FINANCE, INVESTMENT AND ECONOMIC DEVELOPMENT

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Introduction

This paper examines the inter-relationship between finance and investment with the view to formulating an appropriate policy-mix for the promotion of economic development in developing countries such as those of CARICOM. The theoretical framework we employ is in sharp disagreement with the McKinnon-Shaw thesis which attributes the ills of LDCs to "financial repression" and prescribes the comprehensive deregulation of financial markets as a precondition, indeed the requirement, of economic growth. Since the McKinnon-Shaw thesis has underpinned the structural adjustment programmes imposed by the IMF, World Bank and IDB on several LDCs, including some Caricom States, it cannot be left unchallenged. We agree with the judgement of Nobel Laureate J.E. Stiglitz that:

> ...much of the rationale for liberalising financial markets is based neither on a sound economic understanding of how these markets work nor on the potential scope for government intervention. Often, too, it lacks an understanding of the historical events and political forces that have led governments to assume their present role. Instead, it is based on an ideological commitment to an idealised conception of markets that is grounded neither in fact nor in economic theory.[1]

Our first task is to lay bare the dynamics of investment, savings in the context of economic growth. Secondly, we critique the McKinnon-Shaw thesis. Third, we develop a policy framework based on the dynamics of investment, savings and finance in developing countries. Finally, we identify ten minimal elements of an investment-friendly financial environment.

Investment, Savings and Economic Growth

If there is one thing known about economic development it is that investment must increase relative to consumption as a proportion of the national income. Investment, in the words of John Maynard Keynes, is the engine of growth. Investment is made possible through savings. According to Sir Arthur Lewis, no industrial revolution can be understood "until it can be explained why savings increased relative to the national income."[2] Economic development, then, is about accelerating the rate of savings and investment, i.e. of capital formation.

The equality of savings and investment is a fundamental proposition of Keynes' General Theory[3]; indeed, he had great difficulty explaining this equality. The Swedish School came to his assistance with the ex ante and ex post analytical device: whereas savings and investment may diverge ex ante (since savers were not necessarily the same as investors), equality between the two variables would be restored ex post. This is because if part of an ex ante savings remained un-invested, there would be a corresponding decrease in income, leading in turn to reduced savings, and restoration of equality between savings and investment ex post. Similarly, should investment exceed savings ex ante, the resulting increase in income would raise savings proportionately, thus restoring the equilibrium between savings and investment ex post.

Keynes is effectively saying that not only are savings and investment equal, but are really two aspects of the same phenomenon. It is therefore as true to say

that investment is a function of savings as that savings is a function of investment. The two phenomena cannot be divorced for each other. Our Study simultaneously seeks to discover the appropriate climate for both savings and investment.

It was Sir Arthur Lewis who contrasted the savings/investment problems of developing economies and advanced capitalist economies, the latter of which were the concern of Keynes. The operative constraint on economic growth in advanced economies is the availability of labour. Because of the residue of productive capacity accumulated during successive waves of investment over several decades and even centuries, and since they are capital goods producers, advanced economies enjoy unlimited supplies of capital. The economies of the 1930s, with which Keynes was concerned, were operating at extremely low levels of capacity; the problem was therefore one of stimulating effective demand so as to put both capital and labour back to work, and it could confidently be articulated that full employment of labour would be achieved before maximum capital capacity was utilised and inflation enter the picture.

The Lewis prescription is beautifully simple in conception. Observing considerable disguised unemployment in the traditional sector (that the marginal product of labour was zero or less), he suggested that capital imports might be combined with the superfluous labour of the traditional sector, thus enlarging the modern capitalist sector and expanding aggregate income. Lewis, the economic

historian, also noted that even rich urbanising societies, like Australia and Canada, had traditionally imported massive amounts of capital to meet the requirements of social capital investment.[4]

Direct foreign investment was for Lewis the preferred type of capital import, since the foreign investor brought with him not merely liquid capital but technology, management and, above all, access to markets. Direct foreign investment is certainly superior to foreign loan capital in that business failures do not become liabilities of nationals or of the national government. Europeans lost vast sums in failed American investment, but these did not enter the US national debt accounts.

Lewis also anticipated that local entrepreneurs would learn the "tricks of the trade", and would in time develop the capacity to establish enterprises which would progressively reduce the initial dependence on foreign capital. In short, they would learn the art of investment even as they absorbed the capitalist ethic of savings. Lewis is reported to have said that it was in South Korea that he witnessed the full realisation of his theory. There, indigenous enterprises, established with the assistance of foreign capital, now challenge the multinationals on almost equal terms.

Finance and Development

It is to be noted that both Keynes and Lewis focussed on real savings and real investment rather than financial savings or nominal investment. Keynes specifically rejected the classical proposition that savings and investment were brought into equilibrium through the interest rate mechanism: investment, he contended, depended largely on the "animal spirits" and expectations of investors, while the readiness of savers to lend depended on their liquidity preference. Savings and investment were equilibrated, he showed, through changes in aggregate income. Keynes therefore favoured a low interest rate regime that promoted investment. Similarly, finance is excluded from Lewis' basic two-sector model. Even Milton Friedman, the arch monetarist, agrees with Keynes and Lewis:

> ...what happens to output depends on real factors: the enterprise, ingenuity and industry of the people; the extent of thrift; the structure of industry and government; the relations among nations; and so on.[5]

Financial considerations are introduced into the investment/growth argument as the ambitions of investors exceed the capacity of their own equity and retained earnings, and they are forced to borrow from other economic units and households with surplus earnings. The investment decision, then, as Professor Hyman Minsky aptly puts it, is "a decision both to acquire tangible assets and to emit financial liabilities."[6]

As an economy develops, the gestation period of investment projects tends to lengthen and the payback period to become more extended. Surplus lending units must therefore be persuaded to hold the liabilities of deficit spending units over longer and longer maturities. More and more, then, intermediation between savers and investors is accomplished through institutions comprising the financial markets.

Just as successive waves of real investment leave a residue of capital in the form of productive capacity, Professor J.G. Gurley and E.S. Shaw[7] have shown that corresponding waves of financing decisions similarly leave a residue of debt, which makes an imposition on the financial capacity of the economy to sustain the liquidity of that debt. This means savers must be prepared to hold debt for very long periods of time – up to thirty years in the case of corporate bonds and indefinitely in the case of equity. Their incentive to do so is greatly increased if, in the event of some contingency, their financial assets can be readily liquidated without significant loss of value. To sustain the liquidity of debt of increasingly extended maturities, financial markets must be both wide and deep. We should note, however, that the development of financial markets is glacially slow.

Since a portion of the debt residue in a capital importing economy will be foreign, it goes without saying that enough of the national product must be exported to service this foreign debt and to reduce future dependence on foreign capital. An

export-oriented strategy is therefore the only game in town for LDCs like those of CARICOM.

Exchange Rate Regime

The exchange rate regulates the relationship between imports and exports, and takes on increasing importance as the ratio of foreign trade to national income rises. In particular, it determines the price of capital imports, the critical input into the production processes of LDCs, who would therefore wish it to be both inexpensive and stable in price.

Since the Keynesian model is a closed system, there was no serious discussion in the General Theory of an appropriate exchange rate regime. Keynes' concern was that commitment to exchange rate stability should not elevate real interest rates to levels inconsistent with full employment. He noted the wisdom of Mercantilists:

> ...their intense preoccupation with keeping down the rate of interest by means of usury laws ... by maintaining the domestic stock of money and by discouraging rises in the wage-unit; and in their readiness in the last resort to restore the stock of money by devaluation, if it had become plainly deficient through an unavoidable foreign drain, a rise in the wage-unit, or any other cause.[8]

Neoclassical economists welcomed the collapse of The Bretton Woods System in 1971 and the transition to a floating rate regime. They were confident that the "free market" would promote exchange rate stability and that, in any event, exchange rate risks could be effectively hedged in the forward markets. Indeed,

the current attempt to create a single European currency is testimony to neoclassical mis-calculation.

Exchange rate volatility is even more destabilising for LDCs. In Lewis' basic two-sector model, conceived in the early 1950s, money is neutral and fixed exchange rates are assumed. In his 1978 publication, The Evolution of the International Order, Lewis considers free floating exchange rates "a nuisance for countries with no organised forward markets".[9] (Indeed, it is also a nuisance for countries with sophisticated forward markets). Lewis is therefore wary about the use of the exchange rate by LDCs as a means of balance of payments adjustment over the trade cycle. "Besides", he noted, "devaluation is a dangerous medicine for an economy whose imports are large relative to national income." (As are all Caricom member states.) "Nowadays," he continues, "such an economy is likely to find itself on a treadmill, where devaluation raises money incomes and prices, so setting off further devaluation ad infinitum". However, he did indicate that devaluation might be necessary when the cost structure was in severe disequilibrium:

> When one says of our economy that its money costs are too high in relation to world prices for it to be able to provide full employment, this is the classic definition of an "overvalued currency.[10]

Blackman, in the First Adlith Brown Memorial Lecture (1985)[11], demonstrated that for economies in chronic balance of payments disequilibrium, i.e., where the demand for foreign exchange could not be satisfied in the foreseeable future, the equilibrium exchange rate is indeterminate and would not necessarily be

achieved through currency devaluations. In these circumstances, he argued, policy measures should be directed primarily towards a parametric shift to the right of the supply curve for foreign exchange (e.g. increased export earnings) and a parametric shift to the left in the demand curve for foreign exchange (e.g. external debt forgiveness). Various confidence-building measures might also impart greater elasticity in both the supply of and the demand for foreign exchange, promoting a movement towards equilibrium. But parametric shifts are, almost by definition, difficult and time-consuming. (See Charts 2.1 – 2.3). The experience of Guyana and Jamaica has confirmed this thesis.

Since the exchange rate is such an important price for the LDC, we cannot leave it to the vagaries of the market place, even though our options will be limited by the degree of turbulence in the international financial markets. However, we must do everything we can to maximise our options. Most obviously, we must try to maintain internal price stability. For LDCs, this means essentially that we should keep government deficits under control and restrain the excessive rise in money incomes. In the absence of a large war-chest of foreign exchange reserves for central bank market intervention, some rationing of existing reserves, and regulation of destabilising capital outflows and inflows, may also be necessary.

None of the above arguments rules out currency depreciation if real wage rates become hopelessly uncompetitive or the price of a major export commodity falls

precipitously (e.g. oil prices for Trinidad and Tobago in the 1980s). However, such devaluations should be swift and deep enough to be credible rather than piecemeal and drawn out. Repeated currency depreciations through the "free market" must be debilitating, requiring workers to surrender more and more of their product for a decreasing volume of imports. Experience has show both in CARICOM and elsewhere that saving and investment flourish best in an environment of relative price and exchange rate stability.

Critique of the McKinnon-Shaw Thesis

In his influential work of 1973, "Money and Capital in Economic Development"[12], McKinnon invented the term "financial repression". He describes his thesis as follows:

> When governments tax and otherwise distort their domestic capital markets, the economy is said to be financially "repressed". Usury restrictions on interest rates, heavy reserve requirements on bank deposits and compulsory credit allocations interact with ongoing price inflation to reduce the attractiveness of holding claims on the domestic banking system. In such a repressed financial system, real deposit rates of interest on monetary assets are often negative and are difficult to predict when inflation is high and unstable. Thus, the demand for money – broadly defined to include savings and term deposits as well as checking accounts and currency – falls as a proportion of GNP.
>
> But these monetary assets naturally dominate the financial portfolios of small savers in less developed countries. Thus, back in 1973, Edward Shaw and I hypothesized that repressing the monetary system fragments the domestic capital market with highly adverse consequences for the quality of real capital accumulation.[13]

McKinnon therefore prescribes the following:

> Remedying financial repression is implicit in its definition. We suggest keeping positive and more uniformly high real rates of interest within

> comparable categories of bank deposits and loans by eliminating undue reserve requirements, interest ceilings and mandated credit allocations on the one hand, while stabilising the price level through appropriate macroeconomic measures on the other. Then, savers and investors would better "see" the true scarcity price of capital and thus reduce the great dispersion in the profitability of investing in different sectors of the economy[14].

Acceptance of the McKinnon-Shaw paradigm has led several developing countries, including some within CARICOM, to institute financial reforms involving the removal of ceilings on interest rates, the deliberate promotion of a regime of positive and high real interest rates, the removal of exchange controls on capital movements and the floating of the national currency. The basic premise of financial liberalisation is that market determined outcomes would optimise the rate of savings, investment and economic growth in developing countries.

Epistemology

It is remarkable that a univariate theory of a phenomenon so complex as economic development should exert so pervasive an influence as the McKinnon-Shaw paradigm of "financial repression." Indeed, it collapses quite rapidly before epistemological assaults from Professor Stiglitz[15] and Dr. Mary Zephirin (Central Bank of Barbados)[16]. They point out that McKinnon's implications that the free market outcome is Pareto optimal, holds only under rigorous conditions of market "perfection". Indeed, the initial conditions that McKinnon seeks to change are a manifestation of severe market imperfection. It is therefore quite possible, Stiglitz and Zephirin contend, that government intervention could produce sub-optimal

outcomes more favourable than the McKinnon-Shaw "free-market" solution. Indeed, the issue is not whether Government intervenes into the market, but whether or not it intervenes intelligently. According to Gibson and Tsakaldos,

> ...The South Korean case illustrates that government credit allocation schemes need not lead to a decline in the quality of investment and can be important in promoting capital accumulation and growth in the early stages of development.[17]

When the first outcomes of "financial liberalisation" turned sour, McKinnon invoked the intervention of Government to enforce prudential regulation and to promote macroeconomic stability. McKinnon cannot have his cake and eat it too. He cannot insist upon the withdrawal of Government from the market and later invoke Government intervention in the instances of market failure.

Role of Interest Rates

McKinnon's most obsessive concern is with positive and high real interest rates. The logic of his argument is (1) that households do not save unless real interest rates are positive; (2) that higher saving leads automatically to increased investment; and (3) that increased investment leads to economic development.

The persistence of the first proposition is remarkable, since the relationship between the rate of interest and the volume of savings is clearly an empirical issue; and empirical studies of both developed and developing countries suggest that other factors, such as income, exert a greater influence on savings rate than high interest rates. Sometimes people increase savings when real interest rates

are positive; sometimes they increase savings when real interest rates are negative.

Secondly, if the rate of interest on business loans significantly exceeds the marginal revenue of the enterprise, investment will not take place except in hyper-inflationary conditions where product prices can confidently be expected to increase. And since the rate of interest is itself a cost of production, rising real interest rates act as a drag on production, especially in the case of small businesses which depend heavily on commercial bank loans.

Third, it is real savings, as we have seen, not financial savings, which promote growth. If there are no surpluses being generated in the real economy, there can be no real savings to invest no matter how high the real rate of interest. Moreover, as we demonstrate above, the causal relationship between savings and investment does not flow only from the former to the latter, but also from the latter to the former as well.

Financial Market Efficiency

It is also naïve of McKinnon to believe that the mere removal of interest rate ceilings and other forms of "financial repression" automatically results in competitive and effective markets. In this respect he is typical of neo-classical economists who neglect the institutional feature of markets -- a neglect which irritates Nobel laureates R.H. Coase and James Buchanan. Buchanan observes:

> A market is not competitive by assumption or by construction. A market becomes competitive, and competitive rules come to be established as institutions emerge to place limits on individual behaviour patterns. It is this becoming process, brought about by the continuance pressure of human behaviour in exchange, that is the central part of our discipline, if we have one, not the dry rot of postulated perfection. [18]

Coase is even more caustic in his condemnation of the divorce of theory from its subject matter:

> The consumer is not a human being, but a set of preferences ... Exchange takes place without any specifications of its institutional setting. We have consumers without humanity, firms without organisation, and even exchange without markets.[19]

McKinnon was on the right tract when he observed that the financial markets of developing countries were fragmented, that is, that they are imperfect. Indeed, if their markets were not imperfect, these countries would be developed. But financial markets do not become perfect because they are deregulated, but as governments and participants devise and discover rules and practices which make them function better. As they become more competitive, they will allocate resources with increasing efficiency.

Exchange Rates

Finally, in prescribing the complete deregulation of capital flows and the floating exchange rates, McKinnon shows insensitivity to the crucial importance of foreign exchange in the productive processes of LDC economies typified by openness. Since LDCs must import a preponderance of their capital and intermediate goods, only savings which are readily convertible into foreign exchange are usable for investment purposes. In the case of LDCs, therefore, savings are

almost the same thing as foreign exchange. This misunderstanding has also led financial liberalisers to greatly underestimate the current burden of external debt borne by LDCs.

McKinnon-Shaw Theory in Practice

As early as 1989 the World Bank commented that in the "far-reaching programme of financial reforms carried out by Argentina, Chile and Uruguay in the mid-1970s "each programme encountered serious problems, partly because of the way in which financial deregulation was handled and partly because of problems in the real sector."[20] In its study, The East-Asian Miracle, the World Bank also concedes that "financial sector interventions – specifically repression of interest rates and contest-based direction of credit – may have contributed to rapid growth in such economies as Japan, Korea, Taiwan and China."[21] McKinnon himself, the father of "financial liberalisation", now recognises that "our knowledge of how best to achieve financial liberalisation remains seriously imcomplete."[22] However, this has not moved him to re-examine the premises of his original theory, but to reconsider "the order in which the monetary system is stabilised in comparison to the pace of deregulation." He has also learned that "fiscal control should precede financial liberalisation," and that "free foreign exchange convertibility on capital account is usually the last stage in the optimal order of economic liberalisation." The IMF itself has also recently conceded that capital controls may be necessary in certain circumstances.[23] The McKinnon-

Shaw programme is now hedged around by so many caveats and contingencies that there is not very much left of the original theoretical structure.

An Investment Friendly Policy Mix

The above theoretical exercise and recent experience of financial liberalisation permits us to outline an investment friendly macroeconomic policy mix.

Market Orientation

Although rejecting McKinnon's laissez-faire doctrines, we admit to a bias towards the allocation of resources through the market. The market is a social device for the inexpensive allocation of resources and so reduces the burden on a society's information system and decision-making mechanism; but it is not infallible. Wherever, the market allocates resources in an acceptable manner, we will use it; but we reserve the right to intervene where the outcomes of "free market" allocation are unacceptable. This will frequently be the case in LDCs, especially in small countries, where markets are naturally monopolistic or oligopolistic. For example, the commercial banking system of any Caricom state will always be oligopolistic, and so would that of an integrated CARICOM. CARICOM authorities cannot leave the determination of interest rates to a "free market" comprising a few commercial banks that exercise overwhelming market power. Clearly, Central Banks must exercise countervailing power.

Financial Market Deepening

We accept the need for the deepening of financial markets as economic development proceeds. However, this process is slow and cannot be expected to create a decisive expansion of savings from indigenous sources in the short-run. For some time to come CARICOM must rely heavily on capital imports. In the meantime, measures must be put in place for the continuous improvement of financial markets. Not least of all will be the strengthening of prudential regulation of financial institutions.

Direct Foreign Investment

Direct foreign investment should be especially encouraged because of the by-products of technology, management and market access. Indeed, even advanced countries, like the UK, the USA and Canada, actively promote foreign direct investment. Local entrepreneurs may also obtain the benefits of foreign capital through joint-ventures, franchising, production under subcontracts and marketing alliances. Hopefully, in the process they will learn the "tricks of the trade".

Credit Allocation

Because of the imperfection of financial markets, the allocation of scarce credit among various sectors of the economy cannot be left solely to market forces. Government must through fiscal policy primarily, but also through selective credit arrangements as necessary, ensure that crucial industries are not starved of

scarce capital resources. In particular, small businesses must have access to soft loans, accompanied by technical support to the greatest extent possible. This practice is followed even in advanced economies so as to create a nursery of future entrepreneurs.

Interest Rate Regime

We should especially eschew the dogma of high and positive real interest rates. Interest rates should be high enough to deter capital flight, but not calculated to attract "hot" money that may be withdrawn on the slightest provocation. High real interest rates cannot stimulate real savings unless surpluses are generated in the real sector. At the same time high interest rates add to the cost of production, suppressing output and fuelling inflation. Monetary authorities must pragmatically balance the return to savers against the cost to investors. Most damaging of all, savings rates above a certain level render investment in the real sector irrational, and promotes a situation, as occurred in Jamaica not long ago when the financial sector boomed while the real sector stagnated.

Exchange Rate Regime

We must reconcile ourselves to the fact that only internationally traded currencies can realistically be floated on international currency markets; and even so we cannot be sanguine of the stability of even major currencies like sterling or the Euro. To be traded on international markets, currencies must either be backed by commodities, be perceived to be exchangeable for goods and services, or be

regarded as commodities in themselves, as is the US dollar. Caricom currencies are not held by foreigners as stores of value, and frequently not used as units of account by Caricom nationals; strictly speaking they are not floatable. For example; the Jamaican dollar does not "float" against the US dollar; in fact, the US dollar is a commodity bought and sold on the Jamaican financial market. We do not say that fish prices float against the Jamaican dollar in Kingston.

The best hope of achieving the stability of Caricom currencies is for their Central Banks to hold high levels of foreign exchange reserves for defending a given exchange rate or range of rates as do Singapore and Taiwan, which currently hold reserves of US$74 billion and US$113 billion, respectively. Their holdings are much greater than those of the UK, whose sterling more resembles a commodity. (Ironically, large reserves holdings are especially needed when strategic devaluations are required.) High foreign exchange holdings may also permit countries to sustain a limited float similar to that operated in Trinidad and Tobago.

Even though exchange controls should be progressively liberalised, they should be maintained on major capital outflows, or some form of rationing adopted. Excessive inflows should also be sterilised. Sudden shocks to the balance of payments are more likely to come from international capital movements than from foreign trade, and in a liberalised foreign exchange regime any domestic funds or available credit can be used to purchase foreign exchange for effecting

capital flight. Whereas we can see the build-up of imports coming from afar and take preventive measures, massive capital outflows can occur in the twinkling of an eye!

Fiscal vs. Monetary Policy

Since financial markets in Caricom will remain narrow and shallow for the foreseeable future, they will not provide a medium for the effective operation of monetary policy, and Government must rely heavily on fiscal policy for the execution of macroeconomic policy. Government should not fuel inflationary fires through deficit financing, and must generate the surpluses needed to finance infrastructure and to support, though not necessarily own, productive enterprise.

Finally, it must be recognised that operational losses, both in the public and the private sector, are tantamount to the destruction of capital. Just as productive investment promotes economic growth, so will chronic operational losses plunge an economy into a downward spiral of decline.

Elements of an Investment- Friendly Financial Environment

1. A stable or gently rising price level.
2. An interest rate regime with savings rates below 10% and loan rates under 20%.

3. A financial sector which expands in tandem with the real sector and becomes progressively deeper.

4. Progressive liberalisation of exchange controls, especially iron-clad guarantees that original capital, dividends and retained earnings will be remitted with a minimum of red-tape.

5. Arrangements for sterilising excessive inflows of hot money and for moderating massive and untimely capital outflows.

6. Anchorage of the currency to a major internationally traded currency or to a basket of currencies and the maintenance of high levels of foreign exchange reserves, or some pragmatic management of the exchange rate.

7. Primary reliance on fiscal rather than monetary policy in the conduct of macroeconomic policy.

8. Central banking arrangements with maximum independence from Government so as to minimise the likelihood of money creation for the financing of runaway fiscal deficits.

9. Regulatory arrangements which facilitate direct foreign investment.

10. Special arrangements for the financing and technical support of small and start-up businesses.

NOTES

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CHART 2.1

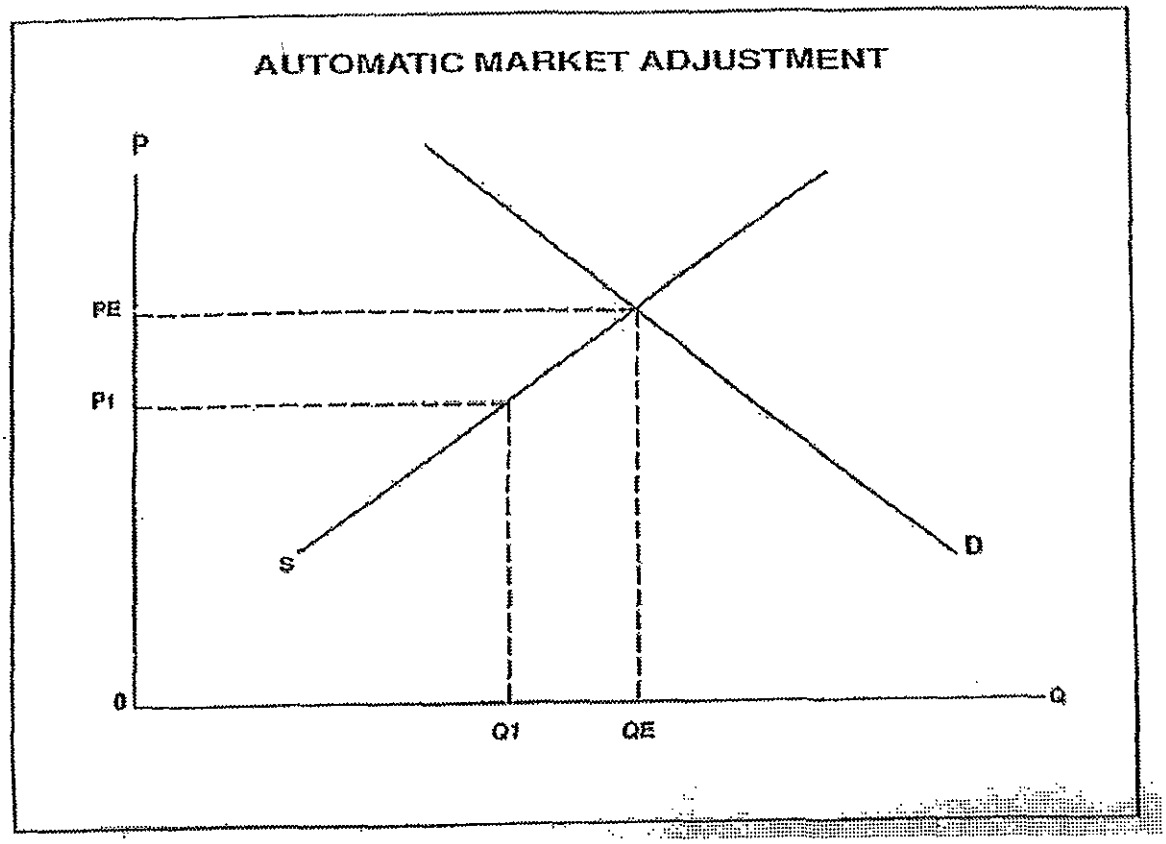


CHART 2.2

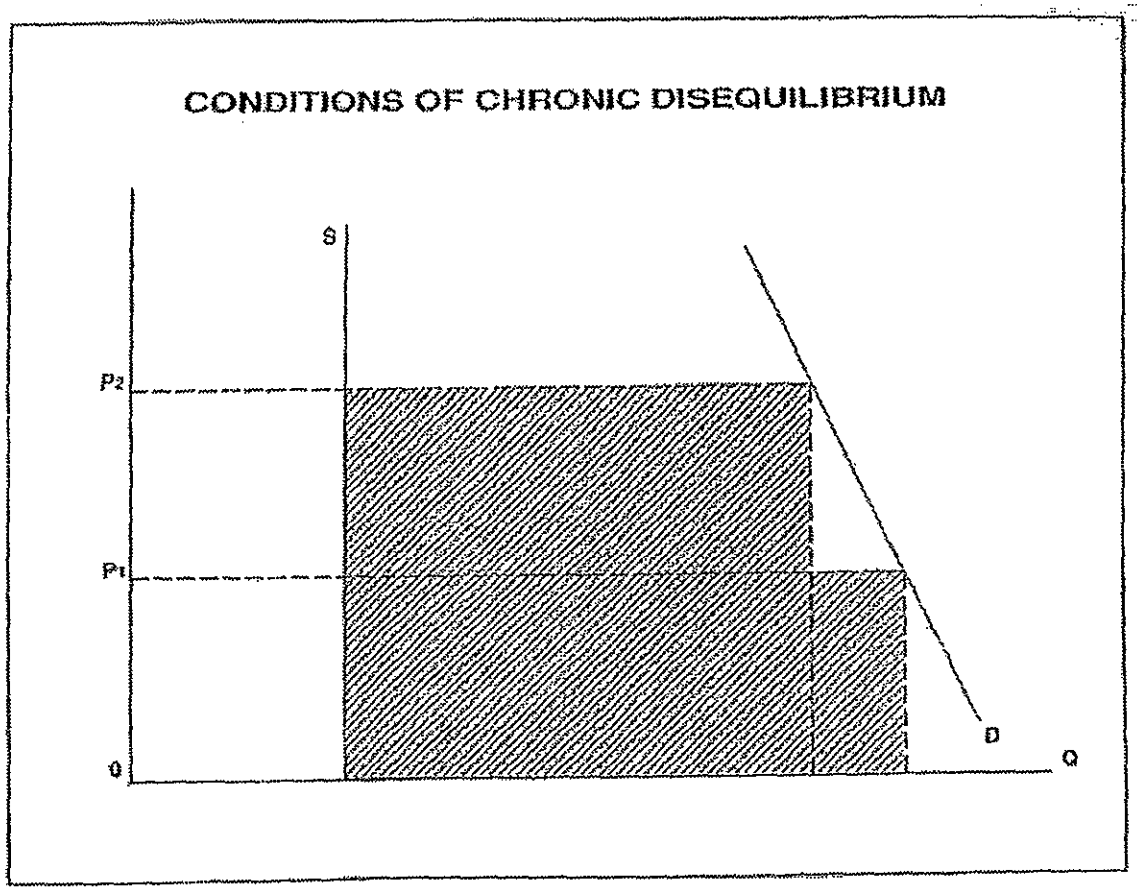
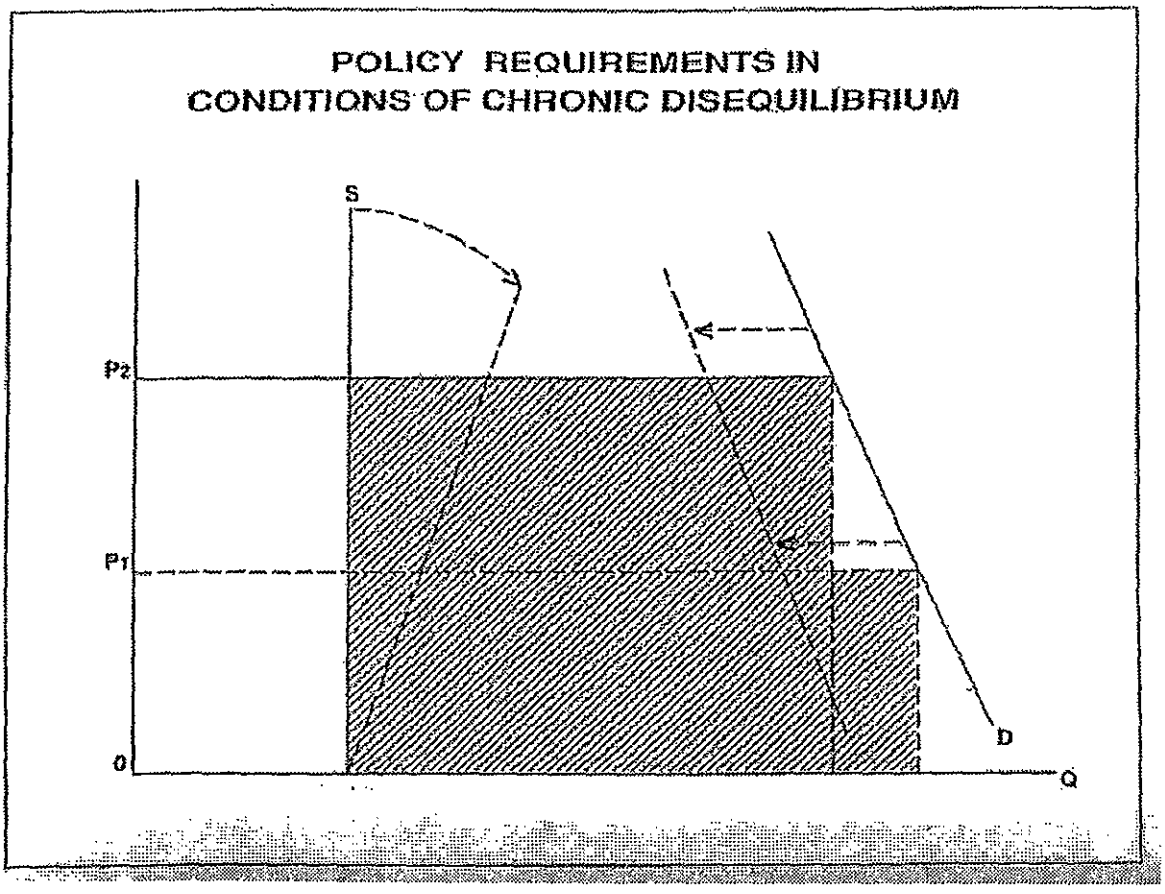


CHART 2.3


POLICY REQUIREMENTS IN
CONDITIONS OF CHRONIC DISEQUILIBRIUM
S
P2
P1
0
D
Q