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Foreign Capital, Economic Growth and Domestic Savings: Some Historical and Empirical Evidences

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INTRODUCTION

The relationship among foreign capital, economic growth and domestic savings is by no means taut. In the 1960s and 1970s, the issues were hotly debated. Against this background, the objective of this essay is to recount the experiences delineated in economic literature, particularly, during 1960s and 1970s decades.

The theoretical and empirical works relating to the effects of foreign resource inflows on the economic development of aid recipients is replete with controversies. Foreign aid theory racks from numerous gaps and is regarded to be far from perfect (Brecher and Abbas 1972:7). It is usually acquiesced that the theories that attempt to explain its, aid's, allocation and consequences are fragmentary and contradictory, the measures that one needs to evaluate its effectiveness are not available, while the measures that do exist are subject to many interpretations.

The main contention of various macro aid-growth models is that foreign resource inflows add to domestic savings, foreign exchange earnings and absorption capacities of the aided economies. More precisely, it is claimed that a conventional developing country passes through three stages on its way from stagnation to self-sustained growth. During the first phase of development, the economy is faced with an absorptive capacity constraint because it lacks in social overheads, infrastructure, managerial ability, technical know-how and administrative and planning capacity. Hence, the investment attained cannot meet the targeted growth rate. Foreign assistance can play a meaningful role by alleviating the binding constraint.

The domestic saving limit becomes the binding constraint in the next stage. A saving gap emerges when domestic saving rate drops short of the minimum rate of investment necessary for reaching the target. A balance of payments deficit may prevail at this juncture. However, since this trade gap is smaller than the savings gap, the latter is considered to be the binding limit on the growth process.

As growth gains impetus, the important needs of the economy, particularly, the requirements for imported capital goods and industrial

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raw materials, are proliferated. The foreign exchange earnings of the economy fall short of its import requirements leading to the formation of a trade or an import-export gap. In this situation, aid helps in breaking the import bottleneck and allows the target growth to be attained, It is, additionally, argued that as the growth process accelerates it becomes possible for the economy to save more out of augmentations in national income. As hinted earlier, during this stage of expansion, major structural transformations occur through import substitution and export expansion which help in bridging the gap between import requirements and export earnings of the county. Then, the need for aid gets terminated and the country stands on its own feet.

The most important assumption of the dual gap approach is that the two gaps can exist separate and independent of each other. The justification for the separate and independent existence of foreign exchange gap is furnished by a further assumption which mentions that less-developed countries are saddled with very inflexible and rigid productive structures. This neither permits expansion of exports nor a reduction in import during earlier phases of growth. The situation is further exaggerated as domestic resources cannot be substituted for imported ones. Therefore, it is claimed that, under the circumstances, foreign assistance becomes essential for fuller utilisation of resources and for enhancing the development process.

However, the aforesaid aspects have been criticised: For instance, Bruton (1969) does not concur with Chenery (1966) and his associates in their treatment of aid as an instrument for breaking bottlenecks. According to Bruton, the main point to mark is that: aid is gap producing and not gap covering and that accepting it as the latter can in fact impede rather than facilitate development of a savings gap. It is argued that two separate gaps are rarely found in the real world. Even if it exists, it cannot be attributed to structural forces emerging from development process as such. It can rather be a consequence of the injudicious policies of the government which saddled the economy with an inflexible and rigid productive structure.

Another important stricture of foreign aid is that foreign resource inflows allow the recipient economy to continue to function with distortions, rigidities and imbalances. This implies that the establishment in such a country is relieved from pursuing necessary institutional reforms, among others.

Aid proponents accept the statement that capital is indispensable for growth- it is marked as key to growth. But it may be quixotic to underestimate the internal conditions and indigenous forces operating in the economy. A favourable set of domestic forces such as favourable attitudes, right motivations, efficient social and economic institutions, necessary skills and social overheads, and the availability of complementary factors of production, among others, are urgently needed

pre-conditions for growth. Therefore, it is claimed that, if other conditions of economic development are ripe, capital will be readily available; if they are not, capital is very likely to be wasted.

AID, GROWTH AND SAVINGS:ARGUMENTS AND COUNTER ARGUMENTS

The tout that foreign aid is instrumental in the growth process does not seem to be fully authenticated by the historical account of aid performance. A sense of strong disillusionment and profound disenchantment prevails among aid donors as well as recipients regarding the efficacy of foreign aid. A substantial lacuna is noticeable between the expectations appended with foreign resource inflows and the attainments of various targets. In spite of productive contributions of foreign resource inflows in several fields, the correlation between the amount of aid received in the post decades and the growth performance is very weak.

Aid critics challenge the conventional thesis that aid promote growth. They affirm that the development process is impeded rather than spurred by foreign resource inflows. An attack has been launched by the radical opponents of aid against the pro-aid theories which champion the use of aid in fostering development. The target of the charge has been the usual assumptions underlying the aggregate aid growth models. The assumptions that national income rises as a consequence of increase in the investment-income ratio and that foreign capital imports add to the domestic investment are rejected as not being wholly correct. It is claimed that foreign resource inflows often tend to increase aggregate consumption more than investment. Statistical proof is quoted which points out that in general an extra dollar of foreign aid is associated with a rise in consumption of about seventy five cents and a rise in increment of only about twenty five cents (Griffin and Enos 1970). Therefore, it has been argud that foreign aid has an adverse and depressing effect on growth and savings. As Griffin and Enos (1970) state, foreign aid often tends to supplant rather than supplement savings.

Savings shrink in an aid recipient economy because foreign resource inflows lead to an augmentation in public as well as private consumption. Public savings are said to be a function of public expenditure policy and official tax efforts. These savings can fall if, government tax efforts are relaxed in view of large capital inflows, and readjustment of public expenditure in favour of public consumption occurs. Similarly, foreign aid may strive private saving efforts by discouraging entrepreneurial classes if they are deprived of some of the attractive investment opportunities.

From the other spectrum, a set of different plausible saving functions is launched which leads to totally different conclusions. Though

public policy and investment opportunities are admitted as crucial determinants of savings, they cannot claim universal applicability. Hence, saving behaviours very from case to case in developing countries. For instance, if investment in a country is principally constrained by a paucity of foreign exchange resource, then one can expect investment to expand and saving to augment as foreign aid starts spouting in. Likewise, it is contended that aid supported programmes of development lead to a redistribution of income in favour of high saving groups and as a result increase domestic savings. The arguments delineated in this section point out that there exists a positive correlation between aid and domestic savings. However, the various saving functions examine above clearly indicate that aid-saving relationship is quite complex. One can expect one dollar of foreign inflows producing either a positive or negative effect on savings.

In addition to the theoretical aspects of aid-saving relationship delineated above, there are number of statistical studies which indicate that foreign savings are inversely related to domestic savings when both the variables are related to the same time period.

EMPIRICAL STUDIES ON FOREIGN CAPITAL AND SAVINGS

The pioneer test of the hypothesis of negative relationship between foreign capital inflows and domestic savings was conducted by Rahman (1968). He utilised the data for thirty-one countries out of a sample of fifty countries included in Chenery and Strout (1966). He found a negative relationship between the savings-GNP ratio and the ratio of capital inflows to GNP and arrived at the following association:

$$S = 0.14 - \underset{(2.5)}{0.25A} \qquad \ldots \qquad (1)$$

where S = savings - GNP ratio, A = Capital inflows - GNP ratio.

Gupta (1970) reached a different conclusion by using the total sample of 50 countries of Chenery and Strout model. He found an insignificant positive relation. He then split the sample into three sub-samples according to per capita incomes. His estimates showed a positive aid-saving relationship for the category with per capita income less than US $ 250 per annum. This shows that the sign of the correlation may be sensitive to the sample of countries studied.

Griffin and Enos (1970) include in their sample 32 developing countries for the period 1962-64. They arrived at the following association:

$$S = 11.2 - \underset{(0.11)}{0.73A} \qquad \ldots \qquad (2)$$

where S = savings - GNP ratio, A = Capital inflows-GNP ratio

They also found a negative association between domestic savings and foreign capital inflows by using time-series data for Colombia and Israel. Hence, they claimed that the tendency of foreign capital imports to supplant domestic savings can be verified by using statistical evidence from numerous countries.

Weiskop (1972) in cross section study of 17 countries found evidence of negative relationship between foreign capital inflows and savings. His estimated equation was:

$$S = a_0 + 0.18Y - 0.23F + 0.18X \qquad \ldots \qquad (3)$$

Where S = Savings, Y = Income, F = Foreign capital inflows, and X = Exports.

Chenery and Eckestein (1970) using time series evidence for Latin American countries estimated the relationship between domestic savings and foreign capital inflows to be negative in 12 out of 16 countries.

FLAWS IN THE EMPIRICAL EVIDENCE

Against the background of the above studies, one might be tempted to conclude that there is an inverse association between domestic savings and foreign capital inflows. However, such econometric results may not be accepted on their face value because these results get distorted due to the misspecification of the variables. The first of these misspecification relates to the definition of foreign aid inflows. In conventional analysis, foreign aid is defined as net deficit on the current account of the balance of payments. It is a mistake considered to be highly misleading to identify aid inflows with current account deficit because the latter may be financed in several ways — foreign aid being only one of them. It may, therefore, be argued that the current account deficit is not an adequate proxy for foreign aid inflows or movements of long term capital (Stewart 1971)

As noted above, the aid critics contend that any increasing current account deficit lends to a corresponding fall in domestic savings. But it is quite likely that the causality may work the other way round, that is, a deficit in current account might be a consequence rather than a cause of low savings. Furthemore, it may well be the case that both reduction in savings and increase in current deficit are the joint consequences of a common cause. It has also been argued that a current

account deficit can be the outcome of the interplay of a number of forces. Therefore, the effect of a current account deficit on national income and savings will finally be decided by the parts accountable for such a deficit. For instance, a deficit generated by financing of a new development project will have different consequences for national income and savings than a deficit cause by a fall in the value of exports even though both might be financed by foreign aid. In a Griffin kind regression analysis, both types of deficit will show analogous outcomes for savings but this is not necessarily the correct position. Therefore, Eshag (1971) affirms that it is somewhat naive to expect a meaningful correlation between savings and a heterogeneous series of deficit on current account.

Furthermore, it can be claimed that the inverse association between foreign capital imports and domestic savings can partly be the outcome of an accounting convention not of behavioural relationship (Papanek 1972). In view of far-reaching data pitfalls in developing countries, savings are usually computed as a residual. Saving estimates are derived by subtracting foreign capital inflows from total investment in a given time period. By definition, such an accounting procedure is certain to divulge a decline in savings whenever foreign resource inflows register an increase.

Estimations of Savings and Foreign Aid

Papanek (1972) advocated that one should be super cautious in distinguishing the uses and sources of foreign resources before subtracting them from total investment in order to derive correct approximations of domestic savings. He claimed that a foreign gift for private or public consumption can have no depressing effect either on domestic investment or savings. He condemned the customary accounting procedure linking to estimation of domestic saving which may wrongly reveal a decrees in savings equivalent to the value of the gift. He, therefore, recommended that one should not subtract such inflows, gifts from investment to estimate savings. However, as pointed out by Newlyn (1972) the problem of a misleading reduction in savings indicated by Papanek (1972) can be avoided if the correct definition of current deficit is used in which current transfers as distinct from capital transfers are included in current account.

It has further been claimed that different studies employed separate ways for the estimation of foreign resource inflows. By and large, foreign resource inflows are computed by considering the difference between current imports and exports of goods and services. This implies that net factor payments from/to abroad are not weighed in the estimation of foreign resource inflows. Such a practice is spurious and it may lead to a specious decrease or augmentation in resource inflows depending upon whether a country's factor income from abroad exceeds or dwindles short of its corresponding factor income remittances to

abroad. If foreign resource inflows are not properly estimated, the resulting computation of savings, which are obtained by deducting foreign resource inflows from total investmentl, are bound to be spurious.

Most of the studies which have ventured to estimate the behavioural correlation between foreign capital inflows and domestic savings suffer from other limitations also. For instance, these studies correlate the dependent and independent variables without making allowance for apposite lags. This does not look pragmatic when most of the aid is tied to projects of long-gestation periods. Thus, lagging of the dependent variables might be quite necessary. Though there is no consensus about the length of the lag, one year's lag is supposed to be too brief for growth as well as savings (Lipton 1972)

Another major flaw of the investigation undertaken by aid critics is that they usually aggregate all the foreign resource inflows and then examine their effects on domestic savings. This is not correct because the effects of foreign loans and grants are not similar to that of foreign direct investment. The poor kind of data used for undertaking regression analysis for computing aid - savings relationship can also be blamed for inserting distortions and biases.

Association Between Aid and Growth

The subject of aid-growth relationship is no less contentious than the association between foreign aid and domestic savings. The critics of aid advocate that foreign aid rather than abetting impedes growth because current aid programmes are habitually counter productive. One may come across prototypes of poor growth performance with large foreign aid inflows as well as cases of admirable growth achievements with little or no aid. In their overall assessment of the contribution of aid to the development of aid recipient nations, it has been observed that there is a very weak relationship between aid and growth.

On the other hand, Griffin and Enos (1970) claimed on the basis of cross - country as well as time series data that foreign aid and economic growth are in fact inversely associated suggesting thereby that aid is detrimental for the recipients. Foreign aid may inimically influence the growth process by reducing domestic savings, by increasing capital - output ratio through distortion of the composition of investment and by assisting the governments in power to uphold *status quo* thereby relieving them of the urgency of undertaking programmes of social and institutional reforms.

The proponents of aid discard the statistical relationship proposing that foreign aid and economic development are inversely related. The rationality behind this dismissal is that growth is a function of host of factors. Therefore, any correlation coefficient derived through regressing growth on foreign aid inflows in an econometric model where aid stands as the single explanatory variable, cannot be considered as

satisfactorily relevant. Moreover, correlation does not imply causation (Issawi and Kellman 1971).

Issawi and Kellman (1971) castigated Griffin and Enos (1970) on the argument that the causality in the inverse growth statistical relationship may not perforce move from aid to growth. According to them it can logically be assumed that it moves in the reverse order, that is, from growth to aid. He, therefore, contended that the negative sign of the correlation coefficient may not be elucidated to mean that foreign capital inflows lead to lower growth rates. It may well be the case that aid was directed according to some need criteria; a need at least partly reflected by lagging growth rates. As claimed by Papanek (1972) poor countries and countries passing through a temporary crisis often have low savings rates *ceteris paribus* and low growth rates. If at the same time, such countries frequently have greater inflow because of greater need, then savings and growth will be negatively associated with inflows for many countries without any causal relationship between them. Aid is a major part of foreign inflows which goes primarily to the needy, poor or the crisis-ridden countries.

The impoverished countries require foreign aid inflows because they have low saving and growth rates are frequently faced with foreign exchange constraints. In view of balance of payments difficulties, the developing countries find it difficult to import the capital goods, industrial raw materials and spare parts principally required for the execution of their development programmes, out of their skimpy foreign exchange earnings. The proponents of aid have come up with statistical evidence proposing that foreign aid is comparatively more able than either direct foreign investment or domestic resources. This statement has been supported by at least three studies which are summarized below.

Economic Growth and Other Variables

Pesmazoglu (1972) on the basis of three samples of countries, found that in all the samples foreign resource inflows were more productive than domestic resources represented either by gross fixed investment or by domestic savings in promoting growth.

Papanek (1973) using cross-country data relating to 31 countries for the fifties and 51 countries for the sixties found that aid coefficient was more instrumental in spurring growth relative to direct foreign investment, other foreign resource inflows and domestic savings.

Stonemen (1975) suggested that foreign aid helps growth on the basis of his regression analysis. He also found that foreign aid inflows were more significant than domestic savings in fomenting growth.

The basic argument that foreign aid does have some concrete role to play in the development process may have some weight. However, the studies cited must be elucidated with great caution as they suffer from the common vulnerability of cross-country data. Also, their strategy is

partial since it needs several additional explanatory variables to furnish a fuller interpretation of growth.

CAPITAL, GROWTH AND SAVINGS : EXPERIENCES OF THE 1970s

The studies recapitulated in the aforesaid sections mostly emerged during early seventies and are invariably based on evidence from the decade of sixties. Therefore, these studies may not provide adequate insight into aid development relation as perceived during the seventies. The experiences of the latter time period may be quite disparate in view of changed global economic scene, primarily caused by global oil crisis and worrying inflationary situation.

Gulati (1978), after empirically testing some of the disagreements of the critics of aid on the basis of cross-country evidence, reached to the conclusion that critics lack sufficient evidence on the supposed adverse effects of capital transfers to developing countries on their savings and growth of incomes. By using data pertaining to 38 developing countries, he regressed the growth of government expenditure on aid and found that the relationship was positive but not significantly different from zero. The results of the exercise were interpreted to reject Griffin andEnos's (1970) claim that foreign aid leads to lower domestic savings through increase in public consumption expenditure. He also spurned Bauer's (1972) thesis that foreign aid but not foreign direct investment, does nothing but causes the growth of the public sector in developing countries (Gulati 1978). According to Gulati (1978), foreign aid was not responsible for the expansion of public sector in the developing world. He, therefore, concluded that there is no causal relation between foreign aid and saving rates in developing countries.

Culati (1978) also obtained a significantly positive correlation between growth and capital imports of all types on the basis of evidence relating to a sample of 38 developing countries. He hastened to add that the existence of a positive relation between foreign capital and growth does not mean that every developing country has the necessary capabilities of using capital in a useful way. He subdivided the 38 countries' sample into two categories. Category I comprised of those countries whose development was primarily constrained by a paucity of investment funds. Category II included 21 countries whose development has been regarded as thwarted by lack of minimum cultural base. By regressing growth rate of GDP on capital flows and savings in each of the two groups of countries, he found that in the case of category I countries, both savings and foreign capital inflows were positively connected with growth of income. A similar finding was not true in the case of countries where growth was principally impeded by social and cultural factors. This latter group of countries was found defending Bauer's (1971)

hypothesis proposing that in the developing countries growth rates are not hampered by a paucity of domestic savings or foreign capital. Gulati's (1978) major conclusion was Bauer's (1971) criticism of inter-governmental aid and Griffin-Enos (1970) attack on all capital imports which were based on the erroneous assumption that these transfers lead to an increase in government expenditure and reduction in domestic saving propensities.

Ram (1980) disapproved of various conclusions reached by Gulati. He questioned Gulati's (1978) indirect method of establishing a positive aid saving relationship by regressing growth of public expenditure on foreign capital imports and recommended that firm inferences drawn from an indirect and relatively incomplete exercise are not justified. He further questioned the basis of classification of countries used by Gulati. The latter's conclusion transfers for development is believed to be largely a coincidence perhaps due to something unusual about the period selected. By using the same set of equations and covering slightly different period, that is, 1965-75, the econometric results of Ram (1980) showed exactly the opposite of that divulged by Gulati's (1978) regressions.

Various studies during early seventies which endeavoured to estimate aid-savings and aid-growth relationship with the help of single equation econometric models along the lines of Griffin and Enos (1970) have been condemned on the ground that too much reliance should not be placed upon single equation estimates of relationship which logically constitute part of a simultaneous system (Ady 1979). Over (1975) questioned the consideration of foreign aid as an exogenous variable in Griffin and Enos model (1970) and pointed out that once aid is considered as an endogenous variable, the Ordinary Least Square (OLS) no more remains an appropriate procedure of estimation. By employing Two Stage Least Square (TSLS) method to cross-sectional data relating to a sample of 36 countries, Over (1975) discovered that under the assumption that aid is endogenous, aid and savings are positively related. Thus, he advocated that a seemingly minor difference in the assumption of the model is enough to reverse the sign of the parameter estimate. A subsequent study by Ady (1979) employing time series data relating to various countries including Colombia found support for Griffin and Enos (1970) hypothesis.

Griffin and Enos (1970) questioned the consideration of aid as an endogenous variable and cited a number of other works in support of their argument that aid is an exogenous variable and that it is primarily ascertained by the policy decision of aid-givers rather than the economic system of the developing countries obtaining aid. This may generally be true in the case of pure aid. However, if one deals with current account deficit of foreign trade as a proxy for aid, as has been done by Griffin and Enos (1970), then it surely comprises some components of an

endogenous character (Ady 1979).

Mosley (1980) passed strictures on the earlier debate over aid-growth relationship on three grounds. Firstly, the existing empirical studies use different variables without appropriate lag structure which is regarded as particularly unrealistic in the case of aid. Secondly, he questioned the single equation models using OLS technique on the ground that these treat some endogenous explanatory variables as extraneously determined. This is claimed to be certainly the case with foreign aid which exerts significant influence on the aided economy's income growth and in return is affected by such growth. A two way relationship is recommended to be operating. The level of GDP is affected by savings, aid and other financial flows and the former in its turn ascertains the aid flows received by a given country. He, therefore, discarded Papanek (1973) type formulations using OLS method. Thirdly, most of the existing empirical research on the issue pertains to the decade of sixties or earlier years. Therefore, he endeavoured to see whether the relationships analysed for that period still hold good.

On the basis of a sample of 83 developing countries for which comparable data for the seventies were available, Mosley (1980) by using the TSLS estimation procedure arrived at the following important conclusions: the statistical results confirmed the negative aid-saving link noted by some during 1960s. However, in his opinion this is little more than a reflecting of the fact that the poorest countries attract the most aid in proportion to their income and that the poorest countries save the least, not a genuine casual relationship. The results further revealed that significantly positive aid-growth relationship noted by Papanek (1973) for the decade of sixties does not hold for the seventies for the total sample of countries. Criticising upon the poor explanatory power of the model as represented by low coefficients of determination where GNP is the dependent variable, Mosley (1980) reiterated that growth is a function of several factors, in particular, weather, domestic political situation, natural resource endowment and export performance. He suggested that the investment/GDP ratio once seen as an over-riding important determinant of growth in developing countries must no longer be seen in this way.

CONCLUSION

Having scrutinised the pro-aid and anti-aid arguments, it remains to be reiterated that the co-existence of high capital inflows, low domestic savings and low growth rates or a simultaneous appearance of low aid inflows, high domestic savings and high growth rates should not be axiomatically explained as an evidence of causal relation between foreign aid and other domestic variables. Any interpretation of the above episode may arise as a result of the interplay of some exogenous forces,

political disturbances, external aggressions, changes in terms of trade, weather conditions, among others, as the important exogenous forces, having categorically no link with foreign aid inflows (Papanek 1972). The complicated attribute of causality vouches for a deeper exploration into the specific conditions of each case. An in-depth investigation of various economic and non-economic forces may in fact be needed for pinpointing the true causes of low savings and low growth. The limited and partial strategies adopted by the pro-aid and anti-aid theorists in their statistical studies do not seem to be very much revealing. The large number and complex nature of arguments generally put forward in favour as well as against foreign aid suggests that any generalisation is not really possible.

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BOOK REVIEW

Joshi, Shyam (1995) *Development Economics and Planning* (in Nepali). Taleju Prakashan, pp 300 including Bibliography, Price NRs20.

There are different views on economic growth and development. Economic growth refers only to an increase in the national income where as economic development refers not only to an increase in the national income but also refers to a change in the economic and social structures of the society, such as standard of living of the people, education, health, nutrition, environmental economic quality etc.

The book under review is designed to cover the syllabus of development economics and planning for the students of M. A., M. P. A. and B. Ed. The book is comprehensive and easy to understand by the target goups. Despite the huge literatures available in this area, the book under review deals the sebject matter more lucidly and comprehensively.

The book is divided into two parts with ten chapters. The first and second part of book contain development economics and economic planning respectively. The first chapter deals with the various definition of development, underdevelopment and abstacle to development.

The second chapter deals with capital formation, human and natural resources, educational development and technological innovation. The third chapter throws light on the propounded theories on the development by reputed scholars. The theories of development from classical to Rostow's stages are discussed more comprehensively, as the author has illustrated the stages of development from selected countries. The policy issues on development such as poverty and inequality, unemployment, transfer of resource and technology and sustainable development are dealt in chapter four.

In the second part of the book the author has dealt with the meaning, charecteristics, history, and extension of economic planning in economic life with its types, fromulation and execution of planning. The chapter eight contains the tools of planning highlighting significance of capital output ratio and factors determining capital output ratio and its limitation with simple idea of cost benifit analysis and investment criteria which is the basis of project appraisal.

The book is written in the simple language and the presentation has also been lucid. Inspite of these, the book incorporates unnecessary explanatory notes in each issue of the contents and too many quotations has made the book as the by product. Similarly the repitition of the quotation makes the book sour in reading. Further, while dealing with the poverty and inequality, investment criteria, cost benifit analysis etc; obvious lacuna of tenchical know how on the part of author is apparent. Despite of these weaknesses the book is useful to the students in particular and for simple readers in general.

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