CHAPTER VI

PROBLEMS OF ECONOMIC PLANNING

With reference to underdeveloped countries

It would be no exaggeration to say that economic planning has assumed a special urgency and significance in the context of the development problems of backward countries. Reference has to be made in this connection to the important historical fact that Soviet Russia which popularised more than any other country the idea of planning was a backward, or what is now called, an underdeveloped country and transformed itself into a developed country within a relatively short period of time by the method of planning. In a sense planning is not so urgent a necessity in a progressive and developed country as it is in a backward and underdeveloped country. An advanced country has ex hypothesi already secured the advantage of a high national income and a high standard of living, the attainment of which is one of the prime objects of economic planning. The plain fact is that an underdeveloped country is faced with a problem of great urgency — sometimes a problem
of life and death, which it must anyhow solve satisfactorily within the shortest possible space of time. The method of planning, which means nothing more and nothing less than a conscious, deliberate effort on a nation-wide scale to achieve distinct economic goals, commends itself to the underdeveloped countries as a quicker and more effective means of achieving economic amelioration than any alternative system.

For an advanced country planning assures at best a measure of stability associated with balanced growth which it would not otherwise enjoy. In other words, it is the prospect of relief from the erratic fluctuations of the trade cycle that constitutes the main attraction for planning in an advanced country. It is a controversial issue, however, whether an advanced country is bound to adopt the planning method in an endeavour to solve the cyclical problem. In any case there is scope for choice between the planned approach and
alternative approach in the form of a Keynesian programme for the elimination of the cyclical fluctuation.

In the case of underdeveloped countries the scope for choice is severely limited. Keynesian theory in its original form has little relevance to the problems of an underdeveloped country. Secondly, the problems confronting an underdeveloped country are so complicated and deep-rooted and, at the same time, the need for solving them is so urgent and imperative that it at once becomes obvious that no piece-meal approach to, but only a thoroughgoing and frontal attack on, the basic problems holds out the prospect of a reasonable solution of the same. In other words the economic climate and atmosphere of an underdeveloped country are by nature such that a comprehensive approach typified by an overall plan for development seems to be most appropriate for such a country.

Dr. Maurice Dobb has compared the
method of planning to the method of military strategy. This comparison is most appropriate in the context of an underdeveloped country. Such a country is threatened by a terrible enemy in the form of mass and chronic poverty and this enemy must be resisted and defeated by a grim battle. The 'General' who has to carry on the war against this enemy must make the best of a bad job. However inadequate and limited his resources may be, he will have to score a decisive victory over the dangerous enemy of poverty and low standard of living.

The task for the 'General', which means in this context the planning authority, is indeed a difficult one. The materials and resources available are short and inadequate, and yet the battle has to be fought effectively so that ultimate victory may be achieved. The resources of an underdeveloped country are necessarily inadequate. As one economist has ironically remarked, the problem of an underdeveloped country can be summed up in the proposition
'country is poor because it is poor.' 1 The plain significance of this is that the resources available to underdeveloped countries in the forms of land, labour, capital and organisation are quantitatively and qualitatively extremely poor. But just as the good General in the battle field does not try to find fault with the materials available to him but tries to plan his strategy in such manner as to achieve victory inspite of all the difficulties and drawbacks, in the same way the planning authority in an underdeveloped country has to plan its economic strategy in such fashion as to achieve a decisive victory over the enemy in the shape of poverty.

An underdeveloped country, therefore, experiences such a sense of urgency even in normal peace-time. That is why the planning method has a natural tendency to take deep roots in such a country. As

Prof. Chenery has rightly observed: "... the primary aim of a developing country is to secure the greatest increase in income (total or per capita) from its available resources in the long run. The main problem lies in evaluating the amount of scarce resources which will actually be required by alternative types of production." ²

Before we come to the practical problems of planning and development in underdeveloped countries, it is necessary to make a brief theoretical analysis at the start. The various growth models that have been worked out by distinguished economists contain very significant lessons for underdeveloped countries, although these models may not be directly applicable to these countries. Further the Keynesian theory, which in its original form applies to developed countries only, has nevertheless certain important implications in the

context of underdeveloped countries also. These have been clearly indicated by Prof. Kurihara. The study of the specific problems of underdeveloped countries may be appropriately prefaced by a survey of some of the theoretical models.

Prof. Kurihara who has worked out the long-term implications of the Keynesian theory (which he characterises as the 'Keynesian theory of economic development') makes the following illuminating remarks on the Keynesian mode of approach:

"... the stabilizing role of a state associated with the name of Keynes must, in our view, be coupled with its developmental role in the specific context of underdeveloped countries."

Prof. Kurihara proceeds to add:

"it is not the stabilization of the effective demand which it is crucial for the State in an underdeveloped country to promote."  

   - K.K. Kurihara, p. 185

4. Ibid. p. 189.
principal economic task of the State in such a country is one of directly or indirectly developing its productive capacity relatively to any given level or rate of increase of effective demand. To fulfil this latter task, it is necessary to mix central control and central ownership in proportions appropriate to the task and consistent with the social philosophy of a particular underdeveloped country." 5 The plain significance of these remarks is that a backward country has necessarily to adopt the method of planning in order to achieve a higher standard of living and a higher level of economic prosperity. In this context Prof. Kurihara also approvingly refers to Mrs. Joan Robinson's view that an underdeveloped economy would have to represent also a Socialist State in order to achieve its industrialization.

Prof. Kurihara points out that Mrs. Robinson's notion of a socialist State designed for the industrialization of an underdeveloped economy is

5. Ibid, p. 190.
essentially the same as 'Keynes' system of State Socialism', though, of course, Keynes' system was originally meant for the stability of an advanced economy. This mode of approach made by Prof. Kurithara may be said to furnish Keynesian justification for economic planning which has to be adopted by an underdeveloped country to expedite its development.

Attention has also to be paid in this context to the growth models which have been worked out by Harrond, Damar and Mrs. Robinson. Although these models throw out significant hints for underdeveloped countries, these can not be considered particularly helpful because they are mainly related to advanced economic systems. Nevertheless, a brief consideration of these models furnishes a useful introduction to the study of development programming for underdeveloped countries. In order to work out a plan for an underdeveloped country it is necessary to have some basic criterion or standard of reference in relation to which its
programme of development is to be chalked out. Certain standards of reference are furnished by Harrod, Domar and Robinson. Harrod has presented the concept of natural growth rate. This is characterised by him as "the rate of advance which the increase of population and technological improvements allow." As rightly interpreted by Mrs. Robinson it signifies the maximum feasible rate of growth. Besides the natural growth rate, he also mentions the warranted rate of growth. This is defined by him as "that overall rate of advance which, if executed, will leave entrepreneurs in a stage of mind in which they are prepared to carry on a similar advance." Practically, this means that if the entrepreneurs invest as much as the community is disposed to save at the full-capacity level of income, and if output goes on growing as much as the growth of real capital then a balanced rate of growth will be assured. The basic idea is

6 Harrod; Dynamic Economics, p. 82.
that there must be sufficient investment to absorb full-capacity savings. According to Harrod the main problem is about an economy in which the natural rate of growth tends to fall behind the warranted rate of growth which is the rate consistent with the savers' desire and investors' profit motive. In other words, he refers to an advanced economy whose capital accumulation tends to outrun its population growth so as to make for secular stagnation. Thus Harrod's conception of natural rate is a significant tool of analysis for explaining the secular instability of advanced capitalism.

It would be more correct to say that Harrod contemplates the possibility of cyclical depression arising from the actual rate of growth, representing 'trial and error' effective demand falling below the 'warranted rate' representing required productive capacity; and also the possibility of secular stagnation arising from the warranted rate tending to exceed the natural rate. In short, Harrod's warranted rate is a tool of analysis to indicate
counter-cyclical and counter-stagnation policies, not to guide industrialisation programming. "7

In Harrod's analysis we find that instability develops on account of the tendency to save and invest in excess of the requirements of the situation, i.e., capital accumulation goes far ahead of population growth. Harrod's analysis is actually irrelevant to an underdeveloped country because in such a country accumulation of capital tends to lag behind the growth of population. Another point requires to be noted in this connection. Harrod has excluded autonomous investment from his analytic scheme, possibly because he wants to demonstrate the instability of a market economy under laissez faire conditions. In this connection we have to note Mrs. Robinson's comment on the position taken by Harrod: "Mr. Harrod's main point is that the warranted rate

can not normally be achieved in pure laissez faire conditions. In the case of an under-developed country, however, autonomous investment is an essential instrument of economic policy and it cannot therefore be excluded from discussion in the context of an underdeveloped economy. Autonomous investment occupies a significant place even in the counter-cyclical programme of an advanced country as demonstrated by Keynes. Keynes pointed out that autonomous investment by the State on the basis of its superior capacity "to calculate the marginal efficiency of capital on long views and on the basis of the general social advantage" can play a very important role in counteracting fluctuations of private investment. In the case of an underdeveloped country such autonomous investment is of far greater importance. Prof. Kurihara rightly points out: "It is indeed difficult to see

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how underdeveloped economies lacking in private initiative and funds could develop their productive capacity and resources without substantial public investment based on long views and the general social advantage whether it is or is not self liquidating in the conventional sense. Moreover it seems reasonable to assume that growth-conscious under-developed economies would gear their autonomous investment, specially of a public nature, to long term projects of a capacity increasing character (e.g. highways, harbour, bridges, railways, dams and the exploitation of natural resources with due regard to conservation.)  

We may refer next to Domar's model. The situation visualized by Domar is essentially the same as that which is envisaged by Harrod. In otherwords it is a situation characterised by

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a high saving ratio and a high productivity of investment. In such a situation effective demand tends to lag behind productive capacity. High saving ratio implies an insufficient demand; on the other hand high productivity of investment is indicative of potential plenty. The situation that arises is highly paradoxical and it was characterised by Keynes as a 'poverty in the midst of plenty'. Domar's analysis also is not quite relevant because the typical situation found in an underdeveloped economy is entirely different from what Domar's model refers to. An underdeveloped country is always faced with a problem of low saving ratio as well as a low productivity or investment.

In this connection a brief reference may also be made to Joan Robinson's theory of capital accumulation. Mrs. Robinson concerns herself with the typical behaviour of a capitalist system according to the 'capitalist rules of the
She constructs a model of a laissez faire closed economy using only capital and labour as productive factors and distributing the whole product to the entrepreneurs and the wage earners. Her model is based on the following assumptions, namely:

1. Wage earners spend all of their wage income on consumption, while profit takers save and invest all of their profit income.
2. Capital and labour are combined in fixed proportions to produce a given output.

The conclusion at which Mrs. Robinson arrives is that the rate of growth of capital is capable of increasing if the net return to capital rises in greater proportion than the capital-labour ratio. In simple language this means that capital accumulation is stimulated by a decline of the real wage rate and weakened by a rise in the real wage rate, technological conditions being assumed to remain unchanged. Mrs. Robinson has used the notion of a golden age to indicate what may be considered a condition of ideal equilibrium. The golden age
is assured when fully employed labour grows at the same rate as the rate of growth of capital. This signifies that capital must grow as fast as labour population when the capital-labour ratio remains constant. Whether or not the economy can remain on the path of golden age equilibrium depends on the behaviour of the profit-wage relation.

Mrs. Robinson's model is also essentially relevant to an advanced economy. She has discussed capital accumulation according to capitalist rules of the game. She appears to signify that individualistic capitalism cannot grow except basically by reducing the price of labour (i.e. real wage rate) relatively to the price of capital (i.e. the profit rate) as well as to labour productivity. This may be said to carry the implication that an underdeveloped economy would do well not to follow the capitalist rules of the game pure and simple but to adopt the Keynesian technique of a mixed-public economy with fiscal-monetary policies directed towards autonomous
Prof. Kurihara has developed a clear-cut criterion by which the development programming of a backward country is to be determined. He has used the concept of "the socially optimal rate of growth." He has defined the socially optimal rate of growth as "a maximum rate of growth of output consistent with the full employment of a growing labour population and the rising trend of labour productivity." Clarifying his point further, he observes that the socially optimal rate of growth can be ensured by maximising the rate of growth of labour productivity and by maximising the rate of growth of labour population. The maximum target rate attainable will be the

10. Reference may be made to Keynesian theory of Economic Development - Kurihara, p. 79.

11. Ibid, p. 44.
higher, the higher is the rate of growth of labour productivity. It implies that output must grow at a rate exceeding labour population growth if the standard of living is to be improved. It brings into prominence the need for capital accumulation and technological progress. The socially optimal growth rate is realizable if it is accompanied with required capital accumulation.

The most important practical problem in connection with development programming of an underdeveloped country is that of the determination of the appropriate economic policy for such a country. To determine the economic policy, however, it is necessary first of all to have a clear conception of the economic realities in an underdeveloped country. In other words it is necessary to analyze the structure of an underdeveloped economy. Perhaps the most striking indicator of an underdeveloped economy is the low per capita income that is so characteristic of
it. What we have to ascertain however are the basic causes of this low per capita income. In the first place reference has to be made to the deficient natural resources of an underdeveloped country. These deficiencies are brought into bolder relief when it is considered in relation to the size of population. It has been rightly observed that "most of the actual underdeveloped economies are confronted with the problem of over population precisely because the per capita amount of principal natural resources (e.g. arable land, coal deposits, oil deposits, iron deposits and forest) is too small to aid substantial industrialization and so to overcome a superfluous population."^{12} Of course mere sufficiency of natural resources is not a guarantee of adequate economic development. There must also be technology and capital for the exploitation of the resources. Nevertheless adequacy of natural resources is a very important factor that is favourable to economic progress.

In the second place reference has to be made to the poor capital equipment of an underdeveloped country. In such a country we have 'a low-saving, low-investing community'. In order that the economy in an underdeveloped country may make further progress it is essential that the community should consume less than its net production so as to ensure a net addition to the existing stock of capital, that is, there must be net investment. Of course this is a fundamental condition of development in all countries. In an underdeveloped country, however, the problem is in this regard extremely urgent and acute.

In the third place, reference is to be made to the technological backwardness of an underdeveloped country. On account of technological backwardness such as economy has a low labour-output ratio and high capital-output ratio, that is, for a given output such a country requires much more labour and much more capital than an advanced country. Technological backwardness
is also indicated in the excessive supply of unskilled labour in such a country.

Structural under-employment is a basic problem in an under-developed country, whereas in an advanced country unemployment is cyclical; in an underdeveloped economy it is structural. Such structural under-employment is basically attributable to chronic shortage of capital in relation to a growing labour population. In an advanced country unemployment arises mainly from a temporary deficiency of effective demand in relation to a given population and capital stock.

Of course cyclical unemployment can not be altogether ruled out of consideration in the context of an under-developed economy. In those under-developed economies where export, income and private investment have attained sizeable proportions the possibility of some measure of cyclical unemployment has to be taken into account. It is however structural unemployment or what Mrs. Robinson has called disguised unemployment or what may be
broadly characterised as non-Kaynesian unemployment that is the fundamental problem in an underdeveloped country. The key to the solution of this problem lies in an increase in the rate of growth of capital and decrease in the rate of growth of population, or both.

In determining the economic policy for an underdeveloped country it is necessary to start with an objective evaluation of its economic resources. In this view it is significant that such an evaluation has formed the starting point of India’s endeavour for planned development. The terms of reference of the Planning Commission clearly bring out this aspect of the matter:

"The Planning Commission will (1) make an assessment of the material, capital and human resources of the country, including technical personnel, and investigate the possibility of augmenting such of
these resources as are found to be deficient in relation to the nation's requirements; (2) formulate a plan for the most effective and balanced utilisation of the country's resources; (3) on a determination of priorities, define the stages in which the plan should be carried out and propose the allocation of resources for the due completion of each stage; (4) indicate the factors which are tending to retard economic developments, and determine the conditions which, in view of the current social and political situation, should be established for the successful execution of the plan; (5) determine the nature of the machinery which will be necessary for securing the successful implementation of each stage of the plan in all its aspects . . . . . . . . 13

The points listed above bring out in a succinct form the basic approach to planning in an

underdeveloped country. Against the background of these essential facts pertaining to the planning endeavour, we have to examine certain basic issues in respect of the development of a backward country.

The question of human resources of a country naturally comes first. The question of human resources is intimately bound up with the trend of population growth of a country. Of course population growth presents only the quantitative aspect of the matter; the qualitative aspect also needs to be considered in terms of skill and efficiency of the people concerned.

Population growth however constitutes a vital aspect of the problem. The planner has to formulate his plan on the basis of the careful appraisal of the population trend. Reference may be made in this connection to the following significant observation made in the First Five Year Plan on the populations question: "If population is growing at a certain rate, the total national output has to be
raised at the same rate merely to maintain existing standards of income and consumption; this means that not only will so much less of further addition to national income be available for ploughing back into investment but a part of what is ploughed back will be taken up by capital equipment required for maintaining per capita incomes constant in the following period. It is true that a growing population increases the manpower potential of the country and also has the effect, in some ways, of stimulating investment. It is also true that the effect of an increase in population can not be judged solely in terms of the effect on per capita income; it affects the whole pattern of production and consumption. It is not possible to judge whether, or not, an increase is favourable or unfavourable to development. In the past, periods of rapid economic development have also been periods of rapidly increasing population, but whether there is any causal relationship between the two or
how it works one cannot say with any certainty. In Britain, between the commencement of industrialisation and now—a period of about 180 years population has increased roughly fivefold. Japan had by 1939 a population of about twice as high as when it embarked on industrialisation. In periods of rapid development and changing techniques it is questionable whether the concept of an optimum population can have any precise meaning. But in the short run—and we are concerned here primarily with the earlier critical stages of development,—there is no doubt that; given a situation in which shortage of capital equipment rather than of labour is the main limiting factor in development, a rapidly growing population is apt to become more a source of embarrassment than of help to a programme for raising standards of living. In other words, the higher the rate of increase of population, the larger is likely to be the effort needed to raise per capita living standards.  

The basic problem in this regard has been summed up by Dr. B. Dutta as follows:

"One of the most difficult problems that an industrialisation process is almost sure to raise in an underdeveloped country, especially in one which is already densely populated, is that of likely repercussions of increase in incomes on the rate of growth of numbers and the reaction of this on the standard of living. Should, however, the increase of population be necessarily regarded as a drawback and a disadvantage? Can not it operate as a stimulating factor by evoking greater demand for the goods that are produced? The problem in this regard has been very appropriately posed by Dr. Dutta as follows:

"One can however ask why should a rapid increase of population be regarded as undesirable and why should it be desirable to arrive quickly at the stage at which fertility rates have become low, when a rapid growth of population in the West was not only

15. The Economics of Industrialisation (1957), by Dr. B. Dutta, p. 159.
an effect but also a cause of economic expansion, and, when, according to a well-known group of economists, a declining trend of population growth is one of the direct causes of a secular tendency towards stagnation. There has been during the last two decades, and especially, since the publication of Keynes's essay on the subject and the increasing recognition of the fact that an expanding population can keep up the rate of growth of national income by increasing the demand for consumer goods and for houses and public utilities and increasing generally the marginal efficiency of investment.  

The whole paradox in this regard is however resolved by a proper analytic approach to the basic problem. The question of declining population which tends to lead to secular stagnation is different from that found in backward countries. The

The stagnation problem of an advanced country is a problem of population, natural resources and technology failing to keep pace with capital accumulation. That is, capital accumulation goes far ahead of the other factors. On the other hand, the stagnation of an underdeveloped economy is due to capital accumulation and the supply of resources failing to keep pace with population growth. From this it becomes clear that the stagnationist apprehension of a declining rate of population is something quite different from the population problem in poor countries. Given a high and rising level of technique, and increasing capital accumulation as conditions precedent, a growing population can reduce the gap between the maximum potential output and the actual output. Given a growing population, on the other hand, a rising level of technical efficiency and a rapid increase in capital accumulation are essential conditions for securing economic expansion.

In any case an increasing population
cannot be considered essential for economic development. Not even the confirmed stagnationist would go so far as to recommend a deliberate policy of population increase to solve the stagnation problem. In fact it is the disadvantage of an increasing population in a country already overcrowded that needs to be specially emphasised. In this context a particular point that needs to be considered is whether economic development would itself stimulate population growth of a serious nature and thereby jeopardise the prospects of an appreciable improvement in the standard of living of the people. A rising trend of population growth has in any case to be faced for sometime by a developing economy in the initial stage. At the same time there is no justification for undue pessimism on the score of the population growth. The dangers from population should not be exaggerated. The explosive period of population growth can be shortened by deliberate policy. 17

17. See B. Dutta, op. cit. pp- 177-78.
Problems of capital formation and skill formation in under-developed economy.

The problem of problems in an under-developed economy is that of capital formation. Rügner Hurkse has given the very definition of an under-developed country by reference to its poor capital equipment. He has said: "The so-called under-developed areas, as compared with the advanced, are under-equipped with capital in relation to their population and natural resources." From this it follows that to become developed and to attain a high economic standard a country must pass through a phase of vigorous capital formation. What is meant by such capital formation? The meaning of capital formation is that society does not apply the whole of its current productive activity to the needs and desires of immediate consumption but directs a part of it to the making of capital goods: tools and instruments, machines and transport facilities, plant and equipment - all the various...
forms of real capital that can so greatly increase the efficiency of productive effort. The term is sometimes used to cover human as well as material capital; it can be made to include investment in skill, education and health - a very important form of investment." 19

An important point to note in this connection is that capital formation is not entirely a function of capital accumulation. In other words it is not merely the people's capacity to save that has to be taken into consideration. Of course the capacity to save is important so far as the supply of capital is concerned. But there is an important point to be considered on demand side also. This means that the inducement to invest may be lacking on account of the limited purchasing power of the people. In other words there is no sense in producing more goods by increased use of capital if there

is no sufficient demand for the goods produced. The deficiency of demand is of course due to the low incomes of the people which again are due to low productivity. Such low productivity, in turn, is also attributable to insufficiency of capital. There is thus a vicious circle which have to be broken through any how if an under-developed country is to be given a fair start on the road to economic progress.

In regard to the supply of capital we have to note certain important points which have been revealed in recent discussions of the problem. In particular we have to take into consideration recent analysis of consumer behaviour which shows that individual consumption functions are closely inter-related. In other words saving does not depend upon the individual's capacity for saving as such. As J.S. Duesenberry has shown, the desire for social emulation by means of conspicuous consumption has
a vital bearing on individual's savings. Buesenberry also refers to the demonstration effect. When people come to know about superior goods or superior patterns of consumption associated with new articles, they experience a certain restlessness and dissatisfaction. As a result their propensity to consume may be shifted upwards. The significance of this new analysis from the practical point of view is that inequality of wealth and income does not necessarily increase the average saving ratio. Conspicuous consumption and demonstration effect may reduce the saving ratio notwithstanding the unequal distribution of income. An interesting fact to which Ragnar Nurkse has drawn attention in this connection is as follows: "The reason why 75 per cent of American families save nothing is not so much that they are poor to save. It is rather
that the example of the consumption patterns kept up by people in the top 25 per cent income group stimulates their wants to such an extent that virtually nothing is left over for saving. 20

This analysis has an important implication for an underdeveloped country because in the case of such a country the conflict between the desire to consume and the need to save is made very difficult by the international disparities in real income levels.

The theory of balanced growth has also an important implication for an underdeveloped country. The rate at which any one industry can grow is inevitably determined by the rate at which other industries develop. Of course some industries will grow faster than others because demand and supply elasticities differ from industry to industry. What is necessary for an underdeveloped

country is the application of capital over a wide range so that the general level of economic efficiency may lie upgraded and the size of the market may be enlarged. 21

Arthur Lewis has observed: "Economic growth is associated with an increase in capital per head . . . . . . . . " 22 At the same time he has raised the question 'how fruitful is capital'? His answer to the question which is based on a careful study of relevant facts throws much light on the problem of capital formation. He gives his answer as follows: "The question is extremely difficult to answer for lack of recorded evidence. We have only informed guesses about the growth of capital and of income over past decades, and these guesses only for a few of the advanced industrial countries. Practically all our knowledge of the quantitative

21. Ibid, p. 14
The relationship between income and capital is due to the pioneering work of Prof. Simon Kuznets and Dr. Colin Clark. "The estimates of the growth of capital and of incomes, for which what they are worth, show remarkable agreement on two propositions, first that in the industrial countries the ratio of the value of capital intensive and capital sparse industries are taken together and secondly, that this marginal ratio lies between 3 to 1 and 4 to 1, when the value of land and other natural resources is excluded from capital and the value of external assets from both capital and income. This result can be expressed in different ways such as by saying that of the average an investment of £.100 is associated with an increase of national income by between £.25 and £.33 per year; or that raising the national income by 3 per cent per annum cumulatively is associated with an annual net investment of between 9 per cent and 12 per cent.
of national income. The industrial countries do indeed tend to invest between 10 per cent and 15 per cent of their national incomes, net of depreciation and their incomes do tend to grow by between 3 per cent and 4 per cent per annum.  

From the foregoing analysis it is clear that investment is necessary to economic growth. Does it however mean that unless there is a prior act of saving investment cannot grow? Or, can we assume that the process of investment will automatically create all the savings that are necessary so that we need not bother about level of savings? All that is necessary is that we should concentrate on investment. Indeed the question may even be raised whether saving will not actually have deterrent effect on investment. These are important issues that automatically arise against the background of Keynesian analysis. We have however to remember that Keynesian analysis is meant for advanced countries. In respect

of such countries it is possible to maintain that investment will necessarily evoke the required amount of saving because the equipment and materials necessary for greater investment are already there and the problem lies in bringing them into use. In the case of an under-developed country the basic problem is that the industrial equipment is nonexistent and it has to be created. To create the equipment a part of the resources available which would be otherwise devoted to the production of consumption goods must be diverted to the production of capital goods. This in turn implies that consumption must be deliberately restricted. In the technical language of economics this means that the propensity to save which is too low in under-developed countries must anyhow be raised to a higher level.

The Role of Monetary & Fiscal Policies in Development Planning

An important question of policy has
to be considered in this connection. Is capital formation to take place in a natural and spontaneous way, or is it to be deliberately stimulated by monetary and fiscal policies? If capital formation is left to the operation of natural economic forces—that is to the natural propensities to consume and to save, then capital formation will in all probability proceed at an extremely slow pace and the development of the country would be unduly delayed. It is in this context that the role of government in expediting the economic development of a backward country, that assumes a special significance. Economic planning becomes an imperative necessity in a backward country if capital formation is to be deliberately accelerated and pushed up to a high level. Whereas private enterprise has to depend on the people's natural response to the rate of interest as the means of helping forward capital formation, the government need not depend helplessly on the spontaneous response of the people. The government
can easily take the initiative in the matter. There are several weapons available to the government to enforce the restriction of consumption and thereby to stimulate capital formation.

The conditions obtaining in an underdeveloped economy are fundamentally different from those in an advanced country. Nevertheless some of the techniques that are utilised in advanced economics may have varying degrees of applicability in underdeveloped countries. Some exploration may be made in a cautious manner in this regard.

In the first place reference may be made to the role of the monetary factor. Keynes has shown how the policy of monetary expansion can be utilised for the purpose of counteracting depression. He has given us what may be called the criterion of absolute inflation or true inflation. The full employment,
in-elasticity of output in relation to increasing effective demand, constitutes the criterion of true inflation. Of course Keynes makes allowance for semi-inflation arising from specific bottlenecks even before the level of full employment is reached. The net result of Keynesian analysis in respect of an advanced countries is that in conditions of unemployment in economic depression monetary expansion may well have a stimulating effect. This has provided a strong justification for a deliberate policy of inflation aimed at stimulating effective demand. Keynes has however shown that the increase of money supply does not directly react upon effective demand but it does so via the rate of interest. In other words, increased supply of money will lower liquidity preference and the latter in turn will reduce the rate of interest which would again provide a stimulus to investment. At the same time Keynes has given us the warning that if we think that money is the drink which will automatically stimulate the econom
system we shall find that there are several slips between the cup and the lip. In this connection we are to bear in mind that Keynes attributes a subsidiary role to monetary policy as a means of combating depression. In his analysis the strategic factors in economic life are the marginal efficiency of capital and the marginal propensity to consume—particularly the former. Hence in his analysis economic policy should be directed towards the stimulation of the marginal efficiency of capital which can be done more effectively by fiscal policy than by monetary policy.

Now we have to consider how far monetary policy can play a useful role in the economic development of a backward country. We have to ascertain how far inflationary financing of investment can contribute towards the rapid development of such

24. Keynes; General Theory of Employment, Interest and Money.
a country. In this connection we have to specifically find out whether the method of inflation will have a strong income generating effect or it will have a powerful capacity increasing effect. In this context we are reminded of Denar's dual character of investment which refers to the monetary expansion via the multiplier effect and also to the real expansion. Of course Domar has in mind the conditions prevailing in an advanced country. But the twofold effect that he has referred to has to be considered in respect of an underdeveloped country. In order to ensure that the real expansion effect or what may be called the capacity increasing effect may be greater than the income generating or the multiplier effect, it is essential that investment in an under-developed country should be very carefully planned. Such a country must scrupulously avoid investment projects of pyramid building or armament variety which stimulate demand without increasing productive capacity. "If an underdeveloped economy is to minimise the danger of chronic inflation, it would
have to assign greater weight to those particular component rates of growth of net investment which have the greatest productivity potentials. " 25

Some very important consequences follow from this analysis. These consequences may be listed as follows -

1) Along with the growth of investment there will also be greater technological progress since capital accumulation and technological progress are closely interlinked. In other words an increase in the quantity of capital may well be associated with an improvement in the quality of the same. In this connection it is appropriate to remember Mrs. Robinson's suggestion - "more machines there are in use the greater are the opportunities for improving the methods of production

in the machine making sectors of the industry. 26

2) The increase of productivity of investment may well lead to an overall increase in the marginal propensity to save. In other words increased profits and dividends will be the source of increased saving. In those underdeveloped economies which have sub-standards of consumption the credit finance growth of net investment will be the only practical way, via its increasing effect on individual incomes, to initiate the habit of saving on the part of consuming units. 27

It thus becomes clear that inflationary financing of investment can well play a significant role in a backward country. In other words there can be what may be called development through inflation.

26. The Rate of Interest (1952) - J. Robinson, p. 63
We may briefly refer also to fiscal measures. It was largely due to the analysis made by Keynes that the economic significance of fiscal measures came to be properly understood and appreciated. Keynes of course laid emphasis on the counter-cyclical aspect of fiscal policy in an advanced country. Later economists have tried to indicate the significance of fiscal measures for economic growth specially in under-developed countries. Through fiscal means the government can function as an investor, as a saver and as an income redistributor. The government can have a direct initiative in productive investment. The government should of course avoid pyramid building type of outlay and concentrate on capacity creating investment. There is some risk that increased productive investment by government may be cancelled by the decreasing effect of private investment which though profitable may be unproductive. Thus private investment may be directed towards theatres and various amusement projects. In such circumstances
the government may have to exercise direct control so that the nation's productive resources may not be diverted into undesirable channels. The government may play its role as an investor and help forward the growth of the economy in three different ways - (a) by increasing productivity of investment (b) by increasing average propensity to tax (increase in taxation will have the effect on private consumption and will thereby increase that part of real income which is available for government investment) and (c) by a decrease in the government propensity to consume (here the idea is that government expenditure of unproductive type will be cut down but socially useful public outlays will be maintained or increased.) Monetary policy and fiscal policy are not two separate and independent policies. They are closely inter-connected and inter-dependent. The modern tendency is to use the term "monetary-fiscal" policy. Deficit-financing, for instance, has both monetary and fiscal implications.
First of all, we may refer to taxation. By imposing taxes the government can draw away the purchasing power of the people in such manner as to reduce their consumption and thereby set free resources that would have been otherwise devoted to the production of consumption goods. Then by suitable investment in public sector with the tax proceeds it would be possible to utilise the liberated resources to help forward capital formation.

The taxation method however has a definite limit. Imposition of tax means the direct placing of a burden on the people and it naturally evokes a certain amount of resentment. This method can not therefore be pushed too far. Another method is that of borrowing by the government on voluntary basis. This is also an important and useful method and it can be used upto a certain limit. But the success of this method depends to a great extent on the spontaneous response of the people to the governments demand for loans. At a time when capital scarcity
is acute and the natural flow of savings is meagre, it is not possible to rely too much upon the people's spontaneous response to government's appeal for loans.

The third method, therefore, that has to be considered in this connection is the method of deficit financing. Is such inflation or deficit financing a legitimate means of generating savings and capital formation in a backward country? The issue is undoubtedly controversial. Nevertheless we get

28. Reference may be made in this context to the views expressed by P.T. Bauer in his book "Economic Analysis and Policy in under-developed countries" (1957) pp. 112-123. While he concludes that the government in an under-developed country will have a wide range of functions, he is not favourably disposed towards what he calls "compulsory saving or taxation for development." He maintains that one's attitude towards this matter is "much affected by one's political position", and he confesses
certain clear cut expressions of views on this point to which we may refer in the present context. Rugnear Nurkse has made certain highly significant observations which bear reproduction at some length:

that his own position is much influenced by his political "dislike of policies or measures which are likely to increase man's power over man, that is to increase the control of groups or individuals over their fellow men." He, however, mentions an important economic point which should be noted in this context. He says: "Any contribution of compulsory saving to development must stem from a difference in the rate of development which results from control of these funds by the government, compared to that which would result from their retention in private hands. This is an involved and rather pompous way of putting the simple and obvious yet often neglected truism, that compulsory saving involves a transfer of resources; and that the process, and its results, can be assessed only if this is firmly and constantly remembered. Its
"I believe public finance assumes a new significance in the face of the problem of capital formation in under-developed countries. There is widespread tendency for the state to take over a greater responsibility for the direction of the process of capital formation. In this situation the rate of accumulation no longer reflects the sum of individual preferences and propensities with regard merits are bound to be misjudged if the total proceeds of compulsory saving are seen as a net addition to resources, i.e., if they are considered to be costless. Yet this is the procedure in almost all development plans of under-developed countries, which usually regard government capital expenditure as a net addition to resources and sometimes indeed even equate government capital expenditure with total investment in the country." This accusation is not, however, justified as a critical study of India's Five Year Plans would show. In India's plans a clear-cut-distinction is made between investment in the public sector,
to saving and current consumption, but is increasingly determined by government's on ground of national policy.

"It can be plausibly argued that the contemporary emphasis on government planning for economic development is to a great extent an outcome of the failure of nations under laissez faire conditions to accumulate capital rapidly enough for the desired rate of growth . . . . . ." 

Nurkse is, however, well aware that there is a limit to forced saving. Any endeavour to generate 

and investment in the private sector. State investment in the public sector consists chiefly of that type of capital expenditure which could not or would not have taken place under private auspices, at least to any significant extent. (e.g., expenditure on agriculture and river valley projects, railway and other forms of transport, heavy and basic industries of particular types, social services etc.)
savings by inflationary methods is bound to defeat itself if it is pushed beyond a certain limit. Says Nurkse: "Inflation, when it passes beyond certain rate, is apt to set up expectations and behaviour patterns such that it completely loses its power to create forced saving. In an advanced stage inflation may even become a cause of capital consumption in a country's economy. These however are extreme conditions. We must admit that over a wide range inflation can be effective as an engine of forced saving and is being effective in this sense in a number of under-developed countries today." 29

We may next refer to the views of W. Arther Lewis on this point. Lewis also has taken the view that inflation may be used as a legitimate means of capital formation in under-developed countries.

He points out that the obstacle to greater investment in the less developed countries is that the current propensity to save is too low, and as such it may well become necessary to adopt inflation within limits to stimulate saving. Such inflation would not have any catastrophic or dislocating reactions; it would rather liquidate itself. The substance of his views is stated as follows:

"Inflations for the purpose of creating useful capital are on the contrary self-destructive, since sooner or later they result in an increased supply of goods to the market. How soon and how large are outputs depends on the nature of the enterprises financed in this way. If a school building programme is financed in this way, prices will rise for a very long time and when the effect begins to show in the increased output of the school leavers, prices may not fall very much. But if new money were spent in the countryside to conserve water supplies on schemes which took only a few months to build, cost very little, and doubled the output of
the lands supplied with water, prices would rise very little and would quickly fall much more.

"It is important to bear in mind that inflation for creating useful capital is ultimately self-destructive. "

The final conclusion at which Lewis arrives is as follows: "The moral is that if inflation is to be used for capital formation it is best done in small doses at a time rather than continuously . . . . . . . . in any case inflations which are used to create useful capital are self-destructive, in the sense that in due course the new capital produces a new stream of consumer goods which either checks the rise of prices or brings prices down. In addition, this rise in real output

may also bring about an increase in saving, and, so provide the savings that maintain investment at its higher level. " 31

Prof. B.R. Shency in the course of his note of dissent to the memorandum of the panel of economists who were associated with the framing of India's Second Five Year Plan observed:

"A distinction must be made between unemployment in the industrial economies and under-employment in under-developed economies. A mistaken analogy between them has been responsible for erroneous policy approach in under-developed economies. The problems of the two economies differed in fundamental respects. In under-developed economy the only factor of production that was in abundance was unskilled labour. There was a scarcity of the other needs of production, machinery, materials and skilled

31. Ibid, p. 224
personnel with the technological and managerial know-how. The simplest form of investment needed some equipment and technical know-how at some stage. In industrial economy on the other hand the rate of saving being generally above the demographic rate, unemployment of labour was accompanied by unemployment or under-utilisation of the complementary real resources of production. Credit creation could bring the two together. Deficit financing or credit creation here is a device of mobilising the real resources. We can not seek in this a solution to the problem of development of under-developed economies. In the latter it was a question of scarcity of savings for which created money is no substitute. Under-employment in underdeveloped countries thus offered no criterion for deficit financing in the way unemployment in the industrial economies offered such criterion. 32

The basic point underlying the statement quoted above is fairly clear. What Prof. Shency means to say is that deficit financing serves a useful purpose in developed countries as a means of bringing into use unutilised resources, and such deficit financing is not attended with risks of inflation. The reason is that the resources lying unutilised are really fit for use in production, the non-utilisation of these resources being a temporary phenomenon resulting from the cyclical fluctuation. In the depression phase of the trade cycle resources (which were previously being utilised in the boom phase) are thrown out of use. The fact is that expenditure by private enterprisers is curtailed in the period of economic depression and this gives rise to the problem of unemployment. The main problem in the context of such a situation is to compensate for the declining private expenditure. If the state takes the responsibility for doing this by the policy of deficit financing the level of total expenditure can
be maintained high and the problem of unemployment can be solved. The money supply created by deficit financing can not give rise to inflation because there is scope for the increase of production of goods. It is in this sense that Prof. Shency says that deficit financing is a device for mobilising the real resources.

The Indian Planning Commission, on the otherhand, has observed, "Deficit financing is safe and useful while there is a slack in the economy and production can be increased fairly quickly by utilising idle capacity or man power. But, once the available production capacities are being more or less fully utilised, a further stepping up of investment expenditure through deficit financing cannot but generate inflationary pressures. In otherwords, the considerations that govern the feasibility of deficit financing are rather of a short-term character and while they warrant an expansion or a contraction of a part of public expenditure in response to the needs
of the situation, deficit financing cannot be relied on for a continuous increase in public outlays year by year except within narrow limits. Such increase can only be supported by expansion on normal budgetary receipts. It is true that the chief advocates of the deficit financing have visualised its use as an anti-cyclical measures in developed economies. But if we analyse the inner logic of the policy of deficit financing it becomes clear to us that it can be used to a limited extent even in an under-developed country. Since deficit financing is co-related to a vast programme for the fuller and more effective utilisation of the country's resources and a certain measure of increase in production is in any case bound to take place, the method of deficit financing may well help to keep up the tempo of increased production by maintaining expenditure at a high level. What is necessary is

33. Review of the First Five Year Plan (1957) p.35.
that a proper balance should be maintained between the increased money supply and the increased production that would actually materialise.

Planning and balance of payments problem in underdeveloped country.

The adoption of the planning method in an underdeveloped country gives rise to certain international complications. Of course it is possible to consider planning in a closed economy in disregard of the balance of payments difficulties. As a theoretical analysis such an approach would be quite in order but to understand the practical bearings of the planned approach it is necessary to take into account the balance of payments problem.

It would not be inappropriate to refer to the fact that the full employment policy of an advanced country was considered by Keynes in the context of a closed economy. In other words, the international complications which might confront a country steadily pursuing a full employment policy were left out of the picture. Later on, however, distinguished Keynesian economists used Keynesian
tools of analysis to explore the international bearings of full employment policy. A brief discussion of the international implications of full employment policy will occupy our attention in the present context in as much as a preliminary analysis will be a useful introduction to the discussion at a later stage of the foreign trade complications that are likely to confront an underdeveloped country engaged in comprehensive national economic planning.

In an endeavour to clarify the international implications of full employment policy we have to postulate in the first place that the responsibility for ensuring full employment in a country is that of the individual country concerned and nothing can absolve a country from this responsibility no matter what happens in the international sphere. Secondly it is not necessary for any country to adopt any trade or exchange practices manifestly injurious to the interests of other countries to ensure full employment at home. Full employment can
be achieved by constructive domestic measures, and it is not necessary for this purpose to adopt beggar-my-neighbour policies. Devaluation, import control and such other practices, if used as the primary means of ensuring full employment, would lead a country along a wrong and harmful path. Thirdly, if different countries try to create independently of one another conditions of full employment within their borders by the adoption of constructive measures this in itself would tend to assume ideal conditions of international economic equilibrium. In this connection the following quotation from the General Theory would be found appropriate and interesting: "But if nations can learn to provide themselves with full employment by their domestic policy . . . . . . there need be no important economic forces calculated to set the interest of one country against that of its neighbours . . . . . . there would no longer be a pressing motive why one country need force its wares
on another or repulse the offerings of its neighbour, not because this was necessary to enable it to pay for what it wished to purchase, but with the express object of upsetting the equilibrium of payments so as to develop a balance of trade in its own favour.

In the fourth place it requires to be noted that although devaluation and import control are open to objection if they are used for the purpose of improving domestic employment by creating external dis-equilibrium, these measures may nevertheless be used in special circumstances for defensive purposes. There is no bar to a country attempting to pursue a policy of full employment unilaterally although the success in the pursuit of such policy may in greater or less degree be conditioned by the relative importance of foreign markets, dependence on imported raw materials etc., to the country's economy. All the same every country has the right

within the limits set by circumstances to pursue an expansion policy with a view to creating further employment. Now, the pursuit of such a policy by one country when other countries are afflicted with economic depression is likely to give rise to an adverse balance of payments for the former country. So long as the country concerned has adequate liquid reserves at its disposal, the adverse balance need not cause it any serious headache. When, however, there are no liquid reserves to fall back upon, or when the liquid reserves are exhausted a country may well have to take recourse to devaluation or import restriction by way of defensive action. Otherwise, the higher prices created at time by the expansion policy will attract goods to it from the outside world, while its exports would be checked. There would be a growing adverse balance of payments against the country which may well wreck the expansion policy adopted by it. The balance of payments position, therefore, is the criterion by reference to which the justifiability or otherwise of devaluation or import restriction is to be considered. There is a
good case for the adoption of devaluation or import restriction by a country which, in the pursuit of an expansion policy, is hindered or hampered by an adverse balance of payments. The adoption of these methods is not, however, permissible when their object is to create a surplus in the balance of payments which is already in equilibrium or to enlarge a surplus already existing. The idea is that these methods should not be used in such a manner that advantage is gained by causing injury to others.

A country having balance of payments in equilibrium or having a surplus may either intend to pursue expansion policy or it may not. If it does decide to pursue an expansion policy it will tend gradually to develop an adverse balance, and its case will become analogous to one we have already considered. If it is not pursuing an expansion policy it must be subjecting itself to a phase of economic depression. Now a country suffering from depression automatically tends to have a surplus in the balance of payments. It does not therefore require devaluation or import restriction. If it nevertheless tries to have these,
it would only be attempting to solve internal problems by external means which would not only be futile from its point of view but which would be fraught with disturbing possibilities from the standpoint of other countries.

The problem may also be considered with reference to another specific case in order to illustrate more clearly the principles we are considering. A country maintaining full-employment at home suddenly finds itself confronted with depression in foreign countries. This naturally gives rise to an adverse balance of payments for this country which originates not so much from increase in its imports but from a fall in its exports, because the demand for its products in the depressed countries falls off. This inflicts a depression on the export industries of the country concerned. This implies a fall-off in foreign expenditure of the country's products which may well have to be counteracted by an increase in expenditure within the country. While this may help
to overcome the depression in export industries, this does not correct the adverse balance of payments which persists. As before, the adverse balance would be initially met by drawing on the country's gold and foreign exchange reserves, and eventually when these are exhausted, recourse may be had to exchange depreciation and import restrictions. At this stage however the policy of increased expenditure at home requires to be brought to a halt, as otherwise inflationary conditions will be brought about. Exchange depreciation and import restrictions will themselves tend to ensure full employment and therefore if even after this, increased expenditure policy is pursued by the authorities at home this would inevitably give rise to inflation.

We have considered the problems arising from depression in a country's export markets. What procedure should be followed when a country faces an inflationary situation abroad? In such a situation the country's exports will rise sharply and imports will fall. The inflationary pressure will tend to
be transmitted to the home country which will need to be counter-balanced by reduced domestic expenditure. If there is considerable increase in the gold and foreign exchange reserve of the country this may well call for an appreciation of currency or a lowering of import barriers. The above analysis brings into prominence the fact that a country pursuing a policy of full employment may have to adopt a number of defensive measures to protect itself from the unfavourable repercussions of international movements of goods. A similar problem may confront a backward country which has embarked on a scheme of deliberate economic development, though of course the nature of the problem and the mode of its solution are entirely different. The international complications that are likely to be faced by an under-developed country which has adopted the method of planned development require careful analysis. At the outset it should be noted that an unorthodox approach has to be made to the whole subject so that
trade practices or policies which seem otherwise undesirable may be impartially examined from the standpoint of the peculiar requirements of underdeveloped countries. To take one example, the method of protection as a means of fostering national industries may seem objectionable from the standpoint of general principles and yet such protection may be fully justifiable in the special context of the requirements of the backward country striving for speedy economic developments. This principle of according favoured treatment to underdeveloped countries in view of the unique and urgent requirements of such countries was fully recognised in the charter of I.T.O. which is known as Havana Charter. Article 13 of the charter lays down: "The members recognise that special governmental assistance may be required to promote the establishment, development or reconstruction of particular industries or branches of agriculture, and that in appropriate circumstances the grant of such assistance in the form of protective measures
is justified. At the same time they recognise that an unwise use of such methods would impose undue burdens on their own economies and unwarranted restrictions on international trade, and might increase unnecessarily the difficulties of adjustment for the economies of other countries."

This point however touches only one small aspect of the complicated problem that confronts the underdeveloped countries engaged in planned development. The vital issue that arises in the external as distinguished from the domestic sphere from the standpoint of an under-developed country is related to the import of foreign capital as a means of expending national development. A report prepared by the Division of Economic Stability and Development of the United Nations Department of Economic Affairs rightly points out: "The use of foreign rather than domestic funds is important particularly in the early stages of economic growth since, before export industries have developed,
foreign currency required for the purchase of foreign capital equipment is likely to be in short supply. When exports have increased, such currency is normally less scarce and if the country's markets and resources permit, it may in time develop its own industries for producing various types of capital goods. 35

An important problem is, what is likely to be the extent of the foreign capital requirement of an underdeveloped country? Closely connected with this question of the magnitude of foreign capital requirement is the problem of balance of payments difficulties which will arise inevitably out of the investment of the foreign capital, the servicing of the debt, repayment of the debt etc. First of all, a reference may be made to the question of the extent of the capital requirement. Regarding the broad problem of the proportion of capital to be raised from

35. Methods of Financing Economic Development in
domestic and foreign sources Prof. Ellsworth has
made certain interesting calculations. "So far as
the physical capital is concerned the major part of
this clearly must come from domestic sources. For
in any country the bulk of its physical capital
assets consist of buildings, roads, dams, irrigation
works, railway installations, harbour facilities and
the like. In the United States, structures of all
kinds amount to approximately half the value of real
capital resources. There is no reason to expect that
in under-developed countries the proportion would be
greatly different, nor that it would be changed
significantly in the course of development. But to
create these capital assets requires local sand,
gravel, cement and bricks, local labour to dig the
foundations, lay the bricks, and pour the concrete.
The remainder of physical capital consist of equipment

and of stocks, and of the latter at least some portion will come from local resources. This leaves as a maximum, something less than half of physical capital assets to be obtained from foreign sources.

"The same does not mean however that foreign lending must or should be limited to this proportion of the total. Thus although the resources needed to provide some half of the physical capital must come from within the developing country, this fact in itself imposes no limit on the relative extent of internal and external financing. Conceivably all the finances needed could come from foreign sources. Conceivably, too, they could all be provided locally, if the rate of savings were sufficiently great and if the developing country could increase its exports or reduce its non-capital imports sufficiently to pay for the equipment that would have to be imported."36 Prof. Ellsworth finally states his conclusion on this point as follows: "Because of the poverty of most under-

developed countries at least the sums required to purchase equipment will probably have to come from abroad -- perhaps 40 percent of the total outlay .... A figure of 40 to 50 percent of the total to be financed locally would appear reasonable, though the proportion in any individual case will of course vary with local conditions. 37

An important point to note is that the larger the proportion of investment that is financed by foreign capital, the more complicated will be the problem of balance of payments. The first factor that has to be considered however relates to the terms on which foreign funds are obtained. Are they being provided in the form of grants? If so, there would not be any problem of debt service. If however the foreign capital is obtained as a loan it will give rise to a problem of payment of interest or remittance of dividends and that will give rise to a balance of

payments problem. Whether debt servicing will also necessitate repayment of principal would appear to depend upon whether the supplier of funds is a private investor or a government. Repayment of principal will have to be made where the lender is a government or an international institution like the International Bank. But so far as private investors are concerned there is no need for their investment to be repaid. Considered as a group, investors regard their investment as permanent and they do not desire to liquidate them for purposes of consumption. This is a special reason for giving preference to private as against governmental investment. In addition to the question of the size of the debt service as determined by the amount of foreign loans there is the further question of the country's ability to earn a surplus of foreign exchange with which to make the necessary payments. When the borrowed funds go into export industries whose output supplants former imports, the means of
servicing the loans is established. Therefore any country engaged in a programme of economic developments must consider the direction of its investment if it is to avoid balance of payments difficulties.

Once a programme of investment is carried out through certain projects, operation of these projects begins and the country faces the task of remitting interests, dividends and possible amortisation payments to its foreign creditors. This will be facilitated to the degree to which the direction of investment has been appropriate.

It is important to remember that any increase of investment has a multiplied effect on income. Whatever the propensity to import, the rise in income will stimulate imports whose increase may be so great as to exceed the foreign exchange made available by the lending country. This consideration raises the important question - how large an investment programme can be supported by a given volume of foreign borrowing? Or the question may be said to
arise in the following form - what rate of investment in the borrowing country can be supported without balance of payments difficulties.

For the avoidance of balance of payments difficulties a country developing with the aid of foreign loans must (1) keep its rate of investment in proper relation to the foreign loans made available, i.e., with an eye to the propensity to consume and the propensity to import of the borrowing country. Secondly the country must (2) direct an adequate proportion of investment into activities which yield an export surplus. Thirdly it must (3) keep the debt service low by increasing the ratio of output to capital. This implies the direction of investment chiefly into industries which are economical in regard to the use of capital. Finally (4) to ensure that the development programme will not be interrupted by a temporary yet possibly serious balance-of-payments deficit, the lending country should furnish some guarantee as to continuity and duration of the flow of loans.