**[Academic Script]**

**Financing Development**

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| **Paper No. & Title:** | Paper – 641<br>Elective PaperE2 – Economic Growth and Policy |
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**Academic Script**

## 1. Introduction

We have seen various models of growth and technical change. All models have emphasised upon the role of investment in the growth and development processes. Hence, it may be of utmost relevance to know how investment for the development process is financed in modern times. We also saw that savings are always equal to investment by macroeconomic identity S=I. We must know if this actually is true for all societies. In this section we shall see the forms of savings, the role of financial systems in economic development and some approaches to financing development. Objectives

1) To understand if investments are necessary for a growth process then how investments are generated.

2) Understand the approaches in development financing.

3) Review the limitations of barter system in enhancing development.

4) Scrutinize the role of financial systems in development financing.

5) Check the role of financial intermediaries in development.

## 2. Types of savings

In a society where money does not exist as a store of value or as an asset for facilitating speculation, savings automatically get converted into investment. The output produced by a society will be sold either as consumption goods or as investment goods.

But, in a society where money and monetary assets exist, savings are held in the form of money assets and such safeguarded money may not directly go into investment activities.

Based upon the saving class, savings are classified into **(i)** private savings and **(ii)** public savings. Depending upon the willingness to save, savings may be **(a)** voluntary **(b)** involuntary and **(c)** forced. **(i)** Private savings are the savings of the private sector of the economy. Individuals save money from their disposable incomes by curtailing consumption and private businesses save out of their profits.

**(ii)** Public sector can save if it incurs lower expenditures than the incomes on revenue account (current account) of the budget. In other words, public sector can save when governments run a surplus on the revenue account of the budget.

**(a)** Voluntary savings arise when households and businesses voluntarily spend lesser than their respective incomes.

**(b)** Involuntary savings arise because of involuntary reduction in consumption caused by taxation or compulsory savings schemes introduced by the government for the public. These are in a way the government's means of borrowing from the public.

**(c)** Forced savings refer to the accumulation of money because of the real balance effect created during inflation. In times of inflation, people feel that the value of their accumulated money is depleting. Hence, to keep the value of their money constant, they accumulate more money by reducing the proportion of income spent on consumption and this is called the real balance effect.

When all these savings are diverted into investment, the rate of growth rises. The growth rate occurring from new investment will be higher when there are unemployed resources in the economy than otherwise. When investment is made, the unemployed resources will be employed and made productive. In other words, idle resources are converted into productive resources and hence growth becomes faster.

When governments borrow from abroad, the savings of foreigners become a source of domestic investment.

**Savings disparities among countries of the world**

We may refer to the World Bank data on savings as a percentage of GDP for various countries. The data reveals immense disparities. The savings to GDP ratio for poor countries is very low. That for the middle income countries is relatively higher. And, the savings ratio for the developed countries of the world is lower than that for the middle income countries. In other words, richer countries do not have very high savings ratio. But, poorer countries surely have low savings ratio.

Thus, as GDP rises, savings ratio improves but when countries become very rich, the savings ratio levels out.

The data also reveals that the savings ratio in the East Asian countries is remarkably higher than that of the Latin American and the Sub-Saharan African countries. Hence, we must find out if high growth rate of GDP resulted in higher savings in the East Asian countries or if higher savings resulted in higher growth. We must also understand the role of governments and financial systems in impacting saving ratio in these countries.

## 3. Analytical Approaches to the study of Development Financing from Domestic Resources

We shall briefly understand three broad approaches to study how development is financed from domestic resources.

**I. Prior Savings Approach**

**II. Keynes' Approach**

**III. Quantity Theory Approach**

**I. Prior Savings Approach:**

This approach is based upon ***classical understanding and stresses the need of prior savings for investment.***

Prior savings depend upon ability to save and willingness to save.

***Ability to save*** according to Keynes is determined by income.

Keynes gave the savings function as,

$S = -a_0 + b_0(Y)$ (1)

Where,

$-a_0$ indicates that savings are negative if income is zero. That is, a nation borrows or withdraws from past savings to meet primary needs.

$b_0$ is the rate at which income 'Y' is saved when income is positive.

The savings ratio as a function of per capita income will then be given as,

$S/N = -a_0 + b_0(Y/N)$ (2)

Where,

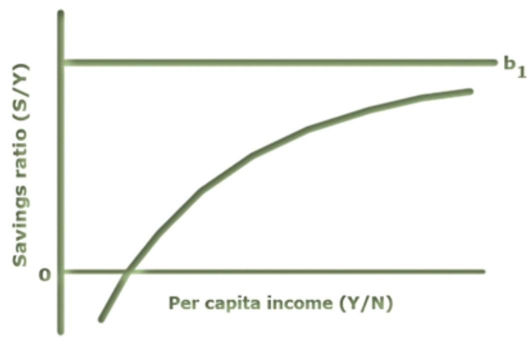
N is the level of population

Multiplying equation (2) by N and dividing it by Y we obtain, $\frac{S}{N} x \frac{N}{Y} = -a_0 \frac{N}{Y} + b_0 \frac{Y}{N} x \frac{N}{Y}$

Which is now, $\frac{S}{Y} = -a_0 \frac{N}{Y} + b_0$ (3)

And equation (3) can be rewritten as, $\frac{S}{Y} = b_0 - a_0 \left(\frac{Y}{N}\right)^{-1}$

Thus we get the saving ratio (S/Y) as a hyperbolic function of the level of income per head. That is, savings ratio will rise with the level of per capita income but at a decreasing rate. This is shown in the figure here:




Several practical reasons are forwarded to explain the hyperbolic relation of growth of savings with per capita income.

***The willingness to save*** depends upon the inter-temporal choice between consumption today and consumption tomorrow. If interest rates are high and the interest incentive is higher than the loss of current utility by curtailing current consumption then people will curtail their current consumption and save more today and consume more tomorrow.

**II. Keynes' Approach to Development Financing**

According to Keynes, when the economy is functioning at less than full employment level, governments can afford to have deficits in the revenue account of the budget. Rather, they must spend more in the economy than what they earn by way of deficit financing. The investments undertaken by the government through excess spending will result in higher employment, higher incomes and subsequently higher savings.

If an economy is at the full employment level, an excess spending by the government will lead to a situation of excess money supply and inflation. The higher level of prices will then reduce the demand for consumer goods and make people save more to keep the value of their real savings constant. This way, savings rise.

Thus in the Keynesian theory, investments determine savings.

**III. Quantity Theory of Money and Financing for Development:** In the quantity theory of money, people hold cash on hand from their income for transaction purposes. The demand for real balance is given as, the demand for money balance divided by the price level. That is, M/P.

If government increases money supply which results in inflation then people will hold greater proportion of their money income to buy goods. But, if the government does not want people to buy more goods but rather save, then the government must increase tax on income by exactly the same rate as the rate of inflation. Thus, the purchasing power is transferred from the people to the government and then the government can spend the tax money for development investment.

## 4. Financial Systems and Economic Development

Financial systems play an important role in development.

Let us review the impact of various areas of the financial system on development.

### 1. Barter system and the issue of development

*An economic system without money hinders economic development in several ways.*

1. Under a barter system, the correct value of factors and goods is not ascertained and hence goods may be oversold or undersold thus, over-remunerating or under- remunerating a producer. Besides, the problem of double-coincidence of wants cannot be avoided in a barter system. Hence, a barter system hinders development by inappropriate pricing.
2. The remuneration of workers cannot be determined by a uniform standard without the existence of money and hence division of labour and specialization cannot be justly remunerated. When labour is underemployed from the income criterion, the willingness of labour to work declines along with a productivity decline. As a result, capital formation and accumulation process is hindered.
3. Savings are protected in the form of land, cattle, precious metals etc. Resources are used up to maintain such forms of savings. Besides, all of these savings may not yield the desired income or productivity as interest rate in a money (monetary) economy.

**2. Informal Financial Sector and Development**

Informal sector does not fall under the scope of the monetary policy instruments meant to promote development. For example, the changes in interest rates directed by the RBI will be adopted by all banks under the control of RBI but will not affect the indigenous money lenders in India.

The unorganized lenders charge exploitative rates from the borrowers and thus the hard earned income of the borrowers is transferred to the profiteering money lender and such a transfer of money is non-developmental.

**3. Monetization and Money Market Integration**

If some sectors of the economy are non-monetized then the evils of a barter system set in.

Besides, such sectors will be untouched by the development efforts undertaken by the banking sector.

For economic development, it is important to monetize all sectors of the economy; and to include all activities under a well organized banking and financial system. Only then, the savings of the saving class will be mobilized by the financial system in the form of credit for the investing class and this way development can be effected.

In a well integrated financial system, regulation of credit and interest rates can be easily done to impact development of all sectors.

**4. Microcredit Facilities**

It is utmost important to provide opportunities to work and earn to all segments of the population. In the developing countries, the extremely poor, the unskilled and the artisans possessing traditional skills are neglected in the development policies. These people constitute a significant proportion of the population of developing countries. When, a significant proportion of the population is neglected thus, the economy is deprived of their productivity. However, owing to the large number, vernacular needs and extremely low repaying capacity; it is not viable for the commercial banking sector to include them in their credit programmes.

Hence, the financial system must create special credit facilities for them so that they can meet their personal and employment related credit requirements.

Developing countries have thus created microcredit facilities for them.

Muhammad Yunus created the *Grameen Bank* in Bangladesh to give microcredit to community groups who would then help themselves to seek work and develop their community and their village.

Yunus and the Grameen Bank were jointly awarded the Nobel Peace Prize in 2006 for their efforts to effect economic and social development from below through microcredit.

**5. Financial Intermediaries**

In present times nations must envisage and provide for various types of financial intermediaries in the organized sector who could mobilize savings from different segments of the economy. Their role is to offer a diversity of financial assets with different yields, maturity and divisibility to suit the requirements of variety of savers.

In modern economies, savings class is distinct from the investing class and hence, such intermediaries are necessary to extract all possible savings from the savers and channelize those for investment.

**6. Financial Liberalization**

Developing countries which have started attaining good growth rate of national income must liberalize their financial sector to give further impetus to savings and investment. When a country is less developed it faces acute shortages of financial resources and hence government rations credit, controls the use of credit, and almost monopolises credit system. But, as economic activity gains momentum governments must free the financial sector from undue controls and regulations so that the market for funds will direct savings and investment.

**7. Fiscal policy and Taxation**

The fiscal policy instruments must also ensure a right mix of public sector and private sector investment for overall development of the nation. A judicious tax policy will improve the incentive to work and improve tax honesty levels among the tax payers.

Government must make enough and effective expenditures for development of all sectors.

## 5. Summary

We have learnt in this lecture the importance of finance for development, the systems of finance and the role of financial intermediaries.

We must remember the prior-savings approach, the approach given by Keynes and the approach explained in the quantity theory of money regarding financing of investment for development.