Chapter 18 Economic Development and Transition

The path to development is long and difficult. As nations struggle to improve their economies and their standards of living they are met with a variety of complex issues.

Economics Journal

Examine the photo on this page. What can you infer about the standard of living in this woman's country? List your ideas on a separate piece of paper.

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Section 1 Levels of Development

Preview

Objectives

After studying this section you will be able to:

1. **Understand** what is meant by developed nations and less developed countries.
2. **Identify** the tools used to measure levels of development.
3. **Describe** the characteristics of developed nations and less developed countries.
4. **Understand** how levels of development are ranked.

Section Focus

Nations throughout the world exhibit varying levels of economic well-being. Many tools are used to measure a nation's level of development.

Key Terms

development
developed nation
less developed country
per capita gross domestic product (per capita GDP)
industrialization
subsistence agriculture
literacy rate
life expectancy
infant mortality rate
infrastructure
newly industrialized country (NIC)

Three billion people—half the world's population—live in extreme poverty. The United Nations estimates that 1 billion people live on less than $1 a day. Concern over these startling statistics has led to close examination of the world's economies.

Social scientists measure the economic well-being of a nation in terms of its level of development. **Development** is the process by which a nation improves the economic, political, and social well-being of its people.

Developed Nations and Less Developed Countries

Some nations enjoy a high standard of living. Wealthy nations, such as the United States, Canada, the nations of Western Europe, Australia, New Zealand, and Japan, are called developed nations. **Developed nations** are those nations with a higher average level of material well-being. Most nations, however, have low levels of material well-being. These are the **less developed countries** (LDCs). LDCs include the world's poorest countries, such as Bangladesh, Nepal, Albania, and the nations of Central and Southern Africa. They also include nations such as Mexico, Poland, Saudi Arabia, and the former republics of the Soviet Union. The countries in this second group of nations are not the world's poorest, but they have yet to achieve the high standard of living of the world's developed nations.

It is important to remember that development refers to a nation's material well-being. It is not a judgment of the worth of a nation or its people. The level of development does not indicate cultural superiority or inferiority. Rather, the level of development indicates how well a nation is able to feed, clothe, and shelter its people. It indicates how healthy people are, how well they are educated, and how productive they are.

Measuring Development

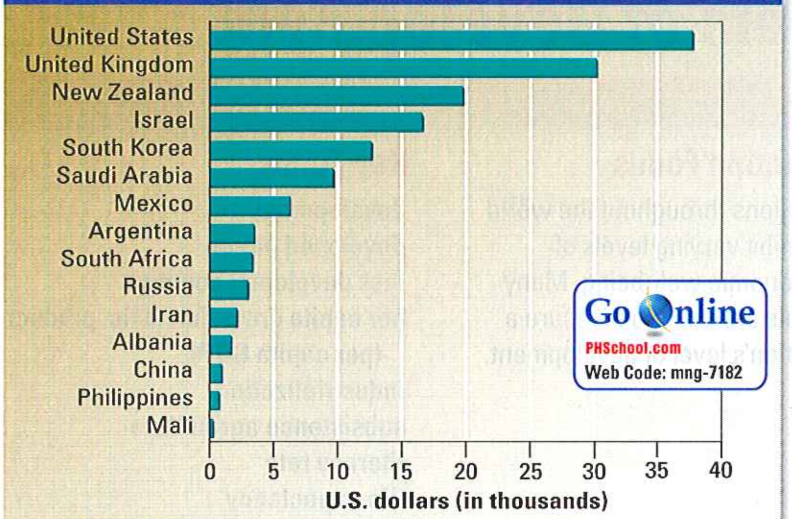
Life expectancy, diet, access to health care, literacy, energy consumption, and many other factors are used to measure development. As you will read below, the primary measure of a country's development, however, is per capita gross domestic product (GDP).

development *the process by which a nation improves the economic, political, and social well-being of its people*

developed nation *nation with a higher average level of material well-being*

less developed country *nation with a low level of material well-being*

Figure 18.1 Per Capita GDP of Selected Nations, 2003



Source: World Bank

BUILDING KEY CONCEPTS

Per capita GDP varies greatly among nations.
Standard of Living **Which nation on this graph do you think has the highest standard of living. The lowest?**

Per Capita GDP

As you read in Chapter 12, gross domestic product, or GDP, is the total market value of all the final goods and services produced within an economy in a given year. It is used to measure the economic activity of a nation. GDP measures the value of production and also provides a measure of income for an economy. **Per capita gross domestic product (per capita GDP)** is a nation's GDP divided by its total population.

per capita gross domestic product (per capita GDP) *a nation's gross domestic product (GDP) divided by its total population*

Development experts use per capita GDP figures because GDP alone is not adequate to compare the living standards within nations. For example, Australia and India have similar GDPs, around \$465 billion for Australia and around \$540 billion for India. Yet, Australia enjoys a high standard of living, while India is very poor. What accounts for this difference? The answer is population size.

Australia's \$465 billion is shared by fewer than 20 million people. India's \$540 billion is shared by about 1.1 billion people. This is why economists use per capita GDP to compare levels of development. Australia's per capita GDP is around \$23,570. India's per capita GDP is around \$500. (See Figure 18.2.)

These per capita figures indicate that the average Australian can more easily meet basic needs than the average Indian. The average Australian also has income left over to spend on nonessentials or to save.

Using per capita GDP to measure a nation's economic health has its limitations, however. Per capita GDP does not take into account a country's distribution of income. Within every nation, some people are wealthier than most, while others are poorer than most. In many less developed countries, the gap between rich and poor is especially wide. In some LDCs, a small, wealthy elite controls much of the wealth while most of the nation's population remains poor.

Energy Consumption

Energy consumption is another way to measure development. The amounts of fossil fuel, hydroelectricity, and nuclear energy a nation uses depends on its level of industrialization. **Industrialization** is the extensive organization of an economy for the purpose of manufacture. Industrial processes generally require large amounts of energy. For this reason, low levels of energy use tend to indicate low levels of industrial activity. High levels of energy use tend to indicate high levels of industrial activity. Because most of the developed nations of the world are highly industrialized, they are sometimes referred to as "industrialized nations."

industrialization *the extensive organization of an economy for the purpose of manufacture*

Nations that have low levels of per capita energy consumption tend to have little industry. Most of the people in such nations are farmers working with simple tools and few machines. This is true of many LDCs, where large portions of the population engage in **subsistence agriculture.** That is, they are able to raise only enough food to feed their families.

subsistence agriculture *level of farming in which a person raises only enough food to feed his or her family*

Labor Force

What does it mean for the economy if a nation has low industrialization? It means that most of the labor force is devoted to agriculture. If most of the people are working simply to raise food for themselves, few are available to work in industry. As a result, there is little opportunity for workers to specialize. (Recall from Chapter 2 that specialization makes economies more efficient.) If individuals—or nations—are unable to produce specialized goods to sell, they are unable to generate cash income.

Consumer Goods

The quantity of consumer goods a nation produces per capita can also indicate its level of development. A large number of consumer goods in an economy means that people have enough money to meet their basic needs and still have some money left over for nonessential goods. Social scientists look to the number of large consumer goods per person to measure development. They count, for example, how many people have televisions, automobiles, refrigerators, washing machines, or telephones.

Literacy

Usually, the more a country's people attend school, the higher its level of development. This makes sense because the greater the number of people that can read and write, the more productive a population can be at both industrial and agricultural jobs.

A country's **literacy rate** is the proportion of the population over age 15 that can read and write. A well-educated nation has a high literacy rate. A low literacy rate indicates a poorly educated nation.

Life Expectancy

Life expectancy is the average expected life span of an individual. It indicates how well an economic system supports life and fends off death. A population that is well nourished and housed, as well as protected from disease, will have a long life expectancy. A population that has a poor diet and shelter and that is exposed to poor sanitation and disease will have a shorter life expectancy.

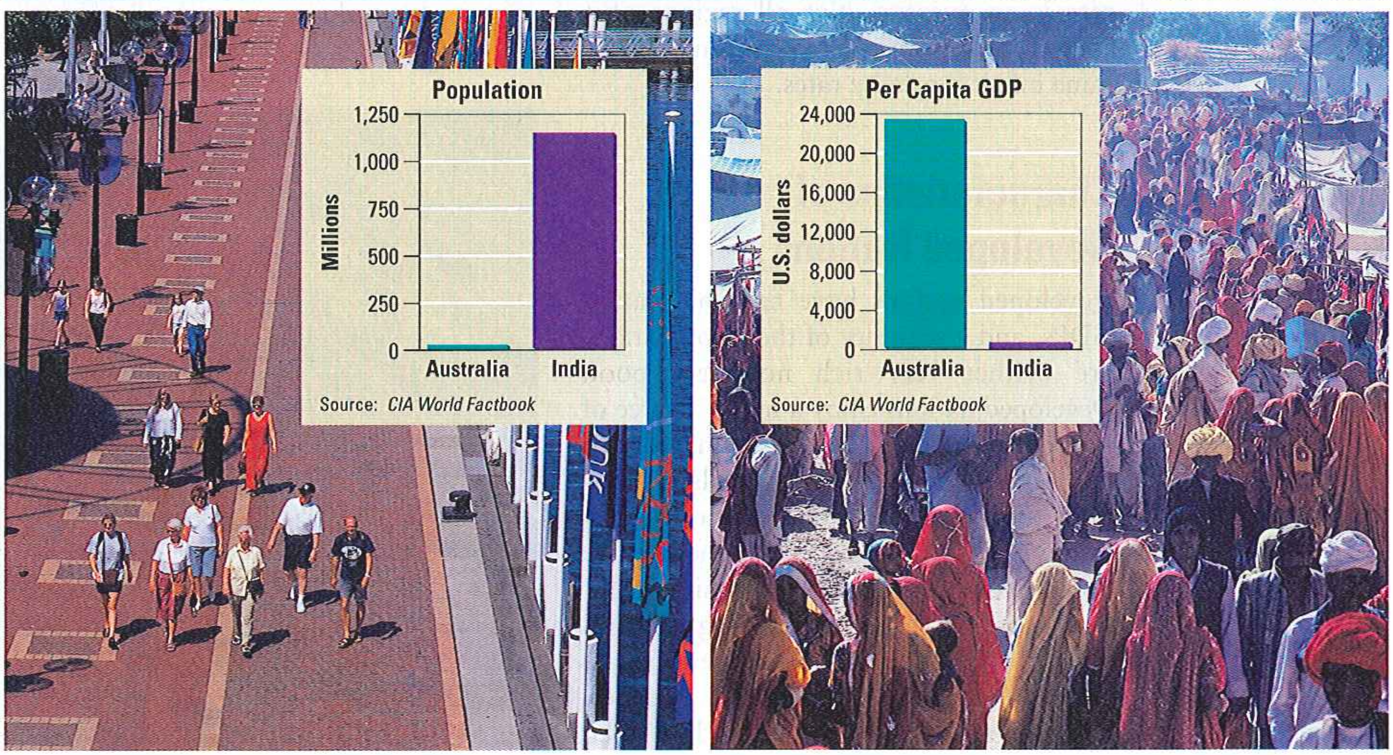
literacy rate *the proportion of the population over age 15 that can read and write*

life expectancy *the average expected life span of an individual*

BUILDING KEY CONCEPTS

Australia (left) and India (right) have very different standards of living.
Gross Domestic Product **What do the photos below tell you about the population levels of Australia and India? How do their population levels affect the measurement of per capita GDP?**

Figure 18.2 **Comparing Australia and India**



▶ **In the developed world, the infant mortality rate is 8; in the less developed world, it is 62.**

infant mortality rate *the number of deaths that occur in the first year of life per 1,000 live births*

infrastructure *the services and facilities necessary for an economy to function*

Infant Mortality Rate

Another measure of development related to nutrition and health care is a country's infant mortality rate. A country's **infant mortality rate** indicates the number of deaths that occur in the first year of life per 1,000 live births. For example, the United States has an infant mortality rate of 6.4. This means that out of every 1,000 infants born alive in a given year, 6.4 of them die before they reach their first birthdays. Like most measures of development, infant mortality rate is an average. Not all regions of a country or sectors of a population have the same infant mortality rates.

Characteristics of Developed Nations

Developed nations have high per capita GDPs, and a majority of their populations are neither very rich nor very poor. Developed nations enjoy a higher degree of economic and political freedom than do less developed countries. They also have a high degree of consumer spending. For example, in the United States, the average household has at least two television sets.

In most developed nations, agricultural output is high, but relatively few people work on farms. Use of advanced irrigation techniques, fertilizers, pesticides, seed varieties, and heavy machinery makes farmers very productive. In the United States a single farmer can feed 80 people. Compare this to many LDCs, where a single farmer can support only his or her own family.

Since only a small portion of the labor force is needed in agriculture in a developed nation, most of the labor force is available to work in industry and services. High per capita energy use in developed nations reflects a high level of industrialization. Widespread use of technology increases the productivity of the work force.

The populations of developed nations are generally very healthy. Infant mortality rates are low, while life expectancy is high. People in developed nations tend to be well educated, and literacy rates are high.

Developed nations have been urbanized for many generations. That is, most of their populations live in cities and towns and have done so for many years. A solid infrastructure has grown along with these cities and towns. **Infrastructure** is the services and facilities necessary for an economy to function. Transportation and communication systems, roads, power plants, schools, and banks are all part of a nation's infrastructure, which determines that nation's capacity to produce.

▶ **Technology plays a huge role in agricultural productivity.**

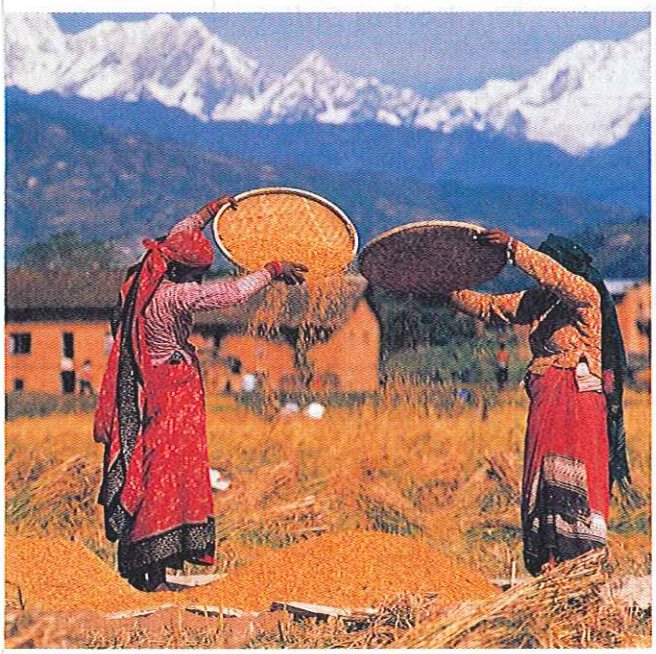
Characteristics of Less Developed Countries

Less developed countries have low per capita GDPs. Low per capita energy consumption signals their low level of industrialization. Many in the labor force work on their own farms and grow only enough food to feed themselves and their families. Unemployment rates are high, often around 20 percent. In addition, much of the labor force is underemployed. That is, some people have work, but not enough. They cannot support themselves or their families because they work less than eight hours a day.

Even if an LDC could produce consumer goods, most of the population would be unable to buy them. Subsistence-level agriculture does not provide a family with an income. It is so labor-intensive that farmers have no time for other work, even if they could find it.

The impoverished economy of an LDC has trouble educating the populace. Resources for schools are limited. In addition, children in subsistence-level economies are often needed to work on the family farm, limiting the amount of time they can spend in school.

Literacy rates in LDCs are very low. In Cambodia, for example, only 35 percent of the people over 15 years old can read and write. Compare this figure with the United States, where the literacy rate is nearly 100 percent.



Global Connections

Global Development and the Environment In 1997, the Kyoto Protocol was signed by 159 nations in an effort to reduce greenhouse gas emissions. Less developed countries, such as Brazil, China, India, and Mexico, voiced concern over who would pay for these measures, and whether they would hamper economic growth. In further discussions, participants recognized that less developed countries may not be able to raise environmental standards while trying to develop their economies. The United States has not signed the Kyoto Protocol. **Do you think less developed countries should be held to the same standards as developed nations?**

In the world's poorest countries, housing is of poor quality. Diet is, too. Along with limited access to health care, these factors lead to high infant mortality rates and short life expectancy.

There are additional characteristics common to most LDCs. In the next section, you will read about some of the difficult issues challenging less developed countries.

Levels of Development

Economic development commonly occurs in the following stages.

- *Primitive equilibrium* Economy has no formal economic organization or monetary system. It exists in equilibrium based on tradition.
- *Transition* Cultural traditions begin to crumble and people adopt new living patterns.
- *Takeoff* New industries grow and profits are reinvested.
- *Semidevelopment* Economy expands significantly and enters the international market.
- *Highly developed* Basic human needs are met easily. Economy is focused on consumer goods and public services.

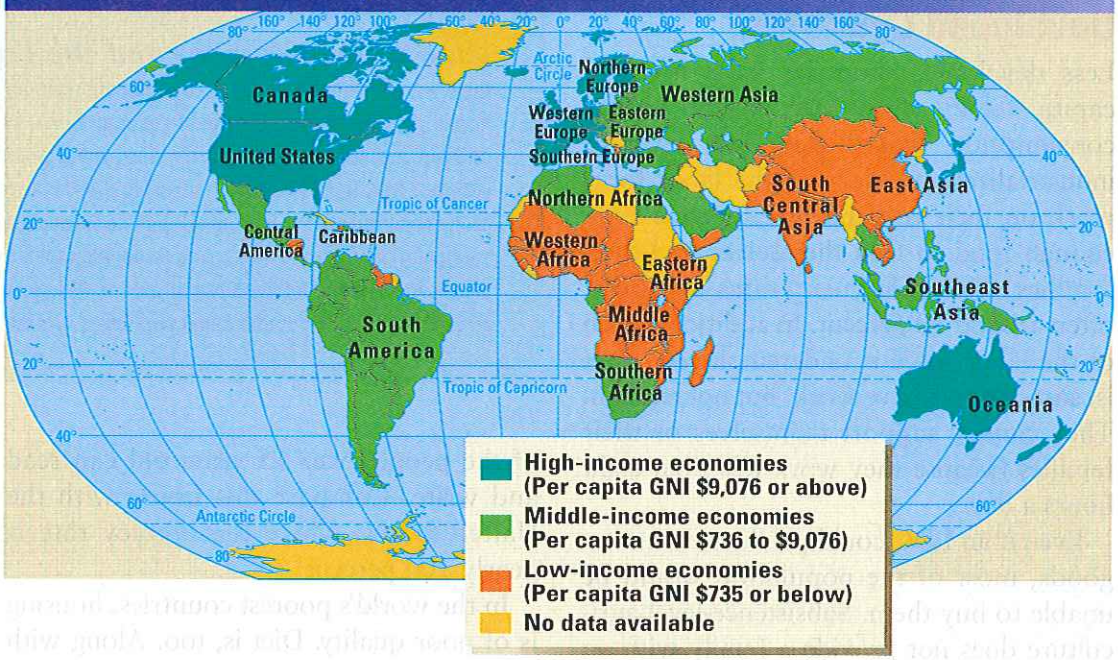
Some of the more successful of the developing countries are referred to as **newly industrialized countries (NICs).** NICs are less

newly industrialized country (NIC) *less developed country that has shown significant improvement in the measures of development*

Although income is only one measure of development, it gives a good indication of a nation's standard of living.

Income Can you see a pattern in the locations of developed nations and less developed countries?

Figure 18.3 Levels of Development



developed countries that have shown significant improvement in development. Newly industrialized countries include Mexico, Brazil, Malaysia, Thailand, Singapore, Hong Kong, South Korea, and Taiwan. The most successful of these—Singapore, Hong Kong, South Korea, and Taiwan—are known collectively as "the four Asian tigers." These countries now have incomes comparable to those of some developed nations.

The World Bank is an international organization devoted to assisting development. It uses per capita gross national income (GNI) to categorize nations as *high income, middle income,* and *low income.* High-income economies are the developed nations. Middle- and low-income economies are the less developed countries. See the map in Figure 18.3 for the distribution of these nations.

Section 1 Assessment

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Key Terms and Main Ideas

1. What is **development**?
2. Why are **developed nations** sometimes referred to as industrialized nations?
3. Why is **per capita GDP** a better measure of development than GDP?
4. What role does **infrastructure** play in a nation's development?
5. List and describe three characteristics of **developed nations** and three characteristics of **less developed countries.**

Applying Economic Concepts

6. ***Decision Making*** Create a list of three factors used to measure a nation's development. If you were in charge of an LDC, how would you attempt to obtain higher levels of development in those three areas?
7. ***Using the Databank*** Turn to the charts showing the health expenditures as a percent of GDP on page 547. **(a)** Which countries spend the least percentage of GDP on health care? **(b)** How do those countries' figures compare to the amount spent in the United States?

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ECONOMIC

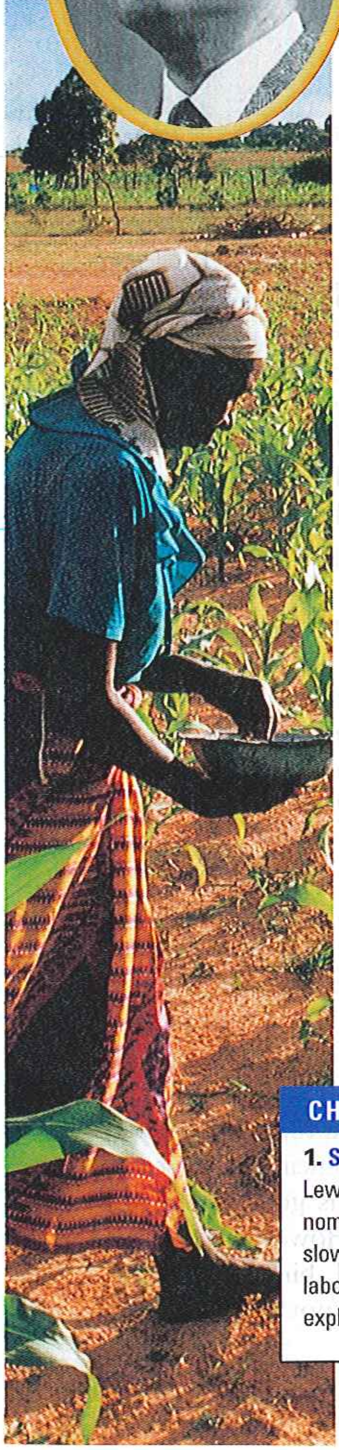
Profile

Economist

Entrepreneur

W. Arthur Lewis (1915–1991)

W. Arthur Lewis rose from working as a file clerk to become a world authority on economic development. Through his economic models, Lewis hoped to bring nations in Africa, Asia, and Latin America into the global marketplace and to help poor farm workers escape from poverty.



A Man of Ideas

William Arthur Lewis grew up on the island of St. Lucia, a poor British colony in the Caribbean. Leaving school at age 14, he went to work as a clerk in a government office. A few years later, he applied for a scholarship to go to college in Great Britain. He enrolled as a business student at the London School of Economics, and received a Ph.D. in 1940.

Lewis taught economics in Britain until 1958. In 1963, he accepted a position at Princeton University, where he became well respected for stressing ideas over numbers.

A Theory of Economic Development

Lewis focused his research and teaching on developing nations. In 1954, Lewis identified a "dual economy" in poor nations—a small, profitable "capitalist" sector dominated by a large, inefficient "traditional" agricultural sector. In 1955, he expanded his ideas into a book, *The Theory of Economic Growth*.

Lewis drew the path of economic development as an upside-down U. Countries grow rich by moving excess farm workers to factory jobs. On the left of the U were poor countries like Bangladesh, where growth was slow because too many people worked in the countryside. On the right were rich countries like the United States, with large manufacturing sectors and efficient farms. Growth in these wealthier countries was also slow, Lewis argued, because "the gains from diverting labour out of agriculture are almost all exploited." At the top, with the fastest-growing economies, were countries like South Korea, where the labor shifted from agriculture helped fuel manufacturing.

Lewis concluded that poor countries should move workers from farm to factory. This idea provided a model for many developing nations.

International Economic Advisor

Lewis put his ideas into practice as advisor to Ghana and as president of the Caribbean Development Bank. Britain's Queen Elizabeth II knighted him in 1963, and in 1979, Lewis was awarded a Nobel Prize in economics.

Because Lewis supported foreign investment in developing countries, critics once attacked his work as justifying capitalist exploitation. The collapse of socialism in most developing nations in the 1980s and early 1990s helped redeem his work.

CHECK FOR UNDERSTANDING

1. **Source Reading** Explain what Lewis meant when he said that economic growth in developed nations is slow because "the gains from diverting labour out of agriculture are almost all exploited."
2. **Critical Thinking** Why might Lewis's ideas have encouraged developing countries' governments to limit economic freedoms?
3. **Learn More** Research economic growth in an African or Asian nation and describe how closely it has followed Lewis's model for development.

Section 2 Issues in Development

Preview

Objectives

After studying this section you will be able to:

1. **Identify** the causes and effects of rapid population growth.
2. **Describe** the effects of the unequal distribution of the factors of production.
3. **Understand** the importance of human capital to development.
4. **Analyze** how political factors and debt are obstacles to development.

Section Focus

Less developed countries face a variety of complex issues. These include rapid population growth, a lack of natural resources, inadequate quantities of physical and human capital, political instability and government corruption, and debt.

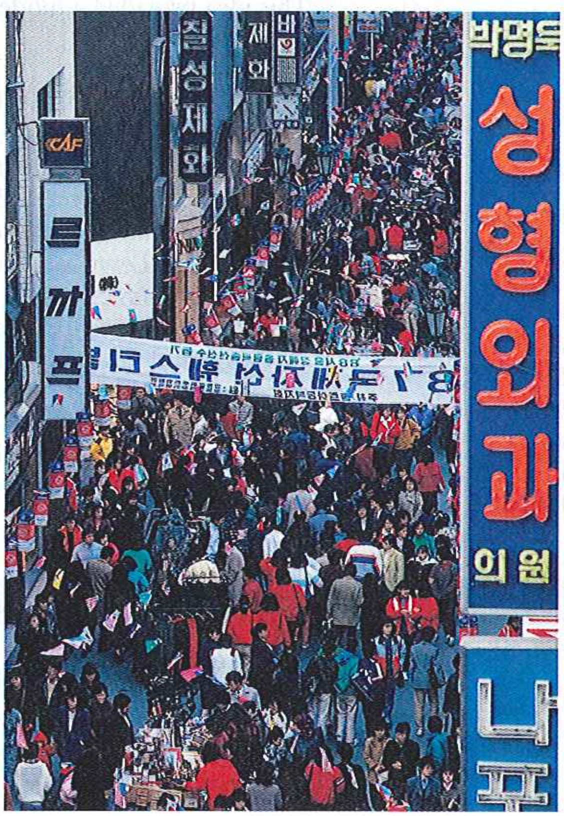
Key Terms

population growth rate
natural rate of population increase
arable
malnutrition

population growth rate *the increase in a country's population in a given year, expressed as a percentage of the population figure at the start of the year*

natural rate of population increase *the difference between the birth rate and the death rate*

If you were an official in the government of a less developed country, you'd quickly discover that there are no easy solutions for ending decades of underdevelopment. The fortunate discovery of oil, diamonds, or some other valuable natural resource could certainly help. Natural resources, however, are but one factor in development.



▶South Korea grew rapidly after the Korean War. Its capital, Seoul, became one of the world's largest cities.

Rapid Population Growth

One of the most pressing issues in development is the rapid population growth experienced by many less developed countries. Some economists point out that a population's quality of life depends on economic productivity, not on population density. Very dense populations can have rising living standards where free markets foster growth. Nevertheless, the already poor economies of many LDCs have trouble meeting the needs of rapidly growing populations.

Causes of Rapid Population Growth

The **population growth rate** is the increase in a country's population in a given year. It is expressed as a percentage of the population figure at the start of the year. The population growth rate takes into account the number of births, deaths, and the number of people migrating to or from a country.

When analyzing population growth in less developed countries, development experts often focus on the **natural rate of population increase.** This is the difference between the birth rate and the death rate.

Many LDCs are experiencing an increase in life expectancy. This is good news for individuals and families. However, while life expectancy has increased, birth rates have not decreased, at least not significantly.

What this means is that births are far outpacing deaths, leading to rapid population growth.

The age structure of LDCs also contributes to rapid population growth. In many LDCs, a high proportion of the population is of childbearing age. In developed nations, the largest segment of the population is older. Populations in developed nations therefore increase at a much slower rate. Figure 18.5 compares the age structure of low-income economies and high-income economies.

Consequences of Rapid Population Growth

The average population growth rate of the less developed countries of the world is estimated to be around 1.7 percent. This may sound low to you, but at this rate the population of LDCs will double from their 1990 figure of 4.1 billion to over 8 billion by the year 2031. Compare this to the growth rate of developed nations, which is 0.5 percent. Their population is not expected to double until 2129.

To stay at its current level of development, a country that doubles its population must also double employment opportunities, health facilities, teachers and schoolrooms, agricultural production, and industrial output. To increase its level of development, an economy must do even more. With all the obstacles less developed countries face, achieving this level of growth is a daunting task.

Population growth is only one factor in development. Many people in LDCs are concerned with sustainable development. Sustainable development describes economic growth that takes into account the health and future of the environment and natural resources. With sustainable development, present economic development lays the groundwork for long-term economic growth in that community or nation.

There are many factors that affect development, as described below. All these factors interact with each other, making both the causes of and solutions to underdevelopment difficult to identify.

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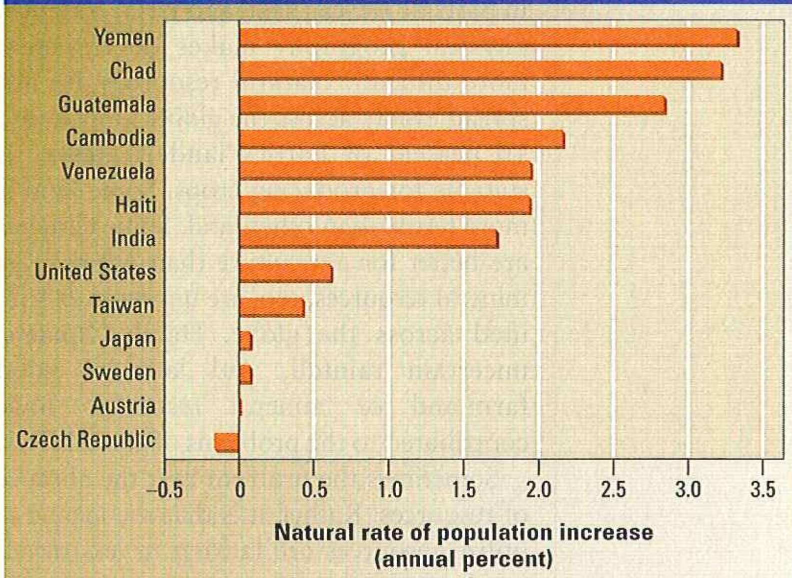
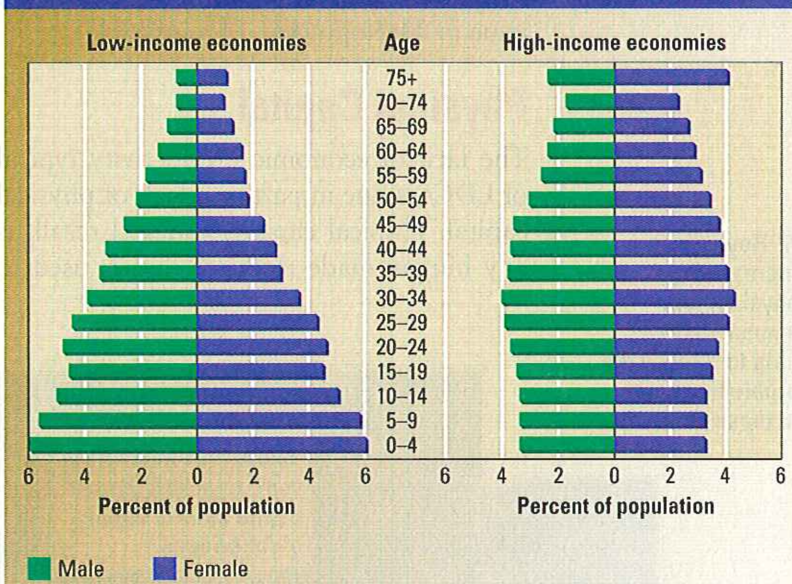
Figure 18.4 **Population Growth Rates of Selected Nations, 2004**



Source: Population Reference Bureau

Figure 18.5 **Age Structures**



Source: World Bank

BUILDING KEY CONCEPTS

Rapid population growth results in a large proportion of the population being young and dependent. If the largest segment of the population is too young to work, then production does not increase along with the population.

Standard of Living **What is Yemen's natural rate of population increase? Describe the shapes of the age structure graphs for low-income and high-income economies. Which shape would you expect Yemen's age structure to have? Why?**

arable *suitable for producing crops*

Factors of Production

In parts of Africa, Asia, and Latin America, physical geography makes development more difficult. Natural resources are not spread evenly across the globe. Only about 10 percent of Earth's land is **arable,** or suitable for producing crops. Some land is more fertile than other land. Some climates are better for agriculture than others. Key mineral resources, too, are unevenly distributed across the globe. Harsh climates, uncertain rainfall, and lack of good farmland or mineral resources have contributed to the problems of some LDCs.

Sometimes the problem isn't the absence of resources. Rather, it is that the means to utilize resources are lacking in less developed countries.

Technology may help LDCs develop the resources they do have. Technology, however, is costly to develop and requires much capital. As you will read below, the formation of capital is another important issue in development.

Physical Capital

The lack of economic productivity typical of LDCs is due in part to a lack of physical capital. Physical capital, you will recall, is any human-made resource that is used to create goods and services. Without capital, industry cannot grow. Agricultural output remains low.

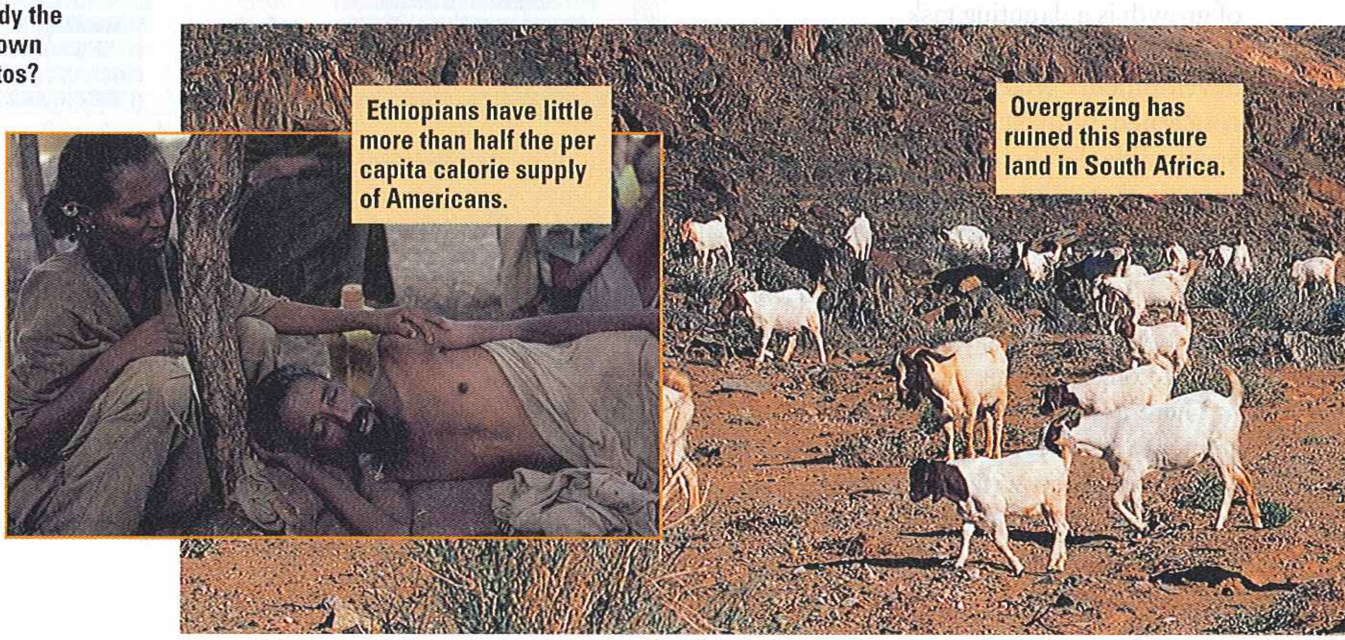
What's more, the resulting subsistence-level agriculture does not give individuals or households the opportunity to save. Neither does the presence of a large dependent segment of a population. A large proportion of dependents means a large number of people who don't produce and who must be supported by others. No savings means no money for purchasing capital.

Some countries turn to foreign investment to boost capital. However, as you will read below, that won't happen unless LDCs invest in human capital.

Human Capital

Human capital is the skills and knowledge gained by a worker through education and experience. Health and nutrition, as well as education and training, are important to the development of human potential. Human capital is crucial to the functioning of an economy. It is the people who develop and utilize technology, who work in agriculture, industry, and services. It is the people who manage businesses and government. When a country doesn't invest in human capital, the supply of skilled workers, industry leaders, entrepreneurs,

▼ How might increased physical and human capital help to remedy the problems shown in these photos?



Ethiopians have little more than half the per capita calorie supply of Americans.

Overgrazing has ruined this pasture land in South Africa.

government leaders, doctors, and other professionals is limited. As a result, foreign investors become discouraged because investment is profitable only if there is a skilled work force to use it.

Health and Nutrition

Proper food and nutrition are necessary not only for survival, but also for physical and mental growth and development. An individual's performance and productivity depend on the benefits of good nutrition.

Inadequate nutrition is called **malnutrition.** The populations of many less developed countries suffer chronic malnutrition. Malnourished mothers may give birth to infants with low birth weight, brain damage, and birth defects. Malnutrition in children slows or delays their physical and mental development. In adults, it can cause lethargy, heart disease, diabetes, and other health problems.

Education and Training

To be able to use technology and move beyond mere subsistence, a nation must have an educated work force. Education and training let people develop new skills and adapt to new technologies and processes. It also helps them develop new and better ways of doing things.

Many less developed countries have low literacy rates. Access to education and participation in education are limited. Adult literacy in many countries is below 40 percent. Only three out of four children in LDCs who begin primary school are still in school four years later. Throughout the world, many children are needed at home to work on the farm, and have no time to go to school.

Improvements in literacy rates in many countries are held back by the gender gap in education. In highly developed nations, the literacy rates for men and women are nearly identical. In many LDCs, however, women's literacy lags behind that of men. The greatest difference in literacy rates between men and women exists in regions that have poor social and economic conditions for women. Some of the factors that discourage families from investing in the education of girls are the following:

- early child-bearing age
- limited job opportunities for women
- lower wages for women
- cultural factors that devalue women

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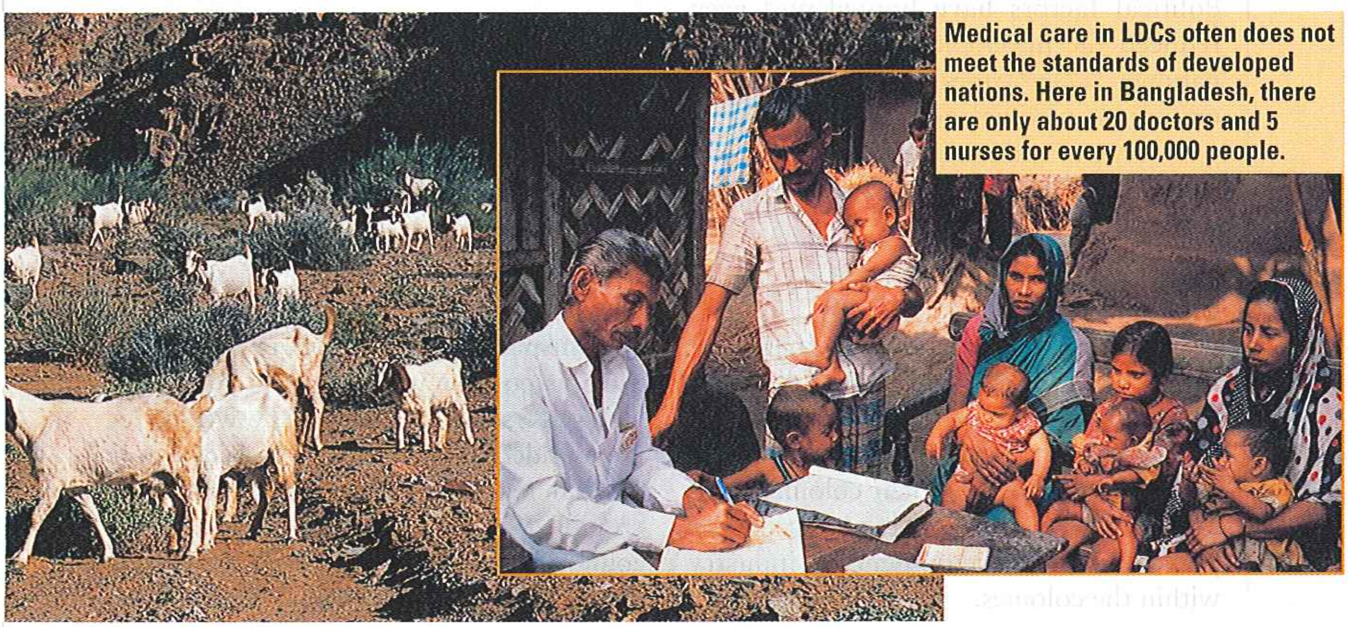
malnutrition *inadequate nutrition*



Medical care in LDCs often does not meet the standards of developed nations. Here in Bangladesh, there are only about 20 doctors and 5 nurses for every 100,000 people.

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Figure 18.6 Education and Literacy

Country	School enrollment rate (percentage enrolled)		Literacy rate (percentage literate)	
	Female	Male	Female	Male
United States	99	91	97	97
Peru	79	81	83	94.5
Indonesia	61	68	84.1	92.9
Nigeria	41	49	60.6	75.7
Yemen	29	72	30	70.5
Chad	20	42	39.3	56
Niger	12	20	9.7	25.8

Sources: United Nations Development Program, *CIA World Factbook*

BUILDING KEY CONCEPTS These Saudi Arabian women (right) are participating in a university course. Since 1960, public education has been opened to Saudi women—if they have permission from their families. **Standard of Living** **Examine the table. What patterns do you see in the school enrollment and literacy rates of males and females?**

"Brain Drain"

Wealthy people in LDCs have the most access to education. Yet, many of the best-educated citizens leave to live and work in developed nations. The scientists, engineers, teachers, and entrepreneurs of LDCs are often attracted to the enormous opportunities developed nations can offer. This loss of educated citizens to the developed world is called "brain drain."

Political Factors

Political factors have limited and even reduced the development of many poor nations. These factors include dependence on former colonial powers, experiments with central planning, and corrupt and unstable governments.

From Colonial Dependency to Central Planning

Many LDCs are former colonies of European powers. As colonies, they had to supply their rulers with agricultural products and raw materials. In turn, they were forced to rely on their colonizers for manufactured goods. This relationship prevented the development of industry within the colonies.

After achieving independence following World War II, many of these new nations turned to central planning, rather than free enterprise, in an effort to modernize their economies quickly. They made some gains in the 1950s and 1960s. In the long run, however, central planning hindered economic growth. As you will read in Section 4, many LDCs are now making the transition to free enterprise.

Government Corruption

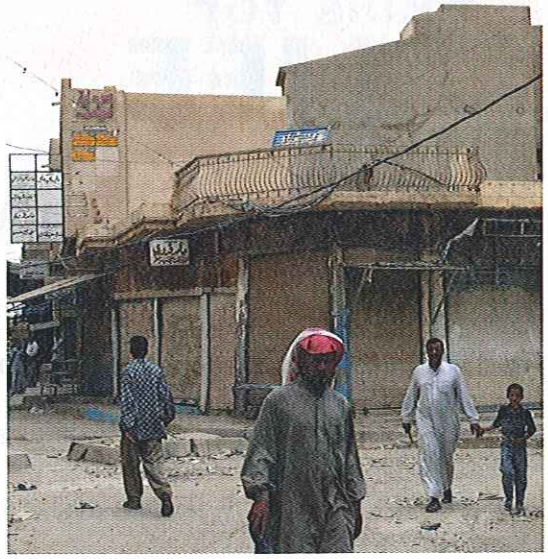
Corruption in the governments of many LDCs also holds back development. Leaders often make political decisions and laws to benefit themselves and their friends, not the country at large. Economic policies often benefit only the urban minority, which has greater political influence.

For example, Mobutu Sese Seko, the president of Zaire (now the Democratic Republic of Congo) from 1965 to 1997, ran a government noted for its corruption and mismanagement. Mobutu Sese Seko used his position to accumulate one of the largest personal fortunes in the world. As he plundered the nation's treasury and natural resources, Zaire's infrastructure crumbled for lack of funding. Today, the country is one of the poorest in the world, with a per capita GDP of only $98.

Political Instability

Civil wars and social unrest plague many less developed countries. El Salvador, Lebanon, Cambodia, and Rwanda, for example, suffered years of civil unrest.

In these countries, war has killed millions of people and created millions of refugees. Military leaders spend huge sums of money on weapons and warfare instead of on education, housing, health care, or other investments in development.



◀ Closed shops and uncollected trash in Al Kut, Iraq, following the overthrow of Saddam Hussein illustrate the economic costs of political instability.

Debt

In the 1970s and 1980s, many less developed countries acquired loans from foreign governments and private banks to finance development. Events in the world economy, however, have hindered repayment of these loans.

In 1973, a political crisis in the Middle East prompted the oil-producing nations of the Organization of Petroleum Exporting Countries (OPEC) to reduce oil exports, and then to raise prices. The price of crude oil rose from $8 a barrel to $35 a barrel. Many LDCs, like most of the world, depend heavily on oil from OPEC. Many had to borrow yet more money to import oil. Increased debt made repayment of loans difficult, if not impossible, for many LDCs.

Between 1980 and 1985, the value of the U.S. dollar appreciated, or increased in value against other currencies, on the world market. Since most of their loans were based on U.S. dollars, LDCs, as a result, had further difficulty in repayment.

Between 1970 and 1984, the combined debt of LDCs increased by 1,000 percent to $700 billion. Today it exceeds $1.5 trillion. In some countries, the foreign debt is greater than the annual gross domestic product. In the next section, you will read about the ways debt repayment is being handled.

Section 2 Assessment

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Key Terms and Main Ideas

1. What is **population growth rate?**
2. How does **arable** land play an important role in a nation's development?
3. How does a lack of physical capital hinder development?
4. What is the connection between human capital and foreign investment?
5. How does **malnutrition** affect human capital?
6. Why are many less developed countries carrying a large burden of debt?

Applying Economic Concepts

7. ***Math Practice*** The United States has a population of about 291 million and a population growth rate of about 0.97 percent. By how many people do you expect the nation's population to increase over the next year?
8. ***Critical Thinking*** How does the formation of physical capital relate to resource development?
9. ***Decision Making*** As leader of a less developed country, what measures could you undertake to limit "brain drain"?

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Skills for

LIFE

Using the Writing Process

Good writers generally follow three steps in the writing process: prewriting, writing, and revising. During the prewriting stage, the writer decides what to write about and gathers information. In the writing stage, the writer decides the purpose of the writing, the audience, and the best form for the work. The writer then prepares a first draft. During the revising stage, the writer reviews the draft for sense, style, and errors, and shapes the work into its final form. Use the following steps to learn more about the writing process.

1. **Prewriting: Develop ideas for writing and organize your information.** Decide upon a general topic, and then brainstorm several possible areas to explore within the topic. Research these subtopics in the library or on the Internet, and list what you have found under each topic. Organize your research findings into a chart like the one below. Use the chart to answer the following questions. (a) What has this student chosen to research for his essay? (b) Why do you think he chose these three countries? (c) What is a likely title for his essay?

2. **Writing: Identify who will read the work and what the purpose is, and write a first draft.** (a) Who are the likely readers of this essay? (b) How should this affect the tone and style of the writing? (c) Would the writer be likely to use an eyewitness approach, an analytical approach, or a biographical approach? Why? (d) Write a topic sentence for the first draft of this essay.

3. **Revising: Review your writing to see whether it makes sense.** Ask one of your classmates to read your topic sentence and make suggestions for improving it. (a) What changes were suggested? (b) Rewrite your sentence based on any useful suggestions your classmate gave you.

Comparison of Three Economies

United States' economy	Sweden's economy	China's economy
market-based economy with low level of government control	mixed economy with moderate level of government control	centrally planned economy with high level of government control
mostly white-collar work force	mostly white-collar work force	mostly blue-collar work force, strong in agriculture and manufacturing
imports much more than it exports	exports and imports balanced	exports much more than it imports
relatively low taxes	high taxes	relatively low taxes

Additional Practice

What problems do you foresee with using a chart to organize ideas? Can you think of an alternative way to organize your research findings?

Section 3 Financing Development

Preview

Objectives

After studying this section you will be able to:

1. **Understand** the role investment plays in development.
2. **Identify** the purposes of foreign aid.
3. **Describe** the functions of various international economic institutions.

Section Focus

Less developed countries can obtain capital for economic development through investment, loans, and grants. Economic policy advice and technical help are also valuable aids to development.

Key Terms

internal financing
foreign investment
foreign direct investment (FDI)
foreign portfolio investment
World Bank
United Nations Development Program (UNDP)
International Monetary Fund (IMF)
debt rescheduling
stabilization program

Building an infrastructure, providing education and health care, and creating technology and industry all require large sums of money. Less developed countries often turn to wealthier nations for the money they need to develop their economies. Businesses, individuals, foreign governments, banks, and development organizations all contribute to the financing of international development.

Investment

As you read in Section 2, the creation of capital is crucial to development. But where does the money for purchasing capital come from? A country can use two methods to finance its economic development. It can either use internal financing or external investment. **Internal financing** is derived from the savings of the country's citizens. A developing country can also look to the developed world for investment funds. External investment originates from other countries and is called **foreign investment.**

Internal Financing

Recall from Chapter 11 the role that personal savings and investment play in capital formation. Savers deposit money in banks. Banks, in turn, lend money to firms. Firms invest in physical and human capital so they can expand. They create new products and provide new jobs. Job growth enables individuals to improve their standard of living. The economy as a whole grows.

In many less developed countries, large segments of the population do not have enough money to save. Many do not even have enough to meet their basic needs. The wealthy elite, with plenty of money to save and invest, often keep their money in foreign banks. They also often invest in foreign companies. This is because overseas savings and investments are often

internal financing *financing derived from the savings of a country's citizens*

foreign investment *investment originating from other countries*

▼ In Brazil, as in most LDCs, the country's large poor population (right) has no money to save, while the tiny elite population (left) chooses to invest its money overseas.

▲ **LDCs often have dual economies: domestic production consisting largely of subsistence agriculture and local markets, and export production in foreign-owned multinational corporations, such as the garment factory show here. Do you think MNCs help or hurt less developed countries? Explain your reasoning.**

more secure. As a result, there is often little internal financing. Most LDCs must, therefore, turn to foreign investment to finance development.

Foreign Direct Investment

There are two types of foreign investment: foreign direct investment and foreign portfolio investment. **Foreign direct investment (FDI)** is the establishment of an enterprise by a foreigner. For example, a foreign company can build a factory in an LDC, merge with an existing firm in an LDC, take over a firm in an LDC, or enter into a partnership with a firm in an LDC. Foreign direct investment often takes the form of a multinational corporation (MNC) establishing production facilities in an LDC. As you recall from previous chapters, a multinational corporation is a large corporation that produces and sells goods and services throughout the world.

foreign direct investment (FDI) *the establishment of an enterprise by a foreigner*

foreign portfolio investment *the entry of funds into a country when foreigners make purchases in the country's stock and bond markets*

MNCs are often attracted to less developed countries in their search for profit. An MNC might locate in a less developed country to take advantage of the natural resources available and the large and cheap labor force. It may also wish to introduce its products to the country.

Some economists feel that MNCs have a positive effect on LDCs. The presence of an MNC can introduce technology, provide jobs, train the labor force, and provide the opportunity for related services and industries to develop.

Other economists argue that MNCs do little to aid less developed countries. These economists argue that most of the money earned by MNCs is not reinvested in the LDC. It goes to the foreign owners of the corporation. On the other hand, if the money were reinvested in the host LDC, critics of MNCs argue, foreign control of the economy would increase.

Supporters of MNCs point to the job opportunities these large corporations provide. But, others argue, most of the industries introduced by MNCs are capital-intensive. That is, they are highly mechanized, providing few jobs relative to the massive size of the labor pool in less developed countries.

Finally, many are concerned about the potential for unethical behavior on the part of MNCs. MNCs are attracted to the labor force of LDCs because wages in LDCs are very low compared to wages in industrialized nations. It can be argued that the cost of living in LDCs is also relatively quite low, justifying the low wages. However, critics charge MNCs with underpaying workers and using the justification that a poorly paying job is better than no job at all. In addition, in many countries, companies do not have to provide the same high standard of working conditions or environmental protection required in industrialized nations.

Foreign Portfolio Investment

Foreign portfolio investment is the entry of funds into a country when foreigners make purchases in the country's stock and bond markets. For example, an investor in the United States buys shares in a mutual fund. The mutual fund buys shares in a foreign company. That company then takes the money gained by the sale and uses it to build another plant or to pay for research and development. In other words, the funds lead indirectly to increases in production.

Foreign Aid

In Section 2, you read about development loans given to LDCs by foreign governments. Sometimes, foreign governments give, rather than loan, money and other forms of aid for development. Many developed nations provide aid to less developed countries for building schools, sanitation systems, roads, and other infrastructure. Such assistance can be motivated by humanitarian concern for the welfare of fellow human beings.

However, there are also military, political, economic, and cultural reasons for one country to extend aid to another. For example, in the early 1940s, the United States gave nearly $50 billion in food, weapons, ammunition, and other supplies to its allies in World War II. Government officials believed that this aid would help win the war. More recently, the United States has supplied large amounts of military aid to nations such as Israel, Egypt, and Taiwan.

In the years following World War II, political and economic concerns motivated American foreign aid policies. American officials noted that the Soviet Union had extended its power by establishing more Communist governments with centrally planned economies around the world. Such actions threatened both democracy and free market economic systems. Containment, or prevention of such expansion, became the cornerstone of American foreign policy.

In 1947, Secretary of State George C. Marshall unveiled a plan to help restore the war-torn countries of Europe so that they might create stable democracies and achieve economic recovery. Congress approved the plan in 1948. Over the next four years, the United States sent $13 billion in grants and loans to Western Europe. The region's economies soon recovered, and the United States gained new markets for American goods.

During the 1990s, the same logic that motivated foreign aid under the Marshall Plan prompted many countries to fund the redevelopment of the war-torn Balkan nations. In the early 2000s, the United States promised funds to help Afghanistan and Iraq recover from years of dictatorship and fighting. Figure 18.7 shows the top five recipients of aid from the United States.

International Institutions

Several international economic institutions promote development. Among the most prominent are the World Bank, the United Nations Development Program, and the International Monetary Fund.

World Bank

The largest provider of development assistance is the **World Bank**, founded in 1940. The World Bank raises money on the financial markets and accepts contributions from the wealthier member nations.

The World Bank offers loans, advice, and other resources to more than 100 LDCs. The World Bank also coordinates with other organizations to promote development throughout the world.

United Nations Development Program

The **United Nations Development Program (UNDP)** is dedicated to the elimination of poverty through development. The UNDP

World Bank *the largest provider of development assistance*

United Nations Development Program (UNDP) *United Nations program dedicated to elimination of poverty through development*

Figure 18.7 U.S. Foreign Aid, 2005

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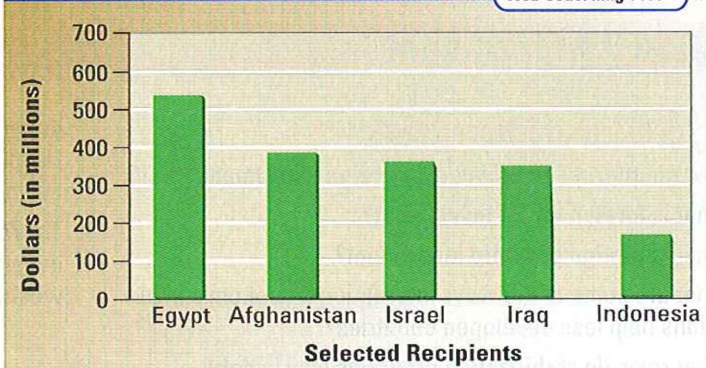
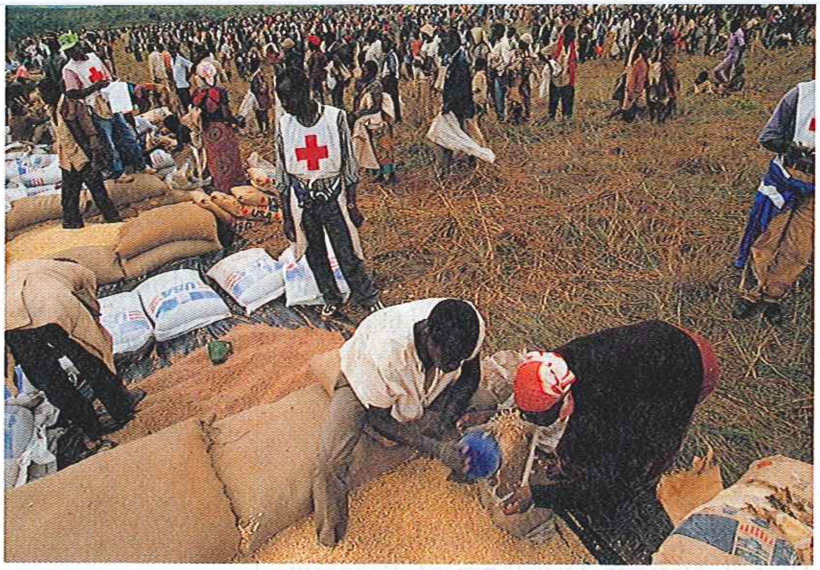


Source: United States Agency for International Development

BUILDING KEY CONCEPTS

Military, political, and humanitarian concerns motivate the United States to extend aid. **Government Why might it benefit the United States to provide aid to Afghanistan?**



▲ Some international institutions, like the Red Cross and the World Food Program, support development by providing disaster relief. Here, workers delivered food aid to victims of Rwanda's ethnic turmoil.

International Monetary Fund (IMF) *organization formed to stabilize international exchange rates and facilitate development*

debt rescheduling *lengthening the time of debt repayment and forgiving, or dismissing, part of the loan*

stabilization program *an agreement between a debtor nation and the IMF in which the nation agrees to revise its economic policy*

is one of the world's largest sources of grant funding for economic and social development. It devotes 90 percent of its resources to 66 low-income nations, where 90 percent of the world's poorest people live. The UNDP is funded by the voluntary contributions of United Nations member states and agencies.

International Monetary Fund

The **International Monetary Fund (IMF)** was originally developed in 1946 to stabilize international exchange rates. The IMF has expanded its role to facilitate development through policy advice and technical assistance to LDCs. It also intervenes when LDCs need help in financing their international transactions.

The International Monetary Fund is often viewed as a last resort for struggling LDCs. If a country has trouble repaying a debt, it may ask its lenders to reschedule it. **Debt rescheduling** involves lengthening the time of debt repayment and forgiving, or dismissing, part of the loan. In return, the debtor nation is expected to accept an IMF stabilization program.

A **stabilization program** is an agreement between a debtor nation and the IMF. The nation agrees to change its economic policies to provide incentives for higher export earnings and to lower imports. By increasing exports, an LDC can earn more foreign money to pay off its debt.

Stabilization programs are sometimes controversial because they can have a negative impact on the poor in the short term. They often require the lifting of wage and price controls, causing wages to go down while prices go up. They may also include cuts in government spending on food, health, and education services. Stabilization programs may also decrease domestic consumption of goods in order to increase exports. After negative experiences in East Asia and Argentina in the 1990s and 2000s, many critics have questioned whether IMF policies are the most effective way to repair a troubled economy.

Section 3 Assessment

Progress Monitoring *Online*
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Key Terms and Main Ideas

1. How do **internal financing** and **foreign investment** differ?
2. What is **foreign direct investment?**
3. What is **foreign portfolio investment?**
4. What are some of the ways international economic institutions help less developed countries?
5. What roles do **stabilization programs** play in **debt rescheduling?**

Applying Economic Concepts

6. ***Decision Making*** Your corporation is thinking about opening a factory in a less developed country. What economic factors will you consider? What ethical factors will you consider? What political factors might be important to consider?
7. ***Try This*** Suppose that you are the president of a less developed country. Write a speech to persuade the wealthy elite of your country to invest at home.

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Section 4 Transitions to Free Enterprise

Preview

Objectives

After studying this section you will be able to:

1. **Identify** some important steps in moving from a centrally planned economy toward a free market economy.
2. **Describe** the political and economic changes that have taken place in Russia in recent decades.
3. **Describe** the actions that China's communist government has taken to introduce free market reforms into China.

Section Focus

Making the transition from a command economy to a market economy is a difficult process. The shift requires tremendous changes on the part of the government and workers.

Key Terms

privatization
work ethic
glasnost
perestroika
light industry
special economic zones

As you read in Section 2, many less developed countries have discovered that a centrally planned economy limits development. For this reason, many communist nations are reshaping their economies. Some, like the former Soviet Union, are dismantling their centrally planned economic systems entirely and replacing them with market-based systems. Others, like China, are modifying their centrally planned economies to incorporate some free market practices.

The transition to free markets and capitalism is a huge adjustment for an economy and a nation. As you will read below, Russia has had to adjust to rapid changes in the economy and political system. China, on the other hand, is slowly introducing market reforms within its existing communist system. Both have given up some sovereign control of their economies to join in the global marketplace.

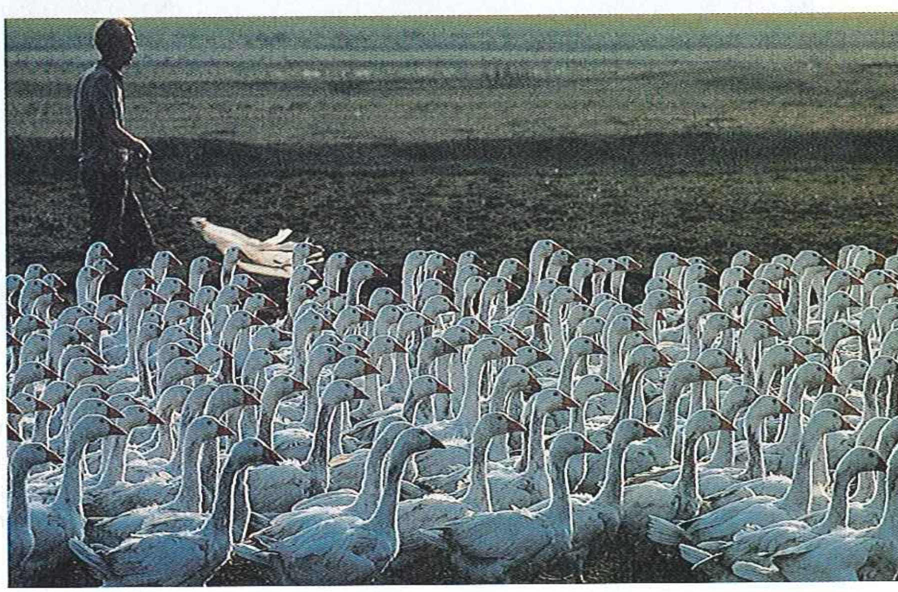
Toward a Market Economy

One of the key elements of a centrally planned economy is that the government, not individuals, owns and controls the factors of production. The government answers the three key economic questions of what to produce, how to produce it, and how to distribute goods and services. In contrast, in a market-based economy, the factors of production are owned by individuals. Individual buyers and sellers answer the three economic questions. One of the first steps, then, in moving from a centrally planned economy to a market economy is privatization.

Privatization

Privatization is the sale or transfer of government-owned businesses to individuals. Private ownership gives individuals, rather than the government, the right to

privatization *the sale or transfer of state-owned businesses to individuals*



▼ **Hungary slowly began privatizing its economy in the 1960s. Instead of raising his flock on a collective, today this goose farmer raises geese at his own expense. He then sells the meat and feathers to a cooperative, keeping all the profits.**

make decisions about what to produce and how much to produce.

There are several ways in which a government can privatize a state-owned business. First, it can simply sell the business to one owner. Another option is to sell shares in the business to interested individuals. A third method is to give every citizen a voucher or certificate that can be used to purchase shares in the businesses when they are privatized.

Simple as this may sound, privatization is a complicated process. One difficulty in privatizing is that only the profitable production facilities will continue to operate. No one will want to buy unprofitable facilities, so many people will lose their jobs. Other job opportunities will eventually appear as successful operations are expanded. However, there may be a period when total employment drops. Some people oppose privatization because it means the end of secure, lifelong government jobs with little or no competition. In a free market, jobs are not guaranteed.

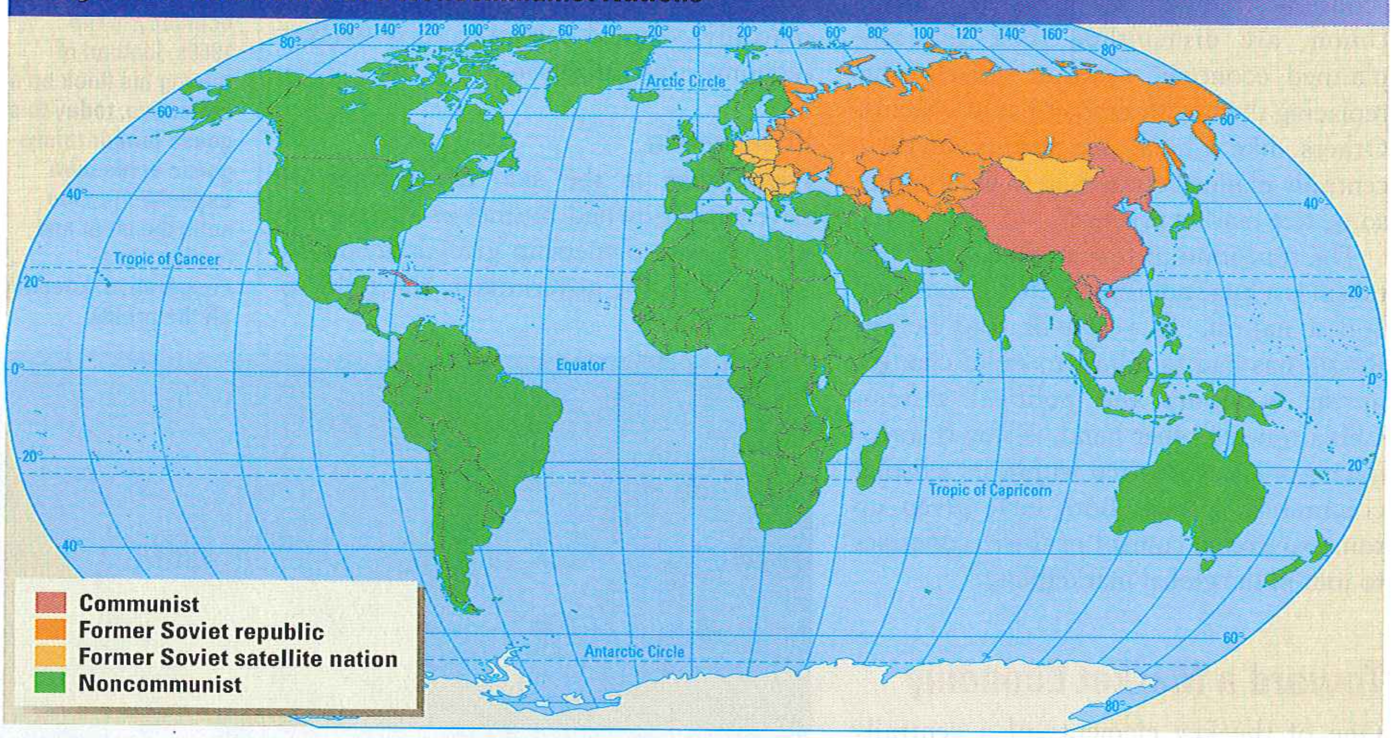
Another difficulty is that there may be only one or two firms in a certain market. Even after firms are privatized, there will be little competition with so few privatized firms.

Protecting Property Rights

Even when it gives up its role as the owner and decision maker, the government still plays a vital role in ensuring the success of a new market-based economy. Legal systems under central planning do not include laws guaranteeing private property rights. A free market cannot function without such rights. As a result, the government must create new sets of laws that ensure a person's right to own and transfer property.

If property rights are uncertain, entrepreneurs will not be willing to make large

Figure 18.8 Communist and Noncommunist Nations



Beginning in the late 1980s, communism in Eastern Europe began to collapse. Countries such as East Germany, Poland, Hungary, and Czechoslovakia made profound changes in their governments and their economies.

BUILDING KEY CONCEPTS **Economic Systems** **Roughly what percentage of the world remains communist?**

investments and take risks because there will be no guarantee they will benefit from successful projects. Entrepreneurs need law and order to prevent criminals from stealing the profits from legitimate enterprises. They also need a legal system that prevents the government from unduly interfering with their everyday business activities.

It will take time to develop the legal culture necessary to support a market-based economy. To have a successful market-based economy, the government must establish property rights, enforce laws, and provide a framework of regulation. Western market economies have developed the roles of government gradually over many decades. Economies making the transition to free markets need to develop these roles more rapidly.

More New Roles for Government

During privatization, government must be prepared to deal with the unrest that might develop from rising unemployment. A government could, for example, institute unemployment insurance.

The government can also play a role in helping workers make the transition from a centrally planned economy to a market economy. Workers in transition often need to learn a new **work ethic,** or system of values that gives central importance to work. In a free market, incentives, not quotas, influence people's labor.

Transition in Russia

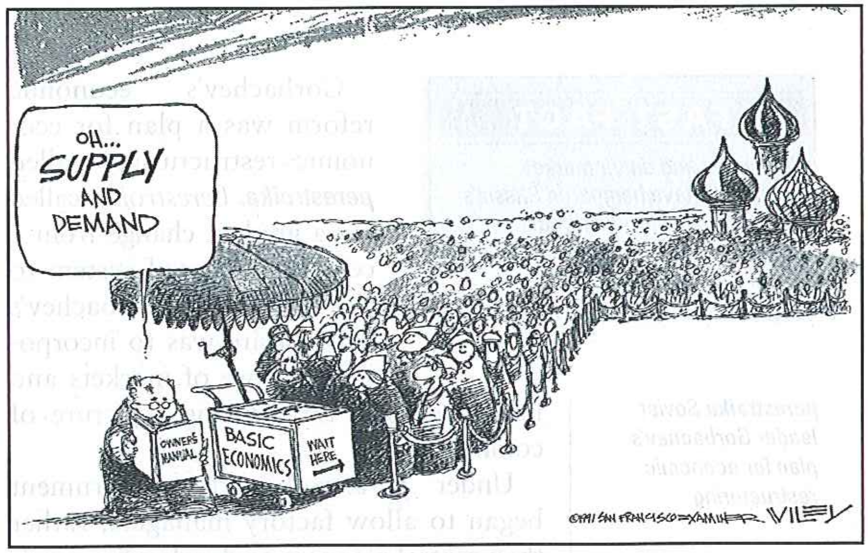
Russia was once the dominant republic of the Soviet Union and the world's most powerful communist nation. In the latter part of the twentieth century, the lagging Soviet economy prompted economic and social reform. Change came quickly to Russia, as economic freedom led to the desire for political freedom.

Communism in Russia

As you read in Chapter 2, the Soviet Union arose out of a pair of revolutions in Russia in 1917, followed by three years of civil war in which the Communists, led by Vladimir Lenin, won control of the government. Under the repressive control of the Communist party, central planning was introduced during the 1920s.

The Soviet government reorganized farmland into state farms and collective farms. State farm workers received wages, similar to factory workers. On the collectives, workers shared any surpluses that remained after the required quantity of products was sold and expenses were paid. Few incentives existed to encourage farmers to work hard. As a result, agricultural output remained low.

Soviet policy also emphasized the development of heavy industry. By 1940, the Soviet Union was the second-largest producer of iron and steel in Europe. The growth of heavy industry, however, came at a great opportunity cost. With so much land, labor, and capital being devoted to heavy industry, little was left over to produce consumer goods. Everyday items such as soap and shoes were in short supply.



▲ **Entrepreneurs in the former Soviet Union had a lot to learn about free market systems.**

Glasnost and Perestroika

In the late 1980s, a new leader, Mikhail Gorbachev, began a series of radical political and economic reforms. Because Gorbachev believed that economic prosperity could not happen without political freedom, he introduced ***glasnost.*** A policy of "openness," *glasnost* encouraged Soviet citizens to say what they wished without fear of government persecution.

work ethic *system of values that gives central importance to work*

glasnost *a policy of political "openness" introduced into the Soviet Union in the late 1980s*

FAST FACT

Corruption and unfair market conditions have hampered Russia's development. ***Foreign direct investment*** *in Russia equals only about 1 percent of its GDP.*

perestroika *Soviet leader Gorbachev's plan for economic restructuring*

Gorbachev's economic reform was a plan for economic restructuring, called ***perestroika.*** *Perestroika* called for a gradual change from a centrally planned system to free enterprise. Gorbachev's main desire was to incorporate the use of markets and incentives into the existing structure of communism.

Under *perestroika,* the government began to allow factory managers, rather than central planners, to decide what goods to produce and how much to charge for them. It converted several factories from the production of military goods to the production of consumer goods. Many factories set goals to improve the quality of goods produced. For the first time in decades, people were allowed to start their own businesses.

Farmers were granted long-term leases on land. By making farmers their own bosses, Gorbachev hoped to increase food production.

With little experience in democracy and free enterprise, however, the transition to a market economy proved difficult. Economic reform produced some initial hardships. People lost secure government jobs, benefits, and pensions. Many people, especially the elderly, were hurt financially. Other Russians, however, quickly began to make the new system work for them, starting their own businesses. Many prospered.

▼ In 1991, Communist hard-liners failed in their efforts to overthrow the democratically elected government of Boris Yeltsin. Yeltsin supporters blocked the Soviet army from the parliament building during the coup.

Collapse of Communism

Enjoying the newfound freedoms of *glasnost* and *perestroika,* many people called for a complete end to communism and the domination of the central government. In 1991, Russians voted in their first democratic election. They chose Boris Yeltsin as president of the Russian Republic. A few months later, some officials and army officers tried unsuccessfully to restore old-style communism. The attempt backfired. One by one, the Soviet republics declared themselves independent nations. At the end of the year, Gorbachev resigned as leader, announcing the end of the Soviet Union.

Transition to the Free Market

Yeltsin came to power by promising rapid progress towards a market-based economy. Under Yeltsin's administration, there were improvements. But many hardships continued. Prices of goods in the Soviet Union were kept artificially low by the government. In 1992, Yeltsin lifted price controls. Now that prices were controlled not by the government, but by the workings of supply and demand, prices tripled.

The distribution of wealth tended to be concentrated in the urban centers such as Moscow. The uneven distribution of income led many to call for additional change. It also led to extensive corruption and widespread organized crime.

Billions of dollars in financial aid flooded into the country from the World Bank, the International Monetary Fund, and through independent donations. However, due to mismanagement and corruption, the funds were not used efficiently.

Today, Russia's economy is smaller than that of the Netherlands, although its population is nine times larger. Russia and the former Soviet republics have great potential as producers and markets, however. Russia has only begun to tap large reserves of oil, natural gas, and other natural resources for sale on the world market.

Transition in China

In the first half of the twentieth century, China struggled with civil war. In 1949, the supporters of communism, led by Mao Zedong, defeated the anticommunist nationalists. The Nationalist party retreated to what is now Taiwan. The communists took power in China's capital city, Beijing. Since then, China developed its own version of communism.

The Great Leap Forward

In 1958, Mao introduced an ambitious development plan called the Great Leap Forward. The Great Leap Forward was intended to turn China into a world economic power in the shortest time possible. All of the country's land was taken over by the central government. The people were organized into self-sufficient settlements called People's Communes.

These communes, sometimes with as many as 25,000 people, contained both farms and industries. Life in a People's Commune resembled life in the military. Communist party officials made all the decisions about what goods were made and who received them. The people's task was simply to work in the fields or factories. They received the same rewards no matter how much or how little they produced.

The Great Leap Forward was a huge disaster. Without incentives for workers, production fell. In the ensuing famine, about 20 million people starved to death under this development plan.

The Cultural Revolution

In the 1960s, Mao instituted a Cultural Revolution. His intention was for China to further embrace communism by destroying all traces of the past. Mao organized an army of radical young men and women, called the Red Guards, to carry out his policy. The Red Guards persecuted people in their attempt to eradicate what Mao called "the Four Olds": old ideology, old thought, old habits, and old customs. Mao succeeded only in further damaging the Chinese economy.

▲ **During China's Cultural Revolution, Mao's sayings were collected and distributed in what became known as Mao's "little red book."**

Transition to the Free Market

Mao died in 1976. He was succeeded by Deng Xiaoping. Deng introduced a new approach that not only shifted more power to local government, but also used the tools of the free market to improve productivity.

Deng began a program of economic reform called the Four Modernizations. The goals of the program were to improve agriculture, industry, science and technology, and defense as quickly as possible. Deng was not afraid to use free enterprise as a means of accomplishing these goals.

Deng replaced the People's Communes with the contract responsibility system. Under this arrangement, the government rented land to individual farm families. Each family then decided for themselves what to produce. The families contracted with the government to provide a certain amount of crops at a set price. Once the contract was fulfilled, they were free to sell any extra crops at markets for whatever prices they could get.

Under this system, farmers had the incentive to grow more crops. Farmers increased their production by about 8 percent. In the first eight years of the program, their incomes tripled.

Industry

As in the Soviet Union, when the communists came to power in China they had used most of the nation's resources to increase

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heavy industry. By the time Deng came to power, however, Chinese technology was outdated.

Deng had two goals for industry. First, he wanted people to spend more money on consumer goods. Therefore he changed the focus on production to **light industry**, or the production of small consumer goods such as clothing, appliances, and bicycles. He also wanted factories to increase production. To accomplish this, Deng gave more decision-making power to factory managers. He started a system of rewards for managers and workers who found ways to make factories more productive.

light industry *the production of small consumer goods*

special economic zones *designated regions in China where foreign investment is encouraged, businesses can make most of their own investment and production decisions, and foreign companies are allowed to operate*

Economic Zones

In addition, Deng set up four **special economic zones** along China's east coast. In these zones, local governments are allowed to offer tax incentives to foreign investors. Businesses are allowed to make most of their own investment and production decisions. Foreign companies are allowed to operate in these zones. Deng located these first four zones near Hong Kong and Taiwan. He hoped to attract foreign investment, companies, and technology from these economic giants. The zones have proved so successful that China now has hundreds of these zones.

Most of China's rapid economic growth has taken place in the special economic zones of the coastal cities. The interior regions lag far behind. Massive projects like the controversial Three Gorges Dam are designed to bring economic growth to the interior. Nevertheless, the population has shifted dramatically. About 120 million people have left inland villages to seek their fortunes in the booming cities. Rapid urban growth has resulted in an increase in crime and life-threatening air and water pollution.

Despite these negative effects, the economy has benefited. Since the start of Deng's reforms, China's economy has quadrupled in size. The question now at hand is whether or not China's political leaders will be able to maintain their Communist regime in the face of pressures for cultural freedom brought about by economic freedom. China's leadership continues to come under criticism for its violations of human rights and political repression.

Section 4 Assessment

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Key Terms and Main Ideas

1. Identify three factors necessary for the transition to free enterprise.
2. Why is **privatization** necessary to create a free market economy?
3. What is ***glasnost?***
4. What is ***perestroika?***
5. Why was the Great Leap Forward such a disaster for China?
6. How does **light industry** differ from heavy industry?
7. What role do **special economic zones** play in China's transition to free enterprise?

Applying Economic Concepts

8. ***Critical Thinking*** What is the main difference between transition in Russia and transition in China?
9. ***Problem Solving*** How could China expand its economic success to the interior?

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Real-life Case Study

The World Bank and Economic Assistance

As World War II drew to a close, much of Europe lay in ruins, and the World Bank was created to help finance the reconstruction. Within a few years, the World Bank changed its mission from helping rebuild war-torn areas to helping developing nations achieve stable economic growth.

Function The primary function of the World Bank is to make loans to countries unable to borrow from other sources. Its loans are used for many purposes: to improve health care, to build transportation networks, and to promote economic reforms. The Bank makes about $20 billion in new loans each year.

The World Bank raises most of its money in financial markets by issuing bonds. In addition, it receives contributions from its member nations, including industrialized nations such as the United States and Japan. Even some developing nations, once borrowers from the World Bank themselves, make contributions.

▲ The World Bank helps finance highway construction in developing nations such as Colombia.

Controversy Despite its worthwhile goals, the World Bank has sometimes been a source of controversy. Some critics have argued that the United States would be better off using its money to help less fortunate American citizens. Others have criticized the Bank for not holding developing nations fully accountable for effectively carrying out projects it has funded.

Accomplishments Still, the World Bank can boast of many significant accomplishments. It has helped many developing countries improve roads, hospitals, schools, and water supplies. In addition, by strengthening the economies of less developed countries, the World Bank has helped build new markets for American goods, which in turn benefits the economy of the United States.

Per Capita Earnings in Selected Countries

GNI per Capita Earnings	Countries	
High income (more than $9,076)	Germany Japan	South Korea United States
Upper middle income ($2,936–$9,075)	Malaysia Mexico	Poland Saudi Arabia
Lower middle income ($736–$2,935)	China Iran	Jamaica Philippines
Low income ($735 or less)	Indai Keyna	North Korea Vietnam

Source: The World Bank

Applying Economic Ideas

1. How does the World Bank work to improve conditions in developing nations?
2. The table shows how the World Bank classifies selected countries according to per capita GNI. What factors might have led to some countries being poor for so long?

Chapter 18 Assessment

Chapter Summary

A summary of major ideas in Chapter 18 appears below. See also the **Guide to the Essentials of Economics**, which provides additional review and test practice of key concepts in Chapter 18.

Section 1 Levels of Development (pp. 471–476)

Nations throughout the world exhibit varying levels of economic success. The most prosperous are called **developed nations.** Nations with relatively low standards of living are called **less developed countries. Per capita gross domestic product** is the primary measure of development.

Section 2 Issues in Development (pp. 478–483)

Less developed countries face a wide range of issues. A high **population growth rate,** lack of natural resources, inadequate human and physical capital, political instability and corruption, and foreign debt often inhibit development.

Section 3 Financing Development (pp. 485–488)

Less developed countries turn to many sources to finance their development, including **internal financing, foreign investment,** and foreign aid and loans. Help also comes in the form of policy advice and technical assistance.

Section 4 Transitions to Free Enterprise (pp. 489–494)

Some communist and former communist nations, such as China and Russia, are making transitions to free enterprise in order to boost their lagging economies. The move to free enterprise requires **privatization** of industry and changes in the legal system.

Key Terms

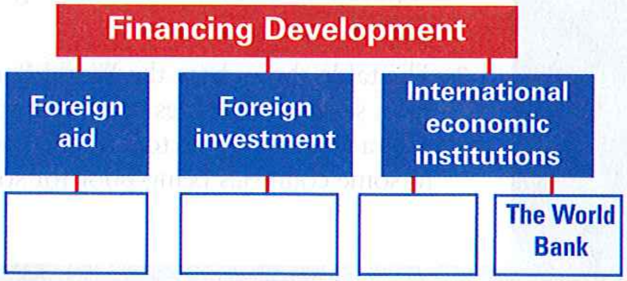
Complete each sentence by choosing the correct answer from the list of terms below. You will not use all of the terms.

malnutrition	**light industry**
infrastructure	**work ethic**
industrialization	**foreign direct investment**
literacy rate	**life expectancy**
internal financing	
debt rescheduling	

1. Measuring a nation's ____ provides data on how many people in that country can read or write.
2. ____ may cause disease in adults, and may cause infants to be born with brain damage or birth defects.
3. The production of small consumer goods is referred to as ____.
4. ____ is the establishment of an enterprise in a country by a foreigner.
5. The services and facilities necessary for an economy to function are called ____.
6. A country undergoing ____ is allowed more time to pay off its loans and have a portion of its loans forgiven.
7. ____ is the extensive organization of an economy for the purpose of manufacture.
8. Economists use the term ____ to describe investment derived from the savings of a country's citizens.

Using Graphic Organizers

9. On a separate sheet of paper, copy the tree map below. Chart financing options for less developed countries by filling in each box with an example and description of a financing option.



Reviewing Main Ideas

10. List and describe three characteristics of less developed countries.

11. Which development status (developed, less developed, or newly industrialized) does each of the following characteristics describe? **(a)** low per capita GDP **(b)** many consumer goods available **(c)** shows significant improvement in the measures of economic performance **(d)** high infant mortality rate **(e)** high life expectancy

12. What issues arise when less developed countries adopt a stabilization program?

13. How did *glasnost* and *perestroika* factor in Russia's transition to a free market economy?

14. What role do special economic zones play in China's transition to a free market economy?

Critical Thinking

15. Drawing Conclusions In measuring development, what relationship exists between the activities of the labor force and energy consumption?

16. Making Comparisons Which do you believe is more important for a nation's development—physical capital or human capital? Why?

17. Recognizing Cause and Effect Describe four consequences faced by nations experiencing rapid population growth.

Problem-Solving Activity

18. Compare and contrast the transitions to free market economies in China and Russia. Describe three unique aspects of each country's transition. Which country do you believe will be most successful in the long run?

Economics Journal

Essay Writing Review your comments on the chapter opener photo. What comments can you add, based on your reading of the chapter? Write a brief essay to accompany the photo. Then, check an encyclopedia or other resource for information on Ghana, the country shown. Revise your essay as needed.

Skills for Life

Utilizing the Writing Process Review the steps shown on page 484; then complete the following activity based on the information below.

19. Study the chart below. **(a)** Who is involved in each of these organizations? **(b)** How could these organizations be compared?

20. You have been assigned the task of writing an essay comparing these three organizations. **(a)** What is a possible title for your essay? **(b)** Compose a topic sentence for your essay.

21. Exchange your topic sentence with a classmate. Analyze each other's topic sentences; then revise your sentence based on your classmate's input.

22. Use the information in the chart below to write a rough draft of an essay. Ask your classmate to read your draft and comment on it.

Global Economic Organizations

	World Trade Organization	G-8 Countries	International Monetary Fund
Membership characteristics	Entrance granted by vote of existing member countries	Top eight industrialized nations	Finances supported by members
Function	Establishes agreements on lowering or abolishing tariffs on a global level	Summit meetings allow members to discuss international issues	Provides monetary services and loans in attempts to stabilize global trade
Countries involved	145 as of 2005	United States, Japan, France, Germany, Italy, Great Britain, Russia, Canada	184 as of 2005

Progress Monitoring *Online*

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As a final review, take the Economics Chapter 18 Self-Test and receive immediate feedback on your answers. The test consists of 20 multiple-choice questions designed to test your understanding of the chapter content.

THE WALL STREET JOURNAL.

CLASSROOM EDITION

DEBATING CURRENT ISSUES: *Tariffs and Trade*

Tariffs are taxes on imported goods. Supporters say tariffs protect American jobs, while critics reply that they hurt consumers by making imported products more expensive.

In this debate from *The Wall Street Journal Classroom Edition,* Jock Nash, a lawyer who represents textiles producer Milliken & Co., and Daniel T. Griswold, an associate director of the Center for Trade Policy Studies at the Cato Institute, discuss whether the United States sould set tariffs on imports to protect American industry.

YES *Should industries be protected by tariffs?*

BY JOCK NASH

There is little made in America that cannot be made cheaper and just as well elsewhere. This is made clear by our nation's chronic and growing manufacturing trade deficit—which is running at the rate of $1.4 billion dollars a day. Currently, we are consuming more than we are producing in goods and services, by a margin of a million dollars a minute.

A growing part of this deficit is attributable to U.S.-based companies moving overseas part or all of their production of goods and services destined for consumption in the U.S. market—not in foreign markets, as the companies claim. Obviously, these companies would not be manufacturing offshore if a tariff prevented their products from entering the U.S. market at a profit.

In 2003, U.S. manufacturing employed 16 million people. This was after losing two million manufacturing jobs in 24 months. Most reports indicate that the majority of these newly unemployed workers drop out of the middle class only to join the countless working poor in the service economy. They are not finding new employment at their previous salaries.

The move to put production of goods destined for sale in the U.S. in other countries effectively destroys the ability of many American workers to earn a good living, as they traditionally have, by adding value to a product whose costs and pricing reflect the realities of the U.S. market. Without protection of some kind—like a tariff—U.S. manufacturing workers are forced to compete head-to-head with foreign workers in the same industry who may be earning pennies an hour. This situation applies to every U.S. industrial sector, from advanced technology products to basic industries.

Nations become great by producing, not consuming. Manufacturing, not trade, is the main source of prosperity. Manufacturing is the engine that increases national productivity and creates wealth. It is worth protecting—by a tariff if necessary.

Many factories have closed down as manufacturing jobs have left the United States for countries with cheaper labor. Would higher tariffs help or hurt workers and consumers?

NO Should industries be protected by tariffs?

By Daniel T. Griswold

An import tariff is a tax, plain and simple. By taxing international trade, tariffs impose higher prices on millions of workers, families, and import-using industries for the benefit of a small number of "protected" domestic producers.

Consider steel and sugar. In 2002, the U.S. government imposed tariffs of as much as 30% on imported steel. But domestic steel producers, to improve their earnings, then raised their prices in line with the now higher-priced imports. As a result, the tariffs kept a few extra U.S. steel mills open by allowing them to raise their prices. However, those higher prices hurt American workers in steel-using industries, such as automobiles, home appliances, and construction. In the same way, restrictions on imported sugar benefit a small number of domestic producers at the expense of candy makers and soft-drink producers. And millions of families suffer because they must pay more for all those products at the store.

Imagine how much poorer your family would be if you had to grow your own food and make all your own clothes, furniture, and appliances. The same truth applies to nations. Trade allows people and countries to specialize in what they do best, exchanging their surplus production for what others can produce most efficiently. Through economies of scale—meaning the more you produce of any given product, the less each item costs to produce—trade reduces the cost of such goods as automobiles, jet airliners, and medicines by spreading the high, up-front costs of research and capital among millions of consumers worldwide. Trade brings new technology to poor countries and protects consumers from domestic monopolies.

It's a myth that manufacturing has declined in the U.S. because of trade. American workers can and do compete successfully with lower-paid foreign workers because better-educated Americans produce so much more per hour of work. Indeed, U.S. factories today produce a greater volume of goods and more sophisticated products than in decades past. Those jobs that have migrated overseas tend to be the lower-paying manufacturing jobs in industries that have been in decline for decades. Protecting such industries with tariffs just keeps wages down by slowing our transition to higher-skilled and better paying jobs.

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U.S. Trade Deficit, 1994–2004

Period	Balance (millions of dollars)	Exports (millions of dollars)	Imports (millions of dollars)
1994	-97,188	702,622	799,811
1995	-95,069	793,725	888,794
1996	-102,869	850,877	953,746
1997	-107,048	933,873	1,040,920
1998	-163,153	932,558	1,095,711
1999	-261,202	957,146	1,219,383
2000	-375,384	1,070,054	1,445,438
2001	-357,819	1,007,580	1,365,399
2002	-418,038	974,107	1,392,145
2003	-495,508	1,020,503	1,517,011
2004	-617,075	1,147,181	1,764,256

Source: U.S. Census Bureau

The trade deficit has widened as more and more manufactured goods sold in the United States are imported from other countries.

DEBATING THE ISSUE

1. What is a manufacturing trade deficit?
2. Both authors focus on the loss of U.S. manufacturing jobs. What impact do you think competition from foreign workers has had on these jobs?
3. **Distinguishing Fact from Opinion** Agree or disagree with Jock Nash's statement: "There is little made in America that cannot be made cheaper and just as well elsewhere." Be sure to support your answer with facts.
4. **Recognizing Consequences** According to Daniel T. Griswold, what happens to consumption when tariffs are placed on imported goods?
5. **Reading Graphs** By how much did U.S. imports increase, in dollars, from 1994 to 2004?

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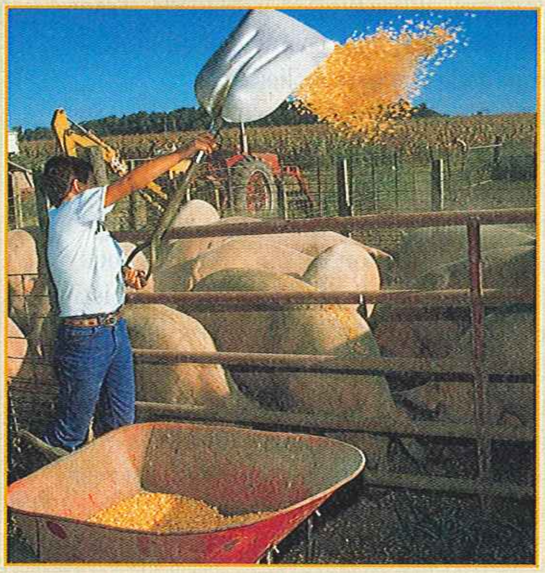

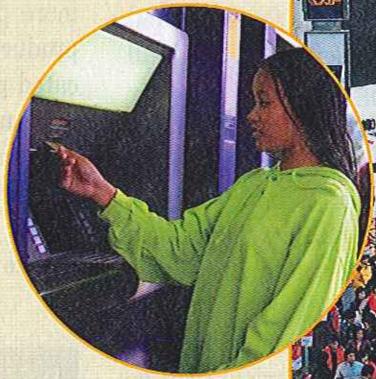

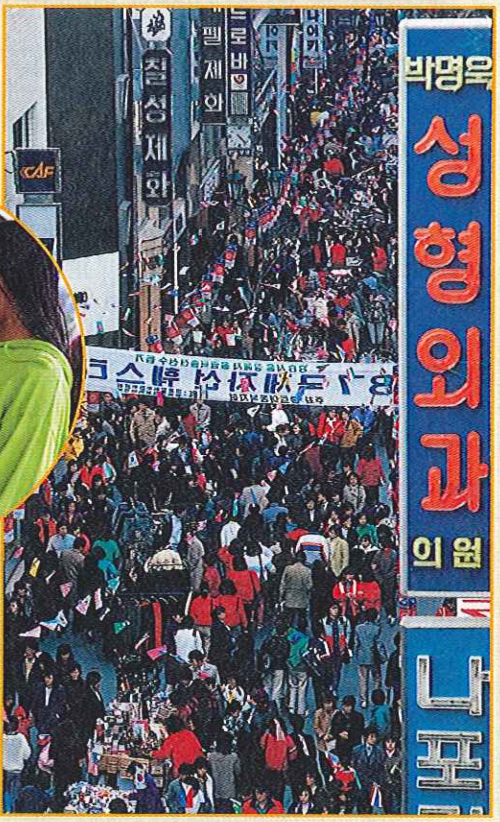
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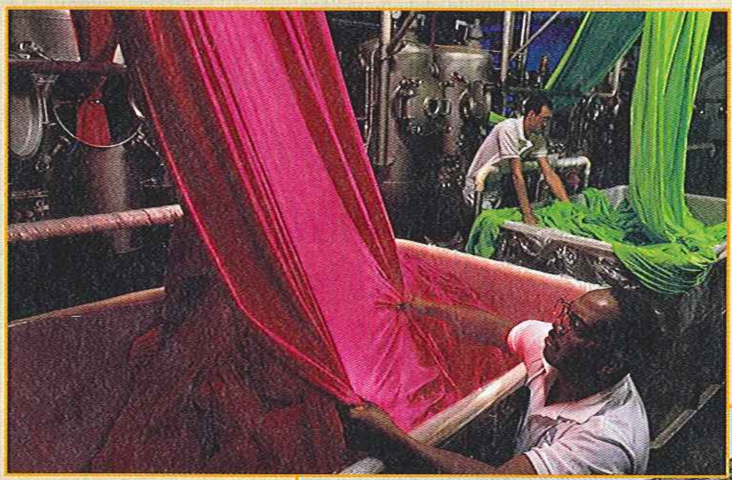


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