# SUSTAINABLE DEVELOPMENT OF FINANCIAL RESOURCE CAPITAL

**Elsa Assidon**
*Université de la Sorbonne Nouvelle (Paris III), France*

**Règis Mahieu**
*Université de Versailles, France*

**Keywords:** Macroeconomic equilibrium, dependent economy, public finance, debt, intergenerational transfers, financial deepening, emerging markets, credit rationing, micro-credit, bank's governance, poverty.

## Contents





## Summary

This article examines how social and financial sustainability can be reconciled. In the first section, it presents the traditional macroeconomic framework of the dependent economy. This framework is illustrated by the Less Developing Countries (LDC) case, where the main actor is currently the state, in a context of still weak financial development, and by connected problems of foreign debt in general.

In a second section, the question of sustainable development of financial resource capital is focused on the institutional strengthening on a wide range of scales, from financial assets markets to micro-credit institutions. Various problems are mentioned: the financial sustainability prima over social concerns in the International Monetary Fund conditionality, the incidence of debt on intergenerational transfers, incertitude and instability on emerging markets, the trade-off between outreach, and sustainability in microfinance.

## 1. Introduction

Sustainable development is an old concept in the field of international and development economics. It referred first, for the Bretton Woods financial institutions ("Washington Consensus"), to sustainability of macroeconomic equilibrium: balance of payments, public budget, external borrowing. The main objective has been to restore equilibrium in these three fields, whatever may be the social sustainability in the societies concerned. This latter problem led to the founding of the Social Development Adjustment (SDA) program in 1989, with the link (a social conditionality) made official in February 2000 in the International Monetary Fund (IMF). But financial sustainability is also internal, concerning the capacity to mobilize resources, via fiscality or financial intermediation, without destroying the future of younger generations. Sustainable financial development is a protection "one to" of the future of the youngest by the oldest. But how can social and financial sustainability be reconciled? The most recent solution (Libreville, HIPC) has been to transform social development (anti-poverty policy) into the conditionality of financial aid.

Financial institutional development is, as a matter of fact, a complex historical process. During the last twenty years, it has been mainly regarded through the financial liberalization paradigm. Defaulted bank loans have been partially exchanged into market bonds in all major Latin American countries since the debt crisis triggered by Mexico in August 1982 (the "Brady Plan"). During the last decade, capital markets rather than banks have become responsible for around half of renewed private flows to emerging economies. Key considerations connected with information, finance securement, and lenders' and borrowers' behavior are reactivated in this context. Nevertheless, since the Mexican financial crisis of December 1994, large-scale multilateral support in early 1995 to Mexico, and furthermore to Russia, Brazil, and Asian countries, has cast doubt on the sustainability of deregulated financial markets. The financial markets' instability has changed the perceptions of the role of the IMF in crisis management. Is this institution able to play the role of the lender of last resort in emerging financial markets? How can sound capital markets be created?

In Section 2, this contribution presents the traditional macroeconomic framework of the dependent economy. This framework is illustrated by the LDC case, where the main actor is currently the state, in a context of still weak financial development and by connected problems of foreign debt in general. In Section 3, the question of sustainable development of financial resource capital is focused on the institutional strengthening on a wide range of scales, from financial assets markets to microcredit institutions.

## 2. Development Needs Financial Resources, but do these Resources Fit with Sustainable Development? The Case of the Dependent Economy

Development implies capital accumulation, and this is a source of problem in a poor country, in the classical case of a "dependent economy" which takes its prices, and its interest and exchange rates from the world market. How to finance investments with weak domestic financial development and low saving rates?

In LDC, there are plenty of small private local investors, in rural and commercial areas, generally with self- or usury-financing. But, at the macrolevel quantitative weight, the first local investor is the state. This investment will be made by the public budget, and in many cases will lead to the "Dutch Disease," i.e., the misallocation of funds and a continuation of underdevelopment. The problems of public investment are often overwhelmed by the official institutions.

Private investment depends on a public "seed money" in most of the cases, and is led by public policy and budget investments. Otherwise, financing is possible by foreign private investment. But this foreign finance can absorb local potential resources and send back its profits to the North without limit. Investment codes are required to limit private transfers.

The two or three gap models sum up the problem: this economy has to borrow a part of the funds for financing investment from abroad. At the same time, foreign currencies allow the import of means of production not produced locally. In a developmentalist scope of voluntary growth maximization, the ratio of investment in the GDP is laid down first; this determines a rate of growth, which has to be equal to or higher than the foreign rate of interest. But are each country's productivity potentialities higher than international rates of interest? Whatever the answer may be, an intergenerational mechanism of current expenditure and borrowing is linked to recurrent expenses and debt service.

### 2.1 Public Management of Financial Resources

Internal financing is a source of problem, when it is an outcome of the state. A political market must control public allocations and avoid corruption. This is a problem of governance. Taxes must be efficient and expenditures have to be controlled to avoid corruption. In the first period (1980–1990) of structural adjustment, the state was diabolized and many public development institutions were closed. An ultraminimal state was planned by the World Bank in the framework of the "core of public expenditures program."

Since the beginning of the 1990s, a new age of "public governance" has been begun, according a renewed credibility to public interventions. The state is recognized as the central actor of development and must be well managed. "Less but better state," associated with the private sector and civil society organizations, was to produce "good governance."

The problem of public resources lies on their instability. Many underdeveloped countries have two main sources of public revenue: tariffs and parafiscality. Tariffs are linked to imports and exports, and more generally to the elasticity of local production to international trade. But internal reasons may play a role in the development of tariffs and have been considered by many authors as a form of rent seeking and "immiserizing." In many cases of "small economies" producing raw materials, financing comes from parafiscality—meaning the surplus retained by parastatal institutions (marketing boards, trading offices, or *caisses de stabilization* in French speaking areas) on exports. This surplus represents a large part of the difference between world market prices and guaranteed prices for farmers and actors of the activity.

Parafiscality refers to the deductions made by parastatal institutions (social security and marketing boards for instance) on the local actors. In the case of stabilization systems, when there is a great difference between export prices and guarantied local prices, the parafiscality deduction may be very high. The problem is to avoid substituting "exploitation" in the name of stabilization, and to ensure that there is a sufficient return to the local actors. Otherwise, parafiscality is merely a tax on windfall gains, and therefore, cannot be considered an effective insurance in case of low prices. The World Bank has imposed the liberalization of the product networks and closed the marketing boards and stabilization institutions. But many peasants have to be protected against local traders and a link is to be found between sustainable agriculture and sustainable local financing.

The Laffer Curve (see Figure 1) has schematized the sustainability of fiscal and quasi-fiscal deduction, but in the case of developing countries, the main problem is the inefficiency of the fiscal system linked to the social environment (for instance, informal activities, corruption, etc.).

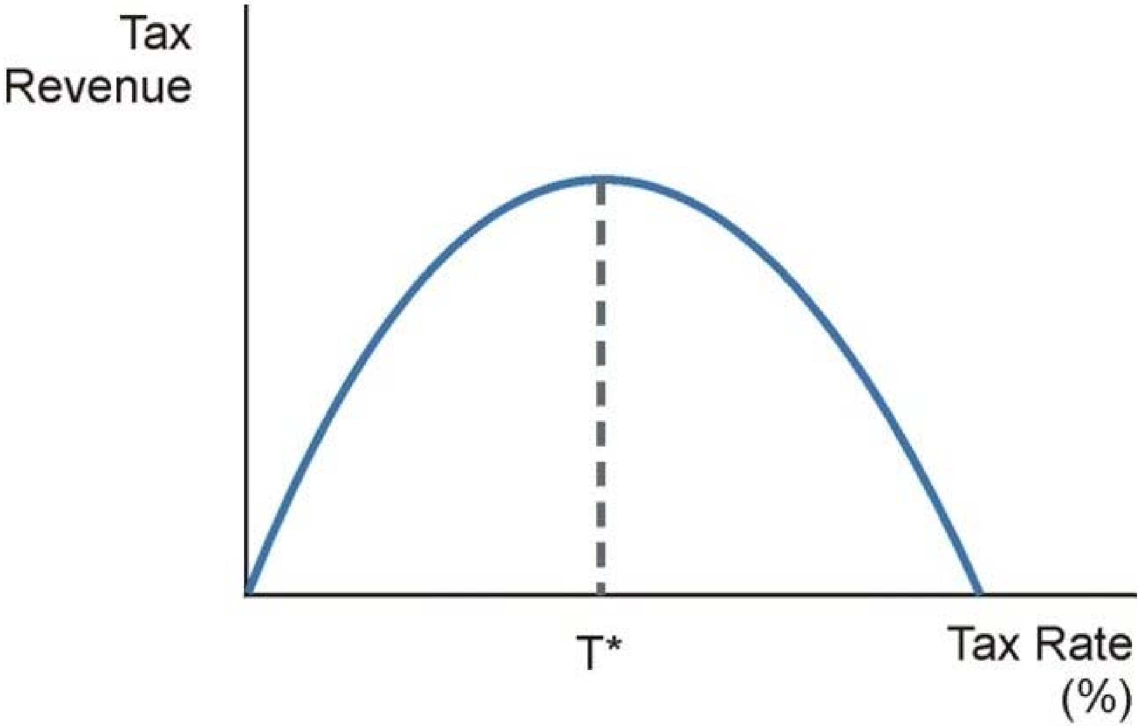


Figure 1. The Laffer Curve

The problem of sustainable expenses lies in the expenses of annual budget induced by investments, "the recurrent expenses." A government has to make investment, but in most of the cases cannot estimate the recurrent expenses that the current budget will have to support. It faces a paradox: the greater are the investments (roads, airports), the lower, in percentage of the initial investment, are the current expenses. Reciprocally, “small is not beautiful”—the small investments, especially those in the social sectors (health, education) are not sustainable as a percentage of the initial investment to pay every year. As theorized by the “small open economy” model, the state, by its effective protection, reallocates to public expenses the “windfall gains”. Then development as the growth of the tradable is never possible. There is a cumulative process of development of underdevelopment (see Box 1). This may be formalized with the model of the dependent economy, as graphically represented in Figure 2. This very popular model attempts to describe the equilibrium conditions of a small open economy which is a price taker on the international market, and points to the real origins of financial problems.

There are two sectors in a small open economy:

- the tradable goods sector (exports plus domestic goods completely interchangeable with the imports) whose price (PT) is determined by the world market; and
- the nontradable goods sector whose price (PN) is determined on the domestic market independently from international prices.

The two sectors have production functions (Cobb Douglas) without capital which use fractions L1 and L2 of the Labor Supply (exogenous), L.

The graphic representation (cf. Figure 2) implies some simplified hypotheses in a context of perfect competition:

– the value of marginal productivity is the same in all domestic sectors;
– full employment;
– the absence of taxes on imports and exports;
– the constancy of terms of trade; and
– the mobility of factors of production.

Technology, capital reserves and labor supply must be taken into account given the production boundary between tradable and nontradable. Equilibrium production is determined at a point A, tangent of the frontier of production (Y*X*) and the Real Exchange Rate (RER = PT/PN).

This equilibrium may incorporate the consumer budget line (OB) which takes into account the relation between income (Y) and the consumption allocation between tradable and nontradable sectors (here mainly tradable). It can be seen within the graph that tradable consumption (OM) is superior to tradable production (OX), and implies importation.

The private nontradable consumption is OC, and so an important surplus of tradable production is CS. This is the key variable linked to the state effective protection. So, in fact CS will be equivalent to public consumption, and implies then the budget deficit.

The equilibrium condition depends, therefore, on the domestic price; it must be such that the production of nontradable satisfies both private and public consumption of nontradable goods.

Simulation of inappropriate policies may be easily done either by a sure valuation of RER (from AB to A'B') due to misallocation of the "windfall gains" either by a substitution into the private consumption (OB to OB') from nontradable to tradable. In these two cases, both the current deficit, and the budget deficit at the new equilibrium point B', will accentuate the influx of foreign capital.

Box 1. The mechanics of underdevelopment

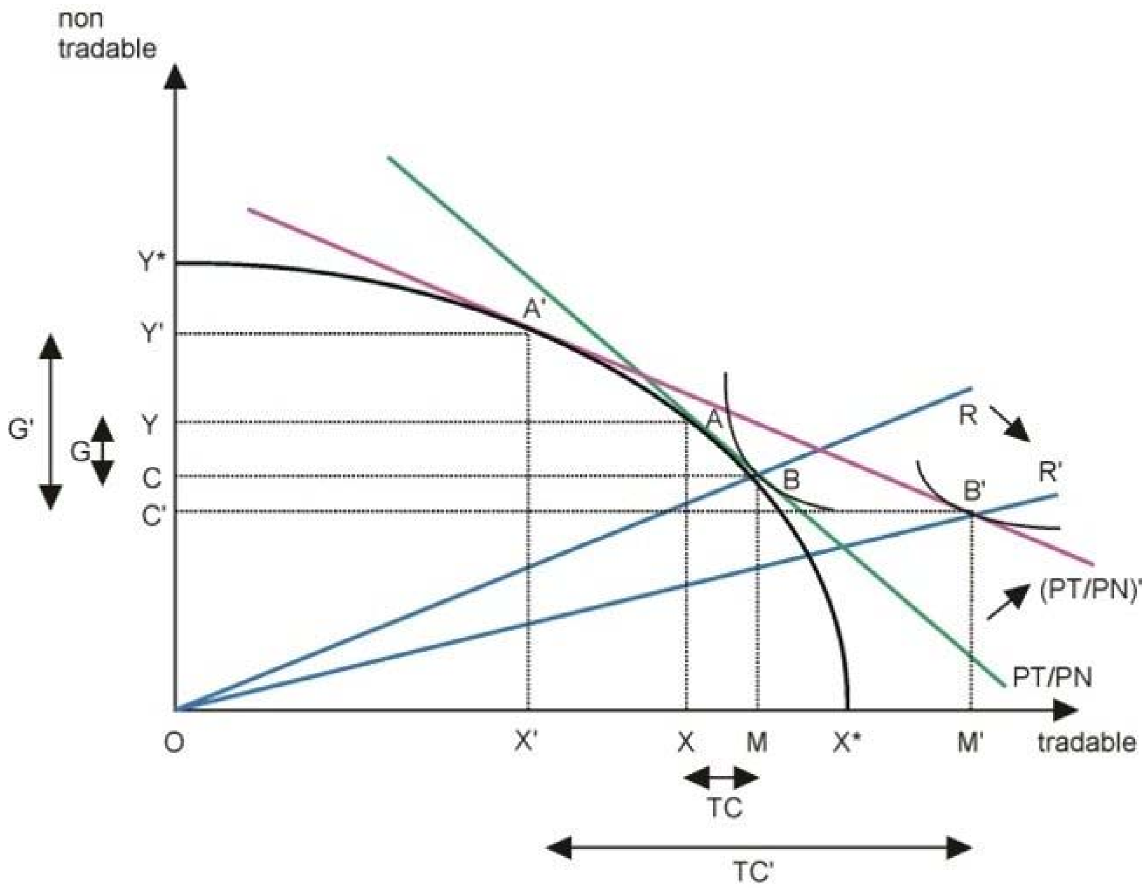


Figure 2. The model of the dependent economy

The model of the dependent economy rests on two keys variables: the Real Exchange Rate (RER) as the ratio between PT and PN (respectively, the prices of tradable and nontradable goods), and the state protection which can be interpreted largely as the propension to reallocate resources to domestic activities. Consequently, this dualistic model shows the first phase of "opening" where the three fundamental deficits, (budgetary, current balance, foreign borrowing) are reduced, and a second phase of "protection" where deficits are redeveloped.

This very rough model can be interpreted as a "development barometer" with an instability between development and underdevelopment ("Dutch Disease") linked to the state economic behavior, and particularly to its allocation of resources. But a sustainable development implies some stability in the financial resource allocation, and this is also a problem of economic context. How can financial resources be found in a budget with tariffs and parastatal resources that are so unstable? According to the "Dutch Disease," the state protection on the economy may transform the shortage of windfall gains into underdevelopment, and it will then have to borrow. If it does so, the state will have to choose who pays the tax burden between the generations.

-
-
-



**Bibliography**

Bulow J. and Rogoff K. (1988). *The Buyback Boondoggle*. Brooking Papers on Economic Activity No. 2, 675–798. Washington D.C.: Brookings Institutions. [A paper analyzing and discussing the buyback condition.]

Bulow J. and Rogoff K. (1991). Sovereign buybacks: no cure for overhang. *Quarterly Journal of Economics* **96** (June), 219–235. [A systematic approach to buyback.]

Claessens S. (1990). The debt relief Laffer Curve: some estimates. *World Development* **18**(12), 1671–1677. [A comprehensive explanation of the debt relief Laffer curve.]

Claessens S. Oks D. and Wijbergen S. van (1993). *Interest Rates, Growth and External Debt: The Macroeconomic Impact of Mexico's Brady Deal*. World Bank Policy Research Working Papers, No. 1147. Washington, DC: World Bank. [The relationships between interest rates, growth and external debt are analyzed, with specific reference to the case of Mexico.]

Fry M. J. (1995). *Money, Interest, and Banking in Economic Development*, Second Edition, 351 pp. Baltimore and London: The Johns Hopkins University Press. [The "bible" of financial matters from a liberalization point of view. For specialists.]

Krugman P. (1989). Market-based debt reduction schemes. *Analytical Issues in Debt*, eds. J. Frenkel, M. Dooley, M. and P. Wickham, 258–278. Washington, DC: IMF. [The schemes for reducing debt are reported and discussed.]

Levine R. (1997). Financial development and economic growth: views and agenda. *Journal of Economic Literature* **35**, 688–726. [A survey, including references about historical banking structures.]

MacKinnon R. (1973). *Money and Capital in Economic Development*, 339 pp. Washington, DC: Brookings Institutions. [Seminal work of financial liberalization paradigm. To be read again above all for the starting point of the thesis: how to bring self-financing agents (mainly poor rural) to the bank?]

Morduch J. (1999). The microfinance promise. *Journal of Economic Literature* **XXXVII**, 1569–1614. [A large survey on microfinance experiences in Bangladesh, Bolivia and Indonesia, with a critical analysis of their financial sustainability.]

Navajas S. Schreiner M. Reyer R. L. Gonzalez-Vega C. and Rodriguez-Meza J. (2000). Microcredit and the poorest of the poor: theory and evidence from Bolivia. *World Development* **28**(2), 333–346. [An interesting analysis of Washington institutions' conceptions in the field of microcredit (see Yaron), and Bolivia's case where microfinance provides the richest of the poor above all.]

Polak J. (1997). *The IMF Monetary Model at Forty*, Working Paper No. 97/49, April. Washington, DC: IMF. [A report on the IMF Model.]

Rogoff K. (1993). Third World debt. *Fortune Encyclopedia of Economics*, ed. D. Henderson, 751–54. New York: Time Warner. [An in-depth overview of Third World debt.]

Yaron J. Benjamin M. and Piprek G. L. (1997). *Rural Finance: Issues, Design, and Best Practices*, Environment, Sustainable Development Studies and Monographs No. 14, 154 pp. Washington., DC: World Bank. [The trade-off between outreach and sustainability views of the World Bank, brought up to date.]

**Biographical Sketches**

**Elsa Assidon** is professor agrégée of economics, has a PhD in economics of University Paris-Dauphine, and she is graduate of the Institut d'Etudes Politiques of Paris. She has been in the Institute of Latin American Studies (Université Paris 3 de la Sorbonne Nouvelle) since the beginning of 1999, after being at Paris-Dauphine University for many years. Her fields of research are development economics, with regard to various topics, successively and mainly: (1) Economic history in West Sub-Saharan African countries, with the study of the commercial activities of the big export-import companies during the colonial era—this research points a particular process of monetarization that would be considered as a genesis of the integration of these economies in the French monetary zone (Assidon (1989). *Le commerce captif*. Paris: L'Harmattan); (2) A comparative study relative to the impact of exchange rate management on macroeconomic adjustment in sixteen Sub-Saharan countries, not including the French monetary zone (Assidon and Jacquemot P. (1989). *Politiques de change et ajustement en Afrique sub-saharienne*. La Documentation française, Ministère de la Coopération et du Développement, translated into English, same publisher); and (3) For a decade Assidon's research has focused on financial development matters (various articles) and on economic development thinking (*Les théories économiques du développement*, La Découverte, Repères, two issues, 1992 and 2000; translation of the last issue in Spanish forthcoming). Assidon's main center of interest lies in market structure studies, particularly in monetary and financial spheres—monetary integration and dollarization, exchange rate management and foreign payments arrangements, credit rationing and banking fragility, and microcredits organizations, with regard to the sustainability of liberalization policies, particularly in Latin America in the last period. Among current debates on development policies and the globalization process, she has published various articles relative to the recent controversies on the "consensus of Washington" and their theoretical backgrounds in market theories. She is an editor of the series *Bibliothèque du Développement* at the publishers L'Harmattan (Paris). A native of Morocco, she has committed her support to struggles for human rights in this country over many years, and as an expert to NGO campaigns or to trade-unions in the French banks. She is a member of the French High Council of International Cooperation (Prime Minister).

**Prof. Francois Règis Mahieu** is Professeur de Sciences Economiques at the Université de Versailles St Quentin en Yvelines (France), where he teaches development economics, public economics and history of economic thought in graduate and postgraduate programs. He has a master of economics degree from Paris I-Sorbonne, a Ph.D. from the University of Paris-Nanterre, and was elected as a full professor in 1989. He has also taught at the Universities of Abidjan, Côte d'Ivoire (1979–1989), Paris I-Sorbonne (1989), and Lille (1990–1993). He did a six month sabbatical in Louvain la Neuve, Belgium (1994). He has written books on economics, ethics, logic and public economics, and many papers on these topics in academic reviews. He is administrator of some French scientific societies—the Association Française de Science Economique, and the Association Charles Gide. He is doing research at the Centre d'économie et d'éthique pour l'environnement et le développement (C3ED) in France.