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# **Financial Factors in Economic Growth**

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There can be little disagreement on the proximate determinants of the pace of economic growth in a country. The simple arithmetic of growth equates it to the product of the incremental output-capital ratio and the rate of investment. However, that identity captures in rudimentary form the divide that characterises development economics. On one side of the divide are those who emphasise the role of the investment rate in raising the rate of growth, a tradition that goes back to the classical economists. This was the approach adopted by the immediate post-World War II consensus on measures to be adopted to ensure the development of the developing countries. On the other are those inspired by the neoclassical economic tradition, who focus on raising the incremental income yielded by a unit of investment. This improvement in the “efficiency” of investment was to be garnered by allowing market signals to determine the volume of savings (that are in pre-Keynesian fashion seen to ‘determine’ investment), the allocation of those savings across sectors and the technical form in which such investment is embodied in each sector.

Even though the “new” neo-classical economics has emphasised the importance of incomplete markets, information asymmetries and the like in real world economies, development economists from the neoclassical tradition have tended to adopt a micro-theoretic approach that presumes that it is possible to approximate an ideal market in real economies. Based on that presumption, they have advanced the argument that the allegedly interrelated phenomena of “inward orientation”, “price-distortion”, and “inefficiency” had eroded the surplus available for investment and limited growth in economies pursuing interventionist growth strategies that used protection to create domestic policy space. Much has been written on the errors inherent in this critique. “Outward orientation” as manifested for example in successful export-performance has been accompanied by highly State-interventionist neo-mercantilist policies rather than any attempt to “get prices right” in the conventional sense. The alleged “inefficiency” of dirigiste industrialization is established through statistical exercises involving dubious concepts such as “total factor productivity” (which is predicated upon the perennial absence of any demand constraint). And there is complete silence on the role of the domestic investment effort in explaining growth performance, notwithstanding the overwhelming evidence which exists on its importance. The neglect of these and other theoretical and empirical arguments helps justify the preference for achieving allocational efficiency as opposed to realising increases in the investment rate in the policy prescriptions of those ostensibly influenced by neoclassical theory.

This paper does not go into that debate but is premised on the empirically verifiable view that higher growth has typically been associated with higher rates of investment. As The Growth Report prepared by the Commission on Growth and Development (Commission on Growth and Development, 2008: 34) has put it in its analysis of the experience of high growth economies: “Strong, enduring growth requires high rates of investment. By investing resources, rather than consuming them, economies make a trade-off between present and future standards of living. That trade-off is quite steep. If the sustained, high-growth cases are any guide, it appears that overall investment rates of 25 percent of GDP or above are needed, counting both public and private expenditures. They often invested at least another 7–8 percent of GDP in education, training, and health (also counting public and private spending), although this is not treated as investment in the national accounts.”

## **Investment, Exports and Growth**

High investment rates seem to matter even in countries which have grown largely on the basis of exports. This comes through from cross-country correlations of investment

ratios, output growth rates and export growth rates. An analysis (Patnaik & Chandrasekhar, 1996) based on twenty years (1968-88) data for 25 developing countries showed a close correlation between output growth and the investment rate (or the ratio of investment to income). Similarly there was an extremely close relationship between output growth and export growth. If it is investment which drives output growth then the high correlation between output growth and export growth must make itself visible in terms of a high correlation between the investment ratio and export growth, which it does. The results of a similar analysis for a more recent period (1996-2005) for a larger group of 48 similarly placed developing countries is provided in Table 1. That analysis too corroborates the existence of the same kind of relationships between investment, output and exports.

<b>Table 1: Relationships for 48 countries, 1996-2005</b>			
	<b>Coefficient</b>	<b>Intercept</b>	<b>R-squared</b>
GDP growth vs average I/Y	0.18	0.36	0.22
Goods export growth vs average I/Y	0.34	2.69	0.08
GDP growth vs goods export growth	0.17	2.60	0.31

Source: Calculations based on data from World Bank, *World Development Indicators Online*.

There are good theoretical reasons why a high investment ratio *ceteris paribus* should give rise to a strong export growth performance. International trade in the different commodities grows, over any period, at different rates. Given these growth rates in world trade, the rate at which a particular underdeveloped country's exports grow would depend to a very significant extent upon its production-structure and the rate at which that structure is changing. In particular since the underdeveloped countries were, by and large, saddled with production-structures specializing in commodities with relatively stagnant world trade, success on the export front depends crucially upon the ability to transform the production-structure rapidly in the direction of commodities where world trade grows faster. And the rapidity of this transformation is linked to the investment ratio: the higher the investment ratio, the faster the transformation of the production-structure and hence the greater the ability to participate in the faster-growing end of the world trade, i.e. the greater the rate of export growth.

## Public and Private Investment

It was not only the rate of investment that mattered, but its source appears to be of some relevance. A controversy that has dogged development economics is the relative importance of public and private investment in ensuring development and the degree to which these two types of investment are complementary rather than competitive. The marketist position, besides favouring private over public investment, has always held that public investment tends to crowd out private investment by either absorbing a part of a "given" volume of financial savings or by increasing the cost of capital or the rate on interest by competing for a share of a "given" volume of savings. Besides the fact that the notion of a given volume of savings is theoretically indefensible when unutilised resources exist, since investment can increase output and therefore the volume of savings generated by the system, this argument ignores a number of roles that public investment plays in developing economies.

To start with public investment in developing countries is crucial to ensure investments in infrastructural areas characterised by lumpy investments, long gestation lags and relatively lower profits, all of which make the private sector unwilling to enter these areas. However, unless these infrastructural gaps are closed, the process of growth can run up against a range of infrastructural constraints such as inadequate roads, shipping

capacities and air transportation, power shortages, poor communication and so on. Secondly, besides infrastructure there are a number of basic industries required for industrialisation which have characteristics similar to infrastructure even though they are tradables, which make them unattractive to private investors. Examples include steel, machine tools and basic chemicals. Unless the government invests and enters the production of these areas, the process of industrialisation may be limited because of limited possibilities of transformation through trade and therefore the inadequacy of foreign exchange to import these commodities. Thirdly, in developing economies with a limited home market, the private sector may lack the inducement to invest unless the state expands its expenditure through public capital formation which directly increases the demand for private sector products (because of the purchases made by the state) or generates indirect demands because of the employment created by public expenditure and the multiplier effects of such expenditure. For these and other reasons public investment can be seen as “crowding-in” rather than “crowding-out” private expenditure. [See for example (Aschauer, 1989) and (Erenburg, 1993)]

## **Lessons from the Indian Experience**

One country which illustrates the positive role that public investment can play is India, though the picture is much clearer in a country like China where public capital formation was and still remains extremely high. The economic policy regime erected in India in the 1950's emphasised the role of public investment, while creating domestic policy space through protection and other forms of intervention. The roots of this regime lay in the freedom struggle. The economy had been dominated by metropolitan capital and metropolitan commodities in the pre-independence period. Freedom meant freedom from this domination; and this could not be ensured without giving the State in independent India a major role in building up infrastructure, expanding and strengthening the productive base of the economy, setting up new financial institutions and regulating and coordinating economic activity. This was necessary for building capitalism itself, though some no doubt entertained the fond hope that all this would add up to a transition to socialism. State capitalism and State intervention in other words were essential instruments for the development of a relatively autonomous Indian capitalism, displacing metropolitan capital from the pre-eminent position it had occupied in the colonial economy.

It needs to be noted that despite the disillusionment with the strategy in the years after the mid-1960s, it served India well during the first 15 years after the launch of planned development in 1951. In particular, it helped India achieve a rate of industrial growth of over 7 per cent per annum compound, which was not only dramatic relative to the pre-Independence record, but creditable when compared with other developed and developing countries. It was the inability of the government to adopt the supportive policies needed to ensure that this process of growth will not run up against an “inflationary barrier” and/or a balance of payments constraint that explains its ostensible “failure” after the mid-1960s.

Three mutually reinforcing and interrelated contradictions need to be noted in this regard. First, the State within the old economic policy regime had to simultaneously fulfil two different roles which were incompatible in the long-run. On the one hand it had to maintain growing expenditures, in particular investment expenditure, in order to keep the domestic market expanding. The absence of any radical land redistribution had meant that the domestic market, especially for industrial goods, had remained socially narrowly-based; it had also meant that the growth of agricultural output, though far greater than in the colonial period, remained well below potential, and even such growth

as occurred was largely confined, taking the country as a whole, to a narrow stratum of landlords-turned-capitalists and sections of rich peasants who had improved their economic status. Under these circumstances, a continuous growth in State spending was essential for the growth of the market; it was the key element in whatever overall dynamics the system displayed. At the same time however the State exchequer was the medium through which large-scale transfers were made to the capitalist and proto-capitalist groups; the State in other words was an instrument for the "primary accumulation of capital". The State exchequer remained the pre-eminent mechanism for "primary accumulation"; through the non-payment of taxes (to which the State generally turned a blind eye), through a variety of subsidies and transfers, and through lucrative State-contracts, private fortunes got built up at the expense of the State exchequer.

The contradiction between these two different roles of the State manifested itself, despite increasing resort to indirect taxation and administered price-hikes, through a growth in the government's revenue deficit. A result of it of course was that the fiscal deficit also went up; this however reflected not a step-up in public investment but a decline in public savings. In the 1950s and the 1960s the revenue account of the Central Government at least was in surplus, but in the 1970s even this went into a deficit, and climbed steadily till the early 1990s. The implications of this growing fiscal crisis were obvious: the government had either to cut back the tempo of its investment or to maintain this tempo through increased recourse to borrowing. If the borrowing is from abroad, then dependence on external debt increases and the pressure for a change in the policy regime builds. If the borrowing is domestic then private wealth-holders may be willing to hold claims upon the State only after they have increased their holdings of other assets, such as urban property or consumer durables or commodity stocks, in which case, *ceteris paribus*, the inflationary impact of a given tempo of public investment keeps increasing. And, since rampant inflation cannot be allowed in a system of parliamentary democracy with virtually non-existent indexation for the vast bulk of the workers, the State would sooner or later have to cut back its expenditure, especially investment expenditure, which would slow down the economy and eventually arouse capitalists' demands for an alternative policy regime. Even if private wealth-holders are willing temporarily to hold government debt without there being any inflationary pressures immediately, this only accentuates the inflation-proneness of the economy in the long-run with identical results. In short, the regime gets progressively engulfed in a crisis.

The second contradiction lay in the inability of the State to impose a minimum measure of "discipline" among the capitalists, requiring them to build competitive capacities and export to global markets to earn the foreign exchange to replenish the national pool of foreign exchange that they tapped to finance the imports of capital goods and intermediates needed for their investments directed at the protected domestic market. This meant that the system face balance of payments difficulties not because it did not adopt an "export-led" strategy, but because it did not ensure that it earned the foreign exchange needed to finance the imports necessary for industrialisation. After all, the State is strongly interventionist even in a country like Japan, but it is interventionism based on close collaboration between the State and capital which simultaneously promotes rigorous discipline among the capitalists.

The third contradiction had its roots in the cultural ambience of an ex-colonial society like India. The market for industrial goods was from its very inception, as we have seen, a socially narrowly-based one. Capitalism in its metropolitan centres however is characterized by continuous product innovation, the phenomenon of newer and ever

newer goods being thrown on to the market, resulting in alterations of life-styles. In an ex-colonial economy like India, the comparatively narrow social segment to whose hands additional purchasing power accrues in large measure and whose growing consumption therefore provides the main source of the growth in demand for industrial consumer goods is also anxious to emulate the life-styles prevailing in the metropolitan centres. It is not satisfied with having more and more of the same goods which are domestically-produced, nor is it content merely with expending its additional purchasing power upon such new goods as the domestic economy, on its own, is capable of innovating. Its demand is for the new goods which are being produced and consumed in the metropolitan centres, and which, given the constraints upon the innovative capacity of the domestic economy, are incapable of being locally-produced purely on the basis of indigenous resources and indigenous technology. An imbalance therefore inevitably arises in such economies between what the economy is capable of locally producing purely on its own steam, and what the relatively affluent sections of society who account for much of the growth of potential demand for consumer goods would like to consume. This imbalance builds pressure for the domestic production of the desired goods based on imports of technology, capital equipment and intermediates or for the import of the final product itself. To the extent that the state succumbs to such pressures, the imbalance between the capacity to produce and the desire to consume contributes to a worsening of the balance of payments.

One consequence of the inflationary and balance of payments crises that result from these contradictions is that the State is forced to cut back on its expenditures, especially its capital and social expenditures, in order to reduce absorption, dampen inflation and limit the current account deficit. The net result is a slowing of growth as happened in India after the crisis in the mid-1960s.

## **Financing Investment and Development**

Given the importance of investment in ensuring higher growth, development theory had traditionally been concerned with identifying the factors that enable the “financing” of higher growth by raising the rate of investment. However, the issue was not seen as merely that of mobilising financial surpluses to expend on investment. Conventionally, the issue of financing for development has been concerned with the question of mobilising real resources, in the sense of restricting consumption and setting aside an adequate share of national output to finance investment.

One conclusion that was often arrived at by those who saw the problem purely in monetary terms was that since poor countries with low per capita incomes were already characterised by low levels of per capita consumption, they were not in a position to raise the rate of savings significantly by squeezing consumption. This was seen as trapping them in a vicious circle of poverty, since low per capita income meant low saving, which kept investment and growth low and therefore income and saving low. Escaping from this vicious circle, it was argued, required injection of surpluses from outside in the form of foreign aid and/or foreign investment. As was pointed out quite early in the debate, this view underestimated the ability of poor countries with substantial inequality to limit the “unnecessary”, luxury consumption of the rich and generate surpluses for investment. It also tended to ignore the fact that for various reasons foreign savings rather than add to domestic savings proved to be a substitute for domestic savings in practice, contributing little to increasing investment.

Moreover it was argued that shifting the focus to mobilising real resources seemed to offer various innovative alternatives for financing development. To start with, since



many poor developing countries were characterised by the availability of unemployed or underemployed surplus labour, if this surplus labour population could be mobilised and put to work on building capital stock, surplus labour was a potential surplus available for investment. This was a point emphasised by Nurkse (Nurkse, 1966) (Kalecki, 1972) and others.

While the validity of this argument was unquestioned, it was recognised that realising this potential required ensuring that agricultural output does not fall when surplus labour is drawn from the agricultural sector where it normally resides and that when there are less mouths to feed in the rural areas the surplus food available there does not result in higher consumption of the remaining peasantry but is available for feeding workers now being put to work in building capital stock. That is the potential surplus residing in a surplus workforce can be successfully mobilised only if it is supported with the mobilisation of surplus wage goods needed to feed these workers. *In sum, it was not only the volume of surplus that mattered but the physical forms in which this surplus was available.*

This would be all the more true if we take account of the fact that there are limits to building capital with the “bare hands” of surplus labourers, who need to work with some capital equipment. So a part of the surplus mobilised to undertake new investment must be in the form of capital goods, a fact take account of in the Feldman/Mahalanobis model, which emphasised the need to allocate a higher share of the surplus to the production of investment goods, especially early stage or investment goods or the “machines to produce machines”. The higher is that allocation the higher would be the rate of growth of the system.

## **Overcoming the Wage-Goods Constraint**

The argument that, given limits on the possibilities of transformation through trade, the institutionally-determined maximal rate of growth of production of agricultural necessities sets a ceiling on the non-inflationary rate of growth of the system was explicated, among others, by Michal Kalecki (1972). This was one of the ways in which the availability of surplus real resources was seen to constrain the pace of development in predominantly agrarian economies.

In this seminal work, Kalecki demonstrated how the exogenously given rate of growth of agriculture, the principal supplier of commodities that enter the wage basket, determined the maximum rate of non-inflationary growth a country could achieve. Within the assumptions of the model, any attempt to raise the rate of growth beyond that level only results in inflation in the prices of essentials, which violates the objective of non-inflationary growth. The rate of growth of agriculture itself was exogenously given because Kalecki saw that rate as being institutionally determined. One implication was that countries that relaxed the institutional constraint by implementing land reforms would record higher rates of agricultural and overall growth. This they achieved because land reform (i) increased agricultural supplies by undermining land monopoly and semi-feudal relations that left the actual tiller with little means and little incentive to invest and thereby increasing land-augmenting investments; (ii) expanded the mass market for manufactures by raising incomes in a more egalitarian rural setting; and (iii) unleashed the energies of the peasantry.

The evidence from countries such as South Korea and Taiwan do support the argument that land reforms, even when implemented under US occupation, provided the backdrop for episodes of high growth. As Cristobal Kay notes (Kay, 2002: 1081): “The state

played a key role in the development process of South Korea. The state was strong and had a high degree of autonomy from the domestic classes in deciding what specific forms of capital accumulation to promote. Through the land reform a relatively egalitarian farming system was created but at the same time the state greatly increased its control over the countryside. About half of the total farmland was transferred to the beneficiaries and two-thirds of all farm households received land under the land reform. Practically no landless peasants or agricultural proletariat exists and socioeconomic differentiation is limited. However, the state subordinated the rural sector to the overriding goal of industrialisation. Thus rural-urban disparities widened as the fruits of the country's spectacular economic growth were only shared to a limited extent with the peasantry. It is thus not surprising to find that the peasantry voted with their feet by emigrating en masse to the urban sector, providing the necessary cheap labour for rapidly growing labour-intensive industries. It could be argued that South Korea's phenomenal economic success was achieved on the back of the peasantry."

In Taiwan too: "The extraction of various surpluses from agriculture undoubtedly made a major contribution to the initial stage of industrial development. The provision of cheap rice kept industrial wages low, boosted industrial profits and enhanced industrial exports. Taxes on agriculture provided the state with domestic financial resources that could be used for investment in industry. The export of sugar and rice, which were acquired through the monopolistic state procurement system of these agricultural commodities, on the one hand, allowed the terms of trade to be turned against the farmers and, on the other hand, generated valuable foreign exchange earnings which the state could channel towards the import of the necessary machinery, equipment and raw materials for industry. The manipulation of the terms of trade also ensured that agricultural labour was willing to work for a lower wage in the industrial sector than would have been the case otherwise, as the returns to agricultural labour were lower than they would have been without agriculture's unfavourable terms of trade." (Kay, 2002: 1082-83).

Thus, the experience of these countries illustrates the key role that land reforms and institutional change in agriculture plays even within the framework of capitalist growth. It needs to be noted that land reforms need not always be the prelude to the exploitation of a fragmented peasantry to generate surpluses for financing development. Rather, if the egalitarianism resulting from land reforms is combined with a fair terms of trade between industry and agriculture, it can help generate a large mass market for manufactures in the rural areas. This is what seems to have happened in the early stages of the Chinese economic reform in the 1980s. A similar trajectory was not pursued in Korea and Taiwan because the "developmentalist State" in these economies adopted a mercantilist industrial growth strategy based on export markets rather than a strategy primarily based on expanding the domestic market.

## **The Investment Goods Constraint**

As noted earlier, it is not enough to have a part of the surplus available for investment in the form of wage goods. Since commodities cannot be produced with bare hands, if the possibilities for transformation through trade are limited, it would be necessary to have the surplus partly in the form of investment goods.

The macroeconomic strategy formalised in the model developed independently by Feldman (Domar, 1972) and Mahalanobis (Mahalanobis, 1955) reflected this concern and was fundamentally influenced by a presumption that dominated much of development thinking of the time. This was that the binding constraint on growth in the

underdeveloped world was the inadequate access to capital stock to employ the available labour force in full. There were two grounds on which that presumption was normally justified. First, that the possibilities of transformation through trade were limited, which in turn limited the imports of capital goods to sustain late industrialisation. Second, that since countries like India had launched on an accelerated industrialisation strategy at a point in time when industrial technology had already evolved in the capital intensive direction for decades, the notion that capital could be constructed from scratch, "with bare hands", in a short period of time, was not warranted.

If in addition the capital stock available at any point in time is "non-shiftable", pre-empting the transfer of machines meant for producing consumption goods to the task of producing machines, then the capacity of the investment goods sector determines the level of investment that could be undertaken in any period. Since for any given average capital-output ratio in the economy, the addition to output depends on the level of investment, the rate of growth of the economy would be higher the greater is the rate of accretion of capital stock. This meant that the task of realising a higher rate of growth is best served by the allocation of a higher share of investment to the investment goods sector, and within it to concentrate on the production of "machines to produce machines" rather than "machines to produce consumption goods".

As noted earlier India's immediate post-Independence industrialisation success was related to its pursuit of a strategy of this type. However, the failure to meet a number of associated prerequisites meant that this success could not be sustained after the mid-1960s.

## **Does "Finance" Matter?**

If the development finance problem is thus essentially one of utilising the potential surplus embodied in unemployed and underemployed workers, while overcoming the wage goods constraint and dealing with the lack of adequate capital stock to employ the labour force in full, where does the question of finance in the sense of monetary resources and fiscal and financial policies come in? Does finance matter at all? "Finance" does matter because, in all modern economies, incomes in the form of wages, profits, rent and interest accrue to those who receive them in money form. These recipients also make decisions as to how much to spend and how much to save in terms of money.

If a growth trajectory has to be stable, the physical volume and the physical forms in which output is allocated between investment and consumption along that trajectory must correspond with the financial allocation made by savers and investors to consumption and savings/investment, and the actual allocation of savings to investment in different sectors. That is, decisions in the financial realm made by households, firms and the government must correspond to the physical pattern of investment and output that decisions of firms and the public sector imply. Otherwise the system would be characterised by excess demand for some commodities and excess supplies of others, with consequences for the level of growth.

One way in which the system can ensure a higher rate of investment in both physical and financial terms and a higher rate of non-inflationary growth is by having the government use a combination of direct taxes on the rich and indirect taxes on luxuries to restrict inessential consumption and mobilise the surplus for investment. The other is for the financial system to intermediate between savers and investors in ways which it

channelizes savings to those sectors to which investment has to be directed if the physical form in which a particular rate of investment has to be embodied is to be realised. It is in these two ways that the monetary form of the problem of financing investment presents itself.

The Mahalanobis strategy, which sought to implement a Feldman-type model in a mixed economy like India with an important role for private savings and investment decision, was premised on the ability of the state to impose the necessary taxes to align the financial sphere with the real parameters chosen by the planner to realise the investment-led growth strategy. The failure of the government to actually impose such taxes and influence savings and investment was an important factor behind the failure of that strategy.

Further, realizing a growth-oriented pattern of production of goods and services requires the state to guide the allocation of investment. Since independent and atomistic decision makers cannot have the economy-wide and “social” seeing power to undertake such coordination and targeting, the state must play a role in overcoming market failure resulting from inadequate coordination. One way to do this is to use the financial sector as an instrument for investment coordination and targeting. Even in developing countries that choose outward-oriented strategies or are forced to choose a more mercantilist strategy of growth based on rapid acquisition of larger shares in segments of the world market for manufactures, the relevant segments have to be identified by an agency other than individual firms. Experience indicates that the state has the capacity to assess and match global opportunities and economy-wide capabilities.

Hence, through its financial policies, the state must ensure an adequate flow of credit at favourable interest rates to these entities so that they can not only make investments in frontline technologies and internationally competitive scales of production, but also have the means to sustain themselves during the long period when they expand market share. The state must not merely play the role of investment coordinator; it needs to use the financial system to direct investment to sectors and technologies at appropriate scales of production. Equity investments and directed credit are important instruments in such a state-led or state-influenced development trajectory.

Neither of the financial prerequisites for development noted above conflicts with the notion popularised by the Keynesian Revolution that the lack of adequate financial savings cannot be the constraint on investment and growth. In that framework the role of the financial sector in mobilizing and channelling savings was secondary and inevitably fulfilled. As Joan Robinson (Robinson, 1952) once put it: “By and large ... where enterprise leads, finance follows.” The financial sector is merely seen as adjusting to the requirements of the real sector.

However, if the financial sector is left unregulated, in economies with substantial private assets and an important role for private agents in investment decision-making, market signals would determine the allocation of financial resources. This could mean that the demand for financial resources from crucial sectors would not be matched by supply because uneven development and inequality may imply that inadequate collateral is on offer, transaction costs are high and/or private returns in particular activities to financial entities are lower-than-expected even though the social returns from such activities are high.

Unregulated allocation of financial resources inevitably leads to the problems conventionally associated with a situation where private rather than social returns determine the allocation of savings and investment. To start with, the allocation of investment may not be in keeping with that required to ensure the profile of production needed to raise the rate of saving and investment. Further, certain sectors such as the rural sector in general or agriculture in particular and the small industrial sector may be largely excluded from formal sector credit provision on the grounds that the transaction costs associated with such lending are high or that default risk is greater. But the problem could go deeper. Unregulated financial entities could direct their investment financed with the savings of depositors to “sensitive” or risky sectors such as real estate and stock markets. Loans to these sectors can be at extremely high interest rates because the returns in these sectors can touch very high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. These activities thrive because of the belief that losses if any can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

These kinds of tendencies affect real investment in two ways. First, inasmuch as speculative bubbles lead to financial crises, they squeeze liquidity, result in distress sales of assets and deflation that adversely impact on employment and living standards. Second, inasmuch as the maximum returns to productive investment in agriculture and manufacturing are limited, there is a limit to what borrowers would be willing to pay to finance such investment. Thus, despite the fact that social returns to agricultural and manufacturing investment are higher than that for stocks and real estate, and despite the contribution that such investment can make to growth and poverty alleviation, credit at the required rate may not be available.

While factors such as these could limit the rate of growth, the private-profit driven allocation of savings and investment could also affect variables such as the balance of payments, the employment elasticity of output growth, and the flow of credit to poverty-prone sectors. It could aggravate the inherent tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, to concentrate investible funds in the hands of a few large players and direct savings to already well-developed centres of economic activity.

These features have important implication for financial policies. They imply that if the government wants to influence the sectors and agents to whom credit is directed and the prices at which such credit is to be provided, in order to realise a particular allocation of investment, a given rate of investment, and an income-wise and region-wise redistribution of incomes, it must impose restrictions on the financial sector to realise these goals. In fact, if certain sectors can survive and prosper only if credit is offered at lower than “market” interest rates even if the transaction costs associated with credit provision is higher, then cross-subsidisation may be required and profits from lending may be lower than otherwise. The subordination of the profit principle that this implies, may require state ownership of crucial financial intermediaries.

Further, even in developing countries which choose or are forced to choose a more mercantilist strategy of growth based on a rapid acquisition of larger shares in segments of the world market for manufactures, these segments have not only to be identified by an agency with greater seeing power than individual firms, but that agency must ensure an adequate flow of cheap credit to these entities so that they can not only make

investments in frontline technologies and internationally competitive scales of production, but also have the wherewithal to sustain themselves during the long period when they build goodwill in the market, which is a function of time. The state must not merely play the role of investment coordinator, but use the financial system as a means to direct investment to sectors and technologies at scales of production it considers appropriate. Equity investments, directed credit and differential interest rates are important instruments of any state-led or state-influenced development trajectory as the experience of countries like South Korea, Brazil and India illustrate.

## **A Role for Development Banks**

As noted elsewhere (United Nations, 2005), left to themselves, private financial markets in developing countries usually fail to provide enough long-term finance to undertake the investments necessary for economic and social development. As a result, firms in developing countries often hold a smaller portion of their total debt in long-term instruments than firms in developed countries. Private institutions may fail to provide such finance because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances, failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned (Stiglitz, 1994).

This creates a shortfall in funds for long-term investments. One way to deal with this problem is to encourage the growth of equity markets. This is attractive because, unlike in the case of debt, risk is shared between the financial investor and the entrepreneur. This enhances the viability of the firm in periods of recession. However, the evidence shows that even in developed countries equity markets play a relatively small role in mobilizing capital for new investments.

To cover the shortfall in funds required for long-term investment, developing countries need to and have created *development banks* with the mandate to provide long-term credit at terms that render such investment sustainable. According to an OECD estimate quoted by Eshag (Eshag, 1983), there were about 340 such banks in some 80 developing countries in the mid-1960s. Over half of these banks were state-owned and funded by the exchequer; the remainder had mixed ownership or were private.

Handicapped by colonial legacies, international inequalities and various systemic biases, these kinds of institutions are a ‘must’ for developing countries. Any national strategy of modernisation in a mixed-economy framework must provide for the establishment of institutions of this kind. However, it is best to create separate development banks to provide long-term capital at near-commercial rates and “policy banks” to provide credit to special areas such as agriculture or the small scale sector where interest rates have to be subsidized and grace periods have to be longer. This allows different criteria to be applied to the evaluation of the performance of these banks, with profitability a more important consideration in the case of the former.

What is more the financial sector in backward countries may have to undertake entrepreneurial functions such as determining the scale of investment, the choice of technology and the markets to be targeted by industry, and extension functions such as offering technical support to the farming community. Stated otherwise, although financial policies may not help directly increase the rate of savings and ensure that the available ex ante savings are invested, they can be used to influence the financial

structure in a manner that ensures that lending leads to productive investment that makes such lending sustainable.

Growth requires not just an adequate volume of credit but an appropriate distribution of such credit. For example, certain sectors – infrastructure being the most obvious – are characterised by significant “economy-wide externalities”. That is, their presence is a prerequisite for and a facilitator of growth in other sectors. But the infrastructure sector is usually characterised by lumpy investments, long gestation lags, higher risk and lower profit. Banks would be wary of lending to such projects, given the maturity and liquidity mismatch involved. Such reticence would be greater in economies with a predominantly private banking system. If private – rather than social – returns drive the allocation of financial savings, these sectors would receive inadequate capital, even though their capital-intensive nature demands that a disproportionate share be diverted to them. Given the “economy-wide externalities” associated with such sectors, inadequate investments in infrastructure obviously constrain the rate of growth. Hence, specialised policy development banks are needed, with sources of finance other than deposits by small savers. While such institutions can be funded by the government or the central bank, government guarantees on borrowing by these entities is needed if adequate capital is to be mobilized.

To provide an example, in Vietnam, the government has continued with targeted lending for specific purposes even after the adoption of financial liberalization policies. This involved the creation of a special Development Assistance Fund (DAF), separate from the commercial banking system, which had as its objectives: (i) the provision of subsidized state loans for medium to long-term investments in priority sectors such as infrastructure, heavy industry and public services, (ii) provision of interest-rate support and investment guarantees for chosen projects, and (iii) provision of short-term export promotion credit. Support in these forms can go to both private and state-owned enterprises, taking account of both commercial and policy criteria, such as encouraging investment in underdeveloped areas, preferential sectors, and projects related to health, education, culture and sport. The DAF has branches in all sixty-one provinces. Initially, the Office of the Prime Minister determined allocation of funds. Funds came from the Social Insurance Fund, the Sinking Fund, the Vietnam Postal Service Savings Company (VPSC), the government budget, loan repayments, and official development assistance (ODA). Subsequently, the DAF has been expected to mobilize its own resources. It continues to draw funds from the sources mentioned above, through negotiation. If funds come from the government budget, this usually involves issuance of investment bonds.

Overall, in developing countries adopting a mixed economy framework where private initiative and investment are significant, the financial sector would have to play a major role in: (i) channelling large volumes of cheap capital to purposefully chosen units and agents; (ii) using the leverage provided by this activity to coordinate and influence investment decisions and ensure that production occurs as per guidelines provided; (iii) ensuring that financial flows are inclusive and reach sectors and sections that would otherwise be bypassed or neglected; and (iv) regulating the sector so as to guard against financial fragility and failure.

To play these roles the state would have to choose an appropriate institutional framework and an appropriate regulatory structure. That is the financial structure—the mix of contracts/instruments, markets and institutions—is developed keeping in mind its instrumentality from the point of view of the development policies of the state. The

point to note is that this kind of use of a modified version of a historically developed financial structure or of a structure created virtually anew was typical of most late industrializing countries. Financial structures in these countries were created to deal with the difficulties associated with late industrial entry: capital requirements for entry in most areas were high, because technology for factory production had evolved in a capital-intensive direction from its primitive industrial revolution level; competition from established producers meant that firms had to concentrate on production for a protected domestic market or be supported with finance to survive long periods of low capacity utilisation during which they could find themselves a foothold in world markets. Not surprisingly, late industrialisers created strongly regulated and even predominantly state-controlled financial markets aimed at mobilising savings and using the intermediary function to influence the size and structure of investment. This they did through directed credit policies and differential interest rates, and the provision of investment support to the nascent industrial class in the form of equity, credit, and low interest rates. Developing countries attempting to catch-up with their developed counterparts have and must do the same.



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