**UNITED NATIONS CONFERENCE**
**ON TRADE AND DEVELOPMENT**

**Review session on chapter I of the Monterrey Consensus:**

# Mobilizing domestic financial resources for development

## Note by the UNCTAD Secretariat

***New York 14 February 2008***

# Mobilization of Domestic Financial Resources for Development

The financial situation of many developing countries has changed since 2002, when the Monterrey Consensus was formulated. But these changes are not so much the consequence of policies that followed the key recommendations of the Consensus, but primarily the result of growth dynamics in the world economy, driven by United States consumption and net imports. In addition, fast catch-up growth in China, India and a few other developing countries have been favourable to export earnings, growth and debt reduction in many developing countries.

At this stage, there is an increasing risk that the correction of global imbalances associated with the expansion of the world economy since the beginning of the new Millennium, will be accompanied by a recession and, thus, a major setback to the developmental progress achieved in recent years. In order to avoid such a setback an internationally coordinated macroeconomic policy response would be required. But there is also a need to review national policies to improve the domestic financial conditions for productive investment, and to render domestic economies less vulnerable to the vagaries of international financial markets and politically determined changes in official financing. To this end more flexible and growth-oriented monetary and exchange exchange-rate policies could help avoid large current-account deficits.

The Monterrey Consensus was absolutely right in para.17, where it pointed to the need for a "sound system of financial intermediation ... to foster productive investments". It thereby addressed a major constraint to stronger domestic capital formation in many developing countries. In most developing countries this constraint is as important today as it was in 2002, and it is imperative to strengthen national financial intermediation systems in such a way that the financing of domestic expenditure in connection with private and public investment comes to the largest possible extent from domestic sources so as to avoid an unnecessary build-up of external liabilities.

The Monterrey Consensus rightly underlined the crucial role of investment for growth and development, and of policies in its support. Especially, it pointed (in para. 10) to the necessity of ensuring favourable internal conditions for "…sustaining adequate levels of productive investment and increasing human capacity" and an "enabling domestic environment that is vital for… increasing productivity (and)... encouraging the private sector". However, there is no general consensus as to what constitutes favourable internal conditions, and what role domestic policies could play in this regard. The Monterrey Consensus failed to recognize a major lesson that could be drawn from more than 20 years of orthodox policy reforms. i.e. the need to revise the role of monetary and fiscal policies to directly stimulate capital accumulation and growth, and to reconsider the possible contribution of sectoral policies and institutions to the process of structural change and technological upgrading.

"Development finance" is not only a finance topic, but also a macroeconomic topic, but there are still a number of important conceptual questions to be solved. For example, it is necessary to challenge the belief that financial savings have to be accumulated prior to the financing of

higher investment, and that, if this kind of domestic financial savings are insufficient, the gap has to be filled by external savings.

There can be no doubt that higher investment always goes along with higher savings. But the ex-post identity of saving and investment is silent about macroeconomic causality. The global boom has provided fresh and convincing evidence that the savings-investment dynamics are much more complex than was assumed in those theories that have been underlying orthodox recipes over the past 25 years. The question for economic policy is not how to raise savings in the first place, but how to <u>finance</u> an increase in investment that will generate rising income and, in this process, higher ex-post savings. This is quite a different issue; one that is related to the functioning of the financial system and the effectiveness of the interplay between central banks and the financial sector. This also means that monetary policy would focus much more than in the past on accommodating the financing needs of domestic entrepreneurs investing in real productive capacity. Under such a regime, monetary policy instruments are no longer exclusively available for fighting inflation, so that additional, heterodox, policy instruments including incomes policies have to be applied. There are a number of examples from the most successful developing countries where low inflation was made compatible with very high growth rates and successful catching-up by this kind of assignment of policies.

Theoretically, financing for investment can originate from the banking system on the basis of controlled monetary expansion by the central bank. On the other hand, it is true that, distinct from mature economies, the institutional requirements for such a process of credit creation are often not in place in developing countries. This requires a reorientation of national monetary and financial reforms and institutional building in the financial sector, which has been badly neglected in the context of orthodox policy reforms. The institutional framework for the financial systems differs considerably across countries, but in most countries it will be worthwhile to revisit the question to what extent credit creation through "monetary financing" will enable investment without the prior accumulation of financial savings at a given level of income.

The experience of today's developed countries shows that an effective and efficient system of financial intermediation takes many years to evolve. The question therefore arises as to the options available for the large number of countries that are still far from having such a system. In the absence of a mature system of private financial intermediation it would be advisable for these countries not to wait for market forces to generate such a system; rather, they should identify locally viable instruments of public policy that would accelerate its development on the one hand, and provide risk capital to strengthen the productive sector of the economy on the other. In the absence of effective financial intermediation systems and/or and stock market financing, public sector financial institutions may need to assume a more important role in the financing of investment in developing countries. Public credit and guarantees, national development banks as well as reforms of taxation and social security systems can contribute to development finance.

The question whether and to what extent developing countries are to finance an increase in their investment ratio from domestic sources appears in a different light today than it did six years ago, when the Monterrey Consensus was formulated. One, though not the only reason for this is the strong rise in the prices of many primary commodities and the concomitant increase in export earnings of many developing countries, including some of the poorest. These are positive developments, but the key challenge remains to translate recent gains from the terms of trade into lasting progress in development through accelerated investment in productive capacity.

At first sight, recovery of commodity prices since 2002 has improved the conditions for the financing of development. But it appears that in many cases a large share of the gains are accruing to foreign owners of companies in the oil and mining sector. Often the contracts with governments of the commodity producing countries were signed under completely different market conditions, so that the foreign companies pay only a relatively small fraction to the local authorities for extraction rights. To the extent that their profits are repatriated, the benefits from the recent commodity boom are lost for development while exporting countries see their stock of non-renewable natural resources shrink. To the extent that profits from the extractive industries are reinvested in the same activities, they serve to accelerate the exploitation of the limited natural resources and to create additional supply capacities that may accentuate any price effect of a reversal in demand in the future. A crucial question is therefore how developing countries could retain a greater share of the commodity rents and how to channel these rents into investment in activities that could help attain a more sustainable path of development through industrial upgrading and diversification.