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Finance Capital and Real Resources

Many of the economic problems that have emerged across Africa over the past three decades originated in chronic budget deficits. A key element in efforts to restart and sustain economic growth and development in Africa is the need for governments to sharply reduce their deficits. Indeed, if African countries are to work themselves out from underneath their debt burdens they need to eliminate deficit financing completely. Africa's debt problem cannot be found while governments and the public sector continue to run deficits irrespective of how generous debt relief becomes.

There are many reasons why countries have budget deficits. Governments have become over-stretched and find cutting expenditure politically difficult. Traditional sources of revenue (such as mining or agricultural taxes) have declined and/or tax compliance has eroded. Yet, these are explanations of why deficits arise, not why they persist. This policy brief examines one reason for the persistence of deficits, namely the view among policy makers that financial capital (i.e. money and credit) can create real capital.

Although this is a widely held belief, it is a major error common to both developing countries and economies in transition. It has fostered the general over-expansion of money and credit producing high rates of inflation, currency devaluation, capital flight, and financial disintermediation. The most compelling evidence of the error is that if finance had been a source of real capital, the extraordinarily high rates of credit expansion that have occurred in Africa would have made the continent exceedingly wealthy. In fact, the reverse has occurred precisely because of the adverse general equilibrium effects that accompany rapid increases in credit.

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The conditions under which finance can "create" real capital—stable prices, adequate foreign exchange reserves, excess productive capacity, and no adverse effects of the credit expansion on expectations—are stringent. Apart from Mauritius and Botswana, they have not been satisfied anywhere in Africa over the last three decades.

Finance can only increase real capital if it mobilizes (i.e., frees up) real savings, which are resources that have been explicitly set aside from current income for purposes other than consumption. In his book *Leading Issues in Economic Development* (1989: 178), Meier explained:

Although the existence of a more developed capital market and financial intermediaries will aid in the collection and distribution of investible funds, they in no way lessen the need for real saving. The rate of investment which it is physically possible to carry out is limited by saving, and a "shortage of capital"—in the sense of a shortage of real resources available for investment purposes—cannot be solved merely by increasing the supply of finance.

The basic task of any financial system is to transfer resources from those who have the capacity and are willing to lend to those who have the capacity and are willing to borrow. By accepting financial liabilities (i.e., providing credit), individual lenders release surplus resources (i.e., their savings) to individuals and firms, who promise to discharge the liabilities from the financial surpluses they anticipate generating from their investments.

Aggregating over all borrowers and lenders in the economy (or, more generally, all savers and investors), gives the familiar national accounting identities:

(1) $Y = C + S$

(2) $Y = C + I + X - M$

where

Y gross domestic product

C aggregate consumption (private and public)

S gross domestic savings

I gross domestic investment (including inventories)

X exports of goods and non-factor services

M imports of goods and non-factor services.

Equating (1) and (2) and rearranging gives:

(3) $S - I = X - M$

The implication is that any difference between domestic savings and domestic investment is balanced by the difference between exports and imports.

Identity (3) can be satisfied in a number of ways. Suppose, for example, government expenditure increases without any change in tax rates. The rise in expenditure can produce one of the following:

• crowd out private investment through higher interest rates;

• if there are idle resources (including ample foreign exchange reserves), the increased demand will raise real output yielding higher tax revenues and increased private saving;

• if there are no idle resources and monetary policy does not limit the growth of demand, prices will rise and government spending will be covered by forced saving (through the "inflation tax"); and

• alternatively, the increased domestic demand may be matched by higher imports. That may occur through exchange rate depreciation. Imports might also be covered by capital inflow from foreign aid, government borrowing abroad, or private flows in response to higher interest rates.

In African countries, there are seldom adequate idle resources (apart from unskilled labor) to permit a substantial "Keynesian" output response to higher government spending. Increased government spending is often directly linked to increased foreign assistance or deficit financing. Private resources are limited, especially when low confidence among investors leads them to shift their resources abroad (or retain them there). Depreciation of the exchange rate has its own costs in terms of inflation and the redistribution of wealth. The "forced saving" solution is costly and counterproductive and ultimately leads to a net loss of resources, especially in highly indebted countries. Finally, changes in interest rates are typically too small relative to other risks to attract capital inflow.

Countries that wish to raise real output on a sustained basis have to mobilize additional resources. (They also have to use their existing resources more efficiently. In this regard, policies that mobilize resources tend to provide the appropriate incentives for using the resources efficiently as well.) This process requires a stable financial setting in which the individuals and firms who generate surpluses will transfer them to those in the domestic economy who have the capacity to create the additional output. By contrast, the explicit use of financial instruments to extract these surpluses (via inflation, low interest rates, or controls designed to generate "rents" that can be "captured") is counterproductive. It eventually reduces saving and investment leading to slower growth or as Africa's experience has shown, economic contraction.

This policy brief is based on EAGER Research, *Restarting and Sustaining Growth and Development in Africa*, 2000, by James S. Duesenberry [duesenb@fas.harvard.edu], and Malcolm McPherson [mmcphers@hiid.harvard.edu], Harvard Institute for International Development, Cambridge, Massachusetts.

The views and interpretations in this policy brief are those of the authors and not necessarily of the affiliated institutions.

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