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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.

Table 1: Relationships for 48 countries, 1996-2005

	Coefficient	Intercept	R-squared
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 rigourous 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 md-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

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