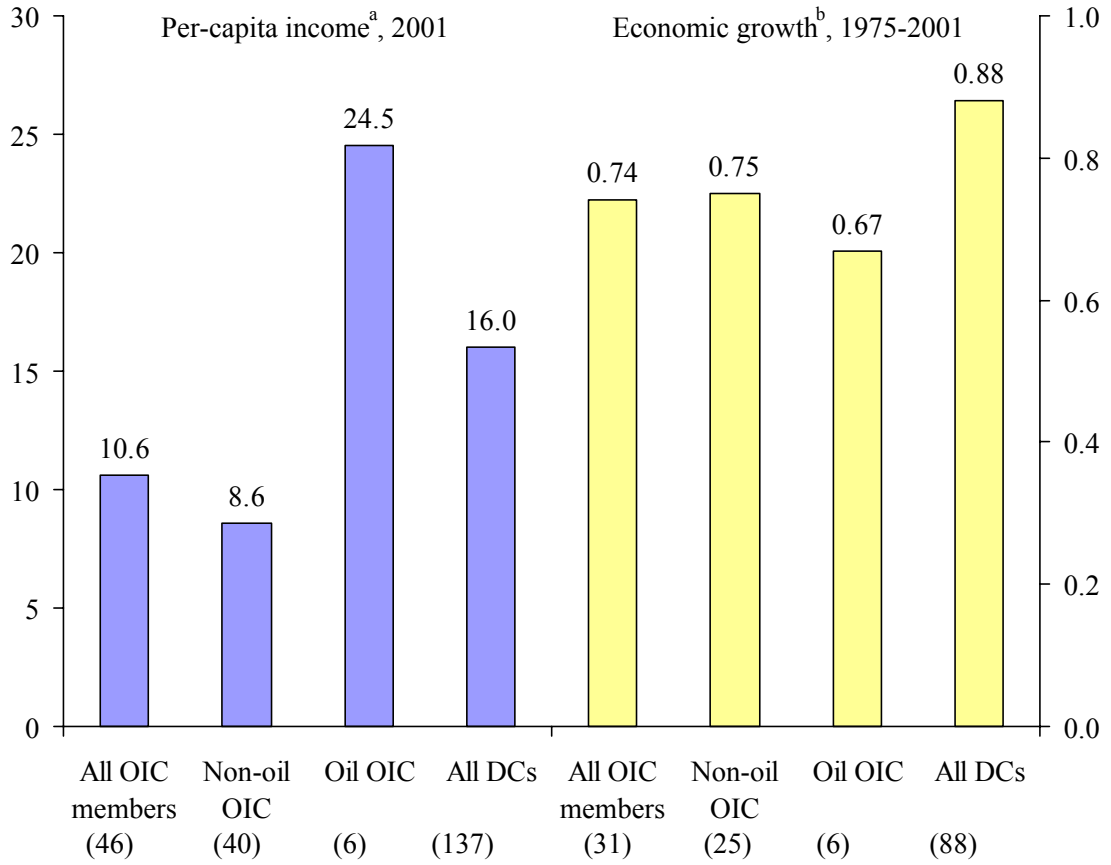
We regard all members of the Organization of Islamic Conference (OIC) as Islamic countries in the following. After shortly portraying their economic development in Section II, we proceed by summarizing earlier thinking on the role of systemic factors hindering, or even preventing, economic development in the Third World (Section III). Section IV argues that the notions of economic distance and colonial legacy, which were ingredients of earlier theories, cannot be dismissed as completely irrelevant. Subsequently, we show that the external environment in which developing countries have to operate continues to be far from perfect in two major respects: (i) The trading system limits the gains of developing countries from participating in the international division of labor (Section V); (ii) international capital markets are plagued by inefficiencies and appear to have proven wrong the proponents of unrestricted capital flows.

II. THE ECONOMIC DEVELOPMENT OF ISLAMIC COUNTRIES IN RELATIVE PERSPECTIVE

The relatively poor economic performance of Islamic countries is reflected in that the average level of per-capita income (in purchasing power parity) was substantially below the corresponding average for all developing countries in 2001. Moreover, the growth in per-capita income of Islamic countries in 1975–2001 fell considerably short of average income growth in all developing countries.

Figure 1 presents both the level and change of per-capita income relative to the per-capita income of the United States, with the latter representing economic development in advanced industrialized countries. In 2001, the average per-capita income of all OIC member countries amounted to about 11 percent of US income, whereas the average per-capita income of all developing countries amounted to 16 percent of US income. The relative income position of non-oil OIC members was even lower. By contrast, the relative income position of major oil exporters among OIC members continued to be more favorable, even though their growth performance turned out to be particularly poor. Growth performance is measured by the ratio of per-capita incomes in 2001 and 1975, both relative to the per-capita in the United States. Hence, a ratio below "one" reveals that countries failed to catch up economically with industrialized countries. While the income gap between the United States and the average of

Figure 1 — Economic Development: Islamic Countries Compared to All Developing Countries



[a]Gross national income per capita (PPP) in percent of GNI per capita in the United States; unweighted average for all countries for which the data are available (number of countries in parentheses).— [b]Ratio of GNI per capita in 2001, as defined in note a, to GNI per capita in 1975.

Source: World Bank (2003b).

all developing countries widened by 12 percent, OIC member countries fell back by about twice as much since 1975.[1]

Against this backdrop, the subsequent sections address the question whether important aspects of the international economic system hindered developing countries in general to catch up economically, and whether systemic factors proved to be particularly hostile to Islamic

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[1] These averages conceal wide variations in country-specific growth trends. As concerns OIC countries, the range is between Malaysia whose per-capita income relative to the United States increased from 14 percent in 1975 to 23 percent in 2001 on the one hand, and Sierra Leone whose per-capita income relative to the United States dropped from 5 percent to 1.3 percent.

countries. Critical writings of the 1970s provide a reasonable starting point as systemic factors figured prominently in this strand of the literature. For quite some time, the arguments raised by critics were dismissed as irrelevant or speculative by mainstream development economics. Surprisingly, however, recent analyses by various authors have, in one way or the other, taken up earlier arguments on the relevance of systemic factors.

III. BLAMING THE SYSTEM: EARLIER THEORIES

As a result of growing disenchantment with previous models of economic development, the so-called dependency theory gained considerable support, especially among Third World intellectuals, during the 1970s (Todaro 1989: 78–82). Particularly in international-dependence models based on Marxist thinking, labeled "neocolonial dependence models" by Todaro, underdevelopment is considered an *externally* induced phenomenon. In the words of a prominent proponent,

> dependence is a conditioning situation in which the economies of one group of countries are conditioned by the development and expansion of others. As relationship of interdependence between two or more economies or between such economies and the world trading system becomes a dependent relationship when some countries can expand through self-impulsion while others, being in a dependent position, can only expand as a reflection of the expansion of the dominant countries ... The basic situation of dependence causes these countries to be both backward and exploited (Dos Santos 1973).

Underdevelopment of Third World economies is attributed to the historical evolution of a highly unequal international system of rich country-poor country relationships. Accordingly, various dimensions of dependence and exploitation characterize the relationships between the *center* of developed countries and the *periphery* of developing countries.[2] First of all, free trade is said to be a convenient vehicle of exploitation (Ghatak 1995: 65). By trading with developed countries, developing countries enter into an "unequal exchange" (Emmanuel 1972) between the center and the periphery. This is because developing countries produce and export mainly primary commodities the demand for which is income inelastic, whereas they import manufactured goods which are hardly produced at the periphery. As a consequence, the benefits from trade are reaped by developed countries, while developing countries suffer welfare losses from declining terms of trade (i.e., a decrease in export prices relative to import prices) (Prebisch 1964).

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2 For a survey, see Griffin and Gurley (1985).

The activities of multinational enterprises (MNEs) are identified as another mechanism of dominating the periphery. Accordingly, MNEs do not only penetrate the markets of developing countries and strangle local producers. They also deprive developing countries of investment resources by transfering profits, or economic surplus in Marxist terminology, to the center. With profit remittances exceeding the initial investment at least in the longer run, MNEs are said to contribute to "the development of underdevelopment" (Frank 1970). Even if the drain of economic surplus from the periphery to the center does not stifle economic growth at the periphery altogether, the emerging pattern of growth is considered inappropriate as it is imposed by dominant economic agents at the center (Amir 1976).

Similar to foreign direct investment by MNEs, other capital flows to developing countries are criticized for adding to economic dependency. Debt-related inflows may induce much higher capital outflows in the form of amortization and interest payments in the course of time. Moreover, debt financing of developing countries depends on the permanent rollover of short-term loans, and the debtors bear the exchange-rate risk as loans are typically denominated in hard currency. As a result, many developing countries find themselves in a foreign debt trap. International financial institutions are blamed for having contributed to the debt problems of Third World economies. In particular the IMF is viewed as an accomplice of financial intermediaries at the center which are interested in open capital markets at the periphery.

The verdict on foreign aid granted to developing countries is no better. Aid is seen as a means to open up the periphery to foreign capital; it "oils the mechanisms of surplus transfer" (Todaro 1989: 105), which is because aid is believed to be used largely for infrastructural projects benefiting foreign companies or for other purposes specified by the donor country. At the same time, local elites in recipient countries frequently appropriate foreign aid inflows. This does not only prevent aid from being used to the benefit of the poor in developing countries, but also creates incentives for local elites to perpetuate poverty as a means to secure their own living on donor-financed rents.[3]

The collusion between dominant players at the center and local – often corrupt – elites at the periphery is not restricted to aid relations. Rather, local elites are generally characterized as accomplices in the exploitation of the developing countries they rule. The perpetuation of

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[3] Note that this critical line of reasoning on aid is not restricted to proponents of dependency theory. Rather, neoclassical economists such as the late Lord Bauer (1972) were among the most forceful critics of external aid; Bauer argued that aid makes countries poorer.

neo-colonial structures is said to be in the self-interest of local elites. Their privileged status in terms of income and power largely depends on the system of inequality and dualism. Hence, inequality and dualism are viewed as permanent, rather than merely temporary phenomena, and are even said to have an inherent tendency to increase.[4]

These arguments blaming the international economic system for underdevelopment in the Third World were dismissed as irrelevant during the "neoclassical free market counter-revolution" (Todaro 1989: 82). According to the newly emerging mainstream in the 1980s, the notions of dependency, center-periphery relations and unequal exchange rested on vague analytical foundations; many of the hypotheses advanced by the dependency theory could hardly be subjected to rigorous empirical tests (Ghatak 1995: 66); and the proponents of this theory were – rightly – criticized for stressing only the negative effects of the international economic system and ignoring positive effects, even though the latter may outweigh the former (Todaro 1989: 104).

In a way, dependency theory shared the fate of still earlier interventionist development models.[5] It fell victim to the new economic mainstream which was increasingly oriented to precise mathematical modeling and up-to-date econometrical testing of concrete hypotheses. Krugman (1993) argues that the neoclassical counterrevolution went too far by simply leaving behind the discursive, non-mathematical development theories of the 1950s. The same may apply to the arguments advanced by the critics of the international economic system. Hence, it may not be surprising that, again similar to development thinking of the 1950s, some discarded insights of the 1970s were rediscovered recently when both analytical and empirical advancements allowed for a more rigorous treatment of systemic factors. This refers in particular to the concept of economic distance which is implicit in the center-periphery framework and to the colonial origins of institutions and economic development.

IV. ECONOMIC DISTANCE AND COLONIAL LEGACIES: STILL RELEVANT?

Earlier critics of the international economic system portrayed center-periphery relations in terms of intentional exploitation. This view may still be held among protesters against economic globalization. The notion of distance in more conventional economic analyses

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4 For a detailed account of dualism, see Singer (1979).

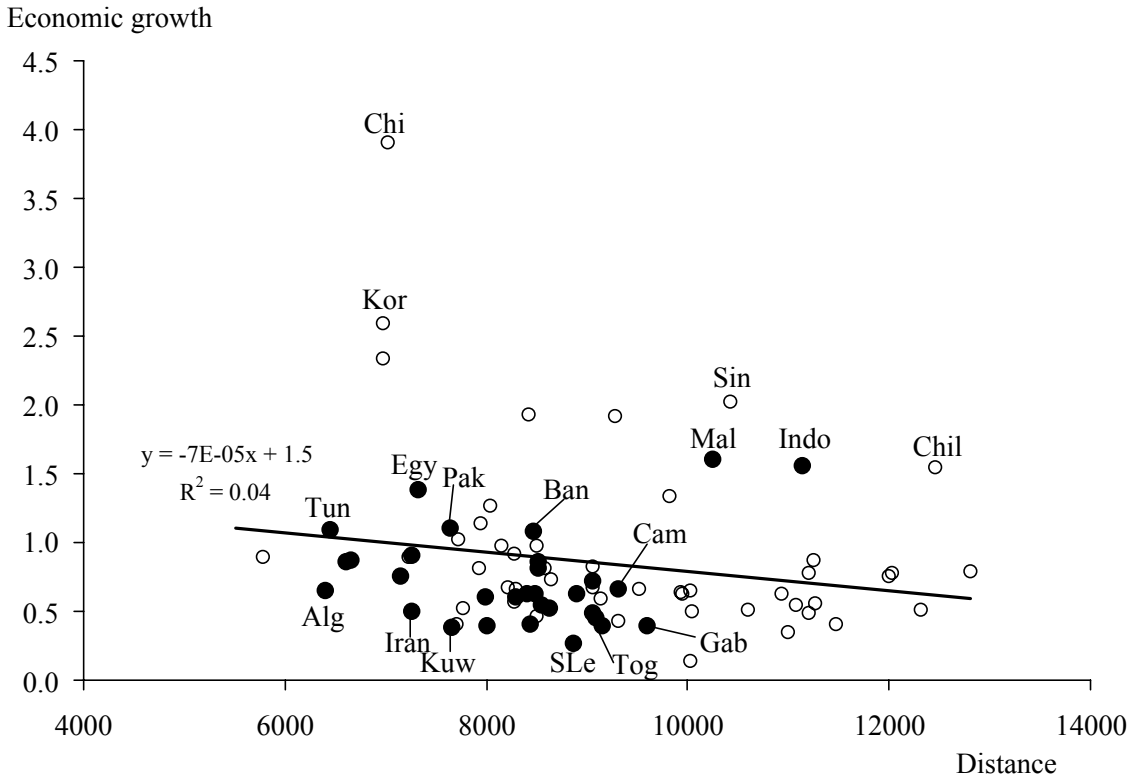
5 For a discussion of the latter, see Krugman (1993).

differs from this view in that distance is not primarily regarded as a means of exploitation, though as a structural impediment to economic development at the periphery. Distance has become a standard argument in mainstream economics, especially with regard to international trade relations. So-called gravity models, considering distance to be a determinant of the intensity of bilateral trade flows, typically reveal that it is more difficult for remote economies to benefit from international trade.

Distance is usually measured in geographical terms, i.e., how far away remote economies are from the economic centers of the world. Yet the concept extends well beyond pure geography. According to new economic geography models, economic transactions between the center and periphery involve higher costs related to information, communication, monitoring and transportation (e.g., Fujita et al. 1999). In addition, trade policy (e.g., tariffs) may put the periphery at a competitive disadvantage in trading with the center (see also Section V). As a result, firms in remote locations tend to be systematically constrained by higher transaction costs on both their exports and intermediate imports. This reduces the amount of value added left to remunerate the factors of production at the periphery (Redding and Schott 2003). Moreover, these authors argue that distance-related transaction costs may lead to a downward spiral with "peripheral countries ... becoming more economically remote over time" (ibid.: 531).

In the following we apply a measure of distance which is very similar to the measure used by Redding and Schott (2003), in order to assess (i) whether distance helps explain the different growth performance of developing countries since 1975, and (ii) whether Islamic countries are at a particularly severe competitive disadvantage in terms of distance to the world's economic centers. Distance in Figure 2 means the average number of kilometers between a particular developing country on the one hand and Germany (representing Western Europe), Japan, and the United States on the other hand. We find the expected negative correlation between distance and economic growth performance. However, the relation is fairly weak. This appears to be mainly because some countries, notably China, Korea, Singapore and Chile performed significantly better than their distance to economic centers would have suggested. Likewise, the growth performance of a few Islamic countries is shown to be favorable, even though they are located far away from economic centers. Malaysia and Indonesia represent the most remarkable cases in point. Hence, distance is relevant, but does not appear to be a binding constraint to economic development in the Third World in general or, specifically, in Islamic countries.

Figure 2 — Distance and Economic Development across Developing Countries[a]



[a] Black dots represent Islamic countries. Economic growth measured as in Section II; see text for the calculation of distance.

Source: World Bank (2003b); http://www.macalester.edu/research/economics/PAGE/HAVEMAN/Trade.Resources/Data/Gravity/dist.txt

In any case, distance cannot explain the inferior growth performance of Islamic countries portrayed in Section II. On average, the location of Islamic countries is slightly less remote than that of other developing countries.[6] Furthermore, Figure 2 reveals that almost all Islamic countries fall below the regression line, i.e., they have performed worse than their distance to economic centers suggests; Bangladesh, Egypt, Indonesia, Malaysia, and Tunisia are the exceptions.

As noted before, there is another aspect of current thinking on economic development at the periphery that is related to systemic factors discussed during the 1970s, even though this link

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6 The average distance to Germany, Japan, and the United States is about 8500 kilometers for 45 OIC members (8600 kilometers for 35 non-oil OIC members), compared to 8900 kilometers for the overall sample of 111 developing countries.

is not immediately obvious. It has become conventional wisdom that the persistent divergence in economic development is largely due to institutional deficiencies in peripheral economies (e.g., Easterly and Levine 2002). The institutional framework comprises various elements, including political stability, government effectiveness, the rule of law and control of corruption (Kaufmann et al. 2002). Most of these elements, as well as the average of them, are strongly correlated with economic growth in developing countries (Nunnenkamp 2003a). At the same time, there is a wide variation in institutional development across developing countries. For instance, institutional development in Islamic countries ranges from fairly advanced in Jordan (0.35), Kuwait (0.40), UAE (0.47), Oman (0.57), Qatar (0.60) and Tunisia (0.66) to highly deficient in Sierra Leone (-1.04), Libya (-1.05), Turkmenistan (-1.07), Sudan (-1.26), Tajikistan (-1.26), Somalia (-1.55), Iraq (-1.75) and Afghanistan (-1.92).[7]

One may wonder what all this has to do with systemic factors that are beyond the control of developing countries. Institutions can be changed, and local governments bear major responsibility if economic growth continues to be hampered by institutional deficiencies. Nevertheless, recent research has highlighted the path dependency of the institutional framework. Acemoglu et al. (2001) show that current institutional deficiencies can be traced back to the colonial past of many developing countries.[8] The findings of these authors may be summarized as follows: First, former colonial powers pursued different strategies depending on whether or not colonizers settled in the colonies. In colonies with high settler mortality, settlements remained insignificant and colonial powers set up "extractive states" without introducing development-friendly institutions for the protection of property rights and the like. By contrast, domestic institutions tended to be replicated in colonies where settlements were feasible because of low mortality rates. Second, extractive states and the lack of institutional development persisted after political independence of non-settler colonies. Prominent among the reasons for the persistence of institutional deficiencies was the motive of local elites now ruling the former colonies to use the existing extractive states to their own benefit. Third, as mentioned before, institutional development, or the lack thereof, has an important say on current economic performance.

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7 Note that the index based on data presented in Kaufmann et al. (2002) ranges from –2.5 to 2.5, with higher values corresponding to better institutions.

8 In a similar vein, the World Bank argues that many business regulations in developing countries are the legacy of European legal systems imposed on former colonies (World Bank 2003a)

Acemoglu et al. (2001) provide convincing empirical evidence on these links for a large number of former colonies for which there are data on settler mortality, the institutional framework and current economic performance. The question remaining in the context of the present contribution is how Islamic countries fit into this general picture. More precisely, it has to be checked whether the relatively poor performance of Islamic states is related to institutional deficiencies, and whether such deficiencies may stem from colonial legacies reflected in high settler mortality. On both counts, empirical evidence provides only weak support. Figure 3 reveals that, on average, Islamic countries are plagued by more serious institutional deficiencies than the overall sample of developing countries, but the difference is rather small when considering the wide variation of institutional development within country groups. At the same time, settler mortality during colonial times was considerably higher in Islamic countries. Nevertheless, there is no clear evidence for colonial legacies to bear major responsibility for the relatively poor economic performance of Islamic countries. This is even though economic growth is negatively correlated with settler mortality and positively correlated with institutional development (Table 1).[9] The critical point is that the link from the colonial past, reflected in settler mortality, to current institutions remains fairly weak (i.e., statistically insignificant) for Islamic countries. Institutions in Islamic countries appear to have developed largely independently from colonial legacies. Hence, the experience of Islamic countries underscores an important qualification made by Acemoglu et al. (2001: 1395), who conclude: "Our findings do not imply that institutions today are predetermined by colonial policies and cannot be changed."

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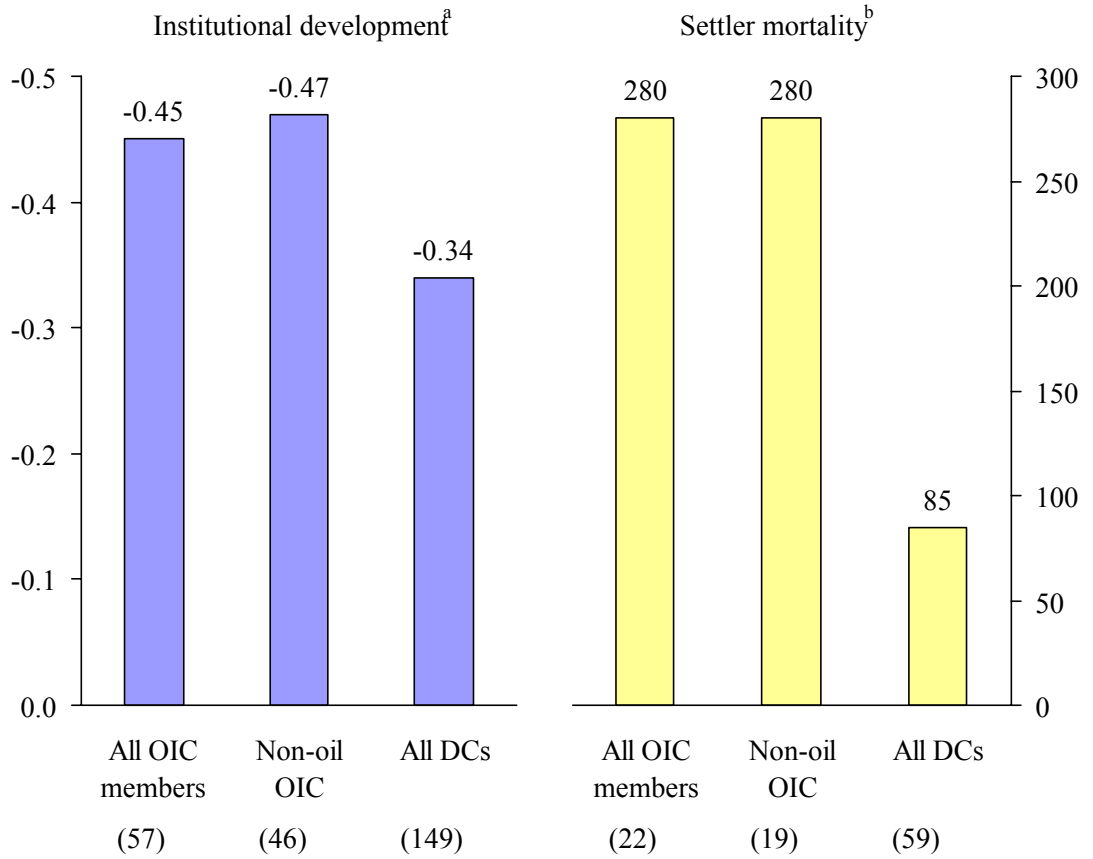
9 The observation that the correlation between institutional development and growth is stronger for non-oil OIC members can be attributed to the importance of oil prices in oil-exporting OIC members.

Figure 3 — Current Institutions and Colonial Legacies: Islamic Countries Compared to All Developing Countries



[a]Median of institutional development; index values range from –2.5 to 2.5, with higher bars corresponding to more serious institutional deficiencies.— [b]Median of potential mortality rates (deaths per annum per 1000 settlers).— Number of countries in parentheses.

Source: Kaufmann et al. (2002); Acemoglu et al. (2001).

Table 1 — Colonial Legacies, Current Institutions and Economic Performance: Correlation Results for Islamic Countries[a]

	All OIC members		Non-oil OIC members	
	Institutional development	Economic growth	Institutional development	Economic growth
Settler mortality	–0.31 (22)	–0.64* (20)	–0.34 (19)	–0.65* (17)
Institutional development		0.29 (31)		0.57* (25)

[a]Spearman rank correlations; * denotes statistical significance at the 10 percent level (two-tailed test); number of observations in parentheses. See text for definition of variables.

Source: World Bank (2003b); Kaufmann et al. (2002); Acemoglu et al. (2001).

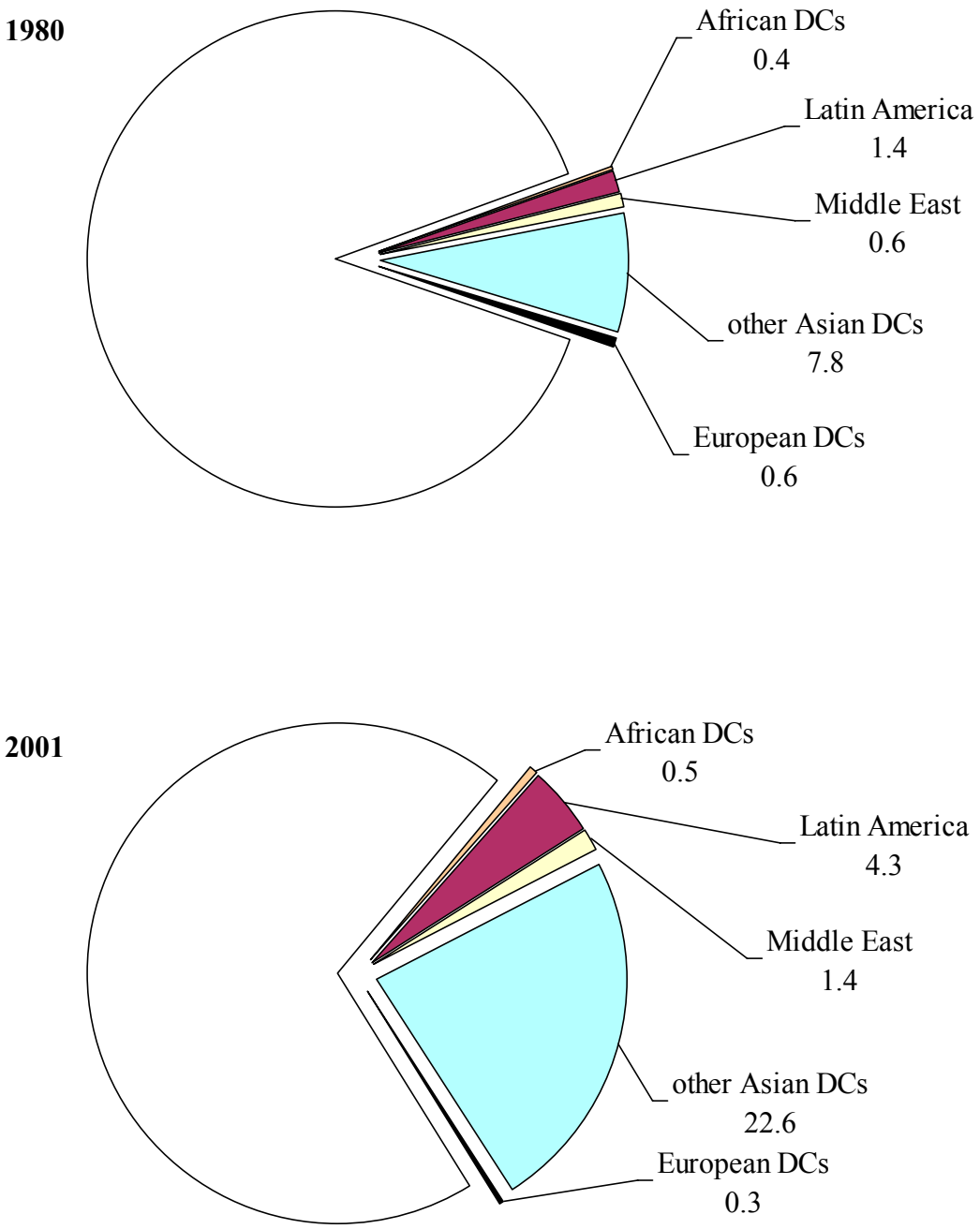
V. INTERNATIONAL TRADE: LIMITED GAINS IN AN UNFAVORABLE ENVIRONMENT?

If institutions can be improved inspite of colonial legacies, one might expect the same for the chances of developing countries to participate successfully in world trade. And indeed, current international trade patterns appear to be in serious conflict with the notions of dependency and unequal exchange (see Section III). In contrast to the formerly prevailing view that the exports of developing countries are largely confined to primary commodities, manufactured exports accounted for two thirds of their total exports in 2001; the share of manufactured exports has more than tripled since 1980 (UN 2003). Furthermore, manufactured exports of developing countries are not restricted to labor-intensive or technologically inferior goods such as metal products, textiles and clothing. Rather, chemicals, machinery and transport equipment contributed 60 percent to manufactured exports of all developing countries in 2001 (up from 38 percent in 1980).

The penetration of world markets by developing countries is also reflected in Figure 4. The share of all developing countries in world trade of manufactured goods almost tripled from 11 percent in 1980 to 29 percent in 2001. Industrialized countries were the target of about 60 percent of the manufactured exports of developing countries (UN 2003). Hence, it would be hardly convincing to argue that the world trading system prevents developing countries from successfully participating in the international division of labor.

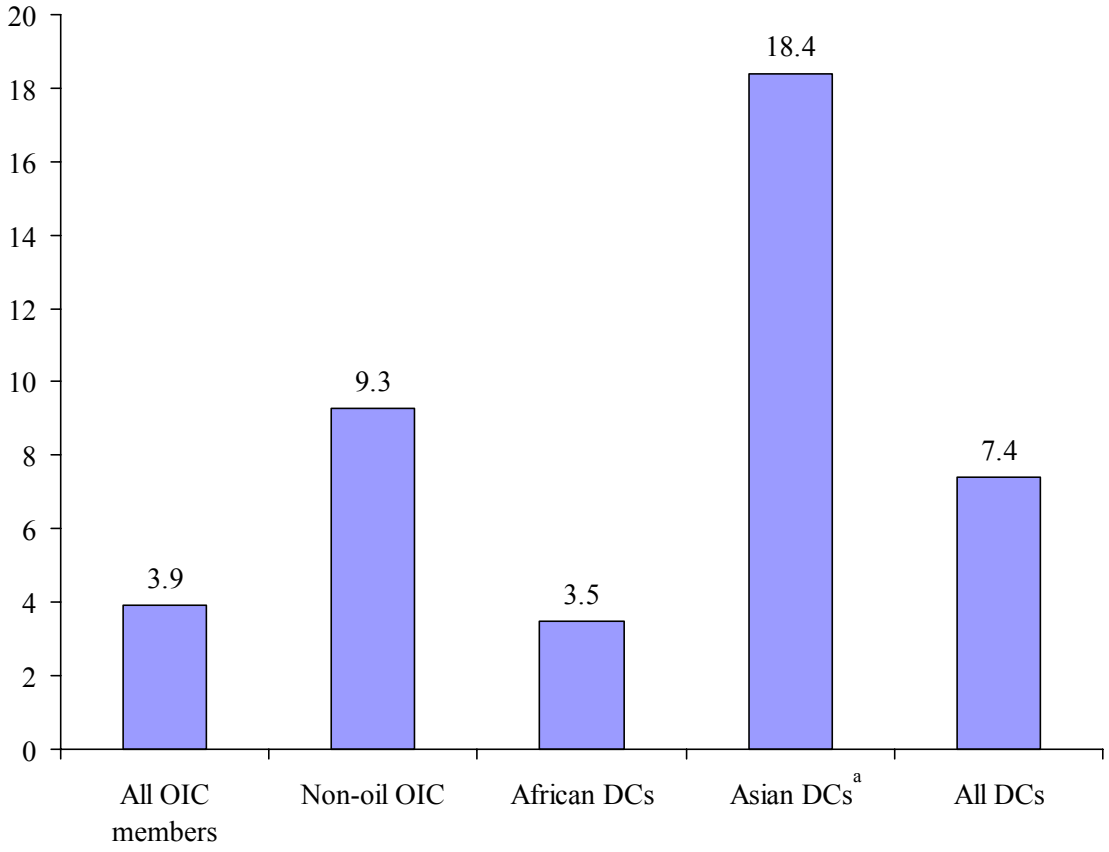
Yet, several qualifications have to be made. First of all, developing countries differ tremendously in making use of international trading opportunities. Successful penetration of world markets for manufactured goods is largely restricted to Asian countries, including some Islamic countries such as Malaysia (Figure 4). In sharp contrast, most of the poor African countries, including various Islamic countries, failed to become competitive suppliers of manufactured goods. Significant differences between regions and developing country groups are also revealed in Figure 5, which presents the change in the share of overall exports in the exporting countries' GDP between the second half of the 1970s and 1997–2001. It turns out that the export orientation of non-oil OIC member countries, on average, increased somewhat more strongly than the export orientation of all developing countries, but by only half as much as the export orientation of Asian developing countries.

Figure 4 — Share of Developing Countries in World Trade of Manufactured Goods, 1980 and 2001 (percent)



Source: UN (2003).

Figure 5 — Change of the Export – to – GDP Ratio for Selected Developing Country Groups, 1997–2001 versus 1975–1979 (percentage points)



[a]Excluding Middle East.

Source: World Bank (2003b).

Furthermore, the differences in export performance were associated with varying developments in the terms of trade (i.e., the ratio of export prices to import prices). As noted in Section III, it had been argued in the 1960s already that the terms of trade of developing countries were bound to deteriorate in the long run. The well-known Prebisch/Singer hypothesis was originally based on the assumption that the exports of developing countries are largely restricted to primary commodities characterized by low income elasticity. This hypothesis had been contentious all the time, for both conceptual and empirical reasons (Ghatak 1995: 340-342; Sapsford and Chen 1999). The significant shift from primary commodity exports to manufactured exports reported above might be expected to have further eroded the relevance of the Prebisch/Singer hypothesis. Yet, recent evidence suggests that the terms of trade between the manufactures exported by developing countries and the

manufactures imported by them from more advanced countries are deteriorating along with the terms of trade between primary commodities and manufactures (Sapsford and Chen 1999: 845). Lutz (1999) finds that, despite the change in the structure of their exports, declining terms of trade are still an issue for developing countries. According to this author, the poorest countries suffered a particularly serious decline in their terms of trade, although there was considerable heterogeneity between individual developing countries.

Figure 6 largely confirms the reasoning of Sapsford and Chen (1999) and Lutz (1999) for the last twenty years. The terms of trade deteriorated for all country groups shown, though to different degree. The decline was below average for Asian developing countries. This indicates that the shift towards manufactures did help contain terms-of-trade losses. Moreover, declining prices for manufactured exports such as electronics seem to be largely due to productivity increases in the exporting Asian economies, rather than exogenous shocks. As concerns OIC members, their terms of trade developed more unfavorably than the terms of trade of the overall sample of developing countries. However, this is to be attributed to the overriding importance of oil prices for oil-exporting OIC members. On average, non-oil OIC members suffered less severe terms-of-trade losses than all developing countries taken together. Finally, it has to be stressed that the averages for OIC (and non-OIC) developing countries conceal huge variations in country-specific terms of trade. For instance, the terms of trade of some Latin American countries, including such diverse economies as Brazil, Costa Rica, and Paraguay, improved considerably when comparing most recent data with the early 1980s. The same is true for several OIC members; cases in point are Jordan and Morocco, but also some very poor economies such as Burkina Faso and Mauritania.

The successful world-market penetration by some developing countries as well as the substantial variation in the gains from trade casts into doubt the widely held view that the prevailing international trading order systematically prevents trade-related benefits of developing countries. This is not to ignore that various trade practices of major players limit the gains developing countries can reap from participating in the international division of labor:[10]

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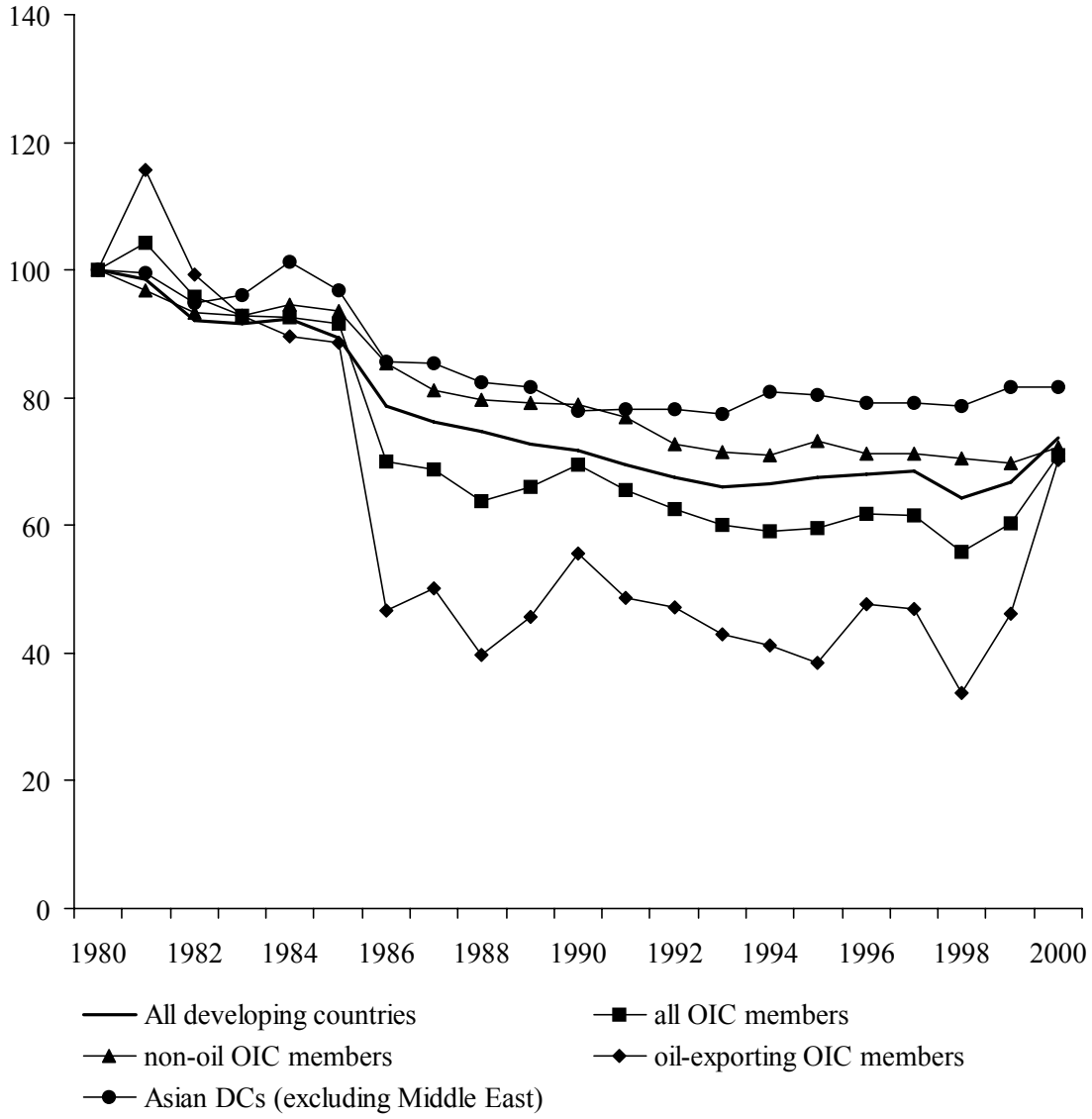
[10] The – selective – evidence below is largely from Primo Braga (2003).

Figure 6 — Terms of Trade for Selected Developing Country Groups, 1980–2000 (1980=100)



Source: World Bank (2003b).

- In agriculture, developing countries face particularly serious constraints. Industrialized countries spend more than US$ 300 billion per annum supporting their farmers, about six times the amount they spend on foreign aid. According to producer support estimates, direct subsidies and border protection that the EU provides for European farmers amounted to more than half of farm output at world prices in recent years.[11] Tariff rate quotas apply to 28 percent of agricultural output, on average, in OECD countries (EU: 39

[11] Producer support was lower in the United States, but even higher in Japan.

percent). Moreover, the protection of agriculture in OECD countries increases with the stage of processing (escalation effect).

- Agriculture is also an area where major players apply double standards. For example, influential WTO members made the WTO accession of Cambodia conditional on commitments by this weak trading partner not to subsidize agriculture and to adopt a maximum agricultural tariff of less than a quarter of tariff peaks in the EU (*The Economist* 2003a).

- Cotton provides a telling example of seriously impaired market access for poor countries that are competitive suppliers of agricultural products. US cotton growers receive US$ 4 billion of subsidies in return for producing US$ 3 billion worth of cotton (*The Economist* 2003b). American cotton costs 50 percent more to produce than African cotton from Benin, Burkina Faso, Chad, and Mali. All four OIC member countries rely heavily on cotton production and exports. Nevertheless, their request for fair trading opportunities was rebuffed in the so-called Development Round of WTO negotiations, which contributed to the failure of the Ministerial Meeting in Cancún in September 2003.

- Developing countries are discriminated in trade with manufactured goods, too. OECD countries are extremely hesitant to phase out restrictive import quotas for textiles and clothing. Other labor intensive manufactures that are produced at competitive terms in many developing countries are subject to particularly high tariff barriers. For instance, the United States collects tariff revenues on imported shoes in the order of tariff revenues on imported automobiles, although the import value of shoes is only about 14 percent of the import value of automobiles.

- On average, tariffs levied by OECD countries on imports from developing countries are four to five times higher than tariffs levied on imports from other OECD countries (*The Economist* 2003b). In some instances, some of which are relevant to OIC members, this discrepancy is even wider. Exports of Bangladesh face an average tariff rate of 14 percent in the United States, compared to 1 percent for French exports.

- Tariffs on manufactures typically escalate with value added in developing countries, thereby discouraging the processing of goods. Furthermore, anti-dumping measures by

OECD countries are disproportionally targeted against competitive suppliers from developing countries.[12]

All this indicates that the global trading system continues to be characterized by many inequities. This does not mean that only the major players are to blame for the deficiencies of the trading system. Developing countries themselves are partly responsible. This becomes clear when considering how developing countries have traditionally perceived the WTO (and, formerly, the GATT), and how multilateral trade negotiations are actually performed.

Since decades, developing countries have insisted on special and differential treatment (S&DT) when it comes to multilateral trade rules.[13] While developing countries required – and, to some extent, received – trade preferences from industrialized countries, they were reluctant to remove their own trade barriers. This approach proved self-defeating for two major reasons:[14] First, it ignored the political economy of WTO negotiations, which is based on *quid pro quo* considerations. In other words, only countries offering better access to their own markets are relevant negotiation partners. It follows that "the rich countries, denied reciprocal concessions from the poor countries, wound up concentrating on liberalising trade in products of interest largely to themselves" (Bhagwati 2002: 26). Second, the reluctance of many developing countries to make liberalization offers ignored an essential insight shared by almost all trade economists, namely that the gains from trade depend at least as much on domestic liberalization as on better access to foreign markets. This is because the protection of local markets implicitly discriminates domestic exporters. It fits into this picture that developing countries with poor export performance typically maintain import barriers that are much higher than those of industrialized countries (Primo Braga 2003).

In summary, developing countries would definitely benefit more from international trade if protectionism by industrialized countries did not discriminate against products in which

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12 In 1995–2002, about three quarters of anti-dumping actions initiated by industrialized countries were targeted against developing countries.

13 S&DT of developing countries was codified in GATT through the so-called Part IV Extension in 1965 and the Enabling Clause on "Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries" in 1979.

14 In addition, various empirical studies have shown that trade preferences, embodied in the Generalised System of Preferences (GSP) since 1971, "did little for the poor countries" (Bhagwati 2002: 27); see also Langhammer (1999) and the literature given there.

developing countries have comparative advantage. Compared to trade barriers that developing countries erect against one another, however, the barriers of industrialized countries against developing countries' exports are rather low. Furthermore, essentially all developing countries are confronted with the same unfavorable external environment. Nevertheless, their trade performance varied tremendously. This strongly suggests that the way in which developing countries adjust to exogenous factors is crucially important. Active participation in multilateral trade negotiations appears to be one of the ingredients of successful world-market orientation (see also Page 2002).

VI. EXPOSURE TO FOREIGN CAPITAL: UNCERTAIN BENEFITS AT CONSIDERABLE COSTS?

While the international trading system is deemed biased against developing countries by globalization critics, international capital markets are widely perceived to be plain harmful to developing countries. In contrast to trade liberalization, capital account liberalization, except opening up to foreign direct investment (FDI), is not an ingredient of what John Williamson (1990) coined the Washington Consensus. Yet, globalization critics rightly point out that particularly the International Monetary Fund (IMF) advised, or rather pressed, developing countries to open up to capital inflows (e.g., Khor 2003). The major justification given for this pressure was that free capital flows would prove as beneficial as free trade to developing countries which, by attracting foreign savings, could complement their limited own investment resources. In contrast to trade, however, the proponents of unrestricted capital flows have "offered more 'banner-waving' than hard quantitative evidence on the benefits of financial globalisation" (Reisen 1999: 7; see also Bhagwati 1998).

The IMF's reasoning that economies which open up to capital inflows have better prospects of development has been challenged by empirical studies; Rodrik (1998) summarizes his findings on the link between capital controls and economic growth in about 100 countries as follows: "The data provide no evidence that countries without capital controls have grown faster." Many globalization critics go further and accuse the IMF to have acted in the interest of globally engaged banks and international speculators, rather than in the interest of developing countries requesting financial support from, and subjected to economic policy conditionality of the IMF. Chile and Malaysia are often refered to as models revealing that the IMF's preoccupation with capital account liberalization was counterproductive:

- Chile discouraged short-term capital inflows by a non-remunerated reserve requirement in the 1990s. This implicit tax may have insulated the country from speculation.

- Malaysia decided against financial IMF support and imposed controls on capital outflows in September 1998. The government as well as many critics of unrestricted capital flows claimed success by pointing to Malaysia's rapid recovery from the Asian crisis.

The effectiveness of capital controls in Chile and Malaysia remains heavily disputed.[15] Nevertheless, it is now widely accepted that, given the vagaries of international capital markets, developing countries are well advised to pursue a cautious and gradual approach to capital account liberalization. Different types of capital inflows are likely to have varying effects on economic development of Third World economies. The risks involved for developing countries drawing on imperfect capital markets appear to be greatest with regard to debt-related capital flows, whereas FDI inflows are widely considered superior to debt.

It is for several reasons that international bond and loan markets may cause more harm than good to developing countries. First, international debt contracts typically shift maturity and currency risks to the borrower. A maturity mismatch results when developing countries have access only to short-term loans, while foreign borrowing finances long-term investment projects. A currency mismatch exists because foreign loans are denominated in hard currency, while the borrower's revenues are often in local currency. Especially poor borrowers will find it difficult to manage maturity and currency risks. Second, debt-related capital flows are characterized by high volatility (Nunnenkamp 2003b: Figure 5). In recent financial crises, various emerging market economies suffered sudden reversals from excessive debt inflows to massive outflows. Even if international speculation did not cause these crises, it exacerbated financial and currency turbulence and deepened recession in the afflicted countries, e.g., in Asia in the late 1990s,. Moreover, according to various critics, the international crisis management clearly revealed that the IMF and its major shareholders are accomplices of foreign banks and investors that were engaged in the crisis countries:

- The IMF did not help prevent the banks and investors from fleeing the countries in financial trouble, and remained opposed to emergency measures such as Malaysia's ban on capital outflows.

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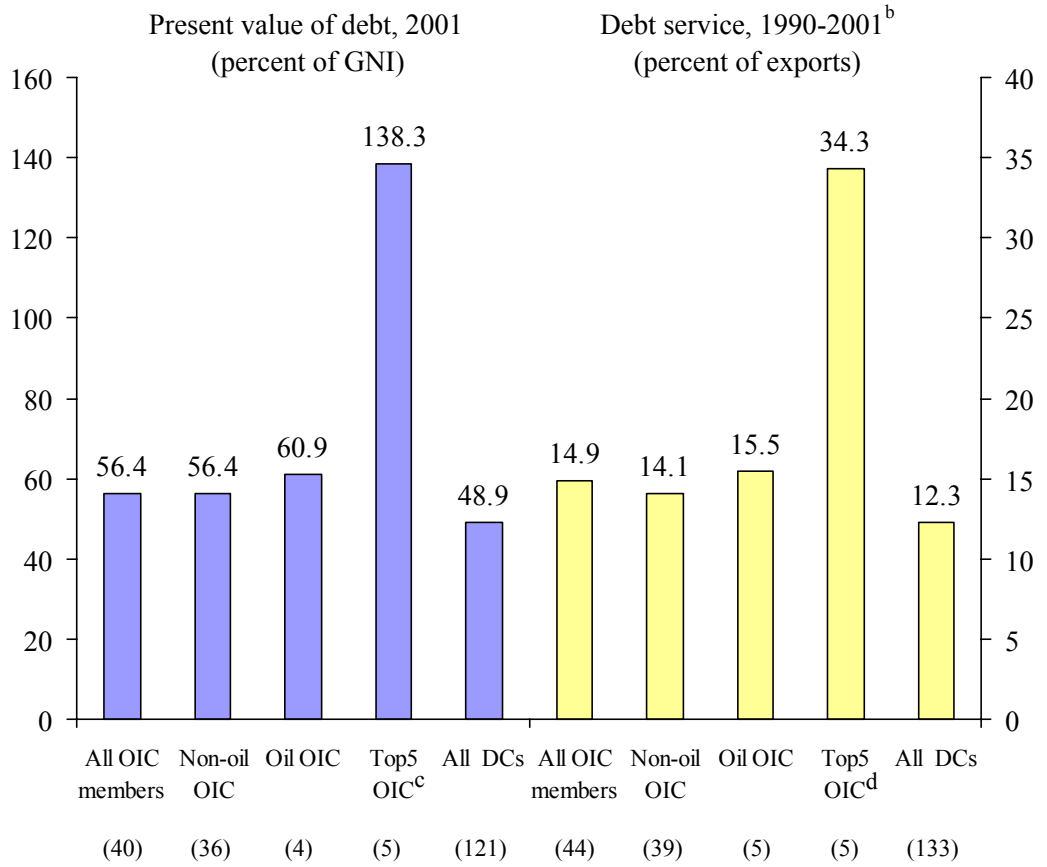
[15] For details, see Nunnenkamp (2001) and the literature given there.

- The unfair distribution of crisis-related costs is exemplified by Sachs (2000) for the case of Korea: "Under the IMF deal, the creditor governments forced Korea to guarantee the repayment of bad debts owed by private Korean banks to private US, European, and Japanese banks. The Korean people are paying billions of dollars in taxes so that their government can make good bad private loans."

Finally, some developing countries are kept in a foreign debt trap that may stifle economic development. High non-performing debt may discourage local investment and, thus, economic growth if local investors anticipate that their returns to investment will be taxed away in order to service foreign debt. It is difficult, if not impossible, to gauge how many, and by how much, developing countries are overindebted in this sense. Yet, Figure 7 offers some clues on the burden of foreign debt. The present value of debt (in percent of the debtor countries' gross national income) was around 50 percent, on average, in all developing countries and OIC member countries. While this may not appear excessive, the median of the debt/GNI ratio amounted to almost 140 percent in the five OIC member countries with the highest ratios. Likewise, the average ratio of debt service payments to export revenues was only slightly higher for OIC members than for all developing countries, but exceeded 34 percent for the five OIC member countries with the highest debt service ratios (Figure 7).

Major creditor countries acknowledged that the foreign debt burden of at least some developing countries was unmanageable when the so-called HIPC initiative was launched in 1996. The aim was to reduce the debt of Highly Indebted Poor Countries to levels deemed sustainable if the beneficiaries of debt relief embarked on promising strategies to alleviate poverty. However, the poverty alleviating effects of the HIPC initiative may be questioned on several grounds. The policy commitments of debtor countries are difficult to enforce. Moreover, effective relief tends to be substantially less than the writing off of non-performing debt on the books would suggest. NGOs such as the Jubilee Debt Campaign keep complaining about debt relief coming too late, offering too little and remaining arbitrary and too complicated (Greenhill et al. 2003). By spring 2003, just eight HIPC countries (out of the "Jubilee 53") had reached the so-called completion point of the initiative and received substantial debt write-offs; six OIC member countries belonged to this group (Benin, Burkina Faso, Mali, Mauritania, Mozambique, and Uganda).

Figure 7 — Foreign Debt Burden of Developing Countries (Median)[a]



[a]Number of countries in parentheses.— [b]Period average.— [c]In ascending order: Côte d'Ivoire, Sierra Leone, Guyana, Mauritania and Guinea-Bissau.— [d]In ascending order: Indonesia, Guinea-Bissau, Uganda, Sierra Leone and Algeria.

Source: World Bank (2003b).

As noted before, highly indebted developing countries might have fared better had they relied on FDI instead of debt. According to current conventional wisdom, FDI is superior in that it offers not only capital but also access to foreign technology and management know-how.[16] Furthermore, the risk properties of FDI are more favorable to developing countries since maturity and exchange-rate risks remain with foreign direct investors. Nevertheless, it is quite striking that FDI appears to be regarded as a panacea by many policymakers and their advisers. This is not only in sharp contrast to the earlier critique of multinational enterprises as one of the mechanisms of exploitation of peripheral economies (Section III). At the same

16 For a detailed discussion, see Nunnenkamp (2003b).

time, the currently prevailing euphoria about FDI tends to neglect several shortcomings related to the access to FDI, the economic effects of FDI and the bargaining position of developing countries competing for FDI.

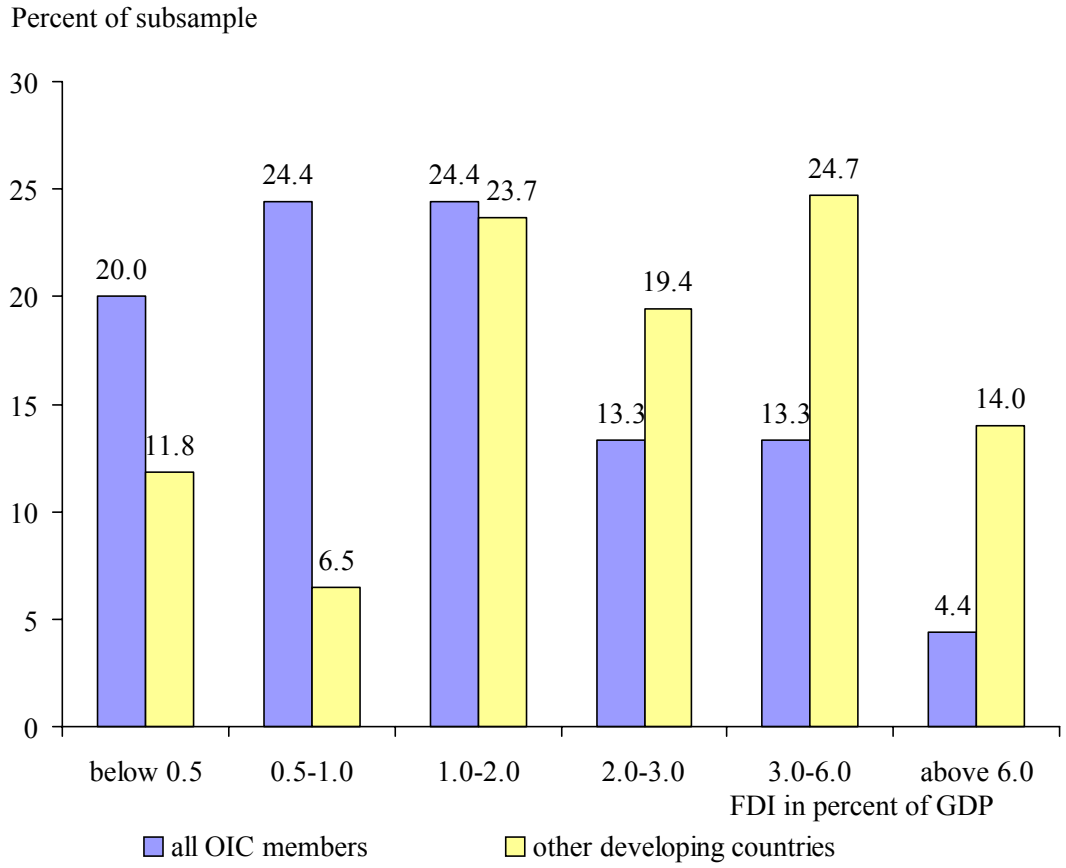
FDI inflows are distributed unevenly across developing countries, even though almost all countries have opened up to FDI. Figure 8 indicates that multinational enterprises are strongly engaged in various Third World locations considered attractive, while they are virtually absent in various other locations. This applies to both OIC members and other developing countries. However, the median of FDI inflows in 1990-2001 (in percent of the host countries' GDP) is considerably lower for OIC members (1.3 percent) than for all other developing countries (2.5 percent). According to Figure 8, almost half of OIC members, compared to about 20 percent of all other developing countries, attracted FDI inflows in the order of less than 1 percent of GDP. FDI inflows to Bangladesh and Cameroon, for example, remained below 0.2 percent of their GDP.

Even in countries with considerable FDI inflows, it is open to question whether FDI actually promotes economic development. Empirical research suggests that this is rather unlikely in host countries where multinational enterprises are operating in foreign dominated enclaves, e.g., in resource extraction, and where a poor endowment of complementary factors of production hinders FDI-induced spillovers to the local economy (Nunnenkamp 2003b).

Against this backdrop, the absence of an international agreement to prevent incentives-based competition for FDI may cause harm especially to developing countries. Uncertain growth effects of FDI notwithstanding, FDI projects often involved subsidies amounting to hundreds of thousands of dollars per job-to-be created, including in developing countries such as Brazil and India (Oman 2001). International policy coordination seems key for host countries to escape the prisoner's dilemma when multinational enterprises start playing different jurisdictions off against one another to bid up the value of incentives. However, industrialized countries are resisting the demand of developing countries to go ahead with effectively constraining the subsidization of FDI. Moreover, industrialized countries refused to agree on binding corporate obligations that developing countries deem necessary to improve the developmental impact of FDI. On the other hand, industrialized countries, notably the EU, pressed for a multilateral investment agreement (under the roof of the WTO) which, according to critics, would have prevented developing countries from pursuing selective and

flexible FDI policies.[17] Taken together, the investment rules proposed by industrialized countries are regarded by many developing countries as seriously biased against their interests. Hence, it is not surprising that the controversy on investment rules contributed to the failure of the WTO Ministerial Meeting in Cancún in September 2003.

Figure 8 — FDI Flows to Developing Countries, 1990–2001[a]: Distribution of the FDI/GDP Ratio



[a]Period average.

Source: World Bank (2003b).

In light of the risks of debt-related capital inflows and uncertain benefits from FDI inflows, many poor developing countries will probably continue to depend on foreign aid inflows. Nonetheless, the donor community of OECD countries constantly fails to meet the internationally agreed target of 0.7 percent of GNP to be devoted to official development assistance (ODA). As a matter of fact, ODA declined from 0.33 percent of the donors' GNP

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[17] For a detailed discussion, see Nunnenkamp and Pant (2003) and the literature given there.

in 1990/91 to 0.22 percent in 2000-2002.[18] Insufficient fund raising by the donor community also hinders the fight against global "public bads" such as Aids and malaria. Jeffrey Sachs (2003) criticizes the miserly response of donors to global emergencies: As concerns the Global Fund to Fight Aids, Tuberculosis and Malaria, "all speakers agreed that the three pandemics are out of control ... Eloquent testimonials demonstrated the value of the fund in dozens of impoverished countries. Yet at the end of the day, the rich country governments ... failed to commit enough to meet the fund's minimum need."

The aid fatigue of donors seems to be largely because the developmental effects of aid fell short of high expectations in the past. According to a well-known study, aid had no measurable impact on the recipients' per-capita income growth across 56 developing countries in 1970–1993 (Burnside and Dollar 2000). Aid recipients having failed to use foreign aid productively bear major responsibility for this dismal outcome. At the same time, however, the donor community deserves part of the blame. The effectiveness of aid could be improved if the focus were on developing countries with particularly low per-capita income and reasonable local policy conditions (Collier and Dollar 2001). In practice, the allocation of aid continues to be in conflict with these requirements (see also Nunnenkamp 2002):

- While lower-income developing countries, on average, receive more aid, the aid-to-GNI ratio of some countries which, according to World Bank definitions, belong to the middle-income group is significantly above the trend line (Figure 9). For instance, this applies to OIC members Guyana and Albania. For some poor recipients with extremely high aid-to-GNI ratios, including OIC members Guinea-Bissau and Mozambique, it is questionable whether aid inflows of this order can be absorbed effectively.
- In sharp contrast to conventional wisdom on the effectiveness of aid, developing countries with unfavorable policy conditions, on average, received considerably more aid than countries where the World Bank regarded policy conditions as good or very good (Figure 10). According to the World Bank's assessment, policy conditions were slightly less favorable in OIC member countries than in other developing countries (Collier and Dollar 2001: Table 3). Nevertheless, several OIC members with poor policy conditions received aid in the order of 14–22 percent of their GDP (e.g., Chad, the Comoros, Niger, and Sierra Leone).

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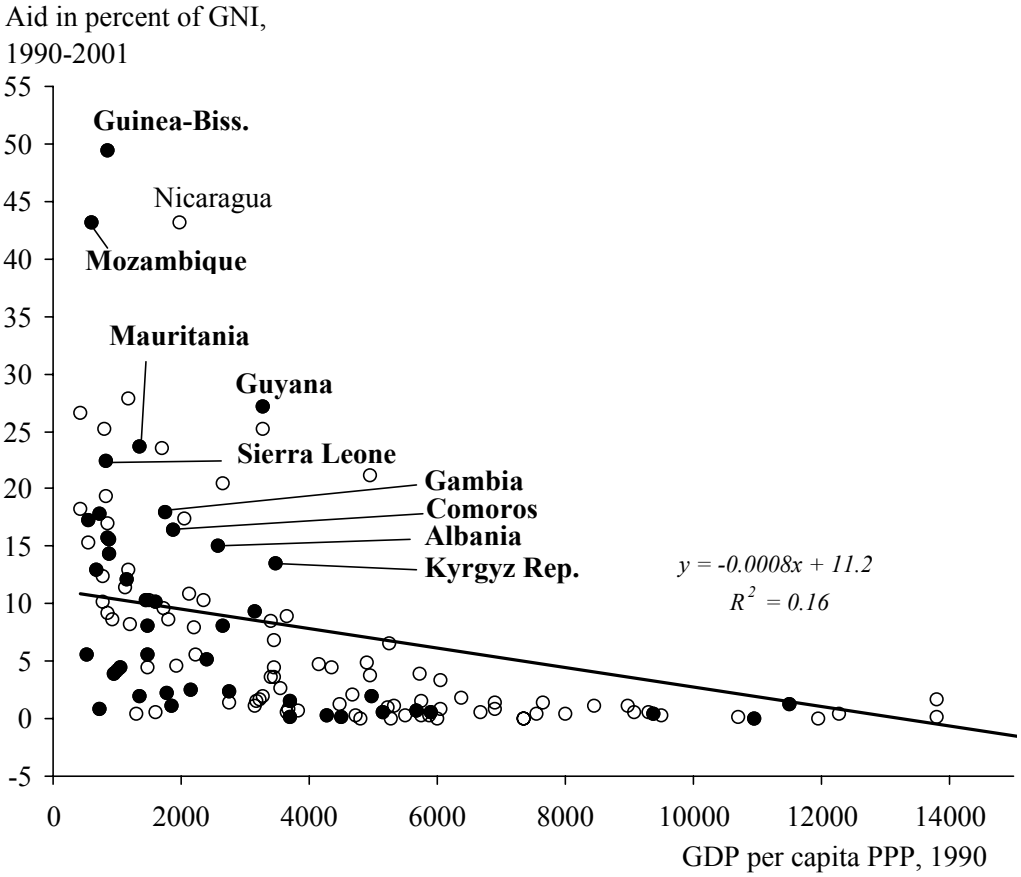
[18] For details, see http://www.oecd.org/statisticsdata/0,2643,en_2649_34485_1_119656_1_1_1,00.html

Figure 9 — Distribution of Aid According to Per-capita Income of Recipient Countries

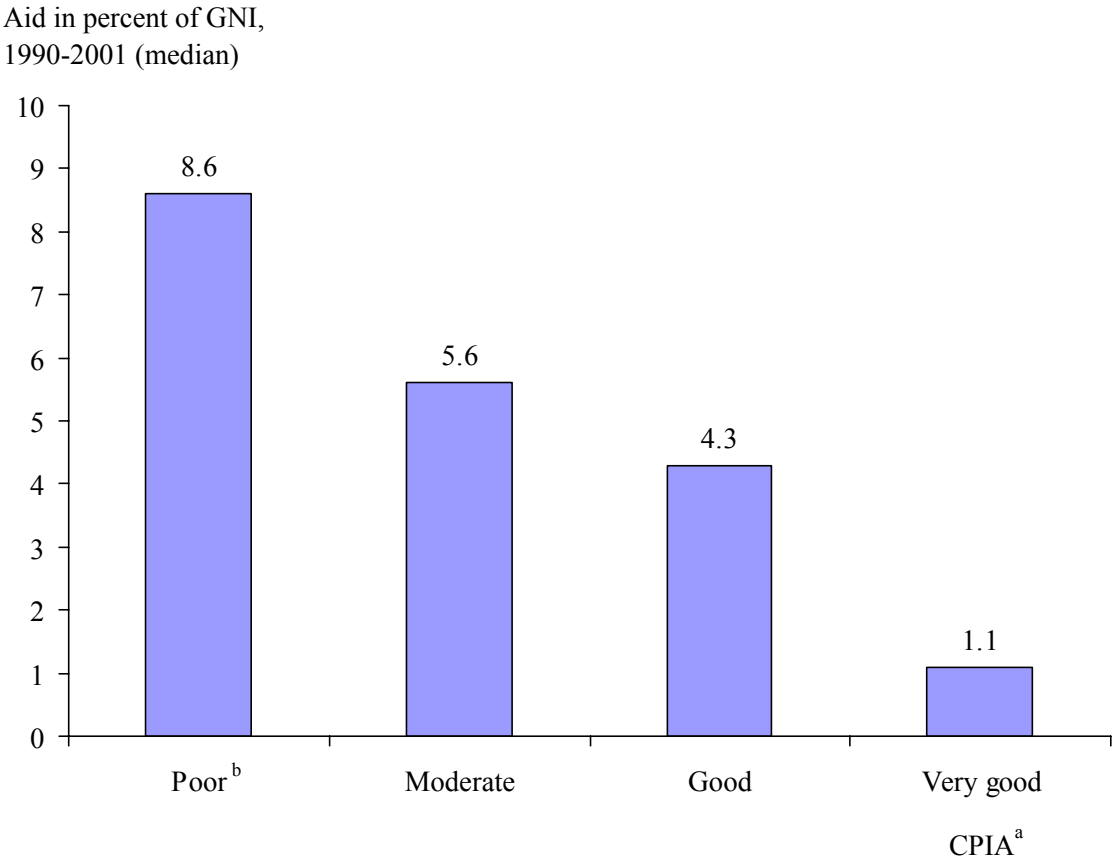


Source: World Bank (2003b).

- Political and strategic considerations have frequently overruled aid effectiveness considerations. Alesina and Dollar (2000) show that political alliances and the colonial past were major determinants of the allocation of foreign aid. US aid to Egypt, Israel, Pakistan, and Turkey are frequently mentioned examples revealing the importance of the former determinant, while French aid to former colonies in Africa represents an example with respect to the latter determinant.

In summary, the promises of major donors to substantially increase their aid budgets, made at the United Nations Conference on Financing Development in Monterrey, Mexico, in 2002, will prove insufficient, even if kept, to promote economic development in aid recipient countries. Aid flows need not just be higher but also better allocated.

Figure 10 — Distribution of Aid According to Local Policy Conditions



[a]CPIA refers to the World Bank's Country Policy and Institutional Assessment as a measure of policy conditions.— [b]Including very poor.

Source: World Bank (2003b); Collier and Dollar (2001: Table 3)

VII. HOW TO REMOVE SYSTEMIC IMPEDIMENTS TO ECONOMIC DEVELOPMENT

It is all too easy to blame the international economic system for persistent underdevelopment of many Third World economies, including large parts of the Islamic world. The trading opportunities of developing countries are constrained by protectionist measures of industrialized countries targeted specifically at the exports of competitive developing countries. The pressure for capital account liberalization, notably by the IMF, invited international speculation against the typically weak currencies of emerging market economies. Various poor countries continue to be trapped in foreign debt, and foreign aid remains less effective than it could be due to political and strategic motives of major donors. Considering the World Bank's leitmotiv "Our dream is a world without poverty", the actual record of this

and other multilateral institutions leaves much to be desired, partly because major shareholders have misused these institutions to press their own agenda.

All this cannot explain, however, why Argentina belonged to the world's relatively rich economies before it fell back dramatically, whereas Asian tigers such as Malaysia caught up significantly to the per-capita income of advanced economies. Likewise, the reference to an adverse external environment helps little to explain the different economic performance within the group of OIC member countries. Before concluding on what the major players in the world economy could, and should do to improve the development prospects of Third World economies, it should, therefore, be stressed that it largely depends on the latter to which extent they could benefit from a more favorable external environment.

Domestic challenges, which are discussed in detail in other contributions to this volume, include various aspects of the much criticized Washington Consensus, notably macroeconomic stability and openness to trade. In addition, recent research has highlighted the relevance of institutional reforms in order to promote sustainable economic development. The colonial legacies that seem to have hampered institutional development in many Third World economies must not be taken as an excuse to fight corruption, enforce the rule of law and enhance government effectiveness.

Although systemic factors were not a binding constraint to Third World development in the past, the external environment in which developing countries have to operate could definitely be improved in various respects. Most importantly perhaps, industrialized countries have to realize that they are no longer alone in running the show when it comes to multilateral trade negotiations. The failure of the Cancún Ministerial Meeting proved that developing countries are increasingly unwilling to simply accept what has been agreed behind closed doors among the major players. Hopefully, the latter will learn this lesson fast by offering more liberalization in areas of vital interest to developing countries. This would not only help prevent the ultimate failure of the so-called Development Round of the WTO, but also put substance to what so far has remained an euphemism.

The removal of trade barriers protecting the agricultural sector of industrialized countries is of utmost importance in this regard. At the same time, Section V provided ample evidence on discriminatory trade practices in the manufacturing sector, which should also figure high on the trade policy agenda. Furthermore, for WTO negotiations to result in a successful Development Round, industrialized countries, notably the EU, should no longer insist on

broadening the agenda to include investment rules. It may well be that developing countries have little to lose if they tied their own hands, e.g., by forgoing the option to impose performance requirements on foreign direct investors. On the other hand, it amounts to hypocrisy when industrialized countries sell the idea of a multilateral investment agreement by arguing that it would result in substantially more FDI flows to developing countries (Nunnenkamp and Pant 2003). Politically, it is clearly counterproductive to press for a multilateral investment agreement that most developing countries will continue to regard as biased, at least unless industrialized countries are committed to stop subsidizing FDI and agree to binding corporate obligations.

It is also in other respects that industrialized countries and multilateral institutions such as the IMF should no longer impose their policy agenda on developing countries. In contrast to the reasoning of many globalization critics, the problem with the Washington Consensus is not that its major ingredients do more harm than good to developing countries. Rather, the traditional approach to press for policy reform in developing countries by combining financial support with economic policy conditions has failed in countries where governments are not reform-minded and local "ownership" of the reform agenda is insufficient. This applies to adjustment programs designed by multilateral institutions, notably IMF programs (Bird 2001), as well as to conditional foreign aid (Svensson 2003). Hence, externally imposed conditionality should be replaced as far as possible by more effective means to encourage reforms in developing countries:

- With regard to IMF lending, it has been suggested to agree *ex ante* on prequalification criteria related to the terms of access to financial support, rather than relying on *ex post* conditionality (Williamson 2000).

- The distribution of aid should increasingly be based on self-defined development strategies of potential recipient countries. This may be achieved by donor contributions to so-called common pools (Kanbur et al. 1999), which would allow donors to grant aid selectively to recipients whose development strategies are considered promising.

Finally, the major players in the world economy should devote more attention and resources to fighting global "public bads". In this regard, two issues appear to be particularly important for promoting sustainable economic development in Third World economies. First, global financial instability and the high incidence of major crises in emerging market economies require particularly the IMF to focus on crisis prevention. To the extent that crises cannot be

prevented, reforms of the international financial architecture should ensure that the ensuing economic costs are shared fairly between developing-country debtors and private foreign creditors. In this context, it is bad news that the proposal for a multilateral regulatory framework for sovereign-debt restructuring failed in spring 2003, due to stiff political opposition by international banks, the US administration and, surprisingly, also some emerging market economies. Second, the challenge remains to provide sufficient financial resources to fight global pandemics such as Aids, tuberculosis and malaria.

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