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Proactive Financial Policies for Financing Productive Investment

In recent years, an increasing number of developing countries have registered current-account surpluses, implying net capital outflows. At the same time, many of these countries have registered higher rates of domestic investment. The mainstream view, by contrast, is that developing countries require net capital inflows ("foreign savings") as a complement to national savings for raising investments and accelerating growth.

Net capital inflows are not sufficient for achieving higher rates of investment, nor are they even necessary for developing countries at all times. In contrast to orthodox theory, higher corporate investment does not require an *ex ante* increase in household savings. Incentives to reinvest company profits, adequate and affordable bank credit as well as investment-friendly macroeconomic and financial policies matter more.

Foreign sources of finance can play a critical role at certain times for certain countries, for instance, to finance imports of capital goods when there are structural impediments to increasing export earnings. But domestic sources of finance have been more important for financing productive investments than foreign sources. From the perspective of firms, self-financing – with retained earnings – is the most important and reliable source for financing investment, but bank credit must play an important complementary role.

As the availability of retained profits is a key determinant of investment, measures that increase the liquidity of firms and encourage their fixed capital investments may spur capital formation. Possible measures include a range of fiscal incentives and disincentives, such as preferential tax treatment for reinvested or retained profits, special depreciation allowances, and high taxation of luxury consumption and income from speculative activities.

The impact of such measures on productive investment can be amplified if banks are encouraged to make loans more easily available for productive investments. To the extent that investment can be financed by the banking system, which has the power to create credit, the prior existence of savings balances in the financial system is not a prerequisite for investment. Appropriate institutional arrangements and additional policy instruments to maintain price stability can prevent monetary policy that stimulates investment from becoming inflationary. In particular, an incomes policy, that prevents excessive nominal wage increases, and a flexible fiscal policy that responds to cyclical changes in aggregate demand can be effective.

Cost and availability of investment finance: policies matter

Monetary policy targeting high rates of domestic investment would also help reduce the costs of bank financing. When interest rates are too high, they negatively impact on the most important sources of financing for investment – company profits and bank credit. This is probably the main reason why the financial reforms undertaken by many developing and transition economies in the 1980s and 1990s generally failed to improve investment ratios. As the reforms involved restrictive monetary policies aimed at maintaining low inflation, they generally involved higher interest rates.

Financial deregulation since the mid-1980s, in many developing countries coupled with capital account liberalization, brought about an expansion of banking activity and fast increases in net inflows of foreign capital, but seldom led to a sustained increase in bank lending to private enterprises for investment purposes. Instead, it led to a boom in lending, mainly for consumption and real estate acquisition. The process often ended in financial and banking crises, in the course of which governments and central banks had to rescue the banking system at considerable fiscal costs.

The expectations that financial liberalization and opening up domestic financial sectors to foreign banks and firms would introduce more competition, which would eventually reduce interest spreads and the cost of credit, did not materialize. Spreads and lending rates have remained generally high, to the detriment of corporate and investment financing. Even after banking crises, commercial banks generally find it more profitable and less risky to extend consumption and housing credit, or to purchase government securities, than to provide longer term loans for investment projects or new business activities.

Banks and other financial institutions influence investment activity in developing countries by the way they allocate financial resources among different types of borrowers and economic activities, according to their own objectives and strategies. Their reluctance, and often unwillingness, to provide long-term investment credit, combined with high interest spreads and lending rates, often reflect a perception of high credit risk and difficulties in collateralizing such loans.

Therefore, governance reforms in developing countries should primarily deal with such institutional shortcomings that pose major obstacles to the provision of long-term credit for investment at reasonable interest rates. These shortcomings tend to differ from country to country, but are likely to involve property rights, provision of collateral, enforcement of credit contracts, and effective competition in the banking sector.

In most countries, access to bank credit still depends heavily on the size of the firm, so that new, innovative and small enterprises, in particular, often encounter severe financing constraints, even when they are able to pay high real lending rates. Financing from securities markets is usually only available to a small number of large private corporations or public entities.

In allocating credit, discrimination between borrowers and projects is inevitable; the relevant question is not whether or not the financial system should discriminate, but the appropriate criteria for such discrimination. Experience suggests that, in many cases, the market mechanism has not optimized credit allocation. Governments can play a role in providing credit to sectors and activities that are strategically important for the economy as a whole. They may resort to direct credit provision by public financial institutions or intervene in financial markets through measures such as interest subsidies, refinancing commercial loans, or guarantees for certain types of credit.

Moreover, stricter control of lending for consumption or speculative purposes could induce banks to extend longer term loans for investment purposes. Where high lending rates reflect perceived risks, government guarantees for loans to finance promising investment projects can help reduce borrowing costs. This would make credit available to firms that have limited access to long term bank credit – or may only be able to obtain such credit at extremely high cost, making most investments unviable. While this may entail fiscal costs when a project financed in this way fails, these costs have to be weighed against the total increase in investments that will only be made because of such guarantees, and the dynamic income effects (including higher tax revenues) which these additional investments generate. They should also be weighed against the fiscal costs of large rescue operations for the financial system, as becomes necessary following financial crises which, in turn, result from excessive credit for consumption and speculative purposes – i.e. a feature that could be observed in many countries in the aftermath of financial liberalization.

Public banking: reconciling commercial and development objectives

Public sector banks, particularly development banks, can also play an important role in financing development. The criticism of public banks has often centered on the claim that state ownership of such institutions will increase opportunities for corruption and patronage, delivering finance to projects without economic merit. But private banks are not immune to corruption and patronage either, especially when linked to conglomerates that rely on them for cheap finance. On the other hand, public and development banks can only fulfill their developmental role if governed by clear mandates, strict rules of accountability, and regular performance monitoring.

It is not only the microeconomic profitability of an investment project that matters, but also the benefits the project generates for the economy as a whole. One way to bring both commercial and development considerations to bear on credit allocation is through joint financing of certain investment projects by private and public banks. Whereas a commercial bank can contribute its expertise in assessing the viability of a project from a private sector perspective, public financial institutions could make judgments from the point of view of the project's overall developmental merit. Participation through public co-financing could reduce the risks to private commercial banks. It might also serve to leverage public financing with private financing, and reduce the risks of patronage on the part of both private and public financial institutions involved. Whether through this or other kinds of creative and non-dogmatic approaches combining the actions of public and private agents, the financial sector can more effectively contribute to productive investment and growth.

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