

Presidential Address

Financing Economic Development

A. R. KEMAL

I. INTRODUCTION

We understand that both the level as well as the composition of investment play a crucial role in the economic development process. However, it needs to be understood that investment contributes to the growth process by increasing the productive capacity, improving the technology, and enhancing the competitiveness of an economy. And when it is supplemented with investment in the social sectors, it also results in human development. The demand for investment depends on strong macroeconomic fundamentals comprising stability of exchange rates, fiscal prudence, feasible structure of financial market, including the regulatory and supervisory framework and the size and quality of the securities and bond markets, and continuity of a consistent investment policy.¹

Two types of capital formation may be distinguished, viz., physical capital and human capital. Since there are significant differences between private and social profitabilities in the social sectors, an optimal level of investment in human resources would depend on the perception of and the decisions taken by the policy-makers to bridge the gap between the two types of profitabilities. Nevertheless, implementation of an investment decision, whether related to physical or social investment, is contingent on the availability of sufficient domestic and external investible resources. The former comprise voluntary and involuntary household savings, corporate savings, and government savings, and are influenced by a number of factors including the level and growth of per capita incomes, time preferences of individuals in the society, financial intermediation, demographic structure, fiscal policy, etc. The foreign investible resources comprising the overseas development assistance and foreign private direct and portfolio investments are influenced by a

A. R. Kemal is President, Pakistan Society of Development Economists, Islamabad, and Director, Pakistan Institute of Development Economics, Islamabad.

¹Other factors such as the law and order situation, availability of skilled workforce, wage rates denominated by productivity, fiscal incentives, etc., also weigh heavily in the investment decisions. The uncertainty affects the levels of investment adversely. The reforms to improve economic security can raise private investment by $\frac{1}{2}$ to 1 percentage point of GDP in the short-to-medium-term and $\frac{1}{2}$ to $1\frac{1}{4}$ percent over long-term [see Poirson (1998)].

host of factors, most important of which are the strong fundamentals of the economy. The investment in human resources depends on the ability of the government to raise sufficient tax revenues, and on the possibility of domestic and foreign borrowing without affecting the economy adversely.

How these processes can be worked favourably in a developing country is my main focus today. After this introductory section, financing of public investments is examined in Section II. The determinants of private savings are analysed in Section III. Foreign capital investment flows, their determinants and prospects for developing economies, are discussed in Section IV. When to open the capital accounts, and their impact on the economy if they are prematurely opened, is analysed in Section V. The need and desirability of financial assistance is reviewed in Section VI, and debt restructuring is examined in Section VII. The institutional framework for proper resource mobilisation is discussed in Section VIII. The concluding section of the paper draws out implications of the analysis for resource mobilisation in Pakistan.

II. FINANCING OF PUBLIC INVESTMENTS

We know that government needs public revenues to finance both current as well as development expenditures. While there is hardly any justification of public sector intervention in commercial activities where there is no danger of private monopolies, there is little possibility that private sector would invest in such social sector projects where financial rates of return are low. Nevertheless, all such projects that have high economic rates of return need to be taken up for the welfare of the common man even if the financial rates of return are low. Such projects can be initiated only in the public sector, unless the private sector is subsidised. The fiscal system, therefore, has to generate sufficient public revenues to finance such projects. Alternatively, these may be financed by domestic borrowing or through Official Development Assistance (ODA). Let us first discuss the domestic resource mobilisation for public sector development.

Fiscal policy can help increase corporate savings by reducing the disposable incomes of individuals, discouraging private consumption, and creating incentives for the retention of profits [see Islam (2000)]. While a higher level of taxation would tend to increase public savings, its impact on aggregate savings is not unambiguous. It may substitute the private sector savings. Similarly, taxing consumption results in a higher level of savings, but such a tax in general is regressive, violating the norms of equity.² Accordingly, such tax structure needs to be designed as would provide sufficient resources for the current and development expenditures but does not result in lower private savings or a violation of the norms of equity.

²Only if the consumption of the rich were taxed would the objectives of savings and equity be simultaneously realised.

Public revenue in South Asia is around 15 percent, and the tax revenue only 10 percent of GDP. One of the main reasons for the low level of public revenue has been the heavy reliance on trade-related taxes at least initially. The pursuance of import substitution policies led to the loss of revenue from import duties and, because the domestic taxes did not rise sufficiently, to the decline in public revenues. Since expenditures continued to rise, the government savings in South Asia have been negative. They were -3.6 , -3.7 , and -2.7 percent of GDP in India, Pakistan, and Sri Lanka, respectively in the late 1990s.

Value-added tax (VAT) for revenues, import duties for protective and personal income, and corporate income tax for equity may be the optimal tax assignments. VAT is a broad-based tax and can yield higher revenues depending on the design and effectiveness with which it is enforced. Tariffs have been the major source of revenue at least in the initial stages. A high rate of trade taxes and dispersion, resulting in a high level of and dispersion in the effective protection rates, lead to production inefficiencies and create anti-export bias. Accordingly, tariffs have been rationalised and this has resulted in major revenue losses.

It is argued that income tax rates may be reduced, as it would result in improvement in compliance, lighten the tax administration, and promote labour supply and savings.³ It is also justified on the ground that high statutory rates with exemptions distort the system and promote rent-seeking behaviour. This undermines the perception of fairness and results in a complex system and misallocation of resources. While such distortions must be removed, reduction in income tax rates is inequitable because the taxes, which will be imposed to protect revenue, will hit the poor.

The net effect of a tax change on total savings depends, on the one hand, on the relative marginal propensities of different groups to save and, on the other hand, on an increase in public investment or reduction in fiscal deficit. Obviously, if the reduction in private savings exceeds the increase in public savings, the aggregate savings would fall. It may help public investment but may crowd out private investment.

The cross-country regression across countries over the 1975-95 period shows that direct taxes are negatively associated with household savings, though the elasticity is only 0.09. Indirect taxes have no impact on the household savings behaviour. The panel data also show the same result, and although the elasticity rises to 0.16, yet it still is quite low [see Callan and Thimann (1997)].

Cross-country studies indicate that capital and labour taxes depress economic activity in the long run. An increase in the proportional capital tax reduces savings and discourages capital formation. Labour tax reduces capital formation provided labour supply is endogenous [see Heijdra and Ligthart (1998)]. Consumption taxes,

³Reduction in the rate of income taxes produces both a substitution as well as an income effect and the sum of these two could be either negative or positive.

on the other hand, tend to increase capital stock in the long run, provided the inter-generational effect dominates the labour supply effect.

Public investment may also be financed by borrowing if sufficient revenues are not available to meet such expenditures. However, its impact on savings needs to be examined carefully. This is because it can result in inflation and destabilise the economy, leading to lower private savings [see Fry (1991)]. However, when there is slack in the economy, increase in public investment would tend to increase the incomes and savings.

III. DETERMINANTS OF PRIVATE SAVINGS

Household Savings

Two types of household savings, i.e., voluntary and compulsory, may be distinguished. The levels and sustainability of per capita income, openness of international trade, financial and capital market structure, pension and provident funds, the taxation structure, demographic transition, freedom of foreign capital transactions, and competition in domestic market have a positive and significant impact on the household savings rate. High and sustained growth in per capita income tends to increase the saving rates; once growth rates start increasing, they are self-sustaining. However, fiscal stimulus can help increase the savings rate, if the growth rates are constrained because of the lack of effective demand resulting in idle capacity.

Voluntary Household Savings

Various cross-country and time-series and cross-section studies on savings behaviour indicate that real GDP and real deposit rates have a positive impact and fiscal deficit and foreign and domestic debt have a negative impact on savings. The public policies that keep down the inflation rate, reduce uncertainties, and promote financial deepening also have a positive impact on savings [For example, see Hadjimichael and Ghura (1995) and Barro (1989)].

The demographic transition may also raise the rate of savings by reducing the household size. Cross-country data show that the rate of growth of population and the share of population below 15 years of age have a negative impact on the savings rate [see Manzocchi (1999)]. The evidence from South-East Asian countries indicates that a reduction in the population growth rate reduces the young depending cohort percentages and increases the savings rate. At the same time, as the proportion of the elderly increases, it can have a negative impact. The net effect on per capita savings depends on initial conditions such as the share of individual cohorts in the total population and the rate of growth of the labour force. As long as the old cohort does not fully dis-save its wealth, and partially transfers it to dependent youth, a fall in the population growth rate necessarily raises the savings rate.

Whereas the individual's time preference is an important determinant of savings, it is influenced by the well-functioning financial markets.⁴ Financial repression forces financial institutions to pay low and often negative real interest rates, and it results in the reduction of household savings [see McKinnon (1973); Shaw (1973); Demiriuc-Kunt and Detragiache (1998)]. High level of non-performing loans reduces the confidence of potential depositors in the ability of banks to repay their deposits, thus inducing a lower supply of funds to the financial sector. Large share of bad loans in the portfolio also induces banks to widen the spread between borrowing and lending interest rates. High inflationary expectations and unstable macroeconomic environment also creates uncertainty in the system. The countries that had experienced significant banking sector problems recorded a fiscal cost up to 20 percent of GDP [see Lindgren *et al.* (1996); Bandiera *et al.* (1999)].

Reforms in the financial sector can increase the savings rate significantly. Financial sector development can help, for example, in mobilisation of domestic resources by facilitating transactions among individuals and enterprises, providing convenient methods of payment, cost-effective mechanisms for transferring savings from surplus sectors on the basis of profitability and risk assessments, and offering a wider choice of modes of savings with various liquidity and risk profiles. An increase in investment efficiency, resulting from information advantage held by banks in dealing with borrowers, as well as their ability to pool risks and lower costs of financial intermediation, induce a higher expected return for savers at any level of risk, leading to higher savings.

Financial repression is a stumbling block to resource mobilisation and its removal is expected to improve the rate of return to the households. However, the evidence on sensitivity of savings to interest rate is mixed [see Ogaki, Ostry and Reinhart (1995)]. It is generally found that sensitivity of savings to interest rates is a rising function of the income levels. For the very poor developing countries it is rather low, i.e., only 0.18; and in most of these countries it is not even statistically significant. However, interest sensitivity for middle- and high-income groups is relatively much higher; for lower middle-income group, it is 0.55; for upper middle-income group, it is 0.58; and for very high-income countries, it is 0.60. This indicates a statistically significant though small positive effect of the real interest rate on national savings ratio⁵ [see Ogaki, Ostry and Reinhart (1995)].

⁴The financial sector development comprises liberalisation, deepening, and broadening. Liberalisation implies removal of entry barriers, reduction of directed credit allocation, deregulation of interest rates, and removal of controls on inflows and outflows of capital. Financial deepening comprises the growth of financial instruments measured by the ratio of turnover in the financial sector to GDP. Financial broadening refers to an increase in the variety of financial institutions and instruments in a country.

⁵The positive effect of interest rate on savings could be outweighed by the negative effect of increased consumption expenditure permitted by easier credit. Accordingly, imposing restrictions on consumer credit may encourage household savings.

A positive impact of financial development on real per capita income growth and productivity has been found in a number of studies. A robust positive econometric relationship has been found between the banking sector development and private savings rate [Beck, Ross and Loayza (1999)]. Financial deregulation, on the other hand, does not necessarily lead to higher savings, especially in the short run. While some countries show positive results, a negative association has been observed especially in the short run. The decline in the savings rate in the short run in most of the countries has been around 2-percentage point [Bayoumi (1993)]. Nevertheless, over long run, most of the losses are recouped. It is, therefore, safe to conclude that interest rate deregulation is not the panacea.

In view of this, there is an urgent need for reforms in the following three key areas. First, the establishment of an appropriate institutional setting and financial infrastructure as the basis for a sound credit culture and an effective functioning of financial markets. Secondly, the proper functioning of markets, so that owners and other stakeholders in financial institutions have a strong incentive to exercise adequate discipline. Third, the creation of regulatory and supervisory arrangements that complement and support the operation of market discipline.

The stock markets have assumed an increasing role as a means to mobilising domestic resources and providing a wider range of financial services. This has been facilitated by the deregulation and liberalisation measures, as well as by specific policies to foster the development of stock markets [ESCAP (1995)]. With a view to ensuring that individuals invest in stock markets, the regulatory framework must be efficient and independent. The confidence of the investors needs to be established by curbing insider trading and speculation. Developing independent domestic credit rating agencies would help a great deal in this direction.

Equity markets provide both an alternative to bank financing and a means to exercise market discipline over bank managements. The ratio of stock market capitalisation to GDP is correlated with several economic determinants that can be influenced by economic policies, suggesting that, over time, public policy can help fill the gaps in the financial market structure.

The breadth and the depth of capital markets can widen the availability of finance to corporate bodies through new instruments, e.g., bonds, and retail savings instruments. However, the existing small markets are vulnerable to speculative runs and other forms of manipulation. When currency markets are too thin and shallow, there can be speculative attacks. Hedging instruments may be used to avoid the losses arising from exchange movements; market-based flexible exchange rates have added new risks of unexpected exchange rate movements and significantly increased the need to hedge currencies and prices. With a view to ensuring that hedging instruments are effective and not another source of speculative activity, it is necessary that the markets where they are traded are deep and the price discovery process robust. Since a large number of investors may not know of the currency

hedging, there is a need to increase awareness and technical training. Speculative attacks or any other type of manipulations may be stopped by regulation to ensure disclosure, transparency, and better accounting and auditing practices.

Involuntary Household Savings

Involuntary savings may be promoted through mandatory provident funds and fully funded pension schemes. These have been employed very effectively in Japan, Malaysia, and Singapore. They have the potential to raise the savings rate upto 3-4 percent of GDP and ensure cash flow, change the short-term liability to a long-term liability, and are an ideal source of term finance for both private and public sectors [DRI/McGraw Hill (1998)]. However, the impact of such schemes on aggregate savings depends on the extent to which they substitute the voluntary savings. Econometric evidence on Singapore's fully funded Central Provident Fund shows that it has stimulated aggregate savings, and similar results have been obtained for Chile, though with a considerable time lag. Nevertheless, it will have a significant impact only in those countries that have a large organised production, especially the corporate sector.

Pension funds add to the institutional investor pool for domestic capital markets. While pension funds potentially could be quite large, it is not all that easy to start new funds, and they may not have sufficient finances initially. It may not be feasible to organise pension funds on a sustainable basis for the informal or unregistered sector. Moreover, because of unscrupulous brokers, these lack credibility. And it is rather difficult to supervise brokers except through a viable national association of dealers. Life insurance, unemployment insurance, and other forms of insurance in the developing economies exist mainly in the government sector and in the formal sectors of the economy. The coverage varies from country to country; it is higher in the countries with a large organised sector.

Corporate Savings

Corporate savings have been an important component of the aggregate savings rate, e.g., in Taiwan, where it accounts for almost one-quarter of the total savings. Corporate savings depend on profitability on the one hand, and dividend and retention policies of the firms on the other hand. Profitability of corporations is basic to the corporate savings rates. This calls for an improvement in the productivity of the corporate sector. While tariff rationalisation is expected to result in higher levels of efficiency, it does not necessarily result in a higher level of profits at least in the short run.⁶ On the other hand privatisation in a competitive market structure is expected to result in higher levels of both efficiency and profitability, and consequently higher corporate savings.

⁶Over longer run, through better allocation of resources and higher growth rates of output, savings may increase.

Fiscal measures can be used to encourage corporate retention. The tax structure that creates incentives to retain profits may result in a higher level of corporate savings. The structure of ownership can be important and may insulate corporations from the pressure for greater dividend distribution.

IV. FOREIGN PRIVATE INVESTMENTS

Foreign capital flows take different forms: official development assistance (ODA), private short- and medium-term lending, foreign direct investment, and portfolio investment. While ODA in the past constituted the major flows across the country, the pattern of flows has changed over time. The concessional official flows have fallen and private flows based on profitability consideration have increased.

Whether foreign capital would help in increasing the investment level depends on the usage of aid [see Calvo and Reinhart (1996); Manzocchi (1999) and Mapalad (1998)]. On average, 60 percent of the aid was used for investment and the remaining 40 percent for reduction in taxes or reduction in domestic borrowing. Even in the case where the financial institutions substantially increase their aid flows, the impact of financial liberalisation on government investment depends on the way in which the aid is spent.

Foreign private investment flow not only provides additional resources, it also brings along a range of dynamic benefits including the transfer of technology, improved management practices, market access, competition, lower capital cost, and building the market confidence. While both FDI as well as portfolio investments add to the investible resources, it is generally presumed that portfolio investments are less useful than FDI. However, capital flows characterised by a high level of foreign direct investment and a low level of portfolio flows are not necessarily optimal; it depends on whether or not the capital flows are permanent and benefit the economy over the long run [Lopez-Mejia (1999)]. If FDI is driven by distorted incentives, it may be welfare-reducing, especially if it is concentrated in the highly protected economic activities. As debt services and investors' remittances start to pick up, non-exporting foreign projects severely constrain the balance of payments. Accordingly, there is a need to ensure that foreign private capital flow into the foreign exchange earning sectors. In view of the limited capability of low-income developing countries to service their foreign debt and investment, FDI should flow towards export-oriented manufacturing, tourism, and activities directly supporting the export sectors.

The risks and the costs associated with private capital flows are closely related to management issues. Prudent management by the financial authorities can minimise those risks and costs considerably. Accordingly, the magnitude, productivity, and volatility of different kinds of foreign capital need to be monitored closely. It must be underscored that it was the lack of portfolio management that led to the maturity mismatch and serious currency crisis in East and South East Asia. Accordingly, target portfolio of foreign capital, comprising the commercial bank

borrowing, equity investment, bond investment, and FDI, must be maintained and monitored.

The FDI may be both a substitute and a complement to domestic investment. It substitutes the domestic investment where plenty of domestic firms exist. Sometimes, it is suggested that any foreign private investment should be encouraged because of the existence of backward and forward linkages. However, FDI is not sufficient for crowding in the investment. Panel data for 32 countries over the 1970-1996 period does not show unambiguous results; in some South and South-East Asian countries FDI has crowded out the domestic investment, and in some others it has crowded in domestic investment.

While the world Foreign Direct Investment (FDI) exceeded \$ 800 billion in 1998-99, in the developing world it was around \$ 208 billion, and South Asian countries had a capital inflow of only \$ 3 billion. The factors responsible for low levels of FDI include investment restrictions, ambivalent attitude towards foreign investment, inconsistent policies, poor law and order situation, and the threat perception increasing further after the nuclear explosions. The region has considerable potential but its realisation will depend on the pace of liberalisation and economic reform, and on domestic and regional stability.

Developing countries can benefit from the growing pool of global capital to supplement domestic resources. Besides, the indirect benefits of foreign capital inflow include knowledge, spillover effects, improved resource allocation, strengthening of domestic financial markets, and a shift to higher returns on investments. The simulation exercises show that foreign investment can have large gains. The dynamic gains range between three to fifteen percent of GDP. The domestic firms that provide intermediate services have shown improvements in productivity [World Bank (1997)].

Countries with the strongest fundamentals, such as a high investment-to-GDP ratio, low inflation and low real exchange rate variability, openness of the economy, health of domestic banks, flexibility of fiscal policy, good state of public finance, fair size and quality of domestic bond market, and the quality of regulatory and supervisory framework over the financial sector, are expected to receive the largest flows as percentage of GDP [Goldstein (1995)]. We may note that long-term inflows react to long-run fundamentals like investment and external debt-to-GDP ratio and are not sensitive to short-run arbitrage condition. The short-term flows, on the other hand, are quite different and basically respond to financial liberalisation and capital accounts.

Developing economies may also leverage additional private sources of finance. For example, multilateral financing agencies may join hands with the private sector and provide joint financing and increase the leverage to help countries and firms to tap international capital in a variety of forms. Similarly, development of linkages amongst stock markets, between the countries of the region, cross-listing of

shares on the regional markets, and structured finance and securitisation offer new opportunities for developing countries.

Offshore funds have greater flexibility and less procedural delays in changing the nature, structure or operation of their product, and they face fewer investment restrictions, short-term trading limitations, and capital structure requirements [Kim and Wei (1999)]. However, such funds can create or fuel a financial crisis because they engage in positive feedback trading⁷ and are eager to mimic each other's behaviour, ignoring the fundamentals of the economy. In the presence of noise traders, even rational investors may engage in positive feedback trading and destabilise the market.

Divestiture of public enterprises may also help in raising foreign resources. However, while divesting, it needs to be ensured that the action results in higher levels of investment over the long run. With a view to maximising the price of the assets, it is advisable to restructure these enterprises and make them profitable before offering them for sale. Decisions such as labour shedding and changes in the price of the output should be taken prior to divestiture to maximise the value of assets. At the same time, higher prices are expected for the assets in countries that have strong fundamentals, a rationalised tariff structure, credible capital accounts, proper regulatory authority, and a history of continuity of the policies within a good governance structure.

Infrastructures development through private funds, especially foreign funds, can play a crucial role in increasing the investible resources. This would be helped by an increase in the internal generation, which is achievable by improving the efficiency of the operational entities and developing the capital markets. Legislation and implementation of the relevant laws and regulations, as well as simplification of procedures, would also go a long way towards promoting private funds. Further development of bond markets and deregulation of investment in contractual savings instruments, such as insurance and pension funds, would help in long-term generation of foreign funds. Furthermore, uses of different variants of "build, own, operate, and transfer" (BOOT) can be effective in raising international funds; but there must be caution that such investments do not generate into government-ensured high returns to capital.

V. OPENING OF CAPITAL ACCOUNTS

The degree of capital account liberalisation and financial deregulation determine the potential gains and benefits to be had from access to foreign financial services. No doubt, the likelihood of a banking crisis increases after financial liberalisation but this happens only in a weak institutional environment characterised by poor rule of law, widespread corruption, inefficient bureaucracy, and ineffective

⁷This means buying the securities as the prices rise and selling them as the prices fall.

contract enforcement mechanisms [Demiriuc-Kunt and Detragiache (1998)]. If liberalisation takes place without a well-developed inter-bank market, banks would find it difficult to deal with temporary liquidity shortages and their spread to other banks would create a panic. Empirical evidence suggests that the limited openness has been rather costly as there is a higher cost of financial services, slower institutional development, and fragile financial system [Mishin (1999)].

The developing countries must not liberalise capital accounts until they put in place an effective regulatory and supervisory regime. The positive effect of liberalisation on financial development may be stronger than the negative effect of a banking crisis in countries that were initially in a state of financial repression. However, in the presence of imperfect information, free capital mobility is likely to amplify existing distortions, create situations of moral hazard, encourage excessive risk-taking, and generate major and costly crises.

Capital inflows have two major effects on the domestic banking system. First, the quasi-fiscal deficit increases as a result of the sterilisation policy that sells high-yielding domestic bonds and buys foreign exchange, earning lower interest rates. Second, the financial system might become more vulnerable because of a rise in lending that may exacerbate the maturity mismatch between bank assets and liabilities and reduce loan quality. Resultantly, the financial sector becomes more vulnerable, especially by a surge in asset prices that is unsustainable. Moreover, with increased capital mobility, the external counterpart of money supply may become more volatile, and the demand for domestically defined monetary aggregates may become more sensitive to international interest rate differentials, thus making it more difficult to identify a stable domestic monetary aggregate.

A statistically significant impact of open capital accounts on financial deepness and economic growth has been observed in a cross-section of developed and developing countries over the period 1986 to 1995 [Klein and Olivei (1999)]. Countries with open capital accounts enjoyed a significantly greater increase in financial depth than countries with continuing capital accounts restrictions. After liberalisation, even financially repressed economies tend to have improved financial development even if they experience a banking crisis.

When international capital movements are eased, banks may start taking foreign exchange risk, i.e., raising funds in foreign currency on international markets and lending to the local borrowers. Prudential limits on foreign currency exposure are circumvented in various ways and currency risk is transformed into credit risk by lending in foreign currency to unhedged domestic borrowers. As the skills to screen and monitor risky borrowers, manage the risky loan portfolios, and effecting efficient supervision can only be acquired through learning-by-doing, the developing countries' banks would continue to be more vulnerable.

Capital mobility may be politically unsustainable even if it enhances efficiency. Capital movements may be impeded not only by legal barriers but also by

other limitations, like the differences in legal systems, language or cultural habits, and technological levels. Thus, for smooth and uninterrupted capital mobility, international fiscal coordination may be necessary.

With a view to avoiding financial instability, capital controls are suggested. These may be classified into controls on capital outflows and controls on capital inflows [Gregorio, Edwards and Valdes (2000); Edwards (1999, 1999a); Tobin (1985)]. The controls on outflows, however, have been largely ineffective; they are easily circumvented, encourage corruption, and have never helped the adjustment process. Moreover, the controls on outflows are generally not a temporary device; instead, they become a permanent feature of the country's incentive structure. Control on short-term capital inflows would rule out the speculative activity, and Chile's experience between 1991 and 1998 is seen as a successful example of this policy.

Imposing tax on foreign capital may restrict capital flows. It may be argued that a global tax on foreign exchange transactions would reduce destabilising speculation in international financial markets but it will be effective only if all the countries tax such transactions simultaneously. Since it penalises short-term credit, the yield curve tends to be inverted. Small firms, which cannot issue long-term bonds in international capital markets, have to borrow at a differential interest rate higher than similar firms in other countries. In other words, there is a bias against firms that cannot borrow for long, which are usually small businesses and firms that are starting operations. Instead of taxes on capital, liquidity requirement of the banking system is the alternative way to reduce vulnerability caused by short-term flows.

The restrictions on foreign capital are being suggested because the country may become insolvent. It may be argued that as long as the intertemporal budget constraint is satisfied, the foreigners would be willing to lend. The solvency condition states that the present discounted value of future balance of trade surpluses must equal the present level of net external liabilities. Intertemporal solvency imposes too few restrictions on the path of the current account and external debt to provide a reliable guide to policy-makers concerning potential problems with a country's external position [Milesi-Ferrett and Razin (1996)]. Even in the presence of intertemporal solvency, the questions about the sustainability of current account imbalances may arise if lenders have doubts about the borrowing country's continued credit-worthiness.

VI. OFFICIAL DEVELOPMENT ASSISTANCE (ODA)

In spite of growth in foreign private investment, there are at least three reasons for continuation of ODA. First, the poor countries do not have strong fundamentals, and, therefore private capital may not flow to such countries. Second, all such activities where the financial rate of return is not high, the private sector may not move even if the project is economically viable. Third, the developing countries have

distortions in the system, and as they would not be able to open their capital accounts, investment would not be forthcoming.

ODA has been the traditional source of capital flows but its significance has declined in recent years. The developing economies have received only \$ 20 billion of ODA as compared to \$ 208 of the foreign capital private flows. The success to raise ODA depends on a favourable external environment in an interdependent world, and as such there is a need for consistency and coherence in the approaches to development between the donor and the recipient countries, and among international institutions, in support of quality development. The need to reinvigorate support for ODA in donor countries cannot be over-emphasised. And ensuring proper utilisation of foreign aid in macroeconomic governance plus a visible commitment to poverty reduction on the part of the recipient countries can go a long way in that direction. Accordingly, there is a need to streamline aid delivery and improve the quality of aid. This would involve more expeditious disbursement, better understanding of the priorities between the donors and the recipients, with due respect for the opinion of the recipient countries, and appropriate measures to ensure availability of counterpart funds.

ODA quantity should be increased as nearly half of the world's population still lives in poverty and the developed countries have committed to devote 0.7 percent of their GNP as ODA. Nevertheless, it should have a clear focus on social sectors including, in particular, human resources development and physical infrastructure development, which have a direct impact on poverty alleviation. New modalities for the delivery of ODA could include support for public/private partnerships to facilitate trade and investment.

There is also a need for further improvements in aid coordination among donors. This would help countries cope with the administration burden associated with aid flows, avoid duplication, and reduce multiplicity of conditionalities. ODA should be directed to low-income countries. This means increasing their productivity through investment in infrastructure co-financed by aid and private sector, so as to compensate for tax incentives for investment in disadvantaged countries, as well as to finance insurance for foreign investors.

VII. DEBT RESTRUCTURING

Debt relief is needed for many poor countries and must be structured to complement other forms of development assistance. Developing countries have large debts which they cannot service. A large debt overhang entails well-known economic costs, induced by both illiquidity and disincentive effects. A high level of debt creates uncertainty about the country's capacity to service its debt and discourages investment. Moreover the investors may perceive it to be a form of tax on future income of the country, thus dissuading investment. Accordingly, they need debt relief rather than debt restructuring, and this should be a component of crisis

management. As a matter of fact, this can be a major source of funding especially for countries whose savings move out of the country by way of debt servicing.

The short-term employment and output costs associated with debt overhang can be substantial and, as such, it is beneficial to both debtors and creditors to act collectively to reduce the face value of debt. However, it is difficult to coordinate debt reduction among a large group of creditors because of the free-rider problem: each creditor has an incentive to refrain from offering debt relief on its own claims and to wait for others to do so, thereby raising the expected value of its own claims. If lenders interact non-cooperatively, each of them, taken individually, may in fact be willing to provide some debt relief although not so much as they would if they were not to act collectively [Helpman (1989)]. Such externalities do not, however, create a *prima facie* case for welfare-improving government intervention, in particular because of the well-known moral hazard problems that such an intervention creates.

Restructuring enhances the lenders' control over the value that they assign to a loan on their balance sheets. This control itself has value. Replacing an old loan with a new one, stretching out payment schedules, adjusting the interest rate, and even forgiving missed interest payments are all ways of maintaining the fiction that a loan still has the same value even though the appropriately risk-adjusted present value of the probable stream of payments to flow from that asset may have been diminished.

As long as lenders have reason to prefer restructuring to default or mere inaction, borrowers have reason to do so as well. In effect, contract terms such as cross-default and negative pledge clauses are a way for lenders to align borrowers' interests with their own. To the extent lenders want to see a non-performing loan restructured, such terms give the borrowers a reason to seeking a restructuring also.

By participating in a formal debt restructuring, borrowers in effect reduce the value of what they owe but do so in an orderly way. Hence the borrower acquires not only a reputation for not servicing debts as promised but also, importantly, a reputation for participating in an orderly resolution of the resulting problem.

The conflicting incentives of borrowers and lenders and the asymmetry of information that a borrower and the lenders have about the borrower's financial condition and prospects create a classic moral hazard situation. Hence the need for mechanisms to commit borrowers to meet their obligations. In the specific setting of what to do when borrowers fail to meet their obligations, the obvious conflict rises from the inferences that future borrowers, including but not limited to those having difficulties at the moment, draw about the likely consequences of their own subsequent non-performance. Creating mechanisms that preserve or even enhance those presumptions, even at the cost of foregoing mutually beneficial actions in some specific transactions, is therefore potentially valuable.

Official lending potentially plays a key role in questions of sovereign credit debt restructuring. Because the borrowing governments in these cases are often

conduits for their countries' private-sector borrowers, official lending is also in effect available more broadly. Greater participation of the private sector is imperative to ensure an equitable distribution of the costs of financial crises between debtors and creditors, but there is no agreement yet on how to "bail in" private lenders. Measures such as conditionality clauses in bond contracts, standstills, and improved bankruptcy legislation are desirable but not exhaustive. Since most of the lenders are in the developed countries, greater transparency and supervision and regulation of international lenders and investors by these countries themselves are needed.

VIII. INSTITUTIONAL FRAMEWORK

A poor institutional framework is the result of a combination of underdevelopment in the realm of contracting and regulations, and of overly powerful political interest groups who have tilted the institutional balance in their favour. Examples of the institutions that govern transactions in financial markets are corporate governance arrangements, financial accounting and auditing rules, debt covenants, or bankruptcy procedures. Examples of labour-market institutions are the tenure profile of wages, dismissal rules and procedures, or the regulations that govern collective action. Establishing a better linkage between the formal and the informal sectors with a view to developing a complementary relationship between them in efforts towards the mobilisation of domestic resources is an important policy concern [Chandavarker (1992); Caballero and Hammour (1998)].

A perfectly competitive banking system transmits economic shocks without magnifying them, but an imperfectly competitive banking system responds to adverse shocks in ways that worsen their impact, inducing negative macroeconomic feedback. The presence or absence of a non-bank financial intermediary or market has major implications for bank soundness and for the robustness of a country's financial system.

Enhanced economic security fosters private investment and growth in developing countries. Based on an analysis of economic security rating for 53 developing countries during 1984-95, it appeared that reforms to improve economic security in specific developing country regions to "best practices" in other developing country regions could raise private investment by $\frac{1}{2}$ to 1 percentage point of GDP in the short-to-medium term. In the longer term, the payoff in real economic growth could be in the order of $\frac{1}{2}$ to $1\frac{1}{4}$ percent a year [Callan and Thimann (1997)]. The results suggest that institutional reforms, including an increase in civil liberties, further boost private sector confidence, and reduce corruption to raise longer-term growth prospects. It is also evident that the political and economic environment affecting private investment decisions includes government leadership, external conflicts, corruption, rule of law, racial and ethnic tension, political terrorism, civil war, quality of the bureaucracy, risk of repudiation of contracts, risk of expropriation by government, and political rights and civil liberties [Poirson (1998)]. Indeed,

expropriation risks and political terrorism are the most important security factors that bear on economic growth. Corruption and contract repudiation also affect growth, but only in the long run.

IX. CONCLUSION

Pakistan's investment levels have been in the neighbourhood of 18 percent, and this percentage is relatively quite low; it has fallen to the lowest level over the last 30 years in the last couple of years, i.e., 15 percent of GDP. No doubt, to a large extent, this is a reflection of the fact that respective governments have taken various actions that have shattered the confidence of investors. The low levels of investible resources have also been one of the major constraints. The main results of the present study, therefore, can help examine the low levels of savings within the country and low and declining foreign private investments for possibly meaningful policy changes.

Whereas private savings of Pakistan are also low, the government savings have been negative for more than a decade. With a view to turning the dissavings to savings, the government is making an effort to reduce its fiscal deficit and to ensure a surplus on the current account of the budget. So far, these policies have had little success. Pakistan has experimented both with an increase as well as a decrease in the tax rates, but public revenues as a percentage of GDP have either stagnated or fallen in the 1990s. Now efforts are being made to improve the tax administration for better compliance, and one only hopes that they are successful. However, one wonders whether higher levels of aggregate savings can be achieved even if the government is able to raise sufficient resources to finance its expenditures. If such revenue comes from savings rather than from consumption of the private sector, the aggregate savings of the economy may fail to rise.

The major determinants of savings, as noted in Section III, include the levels and sustainability of per capita income, openness of international trade, favourable financial and corporate structure, provision of pension and provident funds, strong tax structure, and demographic transition. Despite the doubling of per capita income, the savings rates in Pakistan have ranged between 12-14 percent. Probably the potential for higher savings could not be realised because of the liberalised consumption made affordable by smuggling.

Financial repression has also been responsible for low savings rates. The rates of return on deposits have been barely sufficient to offset the erosion of money due to high inflation rates. In recent years, the financial sector has been de-regulated, but due to a high proportion of defaulted loans, the rates of return on deposits remain low.

The demographic transition also has been instrumental in raising the savings rates. The population growth rates in the 1990s have shown a tendency towards decline. With a fall in the dependency ratio, the savings rates are expected to rise.

Whereas foreign capital is raised to increase the investment levels, on average only 60 percent of the capital flows has been used for investment purposes. Pakistan's experience is even worse, where the impact of capital inflows on investment was marginal. Whenever the external aid was obtained, the government's effort to mobilise resources slackened, and it even increased public consumption. It has generally been said that FDI is preferable to loan because while the former would always lead to higher investment levels, the latter may not. This is not necessarily true. The capital is fungible and FDI may crowd out the domestic investment.

The significance of official development assistance has declined, and that of foreign private investment increased. As compared to the total inflow of 20 billion dollars of ODA, the foreign capital inflow in the form of investment in developing countries has been \$208 billion. No doubt, foreign private investment brings with it dynamic benefits such as the transfer of technology, improved management practices, market access, competitive lower capital, and building the market confidence, yet the fact remains that it may not come to the social sectors, which are vital to the development process of Pakistan at the present stage. Besides, if FDI is driven by distorted incentives, as is the case in Pakistan, or if it flows only to those economic activities which are non-traded, such as the IPPs and motorways, it would severely constrain foreign exchange resources.

Countries like Pakistan need ODA rather badly. However, in a number of years in the 1990s, net ODA flows have been negative in Pakistan. The ODA depends on a suitable environment in an interdependent world and, therefore, a consistency and coherence in the approaches to development would help in using these resources better. There is a need to streamline aid delivery and to improve the quality of it, as discussed in the preceding section of this paper. It would pay if the sensitivities of public opinion in the donor and recipient countries are kept in view. Accordingly, Pakistan should come up with projects and programmes relating to social sectors and poverty alleviation; and the donors may watch their own side.

Pakistan has a large debt which it finds difficult to service. The donors agreed to reschedule the debt in 1999, and they may agree to do so once again. But what Pakistan needs is debt relief rather than just debt re-scheduling. As long as heavy debt looms on the economic horizon, it will remain difficult to overlook the uncertainty about the country's capacity to service debt and encourage investment.

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