Internal v. External Financing Economic Development:

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External Finance Impedes Economic Development

- **Crib Notes**

- Post-War Development Based on External Saving: Net Transfer of Real Resources from Developed to Developing Countries
- There is no Theoretical or Historical Support for this Approach
- It generates inherent Financial Fragility/Crisis
- Ignores Traditional Development Theory: The "Pioneers of Development"
  - Domestic Demand Led Development
  - Based on Keynesian Idea of Disguised Unemployment
  - Creation of Industrial Sector
  - Domestic Financing Is Sufficient
- But Requires Capital Controls: Monetary Sovereignty
  - Ignores Primary Role of Innovation – the Ricardo Problem
- All Countries face a Development Problem: Employment

Introduction

- How to Finance Development?
- Framing the Question: 2 Apppproaches:
  - Economics of Scarcity (supply side)
  - Economics of Abundance or
    - Poverty in the Midst of Plenty (demand side)

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The Two Approaches

- <u>Economics of Scarcity</u>
  - Economic Activity Supply Constrained
  - Pricing to provide Efficient Allocation of Scarce Resources
- <u>Economics of Poverty in the Midst of Plenty</u>
  - Supply is Demand Constrained
  - Expenditure to provide Efficient and Full utilization of existing resources
  - Innovation expands resources
  - Conflict between Innovation and Demand

Economics of Scarcity

- Economics of Choice
  - Limited Resources-Unlimited Wants
  - Maximisation of utility\output subject to externally given resource constraint
    - Utility functions\production functions
- Lionel Robbins' Definition of Economics
  - "Economics is the science which studies human behavior as a relationship between given ends and scarce means which have alternative uses"
- Austrian Approach
  - alternative resource uses - opportunity costs
  - Prices guide future decisions, not past costs
  - What are the alternative uses?
    - entrepreneurs in markets have to discover them
      - discovery of needs drives economic change
      - Incentives drive discovery
    - Equality of Opportunity, Inequality of results

Schumpeter: Money Innovation and Development

- Entrepreneurs have to compete for the resources to innovate
  - Banks Intermediate this process (Ephors of Capitalism)
  - Banks create Purchasing Power (credit) ex nihil
    - Investment is not limited by Saving
- Innovation interrupts routine circular flow equilibrium
  - Competition for resources drives up prices (Forced Saving)
    - Saving adjusts to Investment
- New Processes increase output and supply, drive down prices
  - Deflation, Possible Crisis
  - Return to Circular Flow Equilibrium
- Catching up economies: imitate before they innovate

Economics of Poverty in the Midst of Plenty

- Economics of Effective Demand
  - – Economy is Demand Constrained
- RF Kahn: Always ask are you at Y_{full}?
- Domar: Raising investment to absorb excess capacity output creates more productive capacity and additional supply
  - – Expanding economy faces endemic excess supply
  - – Growth requires continual increase in demand
- Harrod: warranted growth rate
  - To Satisfy Entrepreneurs’ profit expectations
  - LIMIT: NATURAL RATE OF GROWTH

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Keynes and Effective Demand

- Between the *Treatise* and the *General Theory*
  - Royal Committee on Finance and Industry --(The "Macmillan Committee" – What's wrong with the UK economy?)
  - **"Treasury" View (it's not crowding out)**:
    - Private investment decisions are "efficient" (driven by profit)
    - Public Investment is inherently wasteful of resources
      - Because: if it were profitable private sector would do it
  - Keynes: Bank rate sets investment "hurdle" rate
    - Does any private investment earn bank rate?
    - Bank rate just insures gold from flowing out

Keynes: Demand determines Scarcity

- Scarcity (in a monetary economy) imposed by
  - Bank rate in fixed exchange rate system
  - Liquidity Preference in flexible rate system
- Investors prefer to hold financial assets
  - "investment" demand to hold financial assets does not increase output or employment
  - Investment driven by NPV of investment
  - expected earnings dominate cost of finance (interest rate)
- Poverty in the Midst of Plentiful (resources)
- Reaction to First World War stock market fall
  - No change in real quantity or productivity of capital
  - But stock market value of capital (and output) collapsed

Trade and the External Constraints

- James Meade: Gains from Trade
  - Drafted UK proposal for a Commercial Union
  - Havana Conference on Trade and Employment
    - Was to be 3rd Pillar of Bretton Woods
- Gains from Trade depend on full utilisation of resources:
  - On Production Possibility curve
  - Inside PP Curve: greater output provides "free goods"
  - even if costs are higher than competitors!

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Birth of "Development" Economics

- After World War I: Rosenstein Rodan
  - How will the newly created economic and political Balcan states become self-sustaining
- After World War II: Development "Pioneers"
  - Former Asian/African colonies become independent states
    - No longer integrated in Empire
- UN Trusteeship Council to foster political independence of undeveloped economies
- UN recognized need for economic support

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Development in the context of 1950s Economics

- Two Approaches to Development
  - Development "Pioneers" in the 1940s and 1950s Built on the Economics of Effective Demand
  - "Mainstream" Approach Built on Scarcity
    - Savings, Finance, Resource, Finance Gaps
    - Development Requires External Finance and Technical Resources

Keynes' General Theory was Dominant

- But Keynes was about level of utilization of resources
- Cyclical variations in capacity utilization
- More Demand: More Output
  - Domar problem: More Investment more unused capacity – it is a long-term problem
- But Developing Countries
  - do not have Unused productive capacity
  - Mono-commodity producers –terms of trade
  - Primarily Agricultural
- VKRV Rao: Joan Robinson's Disguised Unemployment adapted to the problems of Developing Countries provides the Key to a

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From Disguised Unemployment to Development with Unlimited Supplies of Labour

“How can we account for the fact that, over the whole range of human history, unemployment in the modern sense is, comparatively speaking, a rare and local phenomenon? The answer is to be found in the existence of disguised unemployment. In a society in which there is no regular system of unemployment benefit, and in which poor relief is either non-existent or "less eligible" than almost any alternative short of suicide, a man who is thrown out of work must scratch up a living somehow or other by means of his own efforts.“

“Thus a decline in demand for the product of the general run of industries leads to a diversion of labour from occupations in which productivity is higher to others where it is lower. The cause of this diversion, a decline in effective demand, is exactly the same as the cause of unemployment in the ordinary sense, and it is natural to describe the adoption of inferior occupations by dismissed workers as **disguised unemployment**.”

“Thus we may say that unemployment is present when an increase in the output of capital goods (not offset by an increase in thriftiness) would lead to an increase in the output of consumption goods. Let us apply this criterion to disguised unemployment. If a revival of investment were to occur, dismissed workers would be called back from the hedgerows and the street-curbs into their normal occupations.”

“The analysis of disguised unemployment makes it clear that while everyone is occupied for twenty-four hours a day, so that the total amount of occupation can never be increased, yet employment can be said to increase when part of a man's time is transferred from an occupation in which its productivity is lower to one where it is higher. “

CAN INVESTMENT BE INCREASED WITHOUT DRAWING RESOURCES FROM PRODUCTION OF CONSUMPTION OUTPUT?

V.K.R.V. Rao

... not disagreeable social means for enabling the unemployed to exist. In an underdeveloped and agrarian economy with little capital equipment and a somewhat low state of technical knowledge like India, on the other hand, disguised unemployment is a normal feature of the economy. The term is not applied, as Mrs Robinson applies it, to wage labour taking to less productive work on account of unemployment. It is applied in the case of India to persons who are employed in the sense that they are engaged in household enterprise but who are really in a state of disguised unemployment in the sense that no difference will be made to output by their withdrawal from the occupations concerned. As is pointed out in the recent report of the U.N. Committee of Experts on *Measures for the Economic Development of Under-developed Countries*, 'the disguised unemployed are those

[1] Joan Robinson, *Essays in the Theory of Employment*, p. 84.

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From Disguised Unemployment to Development with Unlimited Supplies of Labour

- **Employment as the Main Problem of Development**
- How to you expand income per head if the whole population is employed in agriculture and there is technical progress in agriculture?
- You have the equivalent of disguised unemployment
  - For the Mainstream this became negative marginal product of labour
- You can transfer labour out of agriculture without reducing consumption per head

- **The obvious answer is manufacturing**
- Wages and Technical progress raising output per man are higher in manufacturing
- The answer to the Employment problem (and the main Development problem) is then transferring disguised unemployed labour into higher productivity occupations
- This requires building a manufacturing sector
- This requires demand for manufactured goods
- This is the basis of all Demand-led Development Theories develope

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Demand-Led Approach:

- Domestic demand for domestic industrialisation
  - Prebisch-Singer-Myrdal terms of trade
  - A transfer of productivity induced real wage increases and demand from primary to manufactured country producers
  - A Constraint on Demand for Domestic Industry
- Demand required for Mobilisation of Domestic Resources
- Sufficient demand growth and income level is required to prevent deindustrialisation
  - required to support transition from manufacturing to the services sector
  - UNCTAD: Trade and Development Report 2003

Post-War Macroeconomics was a struggle between the two Approaches

- Keynesian “Demand Management”: Fine Tuning
  - Analysis in Real Terms – no prices
  - Failed to deal with 1970s Stagflation
- Monetarist counter-revolution
  - Offered Solution to Inflation
  - Price Stability prerequisite to Growth
  - (Keynes: Quantity theory implies full employment)
- Rational Expectations
  - failure is statistically predictable
- Market Fundamentalism – “Real Growth” Theory
- Washington Consensus: Demise of Development Economics
  - Implementation Produces Financial Instability in place of traditional stop-go fiscal policy

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Some “Development Pioneers”

- Rosenstein Rodan: Big Bang
- Ragnar Nurkse: Balanced Growth
- Gunnar Myrdal: Cumulative Causation, linkages
- Raul Prebisch: Center Periphery - Terms of Trade
- Hans Singer: Decline in Terms of Trade
- Celso Furtado: External impluse, Center-Periphery
- Francois Perroux: Asymmetry, Economic Space, Growth Poles
- Albert Hirschman: Unbalanced Growth, linkages
- Nicholas Kaldor: Sectoral Imbalance, Cumulative Causation, Dual Exchange Rates
- Marcelo Diamand: Bottlenecks, Dual x-rates
- Lauchlin Currie: Plan of Four Strategies, focus on urban housing and export diversification
- Henry Wallich: Derived Development
- Michael Kalecki: Medium balanced path
- V.K.R.V Rao: Disguised Unemployment

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Mainstream Alternative Financing for Development

- Constraints on Developing Countries:
  - Scarcity of Domestic Savings
  - Scarcity of Domestic Resources
  - Deficient Capacity to Produce Capital/Traded Goods
- How to Overcome constraints:
  - Increase Domestic Savings
    - Difficult on Subsistence/low income per capita
    - Emigrant Remittances
  - External Financing for Development
    - Bilateral Grants and Concessional lending – ODA
    - Multilateral Institutions – IBRD – IDA - IFC
    - Private direct investment flows –FDI

Theoretical Support for External Financing

"The basic argument for international investment of capital is that under normal conditions it results in the movement of capital from countries in which its marginal value productivity is low to countries in which its marginal value productivity is high and that it thus tends toward an equalization of marginal value productivity of capital throughout the world and consequently toward a maximum contribution of the world's capital resources to world production and income."

Jacob Viner, "International Finance in the postwar World," *Journal of Political Economy*, 55, April, 1947, p. 98.

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Implicit Assumptions and Conclusions

- Assumptions (diminishing returns)
  - Capital Scarcity in Developing Countries: high rate of return
  - Capital Surplus in Developed Countries: low rate of return
  - Capital market arbitrage: capital moves from low to high
- Conclusions
  - Global investors raise their returns by lending to Developing Countries
  - Developing Countries develop more rapidly by borrowing Capital from Developed Countries
  - Global rate of Growth and Wealth Formation Maximised

Cambridge Capital Theory Debates: There is No Theoretical Support for Assumption on Capital Flows

- Impossible to establish an inverse relation between capital scarcity and rate of return
- Not even possible to measure capital
- Thus scarcity cannot be defined
- NB: Real Growth Theory redefines “capital” to include scarce supply of technical/institutional knowledge in developing countries

Conclusions Cannot Be Supported by the Stylised Facts

- No empirical evidence that capital flows from developed to developing countries
- No evidence that foreign capital inflows increase domestic investment and growth
  - They usually produce increased consumption
  - Diversification of indigenous producers via sale to foreign investors
- Relative returns will depend on stable exchange rates
  - And capital flows will have a major impact on performance of exchange rate

Historical Evidence

- Negative net transfers have been the rule
  - Capital Flows from Developing to Developed Countries
  - Alliance for Progress (AfP) --1960s,
  - Latin America's "lost decade" of the 1980s,
  - Mexican, Asian financial crises of the 1990s
  - Excess Reserve accumulations of the 2000s
- Private Flows dominate Official Assistance since 1970s
  - Private flows determined by investors incentives
  - No relation to development needs
  - (e.g. concentration in primary and extractive industries)

Historical Experience?

Brazilian President Getulio Vargas

(in a New Year's Eve speech at the end of 1951)

complained that Brazil had been experiencing negative net financial flows continuously from 1939

(with the exception of 1947).

Financial Transfers under the US “Alliance for Progress”

Former Chilean finance minister Gabriel Valdes to President Nixon, June 12, 1969

> “It is generally believed that our continent receives real financial aid. The data show the opposite. We can affirm that Latin America is making a contribution to financing the development of the United States and of other industrialized countries. Private investment has meant and does mean for Latin America that the sums taken out of our continent are several times higher than those that are invested. ... In one word, we know that Latin America gives more than it receives.”

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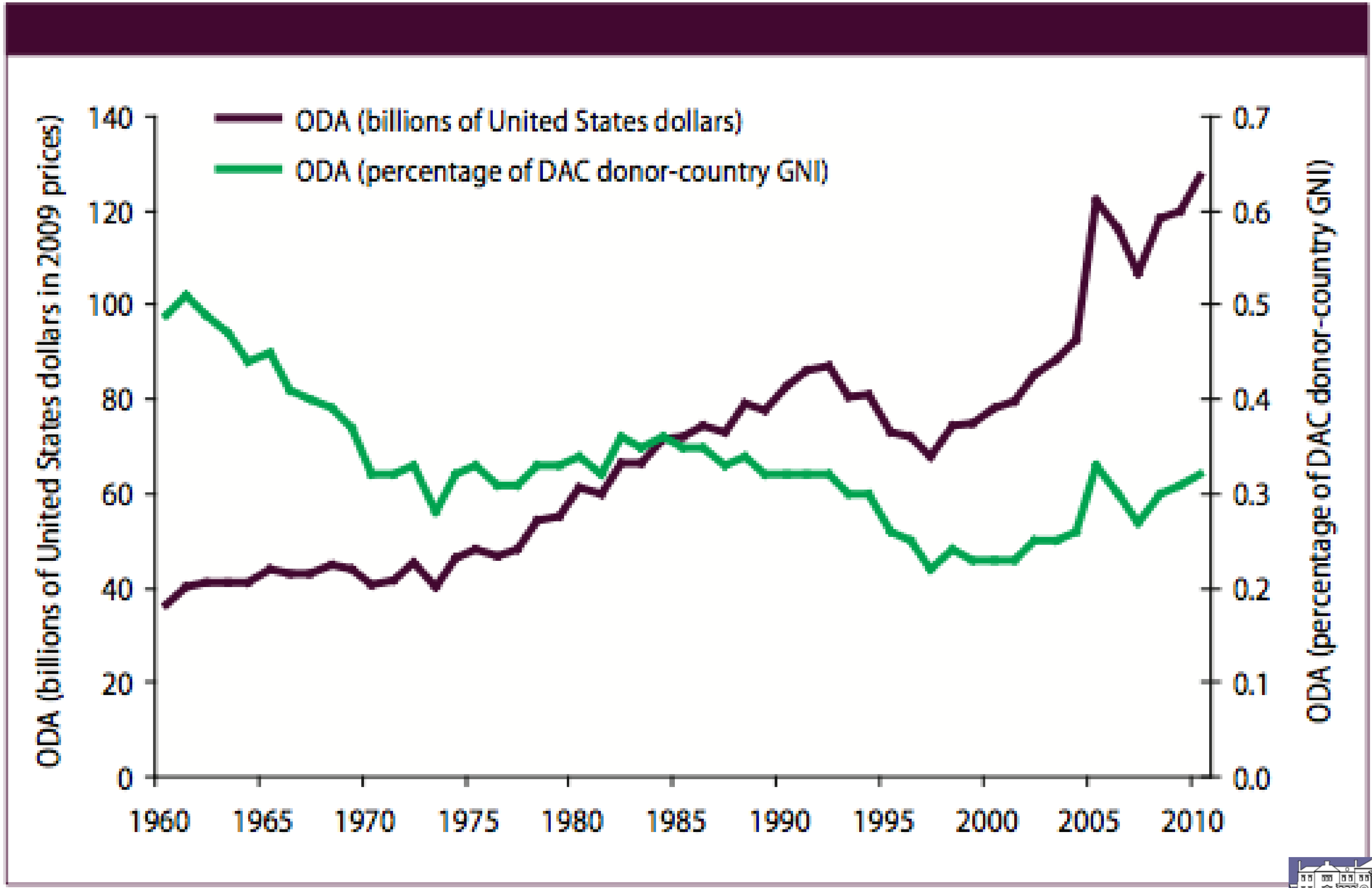
ODA from Development Assistance Committee (DAC) countries in United States dollars and as a proportion of donor-country gross national income, 1960-2010



IDF relative to other sources of external finance of developing countries by region, 2006-2010

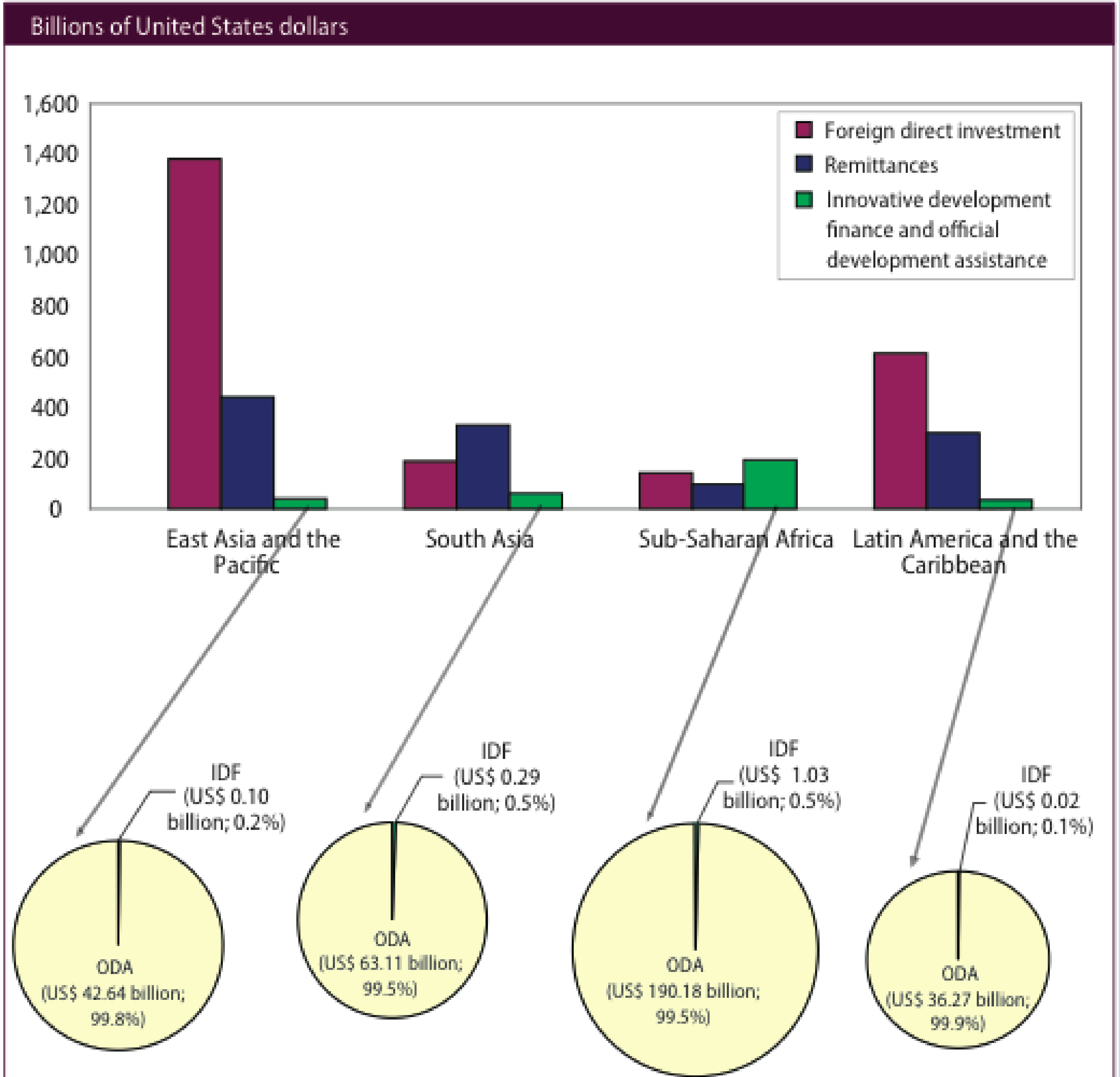


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Figure III.1b
Net financial transfers, by income categories, 2000-2010

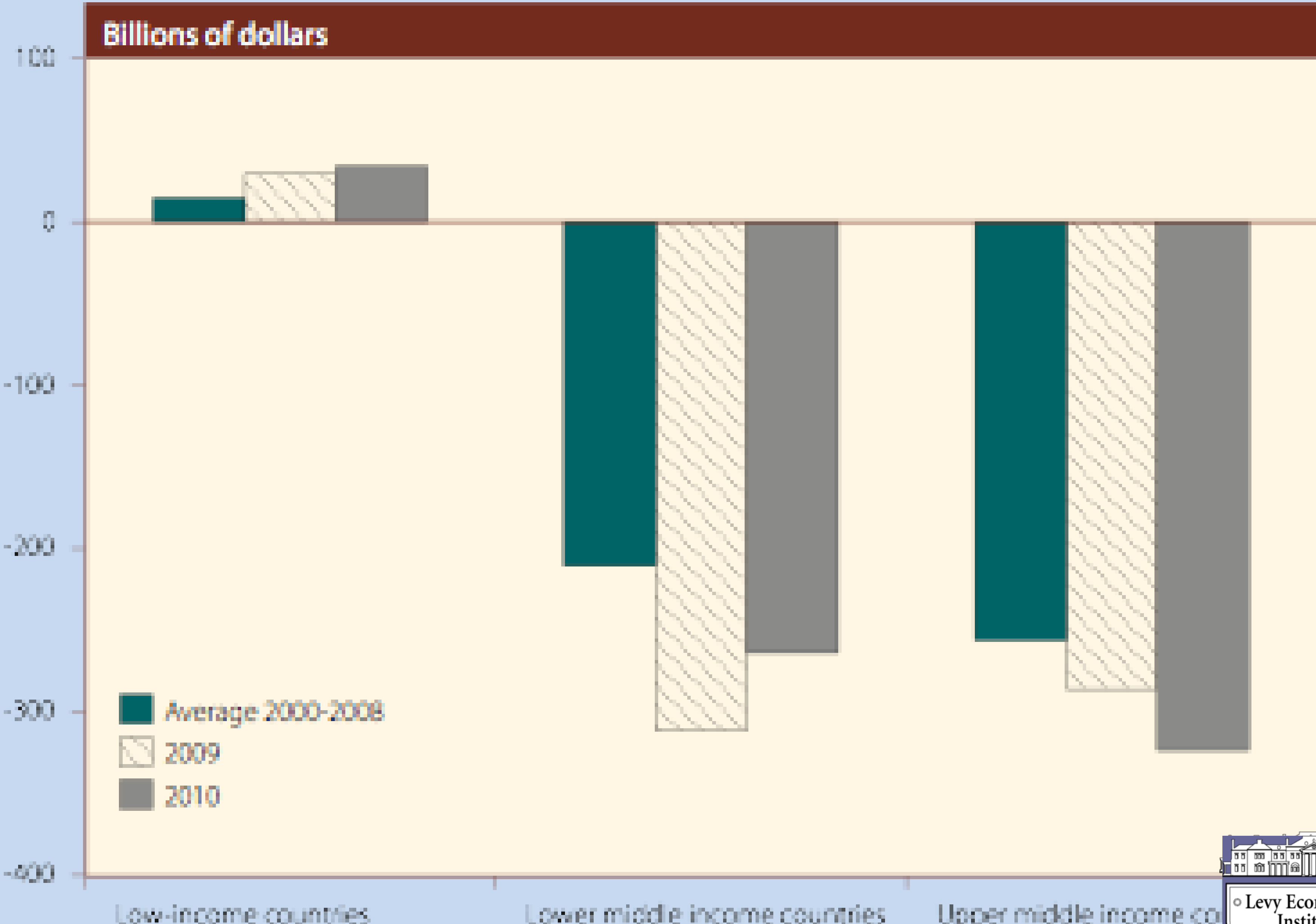

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Table III.1

Net transfer of financial resources to developing economies and economies in transition, 1998-2010

Billions of dollars	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010[a]
Developing economies	**-41.0**	**-128.0**	**-194.0**	**-164.4**	**-210.2**	**-302.7**	**-379.5**	**-597.2**	**-807.8**	**-881.1**	**-876.4**	**-545.1**	**-557.0**
Africa	2.9	1.6	-31.7	-16.4	-4.2	-16.1	-34.5	-76.4	-108.3	-100.9	-99.1	2.9	-35.3
Sub-Saharan Africa (excluding Nigeria and South Africa)	11.5	7.9	2.3	6.4	4.4	5.3	3.5	-0.6	-10.5	-9.1	-4.8	27.3	14.6
East and South Asia	-129.8	-139.8	-122.8	-120.8	-149.2	-175.6	-183.4	-265.7	-385.7	-529.8	-481.3	-427.5	-352.9
Western Asia	34.5	2.7	-35.3	-29.7	-23.2	-46.7	-76.3	-143.7	-175.6	-144.0	-222.5	-48.4	-112.7
Latin America and the Caribbean	41.5	7.4	-4.2	2.5	-33.6	-64.3	-85.4	-111.4	-138.0	-106.4	-73.5	-72.1	-56.1
Economies in transition	**0.7**	**-25.1**	**-51.6**	**-32.9**	**-28.0**	**-38.0**	**-62.5**	**-96.0**	**-117.1**	**-95.9**	**-149.1**	**-81.1**	**-133.0**
Memorandum items:													
Heavily indebted poor countries (HIPCs)	8.8	9.5	7.9	8.3	8.9	8.8	10.7	13.4	11.2	19.0	31.0	29.6	31.0
Least developed countries[b]	12.5	10.2	5.0	8.2	5.9	7.5	5.0	1.3	-7.9	-5.2	-4.5	26.3	16.8

Source: UN/DESA, based on IMF, *World Economic Outlook Database*, October 2010; and IMF, *Balance of Payments Statistics*.

a Partly estimated.

b Cape Verde graduated in December 2007 and is not included in the calculations.

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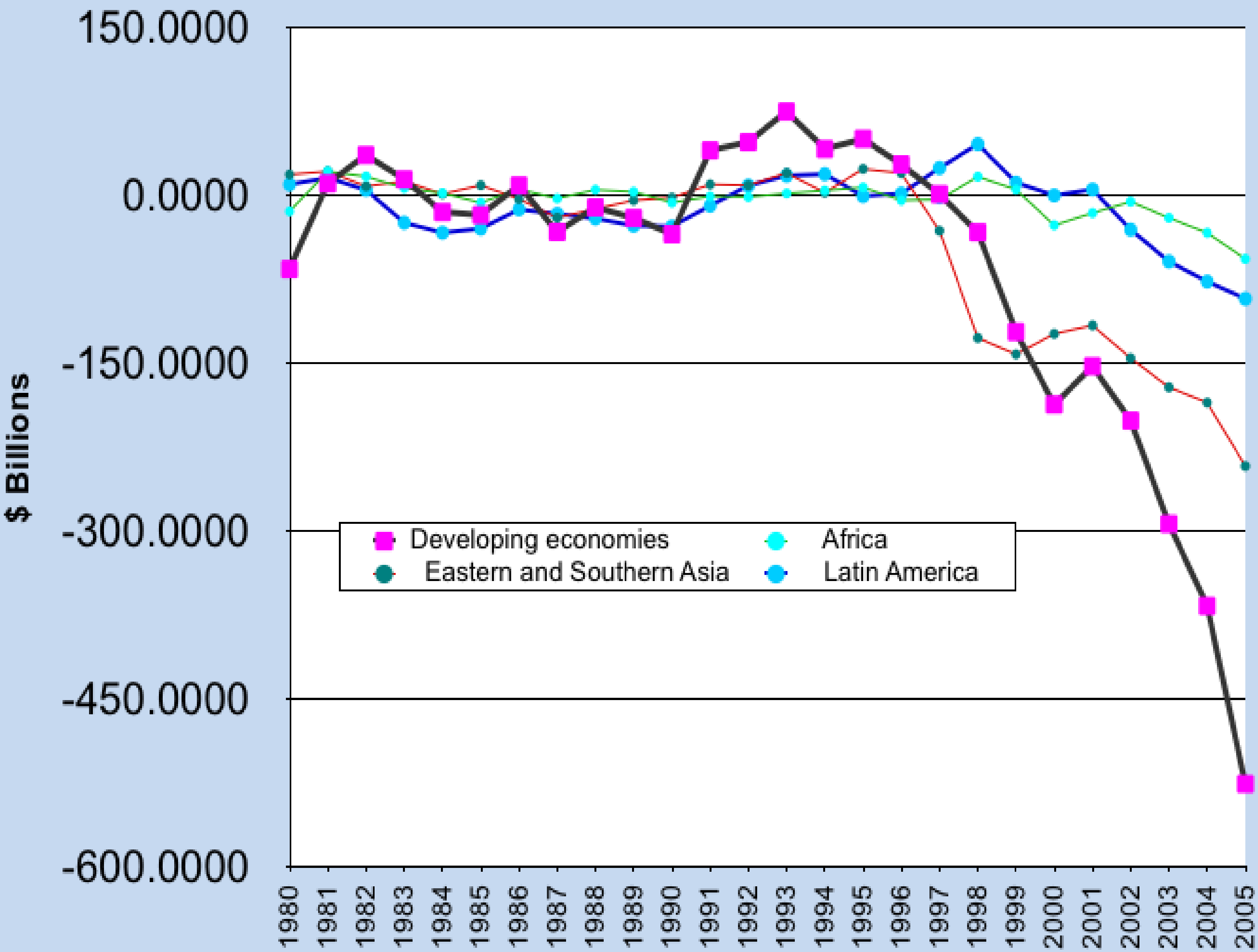
Modern Experience of Net Transfers of Resources



Emerging Market Economies: Capital Flows

$ billion

	2013	2014	2015	2016
Non-Resident Capital Inflows	***1301***	***1090***	***1049***	***1202***
Private Inflows	**1269**	**1048**	**981**	**1158**
Equity Investment	666	687	657	725
Direct Investment	582	586	529	561
Portfolio Investment	84	101	128	164
Private Creditors	603	361	325	433
Commercial Banks	172	175	119	184
Nonbanks	431	186	206	248
Official Inflows	33	42	68	44
International Financial Institutions	-3	12	34	20
Bilateral Creditors	36	30	34	24
Resident Capital Outflows	***-1518***	***-1164***	***-1179***	***-1351***
Private Outflows	-978	-1054	-1105	-1065
Equity Investment Abroad	-418	-397	-388	-406
Resident Lending/Other	-560	-657	-716	-659
Reserves (- = Increase)	-540	-110	-74	-286
Net Capital Flows	***-217***	***-74***	***-130***	***-149***
Memo:				
Net Errors and Omissions	-3	-146	0	0
Current Account Balance	*220*	*220*	*130*	*149*

Source: IIF. See backcover page for guidance on how to interpret these data.

Nonetheless Official Policy has applied Mainstream Approach

- **First United Nations Development Decade-1961**
  - **Kennedy -- Alliance for Progress**
  - **Objective: 5 per cent GDP Growth**
  - **Instrument: One per cent of developed country GDP to be transferred to developing countries**
  - **Assumption: 0.3 per cent private flows,**
  - **Official UN target: 1.0% - 0.3% = 0.7% per cent ODA**
- **Growth Rate Target Achieved**
- **Official Aid Target Not Achieved**

Modern revisionists

- <u>Real Growth Theory</u>
  - Increasing returns to investment in
    - Human capital
    - Market institutions
  - Investment in Developed countries may thus have higher returns than investment in Developing countries- cf Nurkse, Singer
  - Global Financial Markets may thus may be acting efficiently by creating negative net resource flows
  - A Rediscovery of the position of the "Development Pioneers"
    - Demand determines profitability and growth
    - Cumulative causation
    - Increasing Returns to Manufacturing

Modern Equivalent: Build Financial Institutions

"The case for capital account liberalization is a case for capital seeking the highest productivity investments. We have seen in recent months in Asia -- as at many points in the past in other countries -- the danger of opening up the capital account when incentives are distorted and domestic regulation and supervision is inadequate. …

The right response to these experiences is much less to slow the pace of capital account liberalization than to accelerate the pace of creating an environment in which capital will flow to its highest return use.

And one of the best ways to accelerate the process of developing such a system is to open up to foreign financial service providers, and all the competition, capital and expertise which they bring with them."

(i.e. invite the bloodsucking squid to dinner)

(1998) US Government Press Release, 2286, March 9, 1998: "Deputy Secretary Summers Remarks Before The International Monetary Fund."

What do Foreign Financial Institutions Contribute?

- Foreign Banks were the first to exit Argentina in 2000
- Before the Corralito was imposed
- Before the Suspension of debt service
- Did not act to create stable domestic environment
- In Brazil foreign banks are less efficient than domestic banks
- Foreign acquisitions of Latin American banks have been of the best domestic performers

See Mario Tonveronachi, “The Role of Foreign Banks in Emerging Countries – The Case of Argentina, 1993-2000, investigación económica, vol LXV, No. 255, enero-marzo, 2006 and Jon and Fatima Williams ‘Does ownership explain bank mergers and acquisitions? The case of domestic banks and foreign banks in Brazil’, Oxford Centre for Brazilian Studies and Luiz Fernando Rodrigues de Paula, The Recent Wave of European Banks in Brazil”, Oxford: Centre for Brazilian Studies.

Limits to Mainstream Approach of External Finance

- **DOMAR CONDITION**
- A net export surplus can be maintained only if the stock of foreign lending increases at a rate equal or greater than the interest rate charged on the foreign lending
- For a deficit, foreign borrowing must increase at a rate equal or greater than the rate of interest paid on the lending
- If interest rate rises with increasing stocks of foreign loans, then the rate of borrowing must also increase

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Financial Instability and External Finance

- This is the same as the condition for a **successful Ponzi Finance scheme**
- Such schemes are inherently unstable
- Thus, Keynes's recommendation to use capital controls
- But long-term stability will require a balanced structure of production that creates exports sufficient to meet debt service
- Industrial policy is also necessary for policy space

How do we finance demand-led Development?

- Early 19th Century: Germany/France as Industrialising Economies
- Financial Institutions to support Sectoral Transformation
  - List: Protect industrial development
  - Schumpeter: Banks Finance Innovation
  - Sismondi: Industrial Banking
- Early 20th Century Monetary Theories of Fluctuations
- Mises, Hayek, Hahn, Keynes, Hawtrey, Robertson, >>>
  - If Banks can create purchasing power then
  - Investment cannot be limited by Saving
  - Cannot be limited by Domestic Saving
- Financial System can Finance any level of developme

Return to Traditional Approach of Development Pioneers

- What are the available domestic resources?
  - Most developing countries have abundant natural resources
  - But all have unemployed, underemployed or underqualified domestic labour supply
  - Increasing employment presents the greatest unexploited potential for mobilising domestic resources
- Employment increases Income and thus Savings
  - Nurkse: “All Capital is Made at Home”
  - Capital is Accumulation by Disguised Unemployed Labour
  - Requires policy to ensure income is saved and used to increase capital (restrictions on domestic consumption/ imports of developed country consumption goods)

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Schumpeter: Capital Development not limited by Domestic Savings

- Schumpeter: Development is “carrying out new combinations”
    - “financing” as a special act is fundamentally necessary”
    - “It is always a question … of the creation of new purchasing power out of nothing” so that new combinations need not be limited by “savings”
- “**The form financing takes is immaterial**.
    - issue of bank-notes not fully covered by specie … is an obvious instance, but methods of deposit banking render the same service, … or bank acceptances in so far as they serve as money to make payments in wholesale trade”
- “the banker, therefore, is not so much primarily a middleman in the commodity “purchasing power” **as a producer of this commodity**”
- “Means of payment are created in the economic system which are …represented as mere claims to money, but which essentially differ from claims to other goods in that perform exactly the same service …as the goods in question.. So that they may take its place”
- **Banker as “ephor” of capitalism**

How does national wealth increase?

Smith:

- Growth of population employed
- Growth of productivity

Prebisch-Myrdal-Singer

- Trend decline in terms of trade in primary commodities
- Diversify production to include industry

Knowledge Economy

- You cannot buy productivity by buying capital goods
- Technical knowledge is no longer embodies

You have to produce your own technology

You cannot invest in it by buying shares in foreign companies

Financial terms of trade – real exchange rate appreciation

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Saving is not the problem
Finance is not the problem

- How is the Finance Used?
  - Develop Manufacturing to solve employment problem
- But you need external capital goods
  - Manage Manufacturing Exports
  - Prebisch: You can't do it with primary commodity exports
- Support for Exports requires domestic Finance
  - And a competitive exchange rate
    - For manufactures (dual exchange rate?)
  - Control of Exchange rate
  - Requires control of capital inflows

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