Confounding the pundits?

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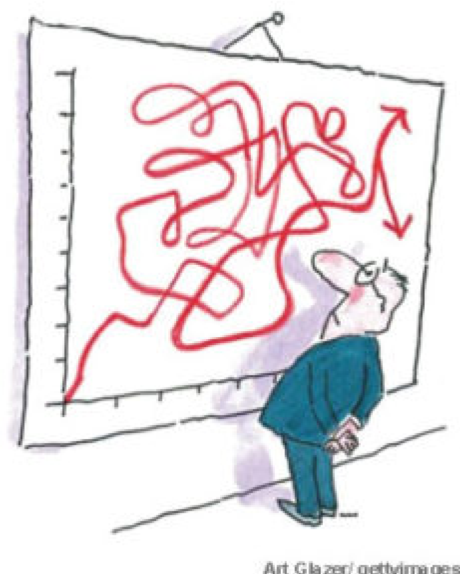
STUDENTS of economics will recall the two-gap theory of development from their courses on growth and development. The genesis of the theory, where economic growth is driven by investment and constrained by saving, lies in the work of economists Sir Roy Harrod of the UK and Evsy Domar of the USA.



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Other development economists, including Hollis Chenery and Alan Strout, extended the Harrod-Domar growth model to a two-gap development model where growth and development are initially constrained by a saving deficit over required investment (the saving gap), and subsequently by a foreign exchange gap whereby required imports are constrained by inadequate export earnings.

The connection between the two-gaps is that while investment drives growth, much of the

required capital goods cannot be locally produced due to low level of development and, as such, they need to be imported. Without adequate exports, which are themselves constrained by low domestic capacities, the required volume of imports underlying the investment path is not financeable. By implication, the two gaps can be reconciled by foreign capital flows (foreign aid and direct foreign investment) in amounts that meet the larger constraint.

Over the 1960-80 period, lots of research focused on empirical verification, refinements, modifications and extensions of the two-gap model. While development theory has advanced since then, the basic presumption that low domestic saving or weak import capacity (poor export performance) could constrain development has prevailed over the years.

When Bangladesh started its development journey in 1972, it also suffered from these constraints. But over the years things have changed fairly dramatically. Today, Bangladesh has a surplus of saving over investment (8 percent of GDP according to national accounts data) and by implication a surplus in the current account of the balance of payments (3 percent of GDP according to Bangladesh Bank data).

By definition, the two gaps must match — the lack of which is a statistical error. The current account balance is a relatively more accurate indicator of the saving-investment surplus. The larger surplus in the national account is most likely a reflection of underestimation of consumption or investment, or both.

Despite this statistical problem, a surplus in the current account is a remarkable result for a country that is still very poor (40 percent poverty rate) and has low income (around $700 per capita). What explains this dichotomy? Does the Bangladesh experience confound the pundits that resources are not a constraint to growth?

Bangladesh's growth rate has increased steadily over the past 4 decades, rising from 3 percent per annum in the 1970s to around 6 percent in the 2000s. Much of this growth was financed by rising saving and investment rates. Thus, the national saving rate expanded from 4 percent of GDP in the mid- 1970s to 32 percent in 2009. The investment rate grew from 6 percent of GDP to 24 percent over the same period.

Commensurate with this, the export (including goods and services and transfers) to GDP ratio surged from 10 percent to 31 percent. The surge in export earnings more than offset the rising imports (goods and services), which expanded from 18 percent of GDP to 28 percent. These outcomes are welcome, and give some reason for Bangladesh to celebrate. But they also reflect a major development challenge that is not yet well recognised by the Bangladeshi policy makers.

With a poverty rate of 40 percent, per capita GDP of only $700 and 80 percent labour force engaged in low-productivity informal activities, there is no room for complacency. The opportunity provided by a hospitable macroeconomic environment in terms of a surplus in the nation's current account is not being used well to push for a higher growth rate.

There is no question that productivity levels are low and a higher growth rate can be achieved with more efficient use of resources. Indeed, formal analysis of total factor productivity suggests that past growth in Bangladesh has mostly been driven by factor accumulation with very little by way of growth in total factor productivity.

Yet, as the experiences of the East Asian economies and India show, the 24 percent investment rate in Bangladesh compares poorly with the 35-40 percent investment rates in these more dynamic economies. As a result, growth rates in Bangladesh are much lower than in these economies. So, the inability to convert the higher saving rates into a higher rate of investment is a source of concern rather than a reason to celebrate.

One does not need to be a development expert to realise that the investment needs of Bangladesh are large. Much of the infrastructure is rundown and inadequate. Lack of electric power and primary energy is threatening to choke off growth and citizens' welfare.

Huge investments are needed to upgrade the transport network at all levels. Massive investments are also needed to upgrade the labour force through education, health and training programs. Large investments are needed in the manufacturing sector to create good jobs.

One might rightly ask that when investment needs are massive, how does one explain the substantial unused savings? More research is needed to fully answer this question. At this

time I have a few hypotheses based on my understanding of what is happening in Bangladesh presently.

The main variable explaining the surplus in the saving and the current account is remittance. The rapid surge in remittances has caused a sharp increase in the foreign currency reserves of the country. The domestic currency has mostly gone into the real estate and stock markets, heating up both these activities and sending the respective prices through the roof.

So, to find out why the surplus saving is not going into productive investments and is instead creating an asset market bubble, one needs to look at the incentive structure, the policy framework for investment, the financial sector, and at the public finances where resources are most needed for investment.

The government's tax policies favour ownership of land, land-based property and stocks over investments in manufacturing and infrastructure. The perceived rate of return on these assets in terms of capital gains through rapid asset price acceleration is far in excess of any imagined competing rate of return from investment in manufacturing or infrastructure.

Capital gains on assets are rarely taxed. Also, wealth taxes on property and income taxes on property income escape with a very light tax burden. Compared to this the relative tax burden on manufacturing and infrastructure is considerably higher.

Second, the overall investment climate for domestic and foreign investment remains constrained in a variety of ways, including regulatory restrictions, high transaction costs, shortage of critical inputs such as power, etc.

Third, the financial sector is still not well-developed and diversified. There is hardly much scope for getting long-term finance from domestic sources for funding long gestation investments in infrastructure. The stock and bond markets are very thin. When rising stock prices are based on economic fundamentals, this is a positive development indicating growing investor confidence in stocks and providing alternative financing opportunities for productive investments.

But the recent stock market frenzy in Bangladesh is more a reflection of excess demand and

speculative behaviour fueled by excessive liquidity, hopes of windfall gains, inadequate information about true value and risks, and a very thin market.

So although existing blue-chip enterprises may make a killing through their initial market offerings in this frenzied market, over the longer-term, as the market adjusts to more normal price levels, the resulting losses for many individual investors will likely dampen confidence and the healthy growth of the stock market. There are allegations of considerable manipulation of stock prices by a few influential players, making this a highly distorted and non-competitive market.

Fourth, due to the gap between the social and private rates of return in many of the human development and infrastructure investments, these activities need to be publicly funded. Over the years, public investment in Bangladesh has been sliding as a share of GDP, partly due to implementation capacity constraints but also due to financing constraints. Poor public resource mobilisation limits the ability to convert private savings into public investment funds.

Both these constraints could be relieved through a public-private partnership (PPP) initiative. This is constrained by inappropriate policy framework in terms of legal issues, incentives, risk-sharing, financing instruments and dispute resolution mechanism.

Resolution of the issues and challenges constraining investment is not impossible. These can be addressed if there is strong political will and commitment. Bangladesh needs to dispel any sense of complacency and move full speed with needed reforms in the taxation policy, public expenditure management, financial sector reforms, investment climate, and PPP framework to take full advantage of the prevailing favourable macroeconomic environment and convert the saving surplus to financing the investment needs of a more rapid rate of growth.

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