The market for development

Plammoottil, George and Saraogi, Ravi

Madras School of Economics, Chennai, India

28 September 2007

The Market for Development

George Jacob Plammoottil
Ravi Saraogi

9/28/2007

Abstract

Markets need some very strong prerequisites to function well and be a self regulating system. Creating markets, where the most basic institutional factors necessary for the functioning of a market is nonexistent, is futile. In other words, talking about private sector development where markets do not even exist is meaningless. Our proposal is based on the idea that we first need to create a platform which can act like a spring board for private sector development. Such a platform is provided by the creation of a Market for Development (MFD). The MFD takes a ramshackle economy by its collar and purges it of all its rigidities, thus providing the scaffolding on the strength of which an all pervasive process of private sector development can take place. The creation of a MFD is thus an integral step for private sector development through which we hope to infuse the process of transforming lives. The process of private sector development can be broken down into two stages, the 'formative stage' and the 'self perpetuating' stage. Nearly all research into private sector development concentrates on the second stage in which the preconditions for the proper functioning of a market are already assumed to have taken place and research tells us what innovations are necessary for the successful functioning of those markets. However, a valid point can be raised here. Are the preconditions that are required for a market to function so easy to come by? We do not think so. The difficult part in the process of sustainable development is setting up the preconditions for proper functioning of a market. This is more fundamental than the second stage and our idea particularly addresses this issue.

The Market for Development

1.1 Introduction

We believe that poverty, hunger and malnutrition in the global economy can be eliminated *without any aid.* The commodification of development, through the creation of an incentive structure, which results in a self regulating market where every market participant gains, is the essence of our idea. There is no philanthropy involved.

Markets need some very strong prerequisites to function well and be a self regulating system. Creating markets, where the most basic institutional factors necessary for the functioning of a market is nonexistent, is futile. In other words, talking about private sector development where markets do not even exist is meaningless. Our proposal is based on the idea that we first need to create a platform which can act like a spring board for private sector development. Such a platform is provided by the creation of a Market for Development (MFD). The MFD takes a ramshackle economy by its collar and purges it of all its rigidities, thus providing the scaffolding on the strength of which an all pervasive process of private sector development can take place. The creation of a MFD is thus an integral step for private sector development through which we hope to infuse the process of transforming lives.

The process of private sector development can be broken down into two stages, the ‘formative stage’ and the ‘self perpetuating’ stage. Nearly all research into private sector development concentrates on the second stage in which the preconditions for the proper functioning of a market are already assumed to have taken place and research tells us what innovations are necessary for the successful functioning of those markets. However, a valid point can be raised here. Are the preconditions that are required for a market to function so easy to come by? We do not think so. The difficult part in the process of sustainable development is setting up the preconditions for proper functioning of a market. This is more fundamental than the second stage and our idea particularly addresses this issue.

Below we list some of the most important ‘preconditions’ for the self perpetuating stage to be successful.

1) **Law and order**- This encompasses the entire support structure like political stability within a democratic framework, law and order for contract enforcement, an efficient judiciary, government regulation, and respect for the law of the land.

2) **Infrastructure**- Markets obviously cannot function efficiently unless the most basic infrastructural needs are met. These needs have to address the problems associated with transportation, communication, information and power.

3) **Human capital**- Markets are a tool to be used by the people to meet their needs. So, the capabilities of the people to make use of the opportunities in the market should not be compromised. To meet this end of developing human capital, particular emphasis must be laid on healthcare, education and social security.

4) **Financial markets-** Law and order, infrastructure, and people (some of whom will be entrepreneurs), are all important for the setting up of a market. However, the glue that combines all the above is a well functioning financial market that enables entrepreneurs to raise funds and consumers to borrow, both necessary for selling and buying.

1.2 The Need for an Alternative

More than 300 million people south of the Sahara have to survive on less than a dollar a day. This figure has gone up by around 100 million over the last 10 years alone. . The UN's development expert Jeffrey D. Sachs has written that sickness plagues Africa like a "silent tsunami" surging over the continent every day.[1]

In countries like Burundi, Ethiopia, Sierra Leone and Uganda and other less developed nations, share of aid in government spending already exceeds 40%. In such countries, “aid will not taper out when growth process succeeds”. It will be difficult to get aid dependent countries “off aid” post 2015. This results in the creation of aid dependent economies. [2]

The present system in which aid is given to LDC’s suffers from the serious drawback of accountability and proper ‘end use’. Between 1970 and 2002 the countries south of the Sahara

[1] http://www.spiegel.de/international/spiegel/0,1518,363604,00.html

[2] www.africanaxis.org/Presentations/Aid%20to%20Africa/What%20aid%20to%20Africa.ppt

received a total of $294 billion in loans. In the same period of time they paid back $268 billion, and accumulated, after interest, a mountain of debt amounting to $210 billion. Why is it that the billions, which both the West and the East poured into Africa during the Cold War, have been so useless? The suspicion is hard to avoid- corruption and lack of accountability. We firmly believe that *aid paralyses*. The solution is not aid. We have had enough of that already. Our proposal does not entail even a single penny of aid!

2.1 The Market for Development

The Market for Development (MFD) is a market which commodifies development. It is basically a capital market for the mobilization and efficient utilization of resources for the purpose of economic development. Let's start by outlining the participants in such a market. First, there is the whole consortium of aid givers to LDC's, ranging from the governments of developed countries, private donors to international agencies such as the World Bank. Apart from the above conventional suppliers of resources, the MFD throws open an investment opportunity to anybody who wants to participate in the market. These participants have a stake in the development of these LDC's as part of a broader objective of overall development of the global economy, humanitarian concerns, or simply earning a rate of return. Second, we have the governments of these various nations who constitute the demanders of resources for carrying out the process of economic and political development in their respective countries. The countries which can list themselves in the MFD will have to satisfy certain criterion as laid out by the regulatory body of the MFD viz. political stability, a functioning democracy, etc. And lastly, we have the beneficiaries of the market process, the citizens of the LDC's, to whom perhaps development of their countries matters the most.

The MFD is a unique system which achieves two purposes- it binds the government to take optimal policy decisions and transforms aid given by donors to investments on which they can earn returns. The byproduct of the above two will be a rapid development of the less developed economies unlike anything that we have seen before.

Each participating country in this market issues *development coupons* to mobilize resources for development. These coupons have a face value and the country can either issue them at a premium or discount depending on the demand that it envisages for such coupons in the MFD. There are intricate details involved in this process such as the size of the issue, face value, number of coupons, etc. These details of the issue are finalized after an extensive due diligence process involving the regulatory body of the MFD. Various parameters are looked into while arriving at the details for the issue such as the development potential of the respective country and accountability of the government.

After the initial offering of the development coupons, the MFD would serve as a secondary market for the trading of the coupons of different countries. The issue of the coupons will be such that each country must hold an amount of its own coupons equal to what it has offloaded in the MFD. In the MFD, the market value of the development coupons will depend on the GDP index, which serves as the underlying basis for measuring performance of the market participants. The market value of development coupons will mirror economic performance and will be highly sensitive to policy decisions, political stability or for that matter anything which has a bearing, either direct or indirect on the GDP of the economy. The broad participation in this market will encourage speculation which will help value the development potential of an economy given the policies its government is following.

Since the individual governments which participate in the MFD will have an equal share of their own coupons as there are in the MFD market, they will have a strong personal stake in preserving the capital value of the coupons held by them, and preserving the capital value of the coupons necessarily involve policies that maximizes GDP. This is a very important step in the proper utilization of the funds that the government collects and is a massive improvement over the present system of ineffective aid.

Also, we envision the creation of a system in which the market value of development coupons is extensively tracked by the people of the country taking out such coupons. What eventually happens is that the government's performance is assessed by tracking movement in the market value of the development coupons. The movement in the market value of development coupons emanates a very strong signal about the performance of the government in trying to maximize the GDP.

We come to another question now. What does the MFD offer to the potential 'investors' who will buy development coupons? The answer is simple. It gives them returns on their investments comparable to any asset in the world. The system of aid is transformed into a *system of investment*. Not only does a buyer of a development coupon get an opportunity to transform lives, he actually gets paid for it! The MFD transforms aid into investments, giving the donors a chance to make money out of their philanthropic activities; these investments then serve as a pool of resources which can be used by the domestic government to foster economic development in the best possible manner to transform lives. All in all, it's a win-win-win situation for all the participants in the MFD. The MFD will successfully result in the creation of an incentive structure in which everybody does what is best for him which also happens to coincide with what is best for the other participants. *The perfect coincidence of personal and the broader social interest.*

2.2 The Principal-Agent Problem

We talked about how the MFD forces the government to behave in a manner which is best for the people it governs. By holding a personal stake of the development coupons equal to 50 per cent of the total issue of such coupons, two purposes are solved. First is obviously that the government will have a strong personal interest in trying to maximize the value of its development coupons and secondly, any threat to sovereignty is settled.

However, we believe that just the stipulation for holding a personal stake of development coupons by the government is not sufficient to ensure responsible behavior. We need to move a step further. What we propose is to use the stock of development coupons, with the government, to create a performance based pay structure for people in the higher echelons of the government machinery. We envision this system to be similar to the performance based stock options that upper management of companies receives. This will act as a safety valve to ensure that the resources rose through the MFD is utilized in the best possible manner, taking care of the problem of the corruption and waste that is involved in a system of help through aid. This system of performance based pay structure has a very successful precedent in the corporate world where every company has embraced the move towards greater transparency and more accountability towards the shareholders.

The development coupons will be extensively tracked by the investors and in order to create an efficient system for information dissemination, there has to be complete transparency. This will automatically be ensured as the government will be working under the watchful eyes of the investors who will be analyzing each and every step of the government and the potential impact of its policies on GDP.

2.3 Choice of Index

The underlying index on the basis of which the market value of the development coupons will be determined has to take into account the following-

1) **Macroeconomic policies**: whether fiscal, monetary, and exchange rate policies provide a stable environment for economic activity
2) **Structural policies**: the extent to which trade, tax, and sectoral policies create good incentives for accumulation by households and firms
3) **Public sector management**: the extent to which public sector institutions effectively provide services complementary to private initiative, such as the rule of law (functioning of the judiciary, police), infrastructure, and social services.
4) **Social inclusion**: the extent to which policy ensures the full participation of the society through social services that reach the poor and disadvantaged, including women and ethnic minorities.

We mentioned before that in the MFD, the GDP will be used as the underlying measure on which the values of the development coupons depend. We strongly believe that though GDP has its own limitations, it is an extremely versatile index which does a good job of capturing the non-economic aspects of development apart from the economic well being of a nation. The effort which a government would put to maximize GDP over the long run would definitely entail steps to see that human capital is fostered, there is no social unrest through growing inequality, people are happy with the social provisioning of public goods, etc because it is upon these factors that the productivity of the people would depend. Thus, speculation on the future values of GDP by a host of investors would necessarily force the index to contain all information relating to economic as well as non economic factors.

Even if in the extremely short term, inequality might increase as some more promising and productive sectors get focus, in the medium term to long term, if the potential GDP is to be achieved in full, all sectors of the economy touching the entire population must develop and it is in this sense that GDP maximization can serve as an excellent tool for transforming lives.

2.4 The Returns for the Investors

How much return can investors expect from the MFD market? Actually, a lot. In the initial stages of development, an overall concerted effort can bring about rapid rates of GDP growth of about 10 per cent per annum. However the speculative nature of the secondary market will result in the future performance of the GDP being discounted and incorporated in the present market value of the development coupon. Thus, the capital appreciation will be much higher than the GDP growth rates. However, we must remember that the MFD's basic purpose is to foster development, and along with serving this objective which involves transforming millions of lives, if the investor participant gets a good return on his development coupons, it's a huge windfall compared to the present system of aid giving. And as for the risk, in a worst case scenario, the entire investment in the development coupons will get wiped out, which leaves the donor no worse than if he would have given aid.

We have identified three reasons why development coupons will in all probability be lapped up by investors like cat laps milk-

1) Rate of return
2) For firms which have a personal stake in the economy of the development coupon issuing country (say, a production unit in a development coupon issuing African nation), it makes sense to pick up development coupons that assist in the overall development of the economy in which they have the stake.
3) Humanitarian reasons

2.5 Exit Strategy

The market for development can continue till perpetuity. The initial issue of development coupons can be followed up by a further issue at a future stage of development. The success of such an issue will obviously depend on the past performance of the country.

However, a country can exit from the market by buying back the development coupons from the market if it feels the very purpose for which it entered the market- creating markets and transforming lives, has been achieved. We do not actually see a need for the participating countries to withdraw from the market since once the MFD takes off; it can serve as a highly effective market for raising funds for further development efforts. In fact we envision a scenario where because of the success of the initial founding countries of the MFD, more countries in need of developmental finance get drawn to the market.

2.6 Does the Idea have any Precedent?

At a very simplified level, the MFD is basically an extension of the concept of the creation of a capital market which commodifies economic development in the sense that we can have financial instruments whose tradable prices are determined by the underlying movement in the GDP index- a veritable measure of economic development. As the alert reader would have guessed, this has direct parallels with nearly all capital markets in existence in the world economy today. The most obvious difference being that instead of firms issuing financial securities, we have countries of the world taking out financial instruments in the form of development coupons to mobilize resources for economic development.

3.1 Private Sector Development

So how does the MFD help in private sector development? We have identified the following three areas-

1) Infrastructure
    a. Transportation
    b. Communication
    c. Information
    d. Power
    e. Education and Human Capital

2) Stability in the economy and economic policies

3) A supportive government committed to providing a conducive environment for private sector development

The beauty of MFD is that all the above in fact become the top priority of the government looking to maximizing the value of its development coupons. Infrastructure is perhaps the most vital element for GDP maximization and the government accords it top priority. Stability in the economy and economic stance of the government is again very important as business confidence depends on it and the government strives to maintain macro economic and political stability which in themselves are important pre requisites for private sector development. Lastly, since the private sector comes to play such an important role in the economy and generates a major chunk of the GDP, it becomes imperative on part of the government to show a supportive face and provide a long term conducive environment for private growth.

What are the checks on the government to ensure that the money raised through the MFD is not squandered? This is where the regulatory body of the MFD has an important part to play.

In the MFD, whatever resources are raised by the coupon issuing country is deposited with the regulatory body in the name of the coupon issuing country. Now, as and when the cash flow of the coupon issuing government demands, the government approaches the regulatory body with an information report detailing the amount of funds that it wants to withdraw (the upper limit being the maximum that the coupon issuing country has garnered from the primary market) and how the withdrawn funds will be utilized. It should be noted that the regulatory body cannot deny funding when requested for the same from any country. The above is only a mechanism to ensure than there is *perfect information and transparency* as to the amount of funds the government is using and the purpose to which such funding is channelized.

In the MFD, the government will also have a strong monetary as well as political incentive to maximize GDP and 'behave responsibly'. The stipulation that the higher echelons of the government be issued development coupons based options ensures that the government machinery has a strong incentive to develop their respective economies. Moreover, since the GDP index acts like a proxy for government performance, to keep itself in power, a government cannot evade the task of GDP maximization.

The above criterion of perfect information and transparency coupled with the strong incentive structure for the government will ensure that the best policies are chosen by the different governments. Such policies may differ from country to country and from situation to situation. However, they will hold a common purpose- maximization of GDP in the most efficient manner.

4.1 Conclusion

The market for development delineated above can serve as a highly effective self-functioning mechanism to draw billions of people out of the trap of poverty. This is probably the most information-efficient method to achieve the above goal. It should be noted that the pursuit of this goal does not need constant supervision as the incentive structure automatically ensures that the mobilized funds are utilized in the most optimal manner. The idea harnesses the power of the markets and the private sector to achieve what previously seemed impossible- transform lives without a single penny of aid, in effect emancipating the poor from the inefficiencies and vagaries of the system of aid giving and receiving.