Trade, Not Aid

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How can the developed countries help the states of Central and Eastern Europe, including the former Soviet Union, to become and remain politically and economically stable, free societies? The foreign aid lobby, international agencies, and many governments have a single answer — give them aid.

Already in place is the 12 billion ECU European Bank eagerly looking for borrowers. Germany gave additional billions; much of it is said to have disappeared without a trace. The International Monetary Fund has put bil-

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lions of dollars into Eastern Europe and will not wait for Western governments to give additional grants and aid to Russia. They plan an advance loan to be followed by World Bank credits, government-to-government loans, including the $24 billion that Presidents Bush and Yeltsin discussed in June.

This is the wrong model, based on the wrong premise — that government-to-government aid or another Marshall Plan will pave the way to peace and prosperity. The Marshall Plan was, indeed, a powerful stimulus to economic development in the early postwar years. The principal stimulus, however, came not from aid but from opening trade within Europe and between Europe and the United States.

Aid facilitated trade. It enabled Western Europe and Japan to recover more rapidly by financing purchases of capital and materials to rebuild the war-damaged infrastructure, to construct plants, and to modernize equipment. Without foreign aid, this process of restoring capital stock and infrastructure would have taken longer.

The more important force for development was trade. Take the case of Germany. Total economic assistance to West Germany under the Marshall Plan (1948-1952) from U.S. loans and grants and from international agencies was about $2.5 billion. West German exports doubled between 1950 and 1952 and doubled again by 1956, bringing an additional $7.5 billion in six years to the West German economy. This money was spent, much of it on imports from other countries in Western Europe stimulating home and foreign economies. Prewar German exports to the United States and its six leading partners in Western Europe were restricted by the military buildup and trade restrictions. In the last peacetime year, 1938, Germany exported only 2.3% of total output. By 1952, this export share had increased to 5.5% and by 1956 to nearly 7% of total output despite the loss of part of its territory and trade.

German exports financed German imports, thereby stimulating its trading partners. In the years 1950 to 1956, the value of German imports from its principal European partners doubled, helping to lift these economies. The story for Japan is a similar story. Trade, more than aid, produced the revival.

When we rank the principal countries that received aid by the share of total loans and grants received during 1946 to 1952 from the United States and international organizations, their order is U.K., France, Germany, and Japan. The economic progress of these countries is inversely related to their share of aid. The principal reason is not that aid is counterproductive. But aid can either accelerate or slow the transformation of an economy. Where investment and trade were encouraged, as in Japan and Germany, development was more rapid. Where countries were more inclined to turn inward in the early postwar years, as in France and the U.K., aid helped to finance costly domestic policies, subsidies, nationalizations, and non-competitive practices.

Mexico and Chile are more recent examples. Once Mexico opened its economy, joined the world trading system, and privatized large parts of its economy, capital poured in. Mexico, which could not service its debt in the early and middle 1980s, now has reserves of nearly $20 billion and has taken steps to slow the capital inflow. Mexican exports to the United States rose $8 billion (33%) in three years, 1988-91. Trade produced more progress and growth in three years than aid and international agency planning had produced in a decade. Chile, a pariah nation until recently, had little aid. By opening its economy, reducing trade barriers, lowering tax rates, and controlling inflation, Chile became a model of successful economic development and restored democratic government.

The collapse of the former Soviet trading system is a major problem for Russia and the rest of Eastern Europe. Western Europe and the United States could best help these economies, and benefit themselves, by reducing barriers to trade. Poland, Hungary and Czechoslovakia can export food, textiles, and steel if quotas and other barriers to trade in these commodities are eliminated or reduced. Their foreign exchange earnings would help to pay for imports of energy and raw materials from Russia and other former Communist countries. Growth of trade would encourage private sector development by raising domestic output and stimulating demands for labor and goods. Once these economies adopted market-oriented reforms and stabilized and opened their economies, capital investment would increase. Foreigners would see opportunities to invest and residents' capital held abroad would be repatriated as in Mexico, Chile and Argentina.

Investors need confidence that exports will be welcome on world markets and that currency convertibility will be maintained. These commitments cannot be made credible unless there are changes in the world trading system that reduce barriers to exports from Eastern Europe, including the states of the former Soviet Union. The U.S. decision to grant Most Favored Nation status is a step in the right direction.

There are three major obstacles to economic development in Eastern Europe. First is the foreign aid lobby and its friends and supporters in international agencies, government offices, universities and elsewhere. These often well-intentioned individuals believe that their plans have a much better prospect for success than anything that
could happen without them.

Second, and more important, is the vision of the European Community as a political system and as a barrier against the movement of people and goods from Eastern Europe (including Russia) and elsewhere. The urgent task for the west, if it wants a stable democratic Russia, is to integrate Russia and its former satellites so that they share in the prosperity achieved through the world market system. This would be accomplished most readily if the countries of the EC would lift their heads from their internal self-inspection and grand designs, open their markets to the exports from their neighbors, and accept the benefits of increased competition. A European free trade system, from the Atlantic to the Urals, closely linked to the world trading system, should be the first priority.

Third is the sluggish pace of change in parts of Eastern Europe, particularly the former Soviet Union. A most urgent requirement is to establish the conditions for free markets in goods and labor. This requires more than privatization. It requires a legal system to enforce contracts and honor commitments, a competitive financial system to mobilize resources and provide credit and money, a system of property rights in goods, capital and labor to make resource allocation more efficient, a bankruptcy law, and an accounting system to provide information on what has been accomplished and whether it is profitable and to facilitate private planning. Despite the stated intentions of its leaders, privatization and reform are slow (except in Czechoslovakia) and, in Russia, subsidies are growing again.

Aid has little chance of removing barriers or accelerating growth. On occasion, government-to-government aid may encourage reform as proponents suggest. More often, aid is used to delay reforms by reducing the pressure that turns political impossibility into urgent necessity. Experience in Africa, Latin America, Israel and Egypt shows that delay, not reform, is the likely outcome.

Eastern Europe has more in common with the countries where foreign aid has failed to produce self-sustaining growth and development than with the Marshall Plan countries. The Marshall Plan countries had experience with property rights and market institutions and a long tradition of economic development within the market system. Most of the unsuccessful countries did not. Foreign aid rarely was used to encourage competition, private property or market institutions. In fact, the principal international lending agencies regard these matters as internal decisions, not something to be imposed or encouraged from outside.

The better way to develop Eastern Europe is through private capital. Government loans bring a platoon of bureaucrats, professors, consultants, and facilitators. Private capital brings technology and management with a personal stake in the success of the enterprise.

The former Soviet Union is a wealthy, underdeveloped area. It has extensive mineral wealth. The states of the former Soviet Union can finance development and import management and technology by selling gold, diamond, coal, and platinum mines, oil reservoirs, gas fields and much more. If these states are concerned about patrimony, they can retain title by offering long-term leases.

China has developed rapidly in the past decade. Foreign aid has been modest. The push for development came, once markets were free, by exporting to the rest of the world and encouraging private capital to enter and share in the profits from development. Capital from Taiwan comes to China without the protection of explicit guarantees against confiscation. Many of us are appalled by China's political system, but this system has made some correct economic decisions, particularly the decision to increase reliance on markets and private capital in development.

Russia and Eastern Europe should do the same. The mark of successful reform will be increased exports and a flow of private capital to Russia and its neighbors that will dwarf any likely amount of foreign aid.