Basics, non-basics, money and credit: 
a development perspective

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Abstract

We approach the developing economy through an agriculture/industry and basics/non-basics demarcation. A Classical-Keynesian rationale for the high interest rates in the country and low interest rates in the town is provided. The institutional requirement is for a strongly inequality-reducing state, intervening in the financing and production of basics and, correspondingly, setting in place disincentives to the production of non-basics.

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1. Introduction

The wealth of the developing nations following the decade of liberalization and the retreat of the State has remained concentrated in the town and in the hands of the rich. South Asia and sub-Saharan Africa remain vestibules of absolute poverty and contain 70 percent of the world’s poor. Furthermore, poverty there is mainly a rural phenomenon (Dorward, Kydd, Morrison and Urey [2004]). The outcome is unsurprising given that the agricultural sector was forgotten in all the structural adjustment exercises. The reduction in public investment and rural infrastructure in agriculture continues. Rural development expenditure across the developing world, including expenditure on public rural employment programs, has shrunk significantly. A fundamental theorem that applies here is that public investment in agriculture crowds out private investment. The retreat of the State from the countryside means that the foundations for long-term growth and poverty alleviation cannot be laid out. Liberalization has meant that the private enterprise has abdicated the countryside and there is no provision of inputs or financial services that are attractively priced, timely and reliable. The theorem is amply validated in sub-Saharan Africa where both supply and demand factors lead to low, stagnant and variable fertilizer use. Private traders selling inputs to small holders in marginal

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areas are severely hampered by negligible access to fertilizers and high credit costs for working capital. Low and variable demand results in low profitability and the absence of private sector initiative in the provision of inorganic fertilizers. Small farmers are prey to uncertain delivery times and packages that are inappropriate in size and formulation. With few suppliers, they are in a weak bargaining position over prices. Since the focus of this essay is financial markets, it is worth observing that the volume of rural credit disbursements has declined and the distribution has shifted in favor of large landholders. Perhaps, by World Bank estimates, only 15 percent of farmers in Asia and Latin America and 5 percent in Africa, get credit from formal sources. The exploitation of the poor in the informal credit market has naturally intensified.

Financial liberalization has been applied to the town. The consequences of dismantling a system of financial repression should have meant a sharp rise in interest rates. While it is true that in some well-documented cases interest rates have spiraled upwards, resulting in crisis and breakdown, over time the efficiency gains brought about by releasing banks to effectively mediate between borrowers and lenders have resulted in soft interest rate regimes. What is not fully appreciated is that the low interest rates in the developed segment of developing countries are the joint products of complementary monetary cum fiscal policy. The basic connection between risk-taking behavior by assets holders and the State is worth recalling (Goodhart [1989]). The basic impulse is risk aversion coupled with the desire to avoid bankruptcy. Borrowers will issue liabilities with a life cycle related to the expected duration of the project and in a form (equity or debt) which reflects the degree of uncertainty of the project to be financed. These preferred habitats will most likely not match those of lenders. The compulsion to keep a large amount of their assets in liquid form for transactions and precautionary purposes would lead personal-sector lenders to exhibit an appetite for shorter-dated assets in capital-certain form than those which borrowers are willing to supply. An excess supply of long-dated, risky securities and an excess demand for short-dated, capital-certain securities could develop. The outcome would be a rise in yields on long-dated securities and a fall in yields on short-dated securities in order to tempt both agents out of their positions and restore equilibrium. The government, on the other hand, is under no such compulsion. It can pay off its maturing liabilities by issuing fiat money. The public sector can issue short-dated liabilities based on its power to levy taxes. In other words, the public sector is in a position to equilibrate the demand and supply of assets of different maturities either by issuing short, capital-certain assets to finance its own long-term capital expenditures.

We believe that a Classical-Keynesian model could be deployed to explain this evidence and, in particular, derive the result that while in the countryside, interest rates are inefficiently and inequitably high, the penetration of the calculus of profitability and thrift in the town has been completed with low interest rates. The next section elaborates upon a non-neoclassical macro-micro model deriving
the main result. The policy implications constitute the next section. The conclusion follows.

2. A structuralist development model

2.1. Classical threads

The foundation of the classical approach is the notion of surplus. It is the basis of the analysis of the division of the product of a capitalistic economy into the wages of labor and profits of capital. Furthermore, on account of the relatively weak position of workers in their bargaining with their employers, the wage rate tends towards the subsistence level. Then the entire surplus can be conceived of as the content of profits. The distinction between basics and non-basics is founded on the distinction between commodities that do not enter the production of any other commodity and commodities that constitute the real wage, directly or indirectly. An increase in basics is necessary to ensure an improvement in the welfare of workers without lowering the rate of profit and thereby the rate of accumulation. The classical time frame is the long period when the forces of competition have worked themselves out, and capital and labor move freely between sectors, establishing thereby a uniform profit rate and wage rate. However, it would not be inconsistent, according to modern classical scholarship, to regard the long run as a succession of short runs (Roncaglia [2000]). The focus is natural when the object of investigation is employment. Keynesian short-run unemployment, due to the insufficiency of effective demand, entails underutilization of productive capacity. The inducement to invest is thereby impaired. In the short run it cannot suffice to regard prices as centers of gravitation. The Adam Smith connection is useful in the analysis of ‘sectoral’ profit rates rather than the ‘basic’ profit rate that would prevail in the long run. Smith argued that the natural rates of profit would differ in every unique employment of labor and capital stock. At given points of time and space, equal capital could command different quantities of labor and procure different normal rates of profit.

Piero Sraffa made the fruitful assumption that in the long-run connection between the rate of profit and the rate of interest, the profit rate was the independent variable, which was determined by the forces that determined the interest rate. The nominal rate of interest was an autonomous determinant of costs of production. For a given choice of technique, there is a price level that depends upon the money wage and the money rate of interest, with the latter regulating the ratio of the price level to the money wage. Two consequences follow: There is a strictly inverse relationship between the profit rate and the interest rate. The connection is related to the behavior of the monetary authorities who, by changing the interest rate, can change the balance of forces between workers and owners. The interest rate, in turn, is not regarded as relating to the profitability of capital which is given. The theory is not different from Keynes’ theory of distribution wherein monetary factors directly
impact on the profit rate with the real wage rate as a residual. Secondly, the interest rate is a monetary phenomenon. In his unfinished notes on monetary problems published after his death, Marx worked out a detailed analysis of the workings of financial markets in terms of the forces of demand and supply of liquidity. He rejected the concept of a natural interest rate determined by technology or the forces of production. Here, as in Sraffa, banks are at a center stage as they maximize their returns and minimize their costs. Changes in the interest rate would impact on revenues in the form of the proceeds of loans and costs in the form of the interest on deposits. Adjustments would occur to restore equilibrium.

2.2. The Kaleckian connection

A common starting point of any structuralist account of a developing economy would be the demarcation of the economy into an industrial and an agricultural sector. For the purposes of the present study, the demarcation cuts across the division of the economy into departments following Marx's schemes of reproduction (Kalecki [1976]). Our Sector I is Marx's department II producing luxury goods for capitalists; Sector II is Marx's department III producing basics for workers. Department I producing investment goods is divided into two parts: investment goods produced in Sector I and investment goods produced in Sector II. This classification is resorted to in order to make non-basics and basics output correspond with the output of Sector I and Sector II, respectively. Non-basics $x_n$ is divided in the familiar way between consumption and investment. Consistent with the division into departments above is the assumption that the agriculture sector is a food sector providing basics, to workers in both sectors. Similarly, the industrial sector output is consumed by capitalists from both sectors. Firms base their investment plans on the rate of interest in industry, $r_n$. Distinguishing the agriculture sector by the subscript $a$, the familiar accounting identity for the non-food sector in nominal terms is given by

$$C_n + C_a + I_n (r_n) = x_n$$

where $C_n$ is luxury consumption by urban capitalists and $C_a$ is luxury consumption by their rural landlord-capitalist-merchant counterparts. In a not dissimilar manner, the macroeconomic identity of the basics sector is given by

$$W_n + W_a + I_a (r_a) = x_a$$

where $W_n$ is the wage bill in the industrial sector, $W_a$ denotes the consumption of food by agricultural laborers and $r_a$ is the rate of interest in agriculture.

The traditional Keynesian adjustment process posits an inversion of the Walrasian tâtonnement adjustment process. Quantities are assumed to adjust to quantity discrepancies on the assumption of chronic excess capacity. The agricultural
sector, on the other hand, is resource-constrained. An increase in the supply of food can only come from investment activities such as irrigation works and so on. Stability of the model is ensured by an increased supply of basics and the weak private inducement to invest in agriculture (Correa and Rao [2004]). The production of luxury commodities is irrelevant. In this context the low growth of the agricultural sector in the developing countries in the 80s and the 90s must be a matter of grave concern. Indeed, negative growth rates were recorded for value added per capita (Darwood, Kydd, Morrison and Urey [2004]). Among the reasons advanced for the chronic rural poverty in the region are rapacious elites and the class-based policies that result thereby, and low savings and investment rates (Kydd, Dorward, Morrison and Cadisch [2003]). There is a contrast between sub-Saharan Africa and Asia here. In the case of the latter, agricultural growth exceeded population growth with continuous productivity increases. In the case of the former, on the other hand, agriculture grew more slowly than population growth from 1965 to 1998 and more slowly than growth in the agricultural labor force from 1980 to 1998. Sub-Saharan Africa also stands out for increasing the area under cereals sharply at the expense of other crops. In other regions, the area under cereals has either declined or increased mildly. The increased cereal area is accompanied by a slight drop in fertilizer consumption in the 90s, a large drop in fertilizer use and a modest increase in cereal yields. The land under irrigation also shows a modest increase. Thus, while Asia is estimated to have achieved 80 percent or more of their increased cereal production from yield increases, more than 70 percent of the increased cereal production in sub-Saharan Africa was the fruit of area increases.

Adding up the two equations above would give us a goods market equilibrium condition. We assume that workers do not save any portion of their income in the familiar way for the sake of convenience and without any loss of generality. Thus, the commodity curve is given by

\[ I_n(r_n) + I_a(r_a) = S(x_n, r_n, r_a). \]

The expression is a representation of the behavior of the capitalist class. In our one-asset world, savings are simply deposited in banks. Thus,

\[ S(x_n, r_n, r_a) = D(x_n, r_n, r_a). \]

Firms, in both departments, are assumed to satisfy their working capital needs by approaching banks. Thus, with \( L \) denoting loan demand with the familiar subscripts distinguishing their origin, we have:

\[ I_n(r_n) = L_n(r_n) \quad \text{and} \quad I_a(r_a) = L_a(r_a). \]
The allocation of loanable funds by banks is an outcome of their portfolio optimization. In the case of agriculture, local financial institutions coexist with curb markets. The process of financial liberalization, it turns out, has not hastened the demise of informal credit markets (Tressel [2003]). The reason is that the latter provide informationally-efficient, long-term contracts to borrowers. Distinguishing them by the superscript $b$, the condition for equilibrium in the credit market in both the basics and the non-basics sector is given by

$$L_n(r_n) = L_n^b(r_n) \quad \text{and} \quad L_a(r_a) = L_a^b(r_a).$$

Adding up, equilibrium in the credit market is given by

$$L_n(r_n) + L_a(r_a) = L_n^b(r_n) + L_a^b(r_a).$$

Banks in both departments rationally operate on both sides of their balance sheets. The supply of deposits is not independent of their costs. The money market equation then is

$$D(x_n, r_n, r_a) = D_n^b(r_n) + D_a^b(r_a).$$

Working out the implicit relationship between the two interest rates, we get

$$r_n = \varphi(r_a).$$

The relationship between the rate of interest in the town and the countryside is inverse, a result that is not easy to rationalize from mainstream theory. In the present instance, a policy stance is immediately suggested. A folk theorem that capitalism leads to a regime of high interest rates might be recalled. In the present framework, this result applies to the developed sector of a developing economy. The suggestion is that monetary authorities should not lean against the wind. High interest rates in the town would induce a reduced investment in the production of luxury commodities and an inducement to increase savings. All this follows nicely from Kalecki’s framework (Sachs [2004]). The State should get its priorities right and clearly indicate the sectors in which investment is to flow. The plan might entail placing disincentives in the production of non-basics, however profitable at the micro-level, in order to prevent the frittering away of scarce resources, including foreign exchange. Correspondingly, incentives have to be created in the appropriate sectors in order to induce private investment. Since private initiatives were unlikely to be forthcoming in adequate quantities, the State had to step in to provide the
complementary investment. Secondly, in view of the pauperization of workers, it can safely be assumed that any increase in the purchasing power of the working class through the creation of jobs would be spent primarily on food and essentials. In that case, the productive capacity of that sector would turn out to be the principal bottleneck to the creation of new jobs so as to generate growth without inflation. It might be that the supply of basics is tantamount to the need to finance employment-led growth. State support is not necessary when technologies are profitable without subsidies and agricultural profitability is dominated by technical rather than price variables. The fiscal and monetary authorities could intervene in a non-distortionary manner to ease constraints to agricultural intensification by relaxing poor farmers’ seasonal financial constraints in order to increase effective demand for inputs.

The virtuous circle could work in the following manner: An appropriate set of policies should reduce prices and interest rates in agriculture. A distinction between tradables and non-tradables could be made. Worker demand is constrained by worker incomes. A fall in prices would lead to a rise in the real income of workers since the commodity in question is food. A consumption or expenditure multiplier will originate as the next step and there would be an increased demand for non-tradables which, in turn, generates local employment. Incomes rise further and so on in a spiral. The existence of leakages cannot be ruled out. In the absence of complementary infrastructure, private producers will not be able to respond to the increased demand, resulting in an inflationary rise in the price of food and a reduction in the real income of workers.

3. Policy implications

In all growth models, the growth path is sustained by the successful evolution of the banking system that harnesses savings on a massive scale. In general, and in models of credit rationing in particular, the initial distribution of wealth is non-neutral and will impact on the joint evolution of the real and the financial sector. The problem here is not one of incomplete liberalization but the anarchistic connection between production and finance in a two-sector economy. The State must be at the vanguard of the system, assuming the major investment risks and provide assurances to farmers that if they invested in agricultural intensification activities, they would not be abandoned. In particular, the focus must be on smallholders’ costs in finance and input and output markets, thereby strengthening them in the unequal struggle with large farmers.

Lending for farming is inherently risky thanks to the vagaries of weather. In addition, the risks of financing assets with a long-term maturity are intrinsically uncertain when the demand for liquidity is high for a non-negligible class of wealth-holders. Funding is the transformation of short-term liabilities into long-term liabilities. It takes place in primary markets. The existence of such markets depends on the smooth functioning of secondary markets which, in turn, rely on
continuous trading to provide liquidity. The provision of liquidity makes long-term bonds and securities attractive to savers who, to use Paul Davidson's expression, are searching for "liquidity time-machines" and prefer not to be locked into long holding periods. From the viewpoint of banks, liability management refers to the capacity of banks to make interest rates attractive for the purpose of inducing an inflow of both wholesale and retail funds which can be used for finance lending activity.

In the countryside, the need is for a system of State-led inducements and investments to kick-start cereal-based intensive growth. A package of "sustainable intensification" has been proposed which consists of an increased use of purchased inputs to avoid aggravating the problem of "soil mining" and the extension of cultivation to less and less viable land (Kydd, Dorward, Morrison and Cadisch [2004]). In rural areas loans from money lenders and landlords are typically 50 percent or more, restricted in size and duration and typically tied to contracts in land, labor and products. To this may be added familiar elements such as transaction costs to the extent of 15 percent to 30 percent of loan value. Also, small farmers are dispersed over the countryside so that lending involves contracting with numerous and inaccessible individuals. In addition, financial markets in rural areas typically do not work well because of restricted competition among suppliers and the high costs of obtaining information about borrowers. Small borrowers, by definition, do not possess initial endowments or collateral and there are chronic difficulties in monitoring the use of funds.

Microfinance has been no panacea because the costs of the business far exceed the value of loans and deposits (Hardy, Holden and Propenko [2003]). On the one hand, overhead and fixed costs are high, independent of the size of the transaction. Usually, the largest component of costs is wages due to the labor-intensive nature of the activity. The interest rates charged on loans as well as the spread is consequently high. A revitalized interest in the subject is founded on the observation that the poor are not a homogenous group with similar needs. Deep outreach emerges after determining the needs of the very poor and meeting them through the design, pricing and delivery of appropriate and viable products and services. Microfinance must be client-driven, attracting new customers and retaining the old through offerings that closely match their preferences (Cohen, [2002]). The principle is to match repayment amounts and cycles to client needs. Likewise, the objective is to match financial flows and repayment cycles. A norm here is flexibility. The poor use financial services to manage risk. Loans are used to expand the sources of income and build and diversify assets. These are global strategies employed to mitigate risks prior to a shock. A second norm is term structure (von Pischke [2002]). Term structure is critical because the capacity to repay over a longer horizon exceeds the short period capacity to repay. Long-lived covenants are desirable almost by definition because the poor are those without steady income streams from regular employment. The prime motive to repay would be credible access to future loans. Impermanent lenders who are dependent on permanent infusion of donations will
4. Conclusion

The agrarian question is still open in calling for a transformation of class relations in favor of the working class. The agenda is to free demand constraints and open up markets in the countryside, and provide a foundation for broad-based productive investment. In that case, Kalecki’s three-pronged programme is worth recalling: an adequate supply of basics, reduction of expenditure on non-basics in order to increase savings for financing public and private investment, and a curtailment of investment in luxury production in order to utilize a portion of private savings to finance public investment.

In order to contemplate the viability of alternate scenarios, it might be worthwhile to step outside the short-run dynamics of developing countries and consider the rise and decline of nations over time (Kindelberger [1996]). Finance comes in cycles with the promotion of trade and industry through capital lending. Eventually, it moves to trading in assets and an obsession with wealth rather than output. Merchants and industrialists undergo a metamorphosis from being risk-takers to rentiers. Consumption increases, savings fall. The ruling class vigorously pursues class-for-itsel action and effectively blocks government intervention. Income distribution becomes more skewed. With greater control over the political process, the rich resist the equitable sharing of national burdens like the cost of infrastructure and public goods.
References


