

***Financing Development***

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What we are looking at is the financial counterpart to the developments in the real sector. I cannot cover all the issues relating to financing development. The focus is on some key issues in relation to development, in the areas of public finance, the financial sector, and external flows into the country. Before I do so I think it is important to understand a little bit about the developments in development economics. One of the key questions that is being asked in development economics is *What Drives Development?* What makes an economy grow? Sometimes a distinction is being made between growth and development. Growth is supposed to mean an acceleration in the rate at which the national income of a country increases. Development is not only supposed to include growth but also some structural changes in the economy, which would make the growth sustainable. We will use the term Growth and Development as interchangeable while noting that there is some distinction between growth and development.

The early literature on development economics emphasised the importance of savings in the development process. Many writers identified the savings constraint as an important constraint to rapid growth. That came from the theoretical proposition that the major driving force of development is investment. The country must increase its level of investment. If the level of investment increases the economy begins to grow. If investment must increase savings must increase. That is why a very reputed growth economist and noble laureate said almost 50 years ago that the central issue in development is how does an economy which saves 5% of its GDP move to a situation where it can have 20% of GDP in the form of savings. Put briefly the first constraint in relation to development that was noticed was savings. If savings of an economy is to be increased it will lead to larger investments and larger investments would lead to larger growth and this I summarise in the famous Harold equation that says that  $G$ , which is growth of the economy, is equal to savings divided by  $V$  incremental capital output ratio.

The incremental capital output ratio means the amount of capital required to produce one unit of growth. Let us assume for a moment that the incremental capital output ratio is 4:1. Therefore, to produce 1 unit of output you require 4 units of capital. If the savings rate of the economy is 12% then it means 12 by 4 is equal to 3, the rate of growth of the economy is 3%. Now there are lot of modifications and qualifications to be made to this, at least it assumes there is one single output in the economy. Therefore incremental capital output ratio of the economy will be the weighted average of the sectoral output incremental ratio. I would say that in the initial stages developmental

economists recognised lack of adequate savings as a major drawback and the growth process could be accelerated only by raising the level of savings and therefore the level of investment. Common proposition in all developmental planning models is to try to find out how much of investment can be made in the economy. Of course later on people also started talking about human capital rather than physical capital in the form of machinery and buildings.

The second constraint was that the lack of availability of foreign exchange could be a serious constraint on the economic growth. In the case of developing economies the need for imports is very high but their ability to export may not be very high, therefore they will run into what will be called the *current account deficit*. Imports more and exports less, but this gap has to be met in some way and this can be done through external flows. This is also referred to as the *two-gap theory*, one gap being that between the savings and investment, and the second, between the exports and imports. The total investments of a country will equal not only the domestic savings but also the net inflow of resources from abroad. This will be called foreign savings. Investment is equal to domestic plus foreign savings. So this I thought will be a background against which we can now try to look at some of the issues relating to public finance, financial sector and capital inflows.

The importance of government in the developmental process was very much recognized in the post World War II period. Many developing countries, I would say almost all developing countries felt that the State has an important role to play. They felt the private sector was deficient or non-existent and therefore the need for the government to play an active role in the development process apart from its traditional role of maintaining law and order came to be emphasised. It was felt that the State has a major role to play and if State has a major role to play then it really means that the State should be in a position to mobilize more resources in order to be able to invest or in order to be able to incur what we call the development expenditure. Therefore, one phenomenon that you will see in almost all developing countries and all the countries of this region as well has been a steady rise in the Tax-GDP ratio over the last 50 years. In fact the ratio increased from 6.31% in 1950-51 to 16.08% in 88-89, and is still around 15% of GDP. There the rise in the tax GDP ratio is explained by the need for the State to take the initiative in the development process. While all this is recognized more recently, an issue that has come up for some analysis has been with respect to the level of fiscal deficit which the State can incur. Old theory is that so long as the government borrows for the purpose of investment there can be no harm in borrowing. Corporations borrow, households borrow so the Government can also borrow and if the borrowing is utilised for the purpose of increasing the productive capacity of the country then there is a legitimate place for borrowing by the Government. This is not being denied. But the problem is that if the government borrows utilizing the resources for purposes of investment, and if the rate of return that the government gets is less than the rate of interest, which is paid on the resources raised through borrowing then it creates a problem. Then it

goes to increase revenue deficit. The *fiscal deficit* is the borrowing, which the government does. It is usually expressed as a percentage of the GDP. In India the combined fiscal deficit of the Centre plus State as of 2000-01 is roughly 9.48% of the GDP. Of this the Centre is 5.70% and the State is 4.57%. You may note that the two do not add up because some part of the borrowing of the State is from the Centre. Therefore, while computing the total fiscal deficit you have to eliminate that. Therefore the fiscal deficit has touched somewhere around 10% of the GDP. So the point I am trying to make is that for the purpose of development there is legitimate need for the government to raise resources and utilize these resources for the purpose of development. However, if the extent of borrowing exceeds a certain level then it creates a problem for the country.

One other dimension of the fiscal deficit is the *revenue deficit*. Revenue Receipts minus Revenue Expenditure of the government is Revenue Deficit. Initially it was felt and it was true also that there was surplus on the revenue account. The surplus of the revenue account was utilized for the purpose of investment by the government. That is also what you would expect any prudent institution or entity to do i.e. current revenues exceeds current expenditure, marking a surplus possible for the purpose of investment. But what has happened in many countries including India is, there is a substantial revenue deficit, which is emerging. The revenue deficit for Centre and States for the year 2000-01 taken together was 6.55%. The total fiscal deficit is 10% and revenue deficit is 6.55% roughly 65% of deficit is accounted for by revenue deficit. In the case of Government of India for example 5.70% is the total fiscal deficit and 4.09% is revenue deficit of the government. Therefore the government has to borrow even to meet its current revenue expenditure. This is justified to some extent because some of the revenue expenditure is for social infrastructure expenditure such as education, health and therefore there is a legitimate need to expand the revenue expenditure. But, however, many of these expenditures then will not give a return to the government. Revenue deficit starts then raising more burden on the government. In fact interest payments as a percentage of GDP in India is close to 4.64% of GDP, interest payments, as a percentage of the revenue receipts is almost about 50%. What does that mean? That 50% or close to 50% of revenue receipts is just utilized in paying interest alone. Now the question one has to address is how to contain fiscal deficit and at the same time enable the government to fulfil its obligations. There has been some attempt to contain the total expenditure in our country. If you look at the Government of India's alone, from 18% it has been able to compress it to 15.5% i.e. there is a compression of about 2.35%. But bulk compression has come from reducing capital expenditure rather than revenue expenditure. This has also been a source of concern.

Let me summarise what I have to say with respect to public finance. The need for the government to play a significant role in the economy also requires the government to raise adequate revenues and to channel those revenues into expenditure that will have the effect of increasing economic growth. But

unfortunately, the extent of borrowing elsewhere also is exceeding what we would regard as the prudent limit. What is Prudent Limits? There is considerable amount of literature on this subject. At what level will Debt-GDP ratio in a country stabilise and there are some conditions under which it will stabilise. So long as the real rate of interest is less than the real rate of growth the Debt-GDP ratio will stabilise. Nevertheless I think the major concern is about the rising Revenue Deficits, which essentially means that current expenditures are to be met out of borrowings. Therefore the issue is one of prioritising expenditure, including the productivity of expenditure consistent with a level of fiscal deficit which is sustainable and which is prudent.

The second area, which I will touch upon, is the Financial Sector. It has always been thought that an efficient functioning of the financial sector is extremely important for an economy both in augmenting savings and in the better allocation of resources. The financial institutions are all called financial intermediaries. They are all financial intermediaries because they borrow with one hand and lend with the other. They are conduits for the transfer of funds from those who can save to those who can invest. So that is the purpose of the financial sector of the system and an efficient system will enable two things. To increase the level of savings; it can also bring about a better allocation of resources that would maximize the benefits of savings. These, in a sense are some of the general propositions that are made in relation to the financial sector. Now if we look at the financial sector it does a number of transformations. One is the liability asset transformations, second is the size transformations. A large number of small people put in the money. They are pooled together and made available to people who require much larger funds. Third is site transformation i.e. the maturity transformation. Many people may put in for short periods but funds may be required for longer periods. But through an appropriate management the financial sector can also raise funds for longer periods through proper portfolio management or through appropriate institutions. Finally there is risk transformation. Suppose you do not have financial intermediaries all savers would have to directly lend to those who have to invest to provide funds but there is a high risk attached to it for pooling the resources of many people the risk per rupee of savings or of the intermediary. A good financial system is required in the economy.

Therefore, in many developing countries in the early period the emphasis was on developing a good financial system. We talk of the width of financial system and the depth of the financial system. The width refers to various types of financial institutions that are required in the economy. The depth means that the number of institutions in each segment of the financial market should be large enough. A good financial system must have width. It must be wide and also be deep. What will come first? Emergence of the financial system or it is the development, which come first. There are two theories here. One is called demand following and the other is supply leading i.e. as the economy grows more and more financial products are required and new financial institutions come into

existence to provide these financial products. This is what we called demand following. On the other hand you may create financial institutions, which supplies certain products, which would stimulate growth in that particular area for example field of agricultural finance. Therefore, it is called the supply-leading phenomenon in the sense of setting up large number of units in the rural areas and therefore providing an opportunity not only to mobilize savings but also to provide credit.

Now there are many issues related to the financial system but I will not go into them but let me mention two or three of them. First of all, for a long time the rate of interest offered on many financial products was kept below what may be called a purely market determined rate. Many economists discussed the issue of financial repression, in the sense of rate of interest offered on the financial products does not fully reflect the supply and the demand. Therefore, it is argued that if the financial system is repressed then it cannot develop both the width and the depth. Therefore, there has been a deregulation of the interest rate regime allowing the market forces more and more to determine the rate of interest on the financial products. This does not mean that the Central Bank of the country does not play a role but the central bank of the country continues to play a major role in terms of setting the conditions under which or creates or introduces measures, which influence the interest. This is not being done in the developing countries but also in the developed countries. But a greater freedom to the financial institutions and the markets to fix the rate of interest has been argued by many people who feel that financial repression is not desired. India as in many other countries in this region moved on to financial sector reforms in the 90s.

The three major elements of the financial sector reforms in India have been removing the external constraints on the financial institutions, introducing prudential norms in order to improve the soundness of the financial institutions and finally the institutional infrastructure being strengthened. When I say removing the external controls in terms of removing direct controls whether it be interest rate or whether it be portfolio policies of the bank and so on and so forth. In India at one time, for commercial banks, we used to have high requirements on the proportion of funds to be invested in government securities. We call it Statutory Liquidity Ratio and there were direct controls over the interest rates and the administrative structures of the interest rates. Step by step these things have been withdrawn even though as I said the Central Bank of India continues to play an important part in terms of ensuring that the rate of interest remains at a level appropriate to the needs of the economy. The second as I said is the prudential norms. While there has been a rapid growth of the Indian Financial System more particularly of the banking system in the 70s and 80s at the end of the 80s and in the beginning of 90s certain concerns had been expressed on the soundness of the institutions and that is why international accepted prudential norms were introduced in the banking system. These international productive standards related to the capital-adequacy ratio, the provisioning norms and the criteria for the classification of non-performing assets. I will not go into

details but these are the accounts of reforms accepted in many countries. Such reforms -the purpose of this is to make the financial institutions strong and these prudential norms are intended to see that the financial institutions grow along the lines so that the soundness and the security are also established.

Other institutions were set up like the institutional strengthening ombudsmen, debt recovery tribunals so that the Financial Sector can perform. As with the Banking system, similar is the case with capital market flows. Regulation of the capital market is also being done primarily from point of view of investor protection. One other point is that the stability of the financial sector has assumed greater importance in the recent affairs. The financial sector has to operate in a delicate balancing situation. On the one hand it should make profits on the other hand it should not be rash enough to risk the funds of others. When a bank or any other financial institution fails, it has systemic reasons. It is not the failure of a single institution because the failure of a single institution spreads to other institutions that are dependent on that institution. In the case of a bank for example not only the depositors lose but there are other banks which are connected to that bank and that is why in the case of financial institutions we talk about the systemic risk although systemic risk is there everywhere even in the manufacturing industry. But the systemic risk is much more in the financial system. If one public limited company fails, its Debtors and Creditors may be affected but not the entire Steel Industry. But in the financial system the financial stability has assumed importance. That is why the prudential regulation has assumed importance.

Lastly I would like to come to the third area which I would like to cover that is capital flows. I mentioned earlier, you all know that the level of investment in an economy can be increased through domestic savings as well as foreign savings. Foreign savings are the inflow of funds from outside. Until almost the middle of 80's, as far as the developing countries were concerned the inflow of resources from outside was essentially official, whether it is through the countries directly or through international institutions. Essentially, inflow of funds from outside was from official sources. But from 90's onwards the private sources of funds have assumed a great importance. It is indeed seen that the capital inflows from private sector have dominated over the official credit in the 90's. The flow of resources from outside takes a number of forms. One is foreign direct investment. The other is what is called portfolio investment i.e. for Institutional investors and others can invest in stocks and other equities, in the equity and the debt of local companies that is portfolio investment. Thirdly there is the direct borrowing, which local companies can do from external sources. So equity and debt are the two important sources, through which funds can be raised. Equity can also be broken up into foreign direct investment and equity investment. The increase has been very dramatic. In fact in 1991 the total capital inflow of capital into emerging countries was 53m\$. By 96-97 it has become 203b\$. After the East Asian Crises you all know this has declined and then picked up but even now

the inflow in the region is of 200b\$. One major advantage of capital flows across borders is that the growth prospects of the country are not limited by the growth prospects of its own savings. Therefore, the capital flows re-distribute the global savings across countries where the savings can be most effectively used. This has been primary argument in favour of capital flows. What are the disadvantages? The disadvantage is when the capital begins to flow back. When funds flow in recipient country makes some adjustments when the capital flows out and that too in a sudden and abrupt manner it causes a serious disruption to the economy. The classic example is what happened in the East Asian Crisis. In 1996, into the five East Asian Countries the inflow of funds was 93B\$. In 1997 net outflow was 12B\$. In one year there was the turn around of 105B\$ which is estimated to be 10% of GDP of these countries. Therefore that was the warning of the possibility of the capital outflows from these countries. In the East Asian crises people talk of the contagion problem. First Thailand, Malaysia, Philippines and then it went to South Korea and also Indonesia. Therefore even countries, which are managing well, can also be affected because of the systemic risk in a global sense.

So what attitude and approach should countries take to capital flows? As I said capital flows have a beneficial effect on the recipient countries. They add to the investment resources, in foreign direct investment, investment brings along with it managerial talent R&D efforts as well, therefore the country can benefit. But at the same time it is extremely important the country keeps a watch on the channels through which the funds can flow. It is normally felt that foreign direct investment is a preferred source of funds because the stability of the FDI is greater than the others. In fact in the East Asian Crises-I have also written several articles on this -- what you find is that bank credit has been one of the most volatile elements in the whole thing, that is bank credit which came in an abundant way. When things were good, they started with withdrawing particularly the short term credit, that is the real problem. We say the banker is one who lends the umbrella when the sky is blue and calls it back when rain comes. So if that kind of banking is done then obviously you see that especially when the credit is extended on short-term period then it becomes very difficult when the period is over.

Of importance is the maturity pattern of the borrowing. If a country depends on short-term borrowings to a large extent then its vulnerability is increased because it is very easy for the foreigner not to roll over at the end of the period. But at the same time it is very important for the country to follow appropriate exchange rate policy. A large amount of money went into Thailand because it kept a fixed exchange rate system. Therefore, foreigners did not anticipate any exchange depreciation and therefore large amount of money came in. This was done in spite of the fact that the internal situation was not very sound. Thailand at one time ran a current account deficit, which was 8% of the GDP. While it is good to get in flow of resources from outside one must see that the level of

current account deficit is at a reasonable level. The manner in which funds flow in are of a type whether the funds flow through channels which are stable and financial system of the country is also on a sound footing. If you look at India's record in this I think management of the external funds has been a success story of the reform process. We have tried to maintain the current account deficit at a very reasonable level. In one year we ran a surplus of the current account and we have been able to move towards current account convertibility. Capital account liberalization is being introduced only in stages. So we have been able to make sure that the funds of resources is managed in such a manner that it does not produce any instability. Of course amount that flows to this country, are much smaller than what flows into other countries. There are many countries in the region, which also receive capital inflows, which are of high order.

Therefore the moral is to try to see the capital flows that come in are properly channelled, sound financial system is in place and an appropriate exchange rate management policy is also pursued. To ban or shut the door on capital inflows would be like the saying "to throw the baby out with the bath water". For what we need to do really is to ensure that the capital inflows are appropriately calibrated, the current account deficit is maintained at a reasonable level and the flow of resources or inflow are channelled in a manner in which they add to the productive capacity of the system. I have indicated broadly three areas which impinge on development and how the development process can be accelerated if we adopt appropriate measures in the areas of public finance, in the financial sector and in relation to capital inflows.