Foreign aid and capital no longer possible for development

by R.M.B Senanayake

We take it for granted that our development must come from foreign funded finance - either foreign aid or foreign capital inflows. Not all countries that developed in the past depended on foreign finance or foreign capital inflows. The USA received foreign capital inflows for its development in the initial stages but later mobilized more resources on its own to sustain the momentum of investment and growth. We too have to do the same.

We invest about 29% of our GDP but are able to mobilize only 21% of the GDP from our own domestic resources. We cannot depend entirely on foreign aid or even foreign capital inflows alone to fund our development. We must make our own efforts to mobilize savings and use them for development. We do save about 21% of the GDP but all the savings are taken by the government and used to fund partly its recurrent budget deficit and only partly its capital expenditure. The recurrent budget must be funded from tax revenue and not from borrowings.

This is a test of fiscal prudence for the Minister of Finance. Will he be able to do so? So far all Finance Ministers since 1977 have by and large failed to do so. Mr. Ravi Karunanayake, the present Finance Minister promises to change it. Wish him luck in dealing with supplementary estimates that invariably increased the realized budget deficit as originally budgeted.

We need to save to fund at least part of our capital expenditure and fund only the development expenditure from borrowings. But this requires all new borrowings for capital expenditure to be vetted by the Ministry of Planning which must itself come out with a perspective plan at the least. Many countries that developed in the past saved money from their incomes and used them to fund new capital expenditure. We are a heavily indebted country. We must at the least save sufficient money from our incomes to fund the foreign debt repayment without having to borrow even that component of government expenditure.

Many countries that developed in the past saved out of their incomes and this taught a lesson to the people to be frugal. But we have failed to do so. Our people like our governments do not show any frugality and carry on spending as if we are a rich country. Most developing countries saved from their comparatively low incomes and pulled themselves up by their bootstraps as it were.

We cannot leave our development entirely to foreign capital inflows either by way of foreign aid or foreign capital inflows. We no longer qualify for concessional foreign aid since we have now reached middle income status. We must make our own efforts to raise funds for development instead of seeking to raise all our development expenditure from foreign capital inflows. We have no special benefits or advantages to offer to foreign investors and such foreign investment is bound to dry up in the future. It has been declining recently.

Much of our private savings is absorbed by the government to fund its continuing budget deficits, leaving very little for private domestic investors to raise from the market. On the current or recurrent account, Finance Minister Karunanayake has promised to avoid deficit budgeting funded by money creation. This is the minimum he must do to be appreciated as a prudent finance minister. But before he can eliminate budget deficits on current or so-called recurrent account he will have to either cut down expenditure or raise more tax revenue. He must at least insist that the Treasury will not fund any losses of the state corporations. They must either raise more private capital or more revenue by increasing their prices or cutting their expenditure. They must not be funded by the Treasury but asked to raise their own funds on the strength of their balance sheets or by selling their assets or wind up and save future losses.

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Nor can we depend on globalization. We are not attractive as a destination for direct foreign investment except as a possible location for reaching the Indian market. This is why foreign capital payments and people exchange with India should be liberalized for we have no other future prospects, not even under globalization. With our liberal attitudes and free markets in capital movements we can become a financial hub. Exchange Control has been liberalized. We need to liberalize other restrictions like movements of technical and professional people and not laborers or unskilled workers although given our people's attitudes to manual work, even this liberalization may be necessary for jobs considered as menial by our people.

The International Monetary Fund has analyzed the wave of financial globalization that has occurred since the mid-1980s. Much of what follows is reproduced from the IMF analysis.

The recent past has been marked by increased capital flows among countries particularly the industrial countries but also, between industrial and developing countries. Capital inflows have been associated with high growth rates in the past as in the capital flows from Europe to the Americas during the nineteenth and early twentieth centuries.

Unlike in the past recent capital flows have included developing countries, particularly some developing countries which are popular destinations for such flows. Generally capital inflows have led to higher economic growth in the countries receiving such capital inflows. But such capital movements have also had destabilizing effects and led to a number collapses in growth rates and significantly caused financial crises that have had substantial macroeconomic and social costs to the people affected there from. So there has emerged an intense debate in both academic and policy circles on the effects of financial integration on developing economies.

Some countries have in the past restricted foreign capital inflows because of the destabilizing effects they could have. Generally however economists would recommend capital inflows because they lead to higher growth rates in the capital recipient countries. Therefore capital controls were not removed despite the movement towards free trade in goods and services even if it affects adversely the trend in the growth rate

This has been so particularly with regard to what is called 'financial globalization', a counterpart of globalization in trade. A serious academic assessment of empirical evidence on the effects of financial globalization for developing economies was therefore necessary. Some of the issues considered by the IMF are

(I) whether financial globalization promotes economic growth in developing countries?

(ii) What is its impact on macroeconomic volatility in these countries?

(iii) What are the factors that appear to help countries obtain the benefits of financial globalization?

The principal conclusions that emerge from the analyses are sobering and informative from a policy perspective. It is true that many developing economies with a high degree of financial integration have also experienced higher growth rates. It is also true that, in theory, there are many channels through which financial openness could enhance growth.

The recent wave of financial globalization that has occurred since the mid-1980s has been marked by a surge in capital flows among industrial countries and, more notably, between industrial and developing countries. Although capital inflows have been associated with high growth rates in some developing countries, a number of them have also experienced periodic collapses in growth rates and significant financial crises that have had substantial macroeconomic and social costs. As a result, an intense debate has emerged in both academic and policy circles on the effects of financial integration on developing economies. But much of the debate has been based on only casual and limited empirical evidence.

What then are the effects of financial globalization for developing economies?

(I) Does financial globalization promote economic growth in developing countries?

(ii) What is its impact on macroeconomic volatility in these countries?

(iii) What are the factors that appear to help countries obtain the benefits of financial globalization?

The principal conclusions that emerge from the analysis are sobering but, in many ways, informative from a policy perspective. It is true that many developing economies with a high degree of financial integration have also experienced higher growth rates. It is also true that, in theory, there are many channels through which financial openness could enhance growth. A systematic examination of the evidence, however, suggests that it is difficult to establish a robust causal relationship between the degree of financial integration and output growth performance.

From the perspective of macroeconomic stability, consumption is regarded as a better measure of the people's well-being than output; fluctuations in consumption are therefore regarded as having negative impacts on economic welfare, although output could still be moving upwards as a trend. As for financial integration as distinct from economic or trade integration, there is little evidence that it has helped developing countries to better stabilize fluctuations in consumption growth. But fluctuations in consumption are destabilizing. So theoretically, large benefits could accrue to developing countries if such stabilization was achieved. In fact, low to moderate levels of financial integration may have made some countries subject to greater volatility of consumption relative to that of output. Thus, some countries may have experienced greater consumption volatility as a result. This causes hardship to people particularly the poorer segments of the people.