Internal v. External Financing Economic Development:

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External Finance Impedes Economic Development

• Crib Notes

• Practice of Post-War Development Based on External Finance: Net Transfer of Real Resources from Developed to Developing Countries
• There is no Theoretical Justification for this Policy
• It also creates Financial Instability/Crisis
• Ignores the Theory of Development Pioneers:
  • 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
Introduction

- How to Finance Development?
- Two Alternative Approaches to Framing the Question
  - Economics of Scarcity
  - Economics of Abundance or
  - Poverty in the Midst of Plenty
The Two Alternatives

• **Economics of Scarcity**
  – Economy is Supply Constrained
  – Pricing to provide Efficient Allocation of Scarce Resources

• **Economics of Poverty in the Midst of Plenty**
  – Supply is Demand Constrained
  – Expenditure to provide Efficient and Full utilization of existing resources
  – Use innovation to expand resources
Economics of Scarcity

• Economics of Choice
  – Limited Resources-Unlimited Wants
  – Maximisation of utility subject to externally given resource constraint

• 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
  – What are the alternative uses?
    • entrepreneurs in markets have to discover them
      – discovery of needs drives economic change
  – Schumpeter: entrepreneurs have to compete for the resources to innovate
    • Banks Intermediate this process
      – Innovation interrupts Walrasian 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 \(Y_{\text{full}}\)?

- Domar: Raising investment absorb capacity output will create more unused 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
Keynes and Effective Demand

• Between the Treatise and the General Theory
  • Royal Committee on Finance and Industry --(The “Macmillan Committee”)

  – **Keynes contests “Treasury” View that:**
    • Private investment decisions are “efficient” (driven by profit)
    • Public Investment competes with private investment
    • Public Investment is inherently wasteful of resources
      – 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
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 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!
Birth of “Development” Economics

- After World War I: Rosenstein Rodan
  - How will the newly created economic and political units become self-sustaining
- After World War II: Development “Pioneers”
  - Former colonies become independent states and lost colonial integration in Empire
- UN Trusteeship Council to foster political independence of undeveloped economies
- UN recognized need for economic support
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 Keynesian Approach to Development
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 un-employment. 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.
V.K.R.V. Rao

...
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 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 developed from Keynes
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
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
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
Mainstream Approach to Financing for Development

- **Constraints on Developing Countries:**
  - Deficient Domestic Savings
  - Scarcity of Domestic Resources
  - Deficient Capacity to Produce Capital Goods

- **How to Overcome constraints:**
  - Increase Domestic Savings
  - External Financing for Development
    - Bilateral Grants and Concessional lending – ODA
    - Multilateral Institutions – IBRD – IDA - IFC
    - Private direct investment flows – FDI
    - Emigrant Remittances
      - Income, not capital
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.”

Implicit Assumptions and Conclusions

• Assumptions (diminishing returns)
  – Capital Scarcity in Developing Countries so rate of return in higher
  – Capital Surplus in Developed Countries so rate of return in lower

• Conclusions
  – Global investors raise their returns by investing in 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 scarcity
Assumptions Cannot Be Supported by the Stylised Facts

- No empirical evidence that foreign capital inflows increase domestic investment and growth
- Relative returns will depend on stable exchange rates
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
  – Private flows not subject to development needs, but to determined by investors incentives
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 1947 the exception).
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.”
Figure III.2
Net ODA of DAC members, 1990-2009, and DAC secretariat simulations to 2010

Percentage of GNI

ODA as a percentage of GNI (left scale)

Total ODA (right scale)

ODA to Africa (right scale)

Billions of dollars (2004 prices)


0.33
0.22
0.26
0.33
0.28
0.31
0.32

### Table III.1
Net transfer of financial resources to developing economies and economies in transition, 1998-2010

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<th>1998</th>
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<td><strong>Economies in transition</strong></td>
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<td>-51.6</td>
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<td>-28.0</td>
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<td>-62.5</td>
<td>-96.0</td>
<td>-117.1</td>
<td>-95.9</td>
<td>-149.1</td>
<td>-81.1</td>
<td>-133.0</td>
</tr>
</tbody>
</table>

**Memorandum items:**

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

ODA (billions of United States dollars)

ODA (percentage of DAC donor-country GNI)

Years: 1960-2010

ODA in billions of United States dollars in 2009 prices:
- 1960: 100
- 1965: 90
- 1970: 80
- 1975: 70
- 1980: 60
- 1985: 50
- 1990: 40
- 1995: 30
- 2000: 20
- 2005: 10
- 2010: 0

ODA as a percentage of DAC donor-country GNI:
- 1960: 0.7
- 1965: 0.6
- 1970: 0.5
- 1975: 0.4
- 1980: 0.3
- 1985: 0.2
- 1990: 0.1
- 1995: 0.0
- 2000: 0.0
- 2005: 0.0
- 2010: 0.0
### Table III.2
Net financial flows\(^a\) to developing countries and economies in transition, 1997-2011

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<tr>
<th></th>
<th>Average annual flow</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010(^b)</th>
<th>2011(^c)</th>
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<td>1997-2000</td>
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Modern Experience of Net Transfers of Resources

- $Billions

- Developing economies
- Africa
- Eastern and Southern Asia
- Latin America
Net financial transfers to economies in transition and developing countries, 1998-2010

Billions of dollars

- Economies in transition
- Developing countries

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

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**Memorandum items:**

| Heavily indebted poor countries (HIPC)<sup>b</sup> | 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<sup>b</sup>            | 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.

<sup>a</sup> Partly estimated.
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**Sources:** Department of Economic and Social Affairs of the Secretariat, based on the *World Economic Outlook April 2010: Rebalancing Growth* (Washington, D.C., International Monetary Fund, 2010) and IMF balance of payments statistics.

* Partially estimated.
### Official development assistance in 2009 and 2010 in relation to commitments and targets

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### Table III.1
Net transfer of financial resources to developing economies and economies in transition, 1998-2010

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<td>-149.1</td>
<td>-81.1</td>
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</tbody>
</table>

**Memorandum items:**

| Heavily indebted poor        | 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  |
| countries (HIPCsb)           |      |      |      |      |      |      |      |      |      |      |      |      |       |
| Least developed countriesb   | 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.
Figure III.1b
Net financial transfers, by income categories, 2000-2010

Billions of dollars

- Low-income countries
- Lower middle income countries
- Upper middle income countries

Average 2000-2008
2009
2010
Nonetheless Policy Application has accepted the 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, 0.7 per cent ODA

- Growth Rate Target Achieved
- Official Aid Target Not Achieved
Modern revisionists

• Real Growth Theory
  – 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.”

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

Limits to External Finance: Domar’s 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.
Financial Instability and External Finance

• The Domar condition 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 as a Developing Country
• France as a Developing Country
• Financial Institutions
  • 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 development
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
  - Increasing employment presents the greatest unexploited potential for mobilising domestic resources

- Employment increases Income and thus Savings
  - Nurkse: “All Capital is Made at Home”
  - Built by Disguised Unemployed Labour
  - Requires policy to ensure income is saved and used to increase capital
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 it 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
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
  - Control of Exchange rate
  - Requires control of capital inflows