The Effective Demand Approach to Economic Development

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Introduction

From Antonio Serra (2011) to the Mercantilists to the Physiocrats to the Classical economists (see Kregel 2004, Jomo and Reinert 2005), the objective of economic analysis was the formulation of policies to further what Adam Smith (1937) called the "Wealth of Nations" or what we would now call the economic development of the nation. This tradition was carried into the twentieth century by Schumpeter's (1912) *Theory of Economic Development*.

However, the increasing dominance of neoclassical economics shifted economists' attention to the identification of the conditions necessary to assure the optimal utilisation of the given resources available to each individual via exchange at market prices to produce maximum individual utility. The behaviour of the overall economic system became a simple consequence of individuals' utility-maximising actions in free markets and direct policy discussion of measures to ensure that the produced development became unnecessary. Indeed, the means to the end of maximum economic welfare, the efficient operation of free markets, became the very objective of economic policy as governments were encouraged to drop policies to harness the operation of markets to aid in the development process and instead to adopt policies to allow free markets to determine development strategy. In the twentieth century these differences came to be represented by the contrast between development economists who believed that the motive force for economic development was to be found on the demand side and those who believed that development can only be supported by lifting constraints on the supply side. While most modern development theory continues to be based on the supply-side approach, this essay seeks to recover the importance of the demand side.

The origins of post-war interest in development: Economic fragmentation

Modern interest in economic development emerged after the First World War in the work of Rosenstein Rodan (1943), motivated by the disruption to integrated economic activities caused by the redesign of national boundaries in the Balkan regions of Southeastern Europe. The creation of new nation-states from prior empires meant that what had been integrated production and supply relations within political boundaries became external trade relations across newly created national boundaries and subject to diverse national economic policies. The interest in development was further supported after the Second World War, when these problems surfaced as a result of the separation of previously integrated European and Asian colonies into independent economic and political entities. The basic problem to be resolved was how these new national economic units could build domestic production capacities that would replace the prior colonial linkages and allow them to become self-sustaining economic entities that could support rapidly expanding populations.

Keynes as the guide to post-war development economics

Simultaneous with this renewal of interest in economic development, Keynes's theory of effective demand was being developed to show how developed economies could make the best of their available resources by promoting policies that pushed aggregate demand to the point of achieving full employment. But the first major policy implementation of Keynes's theory was not to promote government policy to support the level of effective demand required for full employment – that problem was being resolved by the war effort –, but rather how to manage the fully-employed wartime economy. The manual was Keynes's pamphlet *How to Pay for the War* (1940), rather than the *General Theory* (1936). But both were based on the same general approach and understanding of the operation of the macroeconomy.

Thus when the post-war conditions created the problems of promoting development strategies for the newly created national economies, it was natural to look to Keynes's theory as the basis for the formulation of new theories of development. Although it was evident to the early "Pioneers" of development economics (see Meier and

Seers 2001) that there were basic differences in the problems and conditions facing developed and developing economies, they did not reject Keynes's approach to the former problem, but instead sought to adapt it to the needs of developing countries.

For a developed, industrialised economy the problem Keynes sought to resolve was the low level of capacity utilisation of existing productive equipment and labour, while the problem facing developing economies was the prior problem of acquiring productive capacity capable of providing income and employment for the population. The prior need to be met was to accumulate capital and then to use it fully and effectively. The basic underlying problem to be resolved was the same, how to provide employment for all those willing and able to work, but who were unable to find it.

In a general sense, the problem of development may thus be seen as finding economically productive activity for an expanding supply of labour, which can be the result of either high fertility rates or the impact of increasing agricultural productivity, which relentlessly creates excess labour in that sector which tends to predominate in early stages of development. It is thus not surprising that a central concept in the application of Keynes's theory to developing economies came from Joan Robinson's (1936) concept of "disguised unemployment", even though it was primarily formulated to deal with the problem of the appropriate level of demand in an industrialised economy.

In order to meet ambiguities raised concerning the appropriate definition and measurement of full employment to be achieved by Keynesian policy, Robinson proposed that the definition be modified to focus on changes in the level of output. Irrespective of the number or percentage of unemployed workers, she argued that if an increase in investment could produce and increase in output without reducing the output of consumption goods then further fiscal stimulus was merited. The economy was only at full capacity and full employment if output could only be increased by shifting resources from one type of production to another. The Indian economist V.K.R.V. Rao (1952) was apparently the first to make use of the concept in the context of development and was also in all probability responsible for its appearance in a number of early documents on development produced by expert commissions organised by the United Nations (e.g. 1949, 1951).

Although Rao rejected the applicability of Keynes's theory because he believed that the multiplier would be zero in economies with a large proportion of the population employed in subsistence peasant agriculture (an argument also used by Furtado 1963 in the Brazilian context) outside the formal wage system, disguised unemployment could be identified as being present in agriculture if labour could be transferred to employment in manufacturing activities without a reduction in the output of agricultural goods. Thus, an increase in investment in manufacturing capacity could be achieved without a reduction in the consumption of foodstuffs, presenting a prima-facie case for the existence of underemployment of labour in agriculture. While this idea in the hands of those more familiar with neoclassical concepts became the definition of developing countries as exhibiting a zero marginal product of labour in agriculture (cf. the discussion in Viner 1952), it in no way depended on either the marginal theory or the idea that marginal productivity was zero, although this formulation did generate a great deal of resistance among neoclassical theorists.

The development "Pioneers"

As a result of this specification of the conditions facing developing countries the theories proposed in the 1950s and 1960s by what are now called the development "Pioneers" all focused on the creation of sufficient aggregate demand to allow labour to be absorbed in activities outside agriculture. This was especially evident in the theories of Rosenstein Rodan's "big push" or Nurkse's "balanced growth", which sought to generate multiplier synergies across sectors through a coordinated, government-planned investment programme covering the economy as a whole. It was characteristic of these theories that they took as a grounding principle Nurkse's belief that all capital accumulation was the result of domestic-income creation and advocated strictures to ensure not only that the required investment occurred without reducing consumption, but that it should increase incomes without increasing consumption. (See Nurkse 1953, Kregel 2011) It is characteristic of this approach that it rejected outright the traditional neoclassical approach to development based on the appropriateness of allowing comparative advantage through open trade to select the areas of investment and minimised any need to fill resource gaps with foreign saving and finance and thus the necessity of

opening the economy to attract foreign capital inflows to supplement deficient domestic savings or domestic finance. This is evident, for example, in Nurkse, Singer, and others' rejection of the neoclassical view (e.g. Viner 1947) that the return to capital in developing countries would be high because it was in scarce supply, and thus efficient international capital markets would channel it to developing countries, arguing instead that returns would be low because demand was insufficient to produce the levels of demand required for efficient operation at design economies of scale.

These "balanced growth" approaches to development were countered by arguments in favour of "unbalanced" growth, but these theories also relied on the demand generated by the endogenous efforts to offset imbalances that result from the uneven expansion of the development process itself. (cf. Hirschman 1958 and Streeten 1959) Indeed, Hirschman's concepts of forward and backward linkages are a representation of the way in which an investment generates demand for domestically produced inputs and the need for creation of domestic distribution networks. Both provide an alternative explanation of how the multiplier could generate not only increased income and employment, but new areas of activity. A similar process is at work in Myrdal's (1957) ideas of spread and backwash effects in a process of cumulative causation.

The approach of Sir Arthur Lewis (1954), starting from the unlimited supplies of labour was also couched in the need to provide alternative employment opportunities for the exuberant labour in the agricultural sector and was driven by the need to stimulate demand for labour from the more productive industrial sector. It is exemplary that none of these theories were based on the idea that developing countries lacked domestic resources or domestic savings or finance that could be cured by importing capital from abroad. The possibility of external impulses to the development process from foreign trade was looked upon as a complement to domestic demand (e.g. Furtado 1964).

Other theorists looked more directly to the "Keynesian" solution to the problems of providing employment to the expanding available labour force in developing countries by suggesting that the Roosevelt administration's New Deal policies might provide a guide to solving the underemployment problems facing developing countries. Lauchlin Currie, who had championed Keynesian ideas in response to the Great Depression in the US, later became an envoy of the World Bank to Colombia and an adviser to that

country. He noted “It is curious that so little attention has been paid to the lessons that might be learned from wartime experience, especially in the United States. Given an overriding objective to which everything is subordinated, the production possibilities are almost unbelievable.” (Currie 1966, 81) He thus proposed policies concentrating on supporting demand, first in relation to agriculture and manufacturing: “by neglecting the demand side and focusing on the supply, not only do developing countries waste resources and increase inequality, suffering, and poverty, but there is no greater growth in supply than there would have been in absence of additional investment.” (Ibid., 38) He quotes Sidney Dell approvingly: “An underdeveloped country’s first concern is to find useful employment for those of its citizens who at the present time are adding little or nothing to the national real output and income.” (Ibid., 94)

The Latin American approach to demand: Tendency to decline in the terms of trade

Development discussions in Latin America commenced from rather different initial conditions as most countries had achieved political independence in the first half of the 19th century and some of them had experienced a process of domestic industrialisation based on external trade and finance with their former colonisers. But as Prebisch (1950, UNCTAD 1964) pointed out, this was primarily due to the symbiosis between the output of primary materials in the Latin American periphery that found a stable demand in the expanding industrial production of Great Britain to satisfy the Empire. British capital investments that funded industrialisation in South America could be easily serviced with the export of primary commodities. When Britain ceased to be the industrial workplace of the world, replaced by an industrialising country, the US, with its own natural supplies of primary materials, this relation turned antagonistic, and economists such as Prebisch, Singer (1964) and Myrdal (1956, 1957) questioned the ability of developing countries to trade their way to development on the basis of earnings from primary commodity exports alone. This argument, based on the idea of a trend deterioration in the terms of trade between primary commodities produced in the South and manufactured goods produced in the North is also at its heart a discussion of the role of demand in development.

As is well known the terms of trade are normally presented as a differential movement in the prices of primary commodities and manufactured goods to the detriment of the former. Thus, if developing countries are to generate the finance required to build up a manufacturing sector by purchasing manufactured-goods exports from developed countries they would have to increase primary-export volumes more rapidly than the expansion in supply reduced international prices. If developed country demand is price-inelastic, then export revenues may actually decline, causing an external constraint to development.

But that is not all there is to the problems caused by the declining terms of trade. Prebisch was among those who did not see much application of Keynes's theory to the development problems of Latin America. In particular, he returned to the classics and placed emphasis on the role of technical progress, something that was virtually absent from the short-period concerns to reduce excess capacity of the existing stock of productive assets that was at the centre of the analysis of the *General Theory.* Instead Prebisch's real concern was how to ensure that the increase in output per man (and thus the decline in the demand for labour) from technical progress could be transformed into increased real incomes which could generate a demand for labour being displaced by the technological change. A concentration on agricultural production meant a concentration of technical progress in agriculture and an increase in output that was not required to feed the population but would simply increase the excess labour supplies. The excess would have to be exported in exchange for manufactured goods which could be used to build up an industrial sector to absorb the displaced agricultural workers. But, if the higher productivity in agriculture brought only lower prices, there would be no increase in incomes to buy developed-country exports and no increase in domestic real wages to provide increasing demand for the outputs of a nascent industrial sector. Further, if the prices of manufactured goods were administered and the productivity in industry passed on in terms of higher wages for developed-country workers, then their real incomes would increase as a result of both the improving domestic productivity and the improved agricultural productivity in developing countries producing the fall in the relative price of primary commodities they purchased. This would increase demand for

manufactured-goods outputs and even higher productivity due to larger domestic markets for manufactured goods. The successful expansion of industry in developed countries was thus the mirror image of the impossibility of a similar expansion in developing countries because the increased demand from higher productivity was being passed on to real wages in the developed rather than the developing countries. This led to the idea of the unequal exchange (Emmanuel 1972) between developed and developing countries or the interdependence between the needs of development in the centre and the consequent underdevelopment in the periphery that was eventually formalised in dependency theory (Frank 1966, Dos Santos 1969). But the real problem was that the potential increase in purchasing power that could have increased real wages and demand for domestic manufactures was being transferred from developing countries to developed countries via the decline in the terms of trade.

This approach also led to criticism of theories such as Rostow's *Stages of Economic Growth* (1960), which suggested that there was a singular path from underdevelopment to development which could be articulated in a general theory of "stages" of development and which was eventually measured statistically in the work of Chenery (1960). If the advance of the developed countries depended on the underdevelopment of the rest, then there could be no linear advance of all countries to a stage of economic "maturity". At the same time, as Gerschenkron (1962) suggested, the external conditions that developing countries face would change over time, making the "catching-up process" easier from the point of technical innovation, but more difficult from the point of view of the appropriate institutions structure to support development.

Latin American Structural Diversity

It was these consideration that led to an emphasis on the structural difference in the behaviour of developing countries, especially in Latin America, and led structuralist-developmentalist economists to argue that the analysis of Latin American development could not be undertaken on the basis of neoclassical or even Keynesian theory, which was appropriate to developed countries but provided little contribution to the resolution of the structural problems impeding Latin American development: "underdevelopment, specific phenomenon that it is, calls for an effort at autonomous theorization. Lack of

such an effort has led many economists to explain by analogy with the experience in developed economies problems which can be properly expressed only through full understanding of the phenomenon of underdevelopment." (Furtado 1964, 139-140)

The identification of these structural diversities allowed the role of aggregate demand to be downplayed and the important role of structural transformation of demand in different structural conditions to be emphasised. This initially took the form of highlighting the impact of conditions inherited from the Spanish or Portuguese colonial past such as land-tenure systems, indigenous labour supplies and other factors (cf. Stein and Stein 1970).

The most generalised application of the structuralist argument that is associated with economists working at the UN regional commission for Latin America may be found in the theory of unbalanced productive structures proposed by Marcel Diamand (1978). It is a theory of quantity adjustment similar to Keynes's idea of output adjustment. Diamand noted that the growth process in developing countries was not an even one with all sectors expanding as appropriate to maintain an overall equilibrium. Some sectors had inherent differences in the response of supply to price changes. Thus, if the price mechanism were free to allow adjustment to equilibrium for sectors with more inelastic outputs, an increase in demand could only generate an increase in prices, but little expansion in output. The result would be a rise in general prices, which would reduce the level of real wages and induce a shift in the distribution of income towards those inelastic sectors in the form of Ricardian rents. This would cause a decline in the overall level of income until the demand for the output in short supply had contracted to the quantity available. Thus the market-driven price-adjustment process in conditions of unbalanced production would create rising prices, lower aggregate output and a shift in income distribution until adjustments in supply were forthcoming. In some sectors this might be possible but slow, in others structural factors, market imperfections or controls could prevent adjustment. Diamand thus follows Keynes's (1937) recommendation (cf. Kregel 2008) with respect to the UK economy that sectoral adjustment must accompany policies to increase demand and also support the policies of balanced growth advanced earlier.

While these structuralist-developmentalist theories eventually produced the theory of import-substitution industrialisation, this characterisation is only correct to the extent that any strategy based on the need to find alternative employment opportunities for workers expulsed from the agricultural sector due to technological advance and a decline in the market for primary commodities in developed countries would of necessity conclude that a more balanced production structure between primary commodities and manufacturing would be required, and such a conclusion would imply the rejection of comparative advantage and the necessity of building up domestic production to compete with and eventually replace imports from developed countries. In this sense the support of industrialisation is independent of whether the subsequent growth strategy is export-led or import-substituting. But, irrespective of which policy is chosen, it will eventually involve import substitution.

It should thus be clear that irrespective of any problems associated with import substitution, arguments against it are arguments against the use of an expanding manufacturing sector to absorb the expansion of labour supply produced by technical progress in agriculture. This raises the additional question of what type of industrialisation process will take place and what sectors will be expanded and provide substitutes for previously imported goods. Many of the difficulties associated with import-substitution strategies are linked to these choices (cf. Griffin and Enos 1970) and have provided the justified criticism for inefficiencies in the application of these strategies (cf. Diamand 1978).

In addition, an often overlooked aspect of import-substitution industrialisation (ISI) is that it is based on the particular financial structure that emphasises domestic finance. Indeed, many of the difficulties associated with Latin American developing countries' ISI strategies result from the high capital inflows of the late 1970s engineered as a global response to the energy crisis. If foreign capital is borrowed to finance investment in import-substituting sectors it reduces the need for foreign exchange to purchase the imports, but it generates a counterbalancing demand for foreign exchange to meet the costs of imported capital equipment, and more importantly to meet the debt service.

Since the domestic production does not produce foreign sales or foreign exchange, foreign borrowing to finance import substitution leads to a tightening of the external constraint which can only be met by an increase in foreign borrowing.

The post-war supply-side approach and the monetarist counter-attack

Indeed, this reliance on foreign borrowing was the premise of the approach to development promoted by multilateral and official institutions in the immediate post-war period. Rather than emphasising the use of policies designed to expand demand for existing resources they found the cause of underdevelopment on the supply side and sought to resolve these constraints by operating supply-side policies to augment the role of the market. This approach to building on the supply side was based on the presumption that developing countries faced resource constraints and savings constraints due to low levels of per-capita incomes. With savings limited, investment could not rise at rates that were sufficiently high to provide for increasing income. The solution was to be found in channelling external resources to developing countries, and official agencies supported the transfer of resources from developed to developing countries to finance investment that could not be funded from domestic savings. In addition, proposals such as McKinnon's (1973) argued that financial repression, that is the control of the domestic monetary system to produce a favourable environment for investment via low interest rates, actually was the cause of low savings rates and low investment expenditure. This provided an argument for the liberalisation and deregulation of the financial sector.

The genesis to this supply-side approach was the result of a blend of the neo-classical theory of distribution and the newly emerging theories of long-run economic growth. According to marginal theory the return to capital is inversely related to its quantity, and since developing countries lacked capital its return there should be higher than in developed countries where it was abundant. Thus a perfect international capital market should lead to investment of developed-country savings in developing countries. (cf. Viner 1947)

A more subtle explanation came from the need to provide a policy for the UN's first development decade. Having set the target as a 5 per-cent annual growth rate, the

Harrod-Domar formula predicted that with capital output ratios of around 3, the developing countries would be short of savings of an amount equivalent to around 1 per cent of developed-country GDP in 1960. Given the negative impact of the 1930s Depression on private capital flows, it was thought that they would be negligible, despite the argument concerning relative rates of return just cited (see Viner's pessimistic view, 1952) and estimated at around 0.3 per cent of GDP. Thus the official development-assistance target of the UN was set at 0.7 per cent of developed-country GDP to be transferred to developing countries. Despite the fact that this target has never been close to being achieved it remains the official UN target today for real resource transfers from developed to developing countries and is reaffirmed at every official multilateral meeting on development finance. Currently the figure is less than half the target and has never gone much above 0.5 per cent.

Thus at the same time as the development pioneers were emphasising the importance of demand in mobilising domestic resources official agencies and governments were supporting the opposite view that the problem was on the supply side and could only be solved by the transfer of real resources to developing countries. Indeed when the Bretton Woods Institutions revamped their governance structure in the 1970s they created a "Development Committee" with the official title of "Joint Ministerial Committee of the Boards of Governors of the Bank and the Fund on the Transfer of Real Resources to Developing Countries" (see World Bank 1974).

Unfortunately this approach to the operation of international capital markets and the benefits of borrowing foreign savings to finance development is unsupported theoretically as well as empirically. The results of the Cambridge Controversies (See Harcourt 1971) vitiate the argument concerning the supposed differences in rates of return to capital in developed and developing countries, while the entire post-war period has been one that is characterised by negative transfers of real resources, that is, that developing countries have in general been sending resources to developed countries, which is what had initially been argued by the center-periphery dependency theorists.

But this theoretical and real-world failure of the resource-transfer approach did not bring vindication to the theories of demand-led development proposed by the Pioneers. Instead, as the monetarist counter-revolution challenged the Keynesian-inspired

fine-tuning macro-policy approach, a similar counter-revolution was launched against the extension of Keynesian theories to the problems of development (see Lal 1983). This took two lines, the first was to argue against the structuralist idea that developing economies were different from developed economies and thus required different theories and policies. The same policies used with success in developed countries should be adequate for developing countries (cf. Williamson 1989). The second was to attack the role of the protection of state-owned industry in import substitution as producing an inefficient allocation of resources due to rent-seeking behaviour (see Krueger 1974). The solution was to allow the role of the free market to operate more freely both inside and outside developing countries, a proposal that found its official guise in the "Washington Consensus" (Kregel 2008) recorded by John Williamson (1989, 2002). As already noted the main policy objective became the introduction of free markets, rather than viewing the operations of the markets as means to achieve traditional development objectives.

The main consequence of the imposition of these policies by the multilateral lending agencies was a rapid acceleration of foreign-capital inflows, which had already become the dominant form of transfer after the breakdown of stable exchange rates and the Bretton Woods system in the mid-1970s. While the Bretton Woods architects had envisaged an international capital market in which most transfers were done by official or government institutions, after the 1970s oil crisis these institutions and the developed-country governments had come to sanction private capital flows to support the recycling of the OPEC surpluses. The result of these increased flows, instead of meeting the requirement of augmenting the real transfer of resources, was the 1980s debt crisis in Latin America, for which the Washington Consensus was designed as a remedy. And in its turn the rise in private capital flows in the 1990s led to another series of financial crises (see UNCTAD 1998) in Mexico, Brazil (Kregel 1998), Asia (Kregel 1999, 2000) and Argentina (Kregel 2003).

Supply-side external finance, Ponzi finance and international capital flows

This increasingly virulent series of financial crises brought into question the supply-side theory of development based on foreign savings, whether it was done in conditions of open markets or of state-led development. The reason for this is quite simple and has been known since the early post-war recovery. The supply-side approach implies that net capital inflows will finance developing countries' current account deficits used to import manufactured goods to build up a domestic manufacturing sector. However, the build-up of debt which is incurred in foreign-denominated liabilities has to be serviced, and the only way foreign exchange can be earned to service it is through a current account surplus, or by more foreign borrowing. Evsey Domar (1950) has attempted to identify the conditions under which the latter policy could be sustainable by analysing whether the US could run a permanent current account surplus to offset a deficiency of demand in the US in the post-war period. His solution was that it was possible for a country to have a stable ratio of surplus (or deficit) to GDP over time on the condition that its foreign lending was sufficient to increase its stock of outstanding loans at a rate that was equal or greater than the rate of interest charged on the loans. Whether or not Domar's mathematics were necessary to understand the problem, Minsky's financial instability hypothesis (cf. Minsky 1986) would have quickly identified what was a supposed sustainable position with a Ponzi scheme. Domar's solution is to continuously borrow enough to meet the rising debt service on the increasing stock of foreign borrowing. Thus developing countries would have to continue to increase borrowing to meet debt service. Further if the interest rate on the debt was greater than this then the share of debt to GDP would be explosive (as has again been proven by the difficulties facing the Southern-tier Euro countries). In any case, the probability that private lenders would be willing to finance their own interest and principle repayments on a rising amount of outstanding debt is unlikely.

This then provides a third reason why the supply-side approach to development is untenable. But this leaves the problem of how a developing country can finance its demand-led mobilisation of domestic resources. The answer is that the financing cannot come from private foreign sources at market rates of return. This is true even for borrowing in the domestic currency. There is a view that the problem with foreign lending is the problem of the currency mismatch, borrowing in a foreign currency to fund domestic

activity earning the local currency. But even if the borrowing is in terms of the domestic currency the problem remains, as evidenced by the Tequila crisis, in which Mexico had sold peso-denominated debt to foreigners in an amount that was about five times its foreign-currency reserves. When the rise in the foreign deficit brought fears to foreign lenders who tried to sell their pesos for dollars the reserves were exhausted and the peso/dollar exchange rate would have gone to infinity, had not convertibility been suspended. The denomination of the foreign borrowing had an impact now on the end result of the financial crisis.

How to finance domestic development with or without foreign finance

If external finance cannot provide a sustainable development strategy, then what is to be the solution? There appear to be two possibilities. The first involves a return to either grant financing or an enhanced role for multilateral financial institutions in providing non-market long-term financing. For a country seeking to finance its development on the basis of foreign borrowing this would require a strict adherence to the Nurkse principle that increasing incomes go to domestic capital formation or to the Prebisch principle that they go to generating investment in exporting industries. It might thus be possible to arrange a three-stage process in which in the initial stage of building up a domestic manufacturing sector the country experiences an increasing external indebtedness to finance the import of essential capital equipment that generates export potential. In a second stage, exports are sufficiently developed to generate an external surplus which starts to reduce external indebtedness, which eventually manages not only to meet debt service but to pay down the external borrowing. At this stage the external debt burden declines as the manufacturing sector becomes internationally competitive and the country starts to have a positive overall balance and becomes a foreign lender to other developing countries. The difficulty with this approach, which had been envisaged by World Bank researchers in the immediate post-war period (see Kregel 2007), is that it would have required concessional funding or long-term private sector funding of 40 years or more, something that private capital markets are not able to produce in normal conditions.

Failing this possibility, the solution is to rely on domestic financial resources to finance the mobilisation of domestic financial resources. This would require financing of development in the domestic currency and from domestic investors. But according to traditional theory this approach would be thwarted by the lack of domestic savings to finance the required level of demand or by an unwillingness of domestic investors to finance development at rates of interest that allow the government to fund its development programmes because of the rising risk associated with increasing government debt or the debt of government guaranteed development institutions. But these objections misunderstand the architecture of modern monetary systems. According to the theory of soft currency economics (see Mosler 1996, 1997-1998), now better known as Modern Monetary Theory, countries that finance expenditures in domestic currency and have flexible exchange rates have what is called “monetary sovereignty”. This approach, generated from Keynes’s theory of money, Minsky’s theory of banking, Knapp’s State theory of Money (1895, 1924) and Lerner’s (1943, 1951) formulation of functional fiscal policy demonstrates that there is no effective constraint to government financing of investment except the maximum production capacity of the economy to produce goods and services. According to this theory the government solves the problem raised by Minsky (e.g. 1986) that anyone can issue liabilities (IOUs); the problem is to get them accepted. By imposing a tax liability on its citizens that can only be extinguished by rending the governments’ liabilities the government creates a ready demand for its coin and currency. Citizens will have to provide goods or services to the government to be able to meet these tax liabilities. In this view, it is not the government that has to finance its demands goods and services from the private sector, but the private sector that has to offer its goods and services to the government to finance its tax bill. Since there is no effective limit to the ability of governments to issue its own liabilities to pay for its acquisitions, it follows that the same must be true of its debt-service liabilities. Thus, government liabilities should be considered risk-free since there is never any economic constraint to redeeming them or paying debt service. In essence this means that the government never needs to borrow to finance its activities, and thus development cannot be constrained by the willingness of domestic investors to fund government deficits. Nor is there a minimum interest rate that must be paid to attract the required savings.

Indeed, according to this theory the issue of fixed-interest government liabilities such as notes and bonds is only necessary to offset the impact of government spending on bank reserves. When the government makes acquisitions it does so by means of a credit account at the central bank. The credit is transferred to the seller of services in the form of a credit to its bank account. The result is an increase in its bank's reserves, which other things being equal will create a condition of excess supply of reserves which will drive interbank rates to zero bid. If the monetary authority seeks a higher interest rate it will be necessary for the government to borrow the excess reserve funds by issuing positive interest-rate debt to the banks or to the households. The result of the approach of monetary sovereignty is, then, that domestic support of development via government expenditure can never be constrained by the necessity of selling government debt to the private sector or by some specific rate of return. Further, since the private sector will need government liabilities for liquidity reasons other than meeting tax obligations, the government budget will of necessity be in deficit or existing tax liabilities could not be met. Thus, it is not government savings that limits the demand needed for development, nor can it be the lack of private-sector savings.

Monetary sovereignty and capital controls

Like Keynes's theory, this approach was formulated with developed countries in mind, as an argument to support the use of Keynesian expenditure policies to produce full ulitilisation of productive capacity and full employment. But it seems to be just as applicable to developing countries with the appropriate adaptations noted above with respect to the appropriation of Keynes's theory of effective demand and disguised unemployment. In particular, the formulation of the theory for developed economies precludes fixed exchange rates or the application of anything similar to the gold standard because such currency arrangements preclude monetary sovereignty, for they guarantee a payment of debt in a foreign currency for foreign lenders or domestic holders of foreign debt.

But for developing countries the exchange rate is not a variable that can be left to the international capital market. This is the leitmotif of what has come to be called the "New Developmentalism" (See 2010, Bresser 2009, Frenkel 2008, Frenkel and Damill

2011). This is basically because of its impact on the ability of developing countries to formulate and execute strategies to develop domestic manufacturing industry. According to this “new” approach to the traditional theory of developmentalism, less developed countries’ policies are constrained by two structural elements. The first is a tendency for real wages to grow at less than the rate of productivity growth. This is a basic tenet of the Prebisch-Singer-Myrdal tendency for declining commodity terms of trade, but here it represents the generalised difficulty in generating domestic markets capable of supporting domestic industry of a size sufficient to generate economies of scale. The second is the tendency to overvalue the exchange rate required to produce an equilibrium in the manufacturing sector. In the approach of both Kaldor (1965) and Diamand (1978), the exchange rate required to allow a newly created manufacturing sector will in general diverge from the exchange rate determined by the exports of the primary commodity sector, a problem aggravated by any appreciation in dollar prices of commodities. The equilibrium exchange rate for the economy as a whole thus places the developing manufacturing sector at another disadvantage in addition to those created by small internal markets and the inefficiencies associated with a start-up production operation.

The obvious conclusion is that the demand-led approach to development financed by monetary sovereignty will require controls on foreign capital flows. For possible measures, see Gallagher et al. (2011). Indeed, from the position of the “new” developmentalism these resources are not needed and are detrimental to the financial stability of the development process. Thus they must either be eliminated or controlled. This would imply reversing the traditional strategy of encouraging developed countries to transfer financial resources to developing countries to convince them to control or eliminate these private transfers. Since they clearly do not produce an efficient international allocation of capital, as has been seen in the aftermath of the 2007-2008 financial crisis, there is no economic or developmental reason for them to exist. Indeed, many developing countries have been convinced to liberalise and open their domestic capital markets in order to attract international investors and direct investments which they do not need and which have usually been the source of domestic financial crisis. The examples of Japan, Korea and Mexico are instructive in this regard. Thus the constraint currently

facing developing countries is a type of financial terms of trade, in which allowing the international financial market a comparative advantage determines the structure of their domestic financial structure, and the structure of external financial flows produces repetitive crises that prevent a steady mobilisation of domestic resources and employment. But, it is these things that should be the objectives of development policy, not the efficient international allocation of financial services.

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