CHAPTER - III

SCOPE OF FOREIGN CAPITAL IN ECONOMIC DEVELOPMENT.

Need for foreign capital:

The features of underdeveloped countries show that relative scarcity of capital is the most common characteristic of underdevelopment. The major problem for development is, therefore, to increase capital per head and at the same time, to increase the efficiency of its use so as to get maximum rate of return out of the limited resources. This can be done in three ways: (i) by increasing the rate of saving, (ii) by raising the output capital ratio, and finally (iii) by lowering the rate of growth of population. There is a unique relationship between them.

Suppose in an economy rate of saving is six per-cent and rate of capital formation is 6 percent. If output capital ratio is such that 3 units of investment give one unit of income, then there is an increase in income by 2 percent. If population grows by 2 percent per annum, there is stagnation in per capita income.

This relationship between these three variables can be expressed in the form of two equations: (1).

\[ G = S \frac{G}{C} \quad \text{(i)} \]

\[ g = G - p \quad \text{(ii)} \]

Where \( G \) stands for the rate of growth of national income, \( S \) for the rate of saving, \( C \) for the output-capital ratio, \( g \) for the rate of growth of per capita income; and \( p \) for the rate of growth of population.

These two equations show that economic growth can be accelerated by changing one or the other of the variables. If increase in the rate of growth of per capita income is the goal, this can be done by raising the rate of saving, by raising the output capital ratio, or by lowering the rate of growth of population.

But underdeveloped countries do not have adequate facility to change these variables in desirable directions. For example, the rate of saving in most of the underdeveloped countries was of the order of 5 to 6 per cent in 1949. This is illustrated in Table III - 1.

**TABLE III - 1**

Net Domestic savings as per cent of National Income, 1949 (2).

<table>
<thead>
<tr>
<th>Region</th>
<th>per cent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Latin America</td>
<td>8</td>
</tr>
<tr>
<td>Middle East, including Egypt</td>
<td>6</td>
</tr>
<tr>
<td>Africa excluding Egypt</td>
<td>5</td>
</tr>
<tr>
<td>South Central Asia</td>
<td>5</td>
</tr>
<tr>
<td>Far East, excluding Japan</td>
<td>3</td>
</tr>
</tbody>
</table>

During the last decade, there have been enormous efforts in underdeveloped countries to increase the rate of capital formation. Yet, the rate of saving has not increased very much. The average saving rate in underdeveloped countries in 1961 has come to 7 to 8 per cent of gross national product (3).

(2) Source: Calculated from United Nations, Department of Economic Affairs, Measures for the Economic Development, op.cit. p.76.

In India, for example, the average saving rate in 1963, at the end of second plan reached 8.5 per cent of national income. This is inadequate to generate a process of self-sustained growth in the economy. According to Lewis, the problem of increasing saving from about 4 to 5 per cent of national income to something like 12 to 15 per cent is the central problem in the theory of economic development (4). Most of the underdeveloped countries are far behind this target.

Moreover, though there has been some increase in the rate of saving, only in a few cases, the marginal rate of saving has exceeded the average rate of saving. A marginal savings rate considerably higher than the average is the main lever of economic development of underdeveloped countries. Once the level of self-sustaining growth is reached, with average savings of 12 - 15 per cent, the marginal savings rate need no longer be higher than the average rate. The main function of capital inflow is to increase the rate of domestic capital formation up to a level (for instance 12 per cent, yielding an increase of income of 2 per cent per head per annum) which could then be maintained without any further aid (5). Thus the principal condition of aid is to step up marginal rate of savings in underdeveloped countries so as to increase the pace of development.

In respect of output-capital ratios, the underdeveloped countries also have a disadvantage. In initial stages of development, they are likely to have low output capital ratio.


(5) P.N. Rosenstein -Rodan op. cit. p.107.
According to Colin Clark, the capital co-efficient in each country passes through an ascending phase, reaches a maximum and then begins to descend. His argument is that there must be an ascending phase; after all, an economy of handicraftsman and pack of horses uses comparatively little capital. But once a country is highly developed, the capital co-efficient is likely to fall because increments to the national product may consist largely of services rather than goods (6).

Professor Leibenstein also lists a number of reasons which could make a declining capital output ratio (the same thing as increasing output-capital ratio) the result of development. Among those are the probabilities that development will be accompanied by: (i) an increase in the productivity of labour; (ii) increasing ability of the economy to overcome indivisibilities in capital; (iii) relative increase in the demand for services that require less capital per unit of output and so on (7).

Actually, in case of the U.S.A., the capital-output ratio increased from about 3:1 during 1889 to about 4:1 during 1934; it then started falling gradually and was around 2.5 : 1 during 1948 (8). In case of India, capital-output ratio is now on an ascending phase: while in the first plan, it was 2.0 : 1, it increased to 3.6 : 1 in the second plan (9). In the third plan, it might increase further.

This does not of course mean that there is no scope for improvement in capital-output ratio. If there could be improvement in efficiency or technological innovation, same input of capital could produce more units of output i.e. output-capital ratio could be made larger. In recent years China has reduced the capital-output ratio by efficient use of available resources. Malenbaum's study shows that capital-output ratio in case of China during 1950-57 was probably around 2.5 : 1 (10). During this period, China seems to have generated a similar unit of gross income flow with little more than half the gross investment that was applied in India. The record indicates greater 'efficiency' in China in converting a given amount of gross investment into additional capacity or at least additional product. Malenbaum calculates that for the period as a whole, 55 per cent of the difference in the rate of growth in the two countries can be attributed to the greater efficiency with which Chinese applied investment.

But the Chinese case does not seem to be applicable to other underdeveloped countries. A totalitarian country has greater scope to increase efficiency than a democratic country. Most of underdeveloped countries will, therefore, have difficulty in improving efficiency in initial stages of development. Moreover, technological innovation which has a tendency to increase output : capital ratio is a long term phenomenon. Therefore, underdeveloped countries, would require more capital than developed countries to produce one unit of output. For this reason, their dependence on foreign capital would be considerably high.

The increase in the rate of growth of population will also increase the demand for capital. At present, the rate of increase in population in most of the underdeveloped countries is about 2 per cent per year. Some of the projections show that it is likely to be much higher in future. Even if the rate of growth remains constant, underdeveloped countries would require 6 per cent capital formation to maintain the existing standard of living broadly on the basis that capital-output ratio is 3:1. But if 6 per cent increase in national income is desired per year (2 per cent for maintaining the existing standard of living, 2 per cent for improving it and an additional 2 per cent for accelerating the progress of development), the amount of capital formation would be 18 per cent. This is a formidable task for most of the underdeveloped countries. And if there is further increase in the rate of growth of population, the task would be unmanageable.

The foregoing analysis shows that due to low marginal rate of saving, high capital-output ratio and increased rate of growth of population, underdeveloped countries could not be able to generate a desirable rate of economic growth without foreign capital.

It is, therefore, necessary that external resources should be tapped to bridge the gap between internal savings and the capital formation necessary to promote quick industrial development. The role of external finance assumes special importance in the sense that it allows a country to consume or invest more than what it produces. If national income is denoted by $Y$ and the total expenditure (both consumption and investment) in an economy by $E$, while exports and imports are
denoted by \( X \) and \( M \), we obtain a general identity:

\[
E - Y = M - X
\]

This means that the excess of total expenditure over the national income is equal to the excess of imports over exports. This shows that underdeveloped countries will have no other alternative but to consume and invest more than what they produce in order to accelerate the process of development. Thus, capital from outside permits the national income to grow more rapidly, and, therefore, provides a bigger surplus out of which development programme can be financed without pressing on current levels of consumption.

Again, developmental process is always accompanied by deficit balance of payments because of the great need of underdeveloped countries to import capital goods, technical know-how and research methodology in order to carry through a programme of industrialisation. But the demand of developed countries for the products of underdeveloped countries is limited. A number of reasons account for the absence of growth in the demand of developed countries. Firstly, U.S.A. which now occupies the leading place in the world capitalist economy does not depend on foreign supplies of many raw materials and food stuffs, and at the same time, she competes with underdeveloped countries in several commodity markets. Other capitalist countries also try to attain self-sufficiency in food and raw materials, a trend which is bound to be reinforced by the current schemes of economic integration in Western Europe. Secondly, there is sometimes a deliberate policy by the now advanced countries of changing the composition of output, a shift within the sector of industries towards mechanical and precision industries which require small inputs of raw materials as compared to the value added, and
towards the chemical industries, whose dependence on imports from underdeveloped countries (except for oil) is small. There are also a series of technological advances in the developed countries which lead to the use of synthetic substitutes and diminish their dependence on the imported raw materials. Finally, there is low income elasticity of demand for a number of tropical food stuffs in the advanced countries. At a high level of income, an increasing portion of income is generally spent on tertiary industries. Therefore, the demand for food stuffs or raw materials is not likely to increase in developed countries.

On the other hand, the marginal propensity to import in case of under-developed countries would increase along with increase in the rate of development. Import requirements of food might shoot up with their population explosion. Demand for raw materials, components and capital goods would increase at an increasing rate with increased industrialisation. Whereas a shortage of raw materials and components would prevent the full utilisation of productive capacity, a deficiency of capital goods would deprive the country of the capacity to produce.

This shows that underdeveloped countries would have balance of payment difficulties due to their high marginal propensity to import along with incapacity to develop export markets. A developing country is also likely to need additional foreign exchanges for servicing foreign investment. Unless the rate of borrowing is continually increased, a return flow of capital from the borrowing country to the lending country will eventually occur. The transfer problem arising out of the development process may accentuate the difficulties of balance of payments. Finally, an underdeveloped country is likely to experience inflationary pressures in the process of development.
Balance of payments is particularly sensitive to inflationary pressures. Rising domestic prices create new demands for imports and act as a restricting force to exports. All these influences are simultaneously working in underdeveloped countries in recent years.

In case of India, for example, balance of payment difficulty has been acute in the process of development. During the second world war, India emerged as a creditor country, wiped off her foreign debt amounting to over Rs. 450 crores and in addition, accumulated sterling balances amounting to about Rs. 1,700/- crores in 1946-47. But the partition and import of food grains caused severe difficulty to balance of payments and India's balances were reduced to Rs. 833 crores in 1950-51. India adopted planning in 1951. It was expected that the annual deficit in the balance of payments in the plan period would be to the extent of Rs. 180 - 200 crores. But the deficit was much less, about Rs. 318 crores over the whole plan period and this was due to lower volume of food imports on account of increased agricultural production and lower imports of machinery due to slow start in the process of development.

But in the second plan the difficulty of balance of payments became acute. The deficit came to about Rs. 2100 crores as compared to the Plan estimate of Rs. 1100 crores. Indian exports did not make any head way. The annual average of exports in the first Plan was about Rs. 609 crores and it increased to about Rs. 614 crores in the second Plan. Against this near stagnation in Indian exports, there was doubling of world trade during the last decade. Actually, during this decade, India's share in foreign trade declined from 2.1 per cent in 1950 to 1.1 per cent in 1960. As a proportion of national income, exports also have
fallen from 6 to 7 per cent in the early post-war years to under 5 per cent by the end of second five year Plan.

On the other hand, there has been a continuous rise in imports. The annual average of imports in the first Plan was ₹.724 crores and it increased to ₹.1072 crores in the second Plan(11). The third Plan is not likely to alleviate the situation. It is estimated that the annual average of exports in the third Plan would be about ₹.740 crores and imports about ₹.1150 crores. In addition, there would be liabilities on account of services. The repayments of loans and credits falling due within the third Plan period total ₹.450 crores. Other capital transactions are estimated to involve a net outflow of ₹.100 crores. Therefore, a total provision required for capital repayment in the period of the third Plan comes to ₹.550 crores. That means the balance of payments position will continue under strain during the third Plan period.

If there would be rise in general price level during the third Plan, there would be acute deficit in balance of payments. During the first few years of the second five year Plan, the rise in general level prices adversely affected both the average value index of exports and its volume. The government had to take several measures to control the rise in prices. Yet, the price has not yet been stabilised and there are tendencies that prices may rise further in coming years. This implies that a developing country cannot be able to balance its trade without sufficient foreign assistance.

(11) This increase in imports was inspite of stringent import restrictions. Had not the Government followed a policy of import restriction, the imbalance would have been much greater.
This is not only peculiar to India. The same tendency is also noticed in all underdeveloped countries. In 1938, the underdeveloped countries had a favourable balance of trade as their export to developed capitalist countries amounted to 22.5 per cent and their imports only 20.1 per cent of world exports. In 1958, exports decreased to 19.4 per cent and imports increased to 22.5 per cent. If heavy liabilities on account of services and the servicing of foreign capital are added to adverse balance of commodity trade, the position becomes worse.

Imbalance in foreign trade is, therefore, inevitable in the process of development. There are four methods by which developing countries can compensate for the deficits in balance of payments, namely, (i) by loss of governments' gold; (ii) by running down foreign exchange reserves; (iii) by use of drawing rights at the International Monetary Fund and (iv) by arranging foreign aid or loan. The scope of the first three methods are limited. The government cannot afford to lose their gold and foreign exchange reserves year after year to finance balance of payment deficits nor can they draw unlimited funds from IMF to settle their accounts. The only source of adjustment seems to be foreign aid.

This can be expressed in the form of an equation. If \( I = S \) and \( X \neq M \), when \( I \) stands for investment, \( S \) for saving, \( X \) for exports and \( M \) for imports, the problem of balance in underdeveloped countries can be stated as:

\[
I - S = U - F.
\]

\( U \) and \( F \) denoting unfavourable balance and foreign aid respectively. This means that excess of investment over saving in underdeveloped countries would depend upon the rate of foreign aid available. On the other hand, the balance in developed countries can be
stated as:
\[ S - I = F - U. \]
Which implies that developed countries can prevent stagnation by exporting excess of their saving over investment in the form of foreign aid.

Foreign aid is, therefore, indispensable for preventing imbalance in foreign trade and maintaining the development tempo in both developed and underdeveloped countries.

Actually, foreign capital has played a major role in the take-off stage of many economies like those of U.S.A., Canada, Russia and Sweden. For instance, during the years 1874 and 1897, the United States was borrowing to such an extent that its own trade surplus was insufficient to service the debt and it became necessary to get new loans for the payment of interest and dividends on old capital. A similar situation was faced by Canada during the period of its rapid industrial growth from 1900 to 1913 and from 1920 to 1929 when she had to service the past loans by incurring fresh ones. In Russia also, there was a substantial inflow of capital between 1881 and 1913 specially from France which established the base on which the industrial revolution could stand.

The supply of foreign capital, therefore, allows a country to run a deficit in its balance of payments, enables it to import necessary goods and services for increasing the pace of development and permits the national income to grow without pressing on current levels of consumption.

**Scope of foreign capital:**

Foreign capital inflow and foreign economic aid are not synonymous. Aid refers only to those parts of capital inflow which normal market incentives do not provide. It consists of (i) long-term loans repayable in foreign currency, (ii) grants and
'soft' loans and (iii) sale of surplus products for local currency payments (under P.L. 480 in the U.S.) (12). Accordingly neither short or medium-term loans nor private foreign investment should be counted as aid. They are 'trade not aid'. Short and medium-term loans are mostly selling devices for (tied) exports of equipment goods. They are, therefore, excluded from capital-inflow into underdeveloped countries. So also short-term capital movements which are volatile and whose movements depend upon changes in rate of interest and other political and economic conditions. A part of defense support of U.S.A. also contributes to the receiving countries' economic development. But since the purpose here is different, that is not included in economic aid (13). Private foreign investment, both direct foreign investment and portfolio investment, is undertaken in response to normal market incentives and is an important element of foreign capital inflow into underdeveloped countries.

The important question is to examine the scope of private foreign investment and economic aid for accelerating the economic growth of underdeveloped countries. To begin with, the role of private foreign investment may be taken up.

(12) Soft loans are in effect contingent part-grants. That is, a loan is made with the expectation that repayment will depend on the future ability to pay. These loans include very long-term (ninety-nine years) loans repayable at a low rate of interest and loans repayable in local currency which is then relent to the borrower for further domestic investment. A part of the loan may be written off if the project does not become successful. P.N.Rosenstein-Rodan, op.cit. pp. 109-110.

(13) According to Rosenstein-Rodan, about 20 per cent of Defense support of U.S.A. contributes to the receiving countries' economic development.
Between different forms of foreign capital, direct private foreign investment is generally favoured due to the fact that it goes directly into capital formation. The loans or grants received by the local government may not be properly utilised as the economic organisation in underdeveloped countries is not efficient. But as direct foreign investment is imbued by profit motive, it is likely to be productively employed. The second advantage of direct private foreign investment is that it is likely to carry with it modern technology and know-how. Of course the private investors are not very willing to impart technical or managerial knowledge to the local population, because the local population so trained may not stick to the firm and so the loss on this account may be quite heavy. Yet, this difficulty could be overcome by suitable contract or agreement between foreign private investment and local government. Thirdly, direct private investment may induce and promote more domestic investment, either in partnership with foreign capital or into local ancillary industries which the foreign enterprise has indirectly established. Even between direct investment and portfolio investment, direct investment is likely to be better in view of the fact that returns from direct investment are likely to be reinvested for further capital formation, whereas this is not generally true for portfolio investment. If the extra output obtained due to private foreign investment is greater than the profits remitted to foreign country, foreign investment is always preferable. In most of the cases, this is likely to be so (14). Finally, in times of depression, payment of dividends to

foreign countries would not create serious foreign exchange difficulty as dividends would be related to profits.

However, the problems which are important to consider are whether (1) sufficient foreign private investment is available at the present stage, (2) if available, whether it is likely to come to underdeveloped countries and (3) if it comes, whether it will be utilised for domestic economic development.

Availability of foreign private investment:

The answer to the first question is not optimistic. Before the first world war, Britain was the principal lender. Between 1875 and 1913, Britain's foreign investments increased approximately 250 per cent and amounted to approximately £4 billion in 1913. At its peak in 1913, foreign investment took more than half the total of Britain's savings. During the 40 to 50 years before 1913, Britain had invested overseas about as much as her entire industrial and commercial capital, excluding land. As a percentage of net national income, Britain's overseas investments averaged 4 per cent over the entire period 1870-1913; from 1905-1913 the ratio was about 7 per cent and in 1913 was 9 per cent. But gradually the U.K. lost its position and the two world wars deteriorated its balance of payments to such an extent that it could not export capital to any substantial extent. Whereas in 1913, British Capital exports were the equivalent of about £800 million in 1956 prices, they averaged only some £60 million a year from 1953 to 1956.

The United States replaced Britain as the major lending country after the 1st world war. The major period of American foreign investment was the 1920's. By the year 1930, the total of all American foreign investments amounted to about 17 billion dollars. But the depression reduced foreign investment and in
the year 1939, it approximated 11 billion dollars. After the 2nd
world war, there was revival in foreign investment but it was much
less than during the 1920's. The annual average of total private
investment during 1946-1952 was approximately 788 million dollars,
whereas from 1919-1929 the annual average was over 1.6 billion
dollars (adjusted to the price-level of 1948) - more than twice
the rate for the years of 1946-52 (15). This was much low
compared to the needs of underdeveloped countries.

However, in recent years there has been a substantial
change in the volume of private foreign investment. The table
below gives a clear picture of the flow of International Private
Capital from 1952-1958 (16).

| Gross Outflow of Private Long-term Capital: 1952-58 (millions of dollars) |
|-----------------------------------------|----------------|
| United States | 1940 | 1312 | 1628 | 1918 | 3420 | 3920 | (2567)* |
| U.K. | 421 | 506 | 585 | 364 | 557 | 755 | 533 |
| Continental Western Europe | | | | | | | |
| Belgium-Luxembourg | 40 | 40 | 70 | 170 | 160 | 150 | n.a. |
| France | - | - | 490 | 494 | 540 | 457 | n.a. |
| Western Germany | - | - | 54 | 61 | 75 | 185 | 262 |
| Netherlands | - | 7 | 60 | 157 | 59 | 103 | n.a. |
| Switzerland | 117 | 147 | 200 | 260 | 321 | 130 | 33 |
| Total, Continental Western Europe | - | - | 874 | 1142 | 1155 | 1025 | n.a. |
| Grand Total | - | - | 3087 | 3424 | 5132 | 5700 | n.a. |

* Excluding the retained profits of U.S. subsidiaries abroad.
a. Net figures. Entries for all years include only part of the
retained profits of U.K. companies operating abroad.
b. New issues only.

It will be seen from the above table that the growth in volume of long-term U.S. investment has more than doubled between 1952 and 1957. There is also some improvement in the investment of U.K. The German investment has multiplied nearly five times between 1954 and 1958. Yet the availability of private long-term capital is not sufficient to meet the needs of underdeveloped countries. The U.N. experts on economic development estimated the overall capital requirements in the underdeveloped world as a whole at 19 billion dollars annually if the per capita income were to be raised by 2 per cent annually. The actual available savings amounted to only 5.94 billion dollars in 1949 and, therefore, the experts recommended the annual flow of foreign capital to the underdeveloped countries well in excess of 10 billion dollars. But the gross outflow of private long-term capital of U.S.A., U.K. and Continental Western Europe is much less. Moreover, all these capital outflow is not likely to come to underdeveloped countries.

We cannot expect that the volume of private capital will increase to such an extent that the difficulties of underdeveloped countries could easily be overcome. Foreign investment in the 19th century or in the beginning of the 20th century was not only attractive; it was sufficiently consistent with migration of population, the growth of international trade and stable political, economic and social conditions to operate as a vital constructive force in international trade. Conditions are not so favourable now. The needs of underdeveloped countries might now be greater than before, but the resources available are inadequate to meet their demand. Moreover, if the available resources could flow to underdeveloped countries, there might be a significant improvement in their capital formation. But that question is also doubtful.
Direction of foreign investment:

If the past experience has been any guide, we cannot be very much optimistic that available private foreign investment would come in large quantity to underdeveloped countries. In the 19th century, much of Britain's foreign investment was directed to the relatively sparsely settled areas where labour was scarce. Roughly two thirds of the British overseas investment went to the so called regions of recent settlement - the spacious, fertile and virtually empty plains of Canada, the U.S., Argentina, Australia and other new countries in the world's temperate latitudes. Only one quarter of the British investment went to tropical or sub-tropical regions. So these regions remained underdeveloped and they now require more foreign capital than any other region in the world. The American investment is also following the same pattern.

In the past, the American investment did not go to poor countries. The geographical distribution of portfolio investment between 1920 to 1931 was 40 per cent to Europe; 29 per cent to Canada; 22 per cent to Latin America; and about 9 percent to the Far East. A larger proportion of direct investments, almost half, went to poor countries. But most of this was invested in Latin America. Of the total of the U.S. private investment abroad in 1957, more than 53.6 per cent went to Western Europe and Canada. Most of the rest was concentrated in Latin America which has little more than 5 per cent of world's population and less than 15 per cent of its area. In case of direct investments, the share of Western Europe and Canada is about 48.8 per cent and that of Latin America somewhat higher than 34.9 per cent. The following table shows the distribution.
It thus appears that geographical contiguity and close trade relations have been the principal factors influencing the flow of U.S. capital abroad. If this trend continues, the countries of Asia cannot hope to attract any sizeable amount of private capital from the U.S.A.

India, for example, has been the recipient of a very small amount of private American capital—roughly the same amount as Sweden which has about 2 per cent of the population of India. As a matter of fact, the net inflow of private foreign capital in India is of such a low order that it cannot meet the needs of the country. The gross capital inflow from private sources amounted only to ₹25.6 crores in 1959. Again, there was a slight downward tendency in gross capital inflow since 1956.

The following table presents the position of foreign investment in India since 1954-55.

### TABLE III-4

Inflow of Foreign Investments into the Private Sector (18)  
 *(Rs. Crores)*

<table>
<thead>
<tr>
<th>Year</th>
<th>1954 and 1955 (Annual average)</th>
<th>1956</th>
<th>1957*</th>
<th>1958*</th>
<th>1959</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Inflow of private foreign capital (net).</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Gross inflow</td>
<td>14.9</td>
<td>24.9</td>
<td>17.9</td>
<td>2.4</td>
<td>10.8</td>
</tr>
<tr>
<td>(i) Retained earnings</td>
<td>12.0</td>
<td>19.5</td>
<td>9.5</td>
<td>9.8</td>
<td>15.1</td>
</tr>
<tr>
<td>(ii) Cash inflow</td>
<td>1.5</td>
<td>3.1</td>
<td>5.9</td>
<td>4.8</td>
<td>3.3</td>
</tr>
<tr>
<td>(iii) Non-cash inflow</td>
<td>6.4</td>
<td>8.5</td>
<td>11.4</td>
<td>12.3</td>
<td>7.2</td>
</tr>
<tr>
<td>2. Outflow</td>
<td>5.0</td>
<td>6.3</td>
<td>9.1</td>
<td>24.4</td>
<td>14.8</td>
</tr>
<tr>
<td><strong>B. Official capital</strong></td>
<td>1.4</td>
<td>12.1</td>
<td>32.1</td>
<td>25.3</td>
<td>27.3</td>
</tr>
<tr>
<td><strong>C. Gross inflow into the private sector.</strong></td>
<td>21.3</td>
<td>43.3</td>
<td>59.0</td>
<td>52.1</td>
<td>52.9</td>
</tr>
<tr>
<td><strong>D. Net inflow into the private sector.</strong></td>
<td>16.3</td>
<td>37.0</td>
<td>50.0</td>
<td>27.7</td>
<td>38.1</td>
</tr>
</tbody>
</table>

* Revised.

**N.B.** (1) Figures exclude foreign investments in the banking system.

(2) The inflow has been computed, wherever possible, by eliminating valuation changes;

(3) Totals may not add up because of rounding.

The reason why private investment has not come to underdeveloped countries in large quantities is due to the fact that the productivity of one investment depends upon other investments having been made before. Hence it may be more profitable  

to invest capital in countries which already have a lot of capital than to invest it in a new country* (19). Since the economies of underdeveloped countries are underdeveloped, rates of return on investment do not compare favourably with developed countries, social overhead capital is almost nonexistent, domestic demand is low and risks involved are greater, it is unrealistic to expect that sizeable volume of private capital would flow to these countries. Moreover, to the extent that direct private investment abroad is undertaken by giant business corporations, the relatively homogeneous pattern of wants in relatively developed countries makes it easier for these corporations to extend their line of business activity in such countries rather than in underdeveloped countries because less expenditure has to be incurred in developing a market in the former than in the latter.

Character of foreign investment:

But the most important thing is whether foreign investment that would come to underdeveloped countries would be utilised for industrial development of the poor areas. The foreign investments of great Britain did not improve the economies of underdeveloped countries. Foreign investments were concentrated in plantations and mines producing for export and in railways connecting export-producing areas with the sea-ports. Considering Britain's total foreign investment in the period 1870-1913, more than 40 per cent was used directly in railways, 15 per cent in the development of mines and raw materials, and a large proportion of an additional

30 per cent in governmental loans was directed to these activities. Less than 5 per cent of the value of public issues was for commercial and industrial enterprises serving the borrowing countries' home markets (20). It is clear from this that the underdeveloped regions were little affected in their general economic development by direct foreign capital investments. The investments in mining, plantation or railways were seldom integrated into the local economy, but remained attached to the interests of the creditor country. Foreign private capital in India, for example, was associated with the development of export industries such as tea, jute and mining. It also acquired a substantial stake in organised trading and financial activities, notably in petroleum distribution, in the import and export trade, and in banking and insurance. Foreign investment was thus directed towards foreign trade and the related services, rather than towards an expansion of the country's industrial capacity. The country's major consumer goods industry, cotton textiles, grew largely out of local enterprise and capital.

Moreover, the British investments 'did not give rise to a flood of satellite innovations' and 'destroyed more employment opportunities (eg. in traditional village industries) than it opened up' (21). It can, therefore, be said that foreign capital which flowed to the underdeveloped countries was used for purposes of building up economic enclaves meant for exploiting the countries. Such economic enclaves were never integrated into the economic system and consequently they never brought about any advantage to them.


The reason why foreign investment did not bring about an all-round development is due to the fact that it was mainly directed according to profit expectations. There was some development in export industries; as a matter of fact, exports of primary products showed a substantial increase. But increasing exports did not serve the economy as the internal market continued to remain undeveloped as before. Moreover, there was no development in internal demand as the wages of labourers working in export industries did not grow to any appreciable extent. The pressure of increasing population and the lack of the labourers' bargaining power prevented them from sharing the increase in productivity in export industries. But the most important reason why internal economy remained undeveloped is due to the fact that the income-generating forces (of export industries) were damped considerably by leakages abroad. Due to remittance of profits, interest and dividends to the lending country, as well as the high marginal propensity to import and high income elasticity of demand for imports, a given amount of investment in the underdeveloped country generated a much smaller amount of income than would have an equivalent amount of investment in an advanced country (22).

Singer, therefore, pointed out that the lop-sided pattern of foreign investment in underdeveloped countries created a 'dualistic' economic structure - a high productivity sector producing for exports co-existing with a vast low productivity sector producing for the domestic market. In so far as the foreign investment was really an outpost of the economy of the more developed countries, its main secondary, cumulative

multiplier effects took place not where the investment was physically or geographically located but rather, to the extent that the results of these investments returned directly home, they took place in the countries where the investment came from (23). To the extent this dualistic structure persisted and the more productive sector did not become a real part of the economies of underdeveloped countries, foreign investment failed to spread those dynamic forces of progress, those 'increasing returns', resulting from the forward spread of industrialisation.

The character of the U.S.'s foreign private investment also shows that a large part of this is concentrated in the petroleum industry, distributed mainly among the few countries possessing exploitable petroleum resources. In the decade after the war, the total amount of American direct investments outstanding abroad was evenly divided between rich and poor countries. In the richer countries, only a small portion was directed to extractive industries and the major part went to manufacturing industries and distribution. In the poor countries, however, the major portion of the investment was directed to extractive industries and only a small percentage went to manufactures and distribution. The long established pattern of foreign investment flowing into primary production for export persisted in poor areas. Direct investment of U.S.A. by major industries is presented in the following table.

The table shows that in 1957, nearly half (45.9 per cent) of direct foreign investment is in mining, smelting and petroleum—the chief extractive industries and less than a third in manufacturing industries, the development of which is the real need of the underdeveloped regions. But even these figures are misleading, because most of the investment in manufacturing (more than 70 per cent of the total invested in manufacturing) is in Western Europe and Canada and hence makes scarcely any contribution to the development of underdeveloped countries.

The individual foreign entrepreneur, as a matter of fact, does not have any incentive to develop the internal economy of underdeveloped countries. Moreover, recent tendencies show that even foreign private investment may not come for the expansion of raw material supplies for export in underdeveloped countries. Export market for raw materials and food stuffs do not enjoy the same rate of secular expansion as that which came about in the 19th century. The 19th century was an
extra-ordinary period due to rapid growth of population and increased productivity in the Western industrial countries. Again, during this period, Britain was willing to sacrifice her own agriculture to the requirements of international Division of Labour. The policy of U.S.A. is now rather different. In the beginning, the main purpose of American investment in underdeveloped countries was to supply primary raw materials for the U.S. market. On the basis of rough calculation covering 21 important primary products, it has been estimated that 25 per cent of total U.S. imports in the period 1946-50 were derived from U.S. controlled companies abroad. But America is now developing synthetic fibres in place of staple products that were imported from underdeveloped countries. The hope of increasing private investment in underdeveloped countries even for the purpose of development of raw materials for American market does not, therefore, appear to be promising.

The other form of private foreign capital is portfolio investment. Though it is not accompanied by the technology and managerial skill and as such, might involve higher real costs in the earlier stages of economic development, it is more acceptable to the underdeveloped countries because of its lower cost in terms of rate of interest and greater control by the local entrepreneurs. However, the scope of portfolio investment in underdeveloped countries seems also limited in modern times. In the heyday of British foreign investment in 1913, for example, railways and other public utility stocks accounted for 46 per cent of the outstanding investments, while government stocks accounted for another 30 per cent i.e. 75 per cent of the investment was in government bonds or in public utility stocks.
But since then there have been great structural changes. Apart from the growth in the undistributed earnings of giant business corporations, the other major source of savings in the modern economy are institutions like the life insurance companies. The big business concerns prefer reinvestment of their undistributed earnings to purchase of foreign bonds which are a poor attraction to them. Institutional savers may consider bonds too risky. As a matter of fact, the investors in the U.S.A., the major possible source of capital, are not displaying any enthusiasm to absorb foreign bonds, apart from the Canadian securities and the I.B.R.D. bonds, which alone they regard as nearly as good as domestic securities. Portfolio investment is, therefore, not likely to make any significant contribution to the economic development of underdeveloped countries.

Prospects of foreign aid (Loans and grants):
The need for aid is recognised on all hands. They are superior to foreign private investment in many ways. A major advantage is that foreign aid can be used for domestic development in accordance with the country's overall development programme. There is a possibility that foreign private investment may influence long-term economic policy of the recipient country. It may also strengthen the position of the domestic private enterprise in so far as foreign capitalists seek to exploit resources in collaboration with local capitalists. Moreover, direct investment frequently takes place in certain branches of the economy which may not be in line with a reasonable plan for the development of the resources of a country. The nature of private foreign investment is such that it is impossible to plan their volume, their timing, their regional distribution or their functional distribution i.e. the types of development
they should stimulate or promote. They are, therefore, not suitable for planned economic development' (24).

Secondly, foreign private investment is fairly costly. The minimum returns obtained and expected on such investment is of the order of 10 to 15 per cent. Underdeveloped countries may not afford to pay at such a heavy rate. Finally, the needs of underdeveloped countries are so great and investment in public overhead capital involves such large amounts that private investment alone cannot be expected to fulfill the requirements of these countries. Therefore, there is need for considerable reliance on foreign aid.

Between different types of foreign aid, grants are naturally the best in the sense that they do not involve any future burden. In case of loans, there is the difficulty of repayment problem. In case of India, for example, the problem of repayment is likely to be serious during the third five year Plan period. It is calculated that the foreign exchange needs of the third Plan would be about Rs.3200 crores, of which about Rs.500 crores will represent the interest on and repayment of loans contracted in the previous Plans. This sum of Rs.500 crores includes the servicing charges of the foreign loans made also to the private sector, but it does not presumably include the transfer of profits by the subsidiaries or branches operating in India to their principals abroad. These remittances are a further liability to our burden of repayment (25).

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In case of India, about 38 per cent of our second Plan loans are to be repaid in terms of rupees and some of these loans are to be repaid over a very long period. In case of PL 480 assistance, the repayment of the principal is to be made over a period of 40 years, and in the case of the U.S. Development Loan Funds, the period varies from 15 to 20 years. Though repayment in terms of rupees is less difficult than in terms of external resources, yet it is a problem as it does involve the problem of releasing internal resources. As the early years of the second Plan have amply demonstrated, the problem of raising internal resources for developmental purposes is by no means easy, particularly in an environment of inflation (26).

However, both loans and grants i.e. all kinds of aids are to be encouraged in order to add to the total resources of the country. But there does not seem to be bright prospect of foreign aid. The U.S. economy is conceived as the most important source of supply of foreign economic assistance available to developing economies. But on the whole, American aid is widely distributed and rather thinly spread. It shows heavy concentration in the form of 'defense support' aid to countries militarily aligned to the U.S.A. (27). In recent years, the magnitude of U.S.A. aid has come to $5 billion dollars per annum. About 60 per cent of this consists of military aid grants and 'defense support' aid. Although a part of this aid assists economic development, as an offset it creates distortions in the economic structure of the countries receiving such aid. Leaving aside 'defense support', only less than 1/5th of the U.S. foreign assistance is, therefore,

assistance for economic development, properly so called. The agricultural surpluses taking the form of foreign aid (25 billion dollars in 1959, for example) and exported are a domestic cost in support of U.S. agriculture; their sales, at any price, bring relief rather than involve a burden. Leaving this as well as defence support aid aside, foreign aid for economic development represents less than 1/4th of 1 per cent of G.N.P. in U.S.A. (28). According to Rosenstein-Rodan, the United States aid to underdeveloped countries amounted in 1959 and 1960 to around 1.75 billion dollars and consisted the following items: (29).

| Development Loan Fund           | 0.7  |
| Export-Import Bank              |     |
| (gross 0.375)                   | 0.375|
| Export-Import Bank              |     |
| (net 0.275)                     | 0.275|
| P.L. 480 (total sale 0.9) ½     | 0.6  |
| 1/4th of 'defence support'      | 0.2  |

Total Economic Aid ... 1.75

In addition to this, Technical assistance amounted to 0.2 billion dollars and Emergency Fund to 0.2 billion dollars. Technical assistance is not counted as capital inflow; it has formed a part of budgetary appropriations for aid.

Even though foreign assistance forms such a small part of American gross national product, it creates acute controversy amongst the policy makers in U.S.A. Further increase in aid from the U.S.A. does not seem, therefore, to be bright. The capacity of Western Europe or Soviet bloc as exporter of capital to underdeveloped countries in the coming decade is very much limited (30). The domestic requirements of

(30) Prospects of Foreign Aid, op. cit.
Western Europe is growing and with increasing degree of economic integration in the E.E.C., capital will flow within the community and across the Associated Territories. The Soviet bloc aid is concentrated in a few countries and political affiliation is very strong in this case. It is, therefore, difficult to forecast the scope of foreign aid for the development of underdeveloped countries.

To avoid these uncertainties, it is suggested that aid should be internationalised. Aids given by international agencies will eliminate the political element from the giving of aids. Viner has aptly pointed out that government grants or loans cannot be very important except for political and strategic considerations (31). But strategic considerations are not necessarily the best economic considerations. Moreover, when loans are given by institutions like Export-Import Bank, loans are 'tied' in the sense that with the help of these loans purchases can be made only in the U.S.A. That means underdeveloped countries have got to pay more in terms of cost than if they could use the credit in other markets. This enforces bilateralism and as such the underdeveloped countries are not allowed to reap the benefits of multilateral trading system.

Secondly, the grants at present are given only by big countries like the U.S., while it is desirable for all the developed countries to contribute some thing for the welfare of the underdeveloped countries. Myrdal has pointed out that there is a need for fair distribution of the burden of aid among the countries that are better off and 'only under an internationally agreed system of the widely shared responsibility among the advanced nations will it be possible in the present political

climate for the aid forthcoming for this purpose to reach any major magnitude and acquire a basis of stability *(32)*. Rodan points out that all developed countries with income per head above 600 dollars should contribute to aid either a proportion of their G.N.P. (perhaps one half per cent per annum) or preferably specific contributions (which should add up to the total aid required). This would provide an incentive and encouragement to underdeveloped countries for vigorous development efforts *(33)*.

At present the I.B.R.D. is providing some aid for the development of underdeveloped countries. It initially started its lending for the reconstruction of Europe. Since 1952, the great emphasis has been on lending to underdeveloped countries. In 1959 and 1960, capital outflow from International Bank to underdeveloped countries was to the extent of 0.35 billion dollars (net). Being a development bank its lending has necessarily been on the long-term basis and it has also gained experience in matters of technical assistance in so far as it is concerned with formulating comprehensive economic development programmes, administrative skill and engineering capabilities. But with its present framework, it can never be a very important source of development finance.

The Bank was intended to supplement rather than supplant private investment. It was to grant loans where finance could not be raised privately on reasonable terms and there were reasonable prospects for repayment; second, the loan was to be for a specific productive use and the object of loan was to be of sufficient importance to warrant a foreign exchange liability and normally, the extent of any loan was to be restricted to the


*(33)* International Aid for Underdeveloped Countries, op.cit. pp. 110-111.
foreign currency requirements of the project. This foreign currency approach of the Bank came in for severe criticism at the hands of the U.N. expert committee on economic development. The committee pointed out that 'the Bank has not adequately realised that it is an agency charged by the U.N. with the duty of promoting economic development' and the Bank 'cannot be said to be meeting the challenge of circumstances'. With reference to the foreign currency aspect of financing, they remarked, "what is important is to build up the capacity of underdeveloped countries to produce goods and services. The Banks should start from this point rather than from a measurement of foreign currency needs. And if development succeeds, the transfer problem of meeting the debt charges should take care of itself. At present, the Bank puts the cart of foreign exchange difficulties before the horse of economic development" (34).

The experts recommended that the Bank should set itself the target of lending 1 billion dollars yearly for economic development, which, however, remains unimplemented.

The Commission charged by the Bank also creates difficulty for underdeveloped countries to borrow from the Bank. According to the rules of the Bank, the rate of interest charged is related to the one which the Bank would have to pay if it were to make a bond issue of similar maturity in Wall Street. To this are added 1/4 per cent administrative charges and one per cent commission charges. Thus the rate of interest charged has been between 4 and 6 per cent. This charge of one per cent commission is rather excessive in view of the fact that the underdeveloped countries cannot afford to pay a high rate of interest, specially

when they have to have loans from the I.B.R.D. to spend on overheads whose returns are available only after a long period and are rather uncertain (35).

Finally, the lending policy of the Bank is directed towards the creation of overheads and not the development of industries. For example, two-thirds of the Bank's lending so far has been for basic investment in transportation and electric power. Thus, out of the total net loans sanctioned amounting to 6545 million dollars during 16 years of its operation, as much as 4293 million dollars or 65.6 per cent, have been for developing transportation facilities and electric power generation. Of the balance, industry accounts for 1017 million dollars, agriculture and forestry for 504 million dollars, reconstruction for 437 million dollars and general development for 205 million dollars (35).

Again, the Bank does not lend to private firms unless there is a government guarantee which is not liked either by the private firm or by the government. Because, to private firm, it means government interference and to government, it is an increase in their credit responsibility in regard to private business. The Bank is also not willing to finance manufacturing industries under government ownership. This is because the Bank realises that although expenditure on overheads is necessary for the development of any industries in the country, yet it is not necessary for the governments of the underdeveloped countries

(35) M.S.Khan: India's Economic Development and International Economic Relations, Asia, 1961, P68
to have all the industries under their control. Since in underdeveloped countries the government has to play a major part in initiating development, such restriction on lending operation limits the scope of the Bank for industrialising underdeveloped economies.

The Bank established another institution, namely International Finance Corporation in 1956 for the special purpose of encouraging the growth of productive private enterprise, particularly in the less developed areas of the world. When private capital is not available in sufficient quantities on reasonable terms, the Corporation in association with private investors, would participate in loans to private enterprise without requiring any government guarantee of repayment. The I.F.C. has concentrated on aid to industrial ventures. However, so far the Corporation has not made much investment. But since it can make loans in local currencies and free the borrowings from the difficulty of repayment due to the shortage of dollars, there is a possibility that its activities would be accelerated (37).

In 1960-61, an International Development Association has been established as an affiliate of the World Bank. The aims of I.D.A. would be to provide finance to economically backward countries on terms which are more flexible and bear less heavily on their balance of payments than those of conventional loans. It would grant loans on easy terms of repayment with long maturities, or long periods of grace before payment begins, or both. The cost of borrowing funds from I.D.A. would be nominal approximating to the service charges. The Association would also lend to projects in the public sector. The I.D.A. within

(37) M.S. Khan, op. cit, p.71.
two years of its existence have provided 22 loans involving 235 million dollars. It will be interesting to note that the World Bank itself did not attain this rate of momentum in the initial years of its existence even though its resources were incomparably larger than those of the I.D.A. India has been the largest beneficiary of I.D.A. credit, both in terms of the number and the amount of loan. Thus, India was given 7 credits for 122 million dollars out of the credits of 235 million dollars, that is more than 50 percent. Pakistan ranked second with 3 credits involving a total of 21 million dollars.

However, even in case of I.D.A. there is pronounced slant in favour of public utilities. Thus out of the total credit of 235 million dollars provided by the I.D.A., 126 million dollars was for transportation, 79.2 million dollars for agriculture and forestry and 18 million dollars for reconstruction, 6.4 million dollars for water supply and only 5 million dollars for industry (38).

In future, the role of these international institutions may change in character and they may place substantial funds at the disposal of underdeveloped countries for their economic development. In that case, instead of the U.S.A. playing a major part in economic assistance, each developed country may share a part of the burden of development in underdeveloped countries. But at present, these institutions do not play any important part. Their resources are also limited to meet the needs of the developing countries. In 1960, for example, total aid and capital inflow to underdeveloped countries including technical assistance

(38) World Bank Completes Sixteen Years, Commerce, op. cit.
were about 4.5 billion dollars of which the contribution of International Bank was only 0.35 billion dollars. The following table shows the contribution of different agencies in providing capital to underdeveloped countries.

**TABLE III - 6**

Capital and Aid for Underdeveloped Countries.

( In billions of dollars )

<table>
<thead>
<tr>
<th>1960</th>
<th>Total Economic Aid from U.S.A.</th>
<th>1.75</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Private foreign investment (U.S.A.)</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>Gross 1.0 billion</td>
<td>Net 0.9 billion</td>
</tr>
<tr>
<td></td>
<td>Total capital outflow, U.S.A.</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Technical assistance, moreover, amounted to 0.2 billion dollars and emergency fund 0.2 billion dollars.

Other sources.

<table>
<thead>
<tr>
<th>International Bank, (Gross 0.47) net disbursement</th>
<th>0.35</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.K. Public (0.2) and private investment (gross 0.6 net 0.52 minus oil investment 0.17)</td>
<td>0.35</td>
</tr>
<tr>
<td>France public (0.50) and private investment (gross 0.7 net 0.65 minus oil investment 0.2)</td>
<td>0.45</td>
</tr>
<tr>
<td>Other countries of the Free world</td>
<td>0.1</td>
</tr>
</tbody>
</table>

Total 1.25

Technical assistance expenditure other than the U.S. (including the U.N.) amounted, moreover, to around 0.15 billion dollars. The total capital outflow into underdeveloped countries amounted, therefore, to 3.65 billion dollars; Total expenditure on Technical assistance to around 0.35 billion dollars.
The U.S.S.R. supplied economic aid of around 0.5 billion dollars.

This shows that the impact of international agencies in providing aid is not yet significant. As long as they are not effective, the underdeveloped countries cannot rely on the aid of U.S.A. or other developed countries which are likely to be influenced by political factors. In the absence of an assurance of continuity of aid, the role of foreign capital in economic development would be seriously limited, because the assurance of continuity of aid is as important as the amount of aid.

**Improvement in terms of trade:**

The underdeveloped countries can also secure some foreign capital by improving their terms of trade. An improvement in terms of trade promotes a country's development by increasing the country's purchasing power on international markets. Because, if the rate at which exports are exchanged for imports becomes favourable, a country gets more for each unit of export compared with each unit of import and as a whole, there is an increase in income which facilitates development. The actual position in the matter of 'terms of trade' continues, however, to be unfavourable to the underdeveloped countries. This is so because, in many cases, the countries which are most in need of additional development are the ones which produce mainly primary products. Not only is there a tendency of prices of primary products to fall, the prices of primary products generally also fluctuate much more than prices of manufactures and the terms of trade between the advanced and underdeveloped countries are fluctuating much more than the terms of trade among industrialised countries themselves.
A United Nations study has ventured the generalisation that from the latter part of the 19th century to the eve of the 2nd world war, there was a secular downward trend in the prices of the primary goods the underdeveloped countries exported, relative to the prices of the manufactured goods they imported. The result was that, on the average, at the end of this period - which was, however, in the late years of the Great Depression - a given quantity of the former would pay for only 60 percent of the quantity of the latter that it could buy at the beginning of the period (39). Raul Prebisch has also argued that the evidence on prices of exports and imports in the period between 1870's and 1930's of Latin America indicates that industrial centres kept the whole benefit of their technical progress, whereas primary producing countries on the periphery of the world economy transferred to industrial nations a share of the fruits from their own technical progress (40). Both the U.N. Report and Prebisch's study show that the underdeveloped countries helped to maintain, in the prices which they paid for their imported manufactures relative to those which they obtained for their own primary products, a rising standard of living in the industrialised countries, without receiving, in the price of their own products a corresponding equivalent contribution towards their own standard of living.

The terms of trade during the last decade have also been unfavourable to underdeveloped countries. The analysis of the World Economic Survey, 1958 published by the U.N. reveals that ever since 1954 prices of manufactured articles have tended over upwards The prices of primary commodities on the other


hand, with the exception of a slight boom during the second half of 1956 and the first half of 1957, have been declining so that the terms of exchange during the last quarter of 1958 were around 86 (1954 = IOC) (41). Again, with slight improvement in prices of primary commodities towards the end of 1958 and in 1959, the price index of all primary commodities started to slide downward early in 1960. The World Economic Survey of 1960 points out that while internal circumstances were inducing a major expansion in imports, world markets for most of the saleable products of the primary exporting countries had begun to weaken. Due to this, there was a fall in prices of primary goods exported by underdeveloped countries. 'The failure of the average commodity price index to register any advance in 1960, compared with 1959 had, ' as the Survey points out, 'grave implications for most of the primary exporting countries. Instead of being able to finance the upsurge in imports by means of a parallel rise in export earnings, most of these countries found their trade balances deteriorating rapidly' (42).

How unfavourable this trend has been in recent years to primary producers can be illustrated with the example of the United Kingdom. As between 80 and 90 per cent of that country's imports is in the form of primary or semi processed products and about the same proportion of its exports is in the form of manufactured goods, it is an outstanding example of the favourable position which industrialised countries generally have vis-a-vis the underdeveloped countries. The following index figures of U.K's


terms of trade, taken from Sir Robert Hall's study, who was the Economic Adviser to the British Government from 1953 until May, 1961, are eloquent (43).

**Table** III - 7

Terms of Trade of U.K.

1954 = 100

<table>
<thead>
<tr>
<th>Year</th>
<th>Import prices</th>
<th>Export prices</th>
<th>Terms of trade (*)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1957</td>
<td>107</td>
<td>111</td>
<td>104</td>
</tr>
<tr>
<td>1958</td>
<td>99</td>
<td>110</td>
<td>111</td>
</tr>
<tr>
<td>1959</td>
<td>98</td>
<td>109</td>
<td>111</td>
</tr>
<tr>
<td>1960</td>
<td>99</td>
<td>111</td>
<td>112</td>
</tr>
<tr>
<td>1961 (October)</td>
<td>96</td>
<td>112</td>
<td>117</td>
</tr>
</tbody>
</table>

* Export prices divided by import prices.

It will be seen from the above figures that U.K.'s terms of trade are now appreciably more favourable to that country than in 1957. This favourable position is the result of continuing circumstance that, though industrial production has been rising almost everywhere, primary products prices have remained weak. This is what Sir Robert Hall has to say on this situation by way of interpretation and comment:

"It is very convenient for us to get our essential imports so cheaply, and this is one of the reasons for the improved standards of living about which we talk so much. But should we really take too much satisfaction from this? The first thing to remember is that, while our imports are cheap, those

who buy our goods are having to pay more for them. Unless their output has gone up by more than the price per unit has fallen, they will be absolutely worse off. In the past few years, although world trade in primary products has in fact expanded enough to offset the fall in price, the increase has come mostly from countries which, though themselves industrial, also produce primary products. Underdeveloped countries as a group has been actually worse off. Thus, the advantages that we have obtained from the improvement in our terms of trade have been, at least to some extent, at the expense of countries which are poorer than we are*.

This is an eloquent expression of the actual position of terms of trade between developed and underdeveloped countries. If this trend continues, the underdeveloped countries will have great difficulty in finding resources for economic development.

India is more advanced industrially than most of the other underdeveloped countries. During the post-war and Plan period, there has been some improvement in the composition of India's foreign trade. Yet, since nearly two-thirds of India's exports continue to be primary products, raw materials and semi-processed goods, the export prices realised by it continue to be a matter of great concern. Actually, commodity terms of trade have been unfavourable to India during the last decade, 1951 to 1961. During this period, the commodity terms of trade moved against India by 21 per cent (44). This is illustrated in the following table.

The table shows that, in the first year of the first Plan, the terms of trade were substantially in our favour, but declined heavily in the second year. There was an improvement in the next two years, but the index again moved back in the last year of the first Plan by about 5 per cent. This above movement continued in the first two years of the second Plan, but in the last three years of the decade, there was a favourable movement of commodity terms of trade.

The major cause of the worsening of terms of trade was the heavy fall by about 27 per cent in the export unit-value index.

In 1951-52, the index was at a high level, but it declined steeply the next year. This downward movement continued in the third year of the first Plan, though the rate of decline was much less. The export unit-value index became favourable to India in the fourth year, but moved against her by about 8 per cent in the last year of the first Plan. In the first four years of the second Plan the export unit value index was more or less stable, but it improved by about 9 per cent in the last year.
of the decade. The index of Export-Unit-value year by year is presented in the following table.

**TABLE III - 9**

Index of Export-Unit-value

(Base 1950-51 = 100)

<table>
<thead>
<tr>
<th>Year</th>
<th>Index</th>
<th>Year to year percentage change of the index.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1951-52</td>
<td>148</td>
<td>+ 48.0</td>
</tr>
<tr>
<td>1952-53</td>
<td>104</td>
<td>- 29.7</td>
</tr>
<tr>
<td>1953-54</td>
<td>96</td>
<td>- 7.7</td>
</tr>
<tr>
<td>1954-55</td>
<td>102</td>
<td>+ 6.2</td>
</tr>
<tr>
<td>1955-56</td>
<td>94</td>
<td>- 7.8</td>
</tr>
<tr>
<td>1956-57</td>
<td>98</td>
<td>+ 4.2</td>
</tr>
<tr>
<td>1957-58</td>
<td>98</td>
<td>+ 0.0</td>
</tr>
<tr>
<td>1958-59</td>
<td>97</td>
<td>- 1.0</td>
</tr>
<tr>
<td>1959-60</td>
<td>98</td>
<td>+ 1.0</td>
</tr>
<tr>
<td>1960-61</td>
<td>108</td>
<td>+ 9.2</td>
</tr>
</tbody>
</table>

Source: Director General of Commercial Intelligence and Statistics.

The table shows that there has been wide fluctuation in export prices and this has caused great hardship to India.

This shows that if underdeveloped countries have to increase their ability to develop in the absence of sufficient foreign assistance, they must try to improve their terms of trade. If the unit value of their goods sold abroad would be greater than what it is today, they would be able to import more with the same amount of exports. The United Nations study contains the calculation that a 10 per cent change in underdeveloped countries' terms of trade would modify their capacity to import by as much as 1500 million dollars a year (45). In case of India, according (45) Relative Prices of Exports and Imports of Underdeveloped Countries, op. cit.
to the calculations of the Planning Commission, a ten percentage deterioration in terms of trade can make a difference of as much as Rs. 80 crores to the payments position in a single year (46). The Secretariat of the Economic Commission for Latin America has estimated that the improvement in the terms of trade for Latin America from 1946 to 1952 made available to that continent more than 11,000 million dollars - that is to say about 4.3 per cent of the aggregate product of the area for the whole seven year period (47).

But how can the terms of trade be improved for underdeveloped countries? Kindleberger has pointed out that the tendency of terms of trade to move against the underdeveloped countries is due to the low capacity of these countries to shift their resources (48). Many underdeveloped countries produce a few primary products which are usually almost completely exported. The ratio of this export production to total output exceeds 20 per cent (49). In some cases, the export of only one or two staple commodities may account for a large part of foreign exchange receipts. In Chile, for example, copper and nitrate account for about three quarters of foreign exchange receipts; in Greece, tobacco and currants normally bring in more than 60 per cent of all trade revenues; in Egypt, cotton exports alone provide for

90 per cent of foreign exchange. The following table shows the high degree of dependence on one or two commodities in case of a number of underdeveloped countries (50).

<table>
<thead>
<tr>
<th>Country</th>
<th>Export</th>
<th>Percent of total exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Belgian Congo</td>
<td>Copper</td>
<td>25</td>
</tr>
<tr>
<td>French West Africa</td>
<td>Groundnut products</td>
<td>42</td>
</tr>
<tr>
<td>French Equatorial Africa</td>
<td>Cotton</td>
<td>35</td>
</tr>
<tr>
<td>Puerto Rico</td>
<td>Sugar</td>
<td>60</td>
</tr>
<tr>
<td>Ghana</td>
<td>Cocoa</td>
<td>73</td>
</tr>
<tr>
<td>Jamaica</td>
<td>Sugar</td>
<td>39</td>
</tr>
<tr>
<td>Malaya</td>
<td>Rubber and tin</td>
<td>75</td>
</tr>
<tr>
<td>Northern Rhodesia</td>
<td>Copper</td>
<td>81</td>
</tr>
<tr>
<td>Uganda</td>
<td>Copper</td>
<td>74</td>
</tr>
<tr>
<td>El Salvador</td>
<td>Coffee</td>
<td>89</td>
</tr>
<tr>
<td>Iran</td>
<td>Oil</td>
<td>90</td>
</tr>
</tbody>
</table>

This heavy reliance on a narrow range of primary exports has been a source of instability of real incomes, because the demand for such products is inelastic and subject to wide fluctuations. The average year-to-year fluctuations in the prices of fifty commodities studied by the United Nations Secretariat over the period from 1900 to 1950 was 14 per cent per annum (51). This fluctuation in the value of exports adversely affected the rate of development of underdeveloped countries.

(50) A. Pepelasis and others: Economic Development, op.cit. p.41.
This does not mean that dependence on foreign trade is only responsible for adverse terms of trade for underdeveloped countries. Some of the developed countries also depend on foreign trade even more than do many low-income countries. In 1952, for instance, 46 per cent of the national income of the Netherlands originated in the export sector. Belgium, New Zealand, United Kingdom, Denmark and Sweden are additional examples. The difference is that advanced countries produce highly diversified exports, the supply of which tend to be sensitive to world market changes. But the relative inflexibility of the economies of underdeveloped countries in adapting to changing world market conditions and lack of diversification in their output are responsible for adverse terms of trade (52).

This lack of diversification creates also further difficulties for underdeveloped countries. Inspite of increased production of food grains and raw materials, they do not secure much advantage. 'The gain of increased production can', as Singer has pointed out, 'be derived either by increasing income or decreasing prices. In case of underdeveloped regions, the gain has been achieved by price decline of food and raw materials and in the case of manufactured (developed regions), the gain has been derived by increase in income' (53). This is due to the fact that in industrial regions, oligopolistic structures in the major industries and growing strength of the labour unions insisting on a correlation of productivity increases and higher wages have prevented the dispersion of productivity

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(53) The Distribution of Gains between Investing and Borrowing Countries, op. cit.
gains in the form of lower prices. On the other hand, underdeveloped regions tend to produce commodities in which entry is easy and exit difficult and producers are mostly unorganised. This limits their power to raise prices in periods of firm long run demand and to maintain them in depression. The fall in the prices of industrial products, due to greater per-capita productivity in manufactured goods, would have been greater than the fall in the prices of primary products. The fact that the terms of trade actually turn against the primary producing areas inspite of the great increase in industrial production, shows that not only they do not receive the higher productivity gains of the industrial regions but they actually surrender a part of their own productivity gains (54).

Moreover, when income increases, demand for food and raw materials does not increase in the same proportion i.e. income elasticity for food and raw materials is less than one. Technical progress in manufacturing industry actually largely consists of a reduction in the amount of raw materials used per unit of output. This leads to a structural and cyclical fall in prices of food grains and raw materials. On the other hand, there is a rapid increase in the demand for manufactured goods. The wants for new manufactured goods are really overdeveloped rather than underdeveloped in the underdeveloped regions.

(54) Both Singer and Prebisch argue that the benefits of technological progress have gone disproportionately to the advanced industrial nations whereas Lewis suggests that an unlimited supply of labour at subsistence wages has kept prices low for tropical commercial produce. However, the effect in both the cases is the same.
Again, if the terms of trade from the point of view of total earnings are considered, agricultural regions are also at a disadvantage. Because the backward areas do not receive the whole of the earnings from exports. Due to foreign investment and immigrant labour, a substantial part of these earnings, has had to be remitted abroad in the form of export surpluses on the trade account (55). The advanced countries are also bound to get the larger share of the dynamic or indirect gains from inter-regional trade in the form of secondary rounds of economic activities and a general stimulus to economic growth. While an increase in demand for manufactured products leads to a further increase in demand for durable capital goods required to produce them, thus creating secondary rounds of activities through the multiplier-accelerator mechanism, an increase in demand for primary products can only lead to a once-over extension in cultivation, which is bound to come to a stop as soon as the extensive margin of natural resources has been reached. The dynamic gains from specialisation in industry are also likely to be greater because it has a greater educative effect on the people of the industrial region. So the industrial areas enjoy both the direct and indirect gains of international trade. Underdeveloped areas have the worst of both the worlds.

The wide fluctuation in primary commodities also creates acute difficulty for underdeveloped countries in their programme of economic development. There are several reasons for this

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fluctuation. Firstly, the prices of primary commodities fluctuate to great extent because the factors of production used in producing these commodities are generally so specific that they cannot be adjusted easily to the fluctuations in the demand for the commodities. Therefore, whenever there is a reduction in the demand for such commodities, there is a fall in their prices rather than a reduction in their supply. Secondly, the manufacturers want to maintain a fixed relationship between the working stocks and the production of the commodities, and therefore, when the consumption of those commodities diminishes there occurs a greater reduction in the demand for raw materials. Finally, the speculative business in the inventories often aggravates fluctuations in the demand for raw materials rather than diminishes them (66). As long as underdeveloped countries specialise in the production of primary commodities, they cannot, therefore, improve their terms of trade vis-a-vis developed countries.

It follows, therefore, that the only remedy for improvement of terms of trade is to work towards greater elasticity and adaptability of resources in underdeveloped countries. That will secure the advantages of terms of trade and gain from industrialisation. But this is a long-term problem. Immediately protection in the share of import control and export promotion should be adopted to improve the situation.

**Import control and export promotion**:

Actually, in initial stages of development, protection will improve terms of trade, increase the scope of industrialisation and save the supply of foreign exchange.

(a) Improvement of terms of trade:

Although each country gains from trade and gains the more, the less the obstacle to trade, this is not to deny that some of the underdeveloped countries may, by imposing tariffs or similar obstructions to the trade of developed countries, increase their own gain from trade. This may be shown by means of offer curves (vide diagram No. III - 1).

Suppose that, under conditions of free trade, the intersection of A's offer curve with that of B is at P₁, and the terms of trade are consequently measured by the slope P₁X₁ / OX₁ ( = OY₁ / OX₁ ) of the vector OT₁. A now imposes a tariff on import of manufactured goods of 33⅓ per cent. This may be represented, in terms of offer curves, by raising A's offer curve at each point by one third of its vertical distance from the OX axis. In effect, A is now insisting that whatever may be the volume of exports, the government will exact taxes at the frontier equivalent to one-third of the value of imports entering the country. Thus for exports measured by Oa, consumers will receive imports equal to ab, while the government exacts the value equivalent of imports of amount bc.

There is now change in equilibrium position. The upward movement of A's offer curve establishes a new equilibrium at P₂ instead of P₁. It now gives up the smaller quantity of exports OX₂, instead of OX₁, and obtains a slightly smaller amount of imports (or their value equivalent in the form of import duties). Even though the total of imports is smaller than before, the reduction in exports is still greater. A gains from the imposition of the tariff, in the form of improved terms of trade, as is indicated by the steeper slope of OT₂ as compared to OT₁ (57).

DIAGRAM NO- III-1
TARIFF AS A METHOD FOR IMPROVING TERMS OF TRADE
DEVELOPED COUNTRY- B MANUFACTURE

UNDERDEVELOPED COUNTRY- A
This shows that underdeveloped countries could always improve their terms of trade by using tariff provided there was no retaliation from the side of developed countries. But if developed countries follow suit, gains accruing to underdeveloped countries would be nullified. Suppose B imposes import duties, its curve will move to the right, pushing the equilibrium point \( P_2 \) towards \( P_1 \) or beyond that and so both countries would lose in the bargain and total trade would be restricted. Imposition of tariff would, therefore, improve terms of trade if there were a moderate increase in import duty and developed countries were persuaded to help the underdeveloped in their difficulties.

(b) Import regulation as a means of economic development:

Though tariff may not be very helpful in improving terms of trade of underdeveloped countries, import regulation i.e. restriction of imports of consumer goods and increased import of capital goods will lay the foundation for economic development. Restriction of consumer goods will also increase the competitive capacity of underdeveloped countries and enable them to start import-substitute industries in their own countries. In other words, protection in some form or other would provide necessary facility for industrialising underdeveloped countries.

Even in hey-day of free trade, protection was accepted as a measure to improve infant industries. The classical and neo-classical economists conceded that a policy of protection based upon the infant industry argument is justified in some of the primary producing countries. They were only sceptical about the ability of a country to limit protection to infant industries. But Hamilton and List for the first time emphasised the developmental aspect of protection. Hamilton supported protection to create an extensive demand at home to absorb the agricultural
surplus by means of development of manufactures. He emphasised the importance of industries and pointed out that industries gave more opportunity for division of labour and use of machinery, offered scope for diversity of talents and dispositions, attracted foreign labour and capital and created a stable demand for the products of domestic agriculture. List followed the same path with greater vigour and emphasised the role of protection for organising the productive forces of a nation. The most important point in Lists' argument which has special bearing for underdeveloped countries is his emphasis on balanced economy. The argument for a balanced economy in a predominantly agricultural country is naturally an argument for occupational diversification through industrial development.

In case of India, Adarker also built a general theory of protection. The case for industrial protection in India, according to Adarker, goes beyond the traditional infant industry argument. It has rather to do with the fundamental lack of balance between industry and agriculture.

As a matter of fact, the problem of underdeveloped countries is such that the theory of protection can be linked up with the theory of economic growth. As has been pointed out earlier, the essence of the situation of an underdeveloped economy is that the market forces do not themselves engender development. Temporary interference with the freedom of trade can develop new skills and aptitudes, expand markets, can bring dormant resources into active use and create external economies which are essential to development. Prof. Ganguli has pointed out that protection can assist economic development in three ways:

(1) It increases the size of the market in the inclusive sense and leads to greater economies of production; (2) it creates
external economies which benefit all firms in an industry and may even benefit a number of industries simultaneously; (3) provided that there is balanced growth of productive activity, protection leads to an increase in the size of the market and a higher level of productivity and real income acting and reacting on each other and moving up in an ascending spiral of economic prosperity (58). Free trade is, therefore, not realistic for poor countries and is not relevant under dynamic conditions.

Myrdal goes further and points out that free forces of international trade would develop developed countries more and bring about greater deterioration for underdeveloped countries. 'A widening of markets often strengthens', Myrdal argues, 'in the first instance the rich and progressive countries whose manufacturing industries have the lead and are already fortified by the surrounding external economies, while the underdeveloped countries are in continuous danger of seeing even what they have of industry and, in particular, small scale industry and handicrafts priced out by cheap imports from the industrial countries, if they do not protect them' (59). That means free trade tends to have strong 'back-wash' effects on the underdeveloped countries and strengthens the forces maintaining stagnation and regression. Free forces of international trade should, therefore, be restricted and import restriction and export promotion should be


deliberately planned to shift import demands from some commodities to others and generally to goods needed for economic development. Whereas import restriction in developed countries is likely to restrict foreign trade since in such a country there is no mechanism whereby a restriction of the imports of one group of commodities is automatically compensated by an increase of imports of another group, in underdeveloped countries there will only be a shift in demand and thus there would be no decrease in the size of world trade. A double standard morality in international trade—free trade for developed countries and import restriction and export promotion for underdeveloped countries, is therefore rationally motivated (60). The developed countries should recognise this legitimate need of underdeveloped countries and assist them in their policy of protection.

The argument that protection is undesirable because it distorts existing factor endowments is hardly correct. Factor endowments are not fixed for all time to come. They change with technology and they can also be changed by international factor movements. The point that is made by Romney Robinson, who suggests that the doctrine of comparative advantage is more useful in explaining where a country has been than in indicating where it might go, has great analytical validity (61). If protection develops an economy, it is not incompatible with the theory of economic development. Static free trade may give less than an optimum position for the world because of increasing


returns to scale available in an industry but unrealizable at the low prices maintained under free trade. With protection and higher prices, an increase in scale will make possible an ultimately lower price than that which prevailed with free imports. That is why even Kindleberger who pleads for free trade on the basis of comparative advantage points out, 'But if, instead of perfect competition, demand curves slope downward; if factors within countries can change in quantity and have limited mobility, and immobility of factors between countries is not universally respected; if the state of the Arts is permitted to change, and not all at once but continuously; if imperfect factor markets permit unemployment and disparities between social and private cost, the theory of comparative advantage may not be relevant to development' (69).

Actually, no capitalist country has ever followed completely free trade. Time and again, in the process of economic development, the capitalist countries have adopted protection and expanded their economies. Japan is perhaps the classic example. The textile, electrical equipment, steel machinery and shipbuilding - all had their start in protection. And once these industries were developed, Japanese economy took a different turn and even its stagnant agriculture was rapidly regenerated. There was no need for further protection. It follows that underdeveloped countries should now temporarily interfere in the freedom of trade in order to improve the industrial base of their countries.

(c) Import control and export promotion to save foreign exchange.

In every country where development plans are being implemented, crisis in the balance of payments occur with a

(62) Economic Development, op. cit. p. 244.
frequency and regularity that suggests that this is inevitable in the process of development. Conventional analysis tells us that a balance of payments deficit is due to an 'improper' relationship between money income and the general price level and to an improper relationship between the prices of domestically produced and used goods and those of internationally traded goods. The essential elements of adjustment are manipulation of credit and appropriate price changes in deficit and surplus countries. The relation of these forces may be presented in schematic form (63).

<table>
<thead>
<tr>
<th>Short-run adjustment</th>
<th>Long-run adjustment</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Deficit country</strong></td>
<td><strong>Surplus country</strong></td>
</tr>
<tr>
<td>Reduced foreign balances.</td>
<td>Increased foreign balances.</td>
</tr>
<tr>
<td>Loss of gold.</td>
<td>Gold inflow</td>
</tr>
<tr>
<td>Higher discount rates.</td>
<td>Lower discount rates.</td>
</tr>
<tr>
<td>Short-term borrowing.</td>
<td>Short-term lending.</td>
</tr>
<tr>
<td></td>
<td>Rise in prices.</td>
</tr>
<tr>
<td></td>
<td>New Equilibrium.</td>
</tr>
<tr>
<td>Reduced business activity.</td>
<td>Increased business activity.</td>
</tr>
<tr>
<td></td>
<td>Increased imports.</td>
</tr>
<tr>
<td></td>
<td>Decreased exports.</td>
</tr>
<tr>
<td></td>
<td>New Equilibrium.</td>
</tr>
</tbody>
</table>

This shows that adjustment in balance of payments requires extremely stringent conditions. On the part of the deficit country, there should be reduction in money income and fall in prices. Reduction of money income requires a reduction in money wage rates and this is a notoriously difficult task in

(63) Ellsworth, op.cit. p.324.
any society. Reduction of prices in a developing economy is also extremely difficult. Moreover, even though relative prices are flexible, it does not necessarily mean that demand in all cases will respond to changes in prices. The application of conventional analysis to adjust balance of payments is, therefore, extremely limited.

The Keynesian analysis shows that the existence of disequilibrium in the balance of payments has direct and important effects upon the level of income, and through these reactions, also upon imports and exports. Abstracting from the movements of capital, the fundamental income-foreign trade identity can be stated as:

\[ R = Y - A \]

where \( R \) denotes trade balance, \( Y \) denotes aggregate national output part of which may be exported and \( A \) denotes aggregate domestic absorption part of which may be through imports. An excess of \( Y \) over \( A \) shows positive (active) trade balance; and excess of \( A \) over \( Y \) shows negative (passive) trade balance. A zero value of \( R \) indicates that the country is at balance in its foreign trade; absorption equals output (64).

Since in a developed country with excess capacity, an excess of \( Y \) over \( A \) promotes growth through an increase in exports (65), it is assumed that an excess of \( A \) over \( Y \) will make it possible for an underdeveloped country to absorb at home in consumption and investment more than what it produces and this will facilitate development. That means income multiplier effects

of an excess of imports over exports will be an engine of growth in underdeveloped countries.

But the important defect of this analysis is that a deficit in trade balance may translate itself into a higher volume of consumption and prevent the growth of the economy. Actually, the fundamental role of foreign trade in the process of capital formation is whether the proportion of capital goods has increased as a result of foreign trade. Sachs, therefore, points out that if an underdeveloped country could not transform consumer goods into capital goods through foreign trade, there could not be a process of growth (66).

But there are innumerable difficulties in such a process of change. It is easier to have import substitution in case of consumer goods than in case of capital goods which require long time and heavy investment. The case of India shows that though imports of luxury radios, gramophones, portable air conditioners, watches etc. have been restricted, domestic industries in all of these commodities have been deliberately encouraged under the comfortable slogan of industrial progress (67). This shows that the physical transformation functions performed by foreign trade are more significant in an underdeveloped country than the multiplier effects (68).


(68) The Pattern of Development of Import-Sensitive Economies, op. cit.
There should be attempts, therefore, to bring about the necessary physical transformation by controlling imports and increasing exports. The score of limiting total imports in underdeveloped countries is severely limited. Import restriction implies shift of imports from consumer goods and food grains to capital goods, components and raw materials for the sake of increasing capital formation. Put putting of restrictions on the imports of consumers' goods in itself would not accumulate capital. Import policy must be accompanied by the domestic act of saving. Otherwise, import restriction of consumer goods will increase domestic demand for these goods and in the absence of elasticity of domestic supply, there will be pressure on price level.

However, the major problem in case of underdeveloped countries is to increase exports in order to earn foreign exchanges. Shortage of foreign exchange is holding up production quite seriously in many underdeveloped countries. Sir Mac Dougall's study of India's Balance of Payments shows that many factories are today lying partially idle in India through lack of imported supplies. More imports could make possible an increase in production several times as great in value and, by raising income, raise savings and investment and thus the rate of economic development (69). But the ability to import in an underdeveloped country will depend on the capacity to export. If exports could be increased, more foreign exchanges could be secured and industrial production could further be accelerated.

The trend of world trade between 1938 to 1958 as presented between developed capitalist countries, underdeveloped countries and socialist countries shows that the socialist countries have improved their position much better than the other two types of countries. The share of socialist countries in world exports has increased from 7.2 per cent in 1938 to 11.4 per cent in 1958 whereas the share of developed and underdeveloped countries has decreased from 67.4 per cent and 30.4 per cent to 60.3 per cent and 27.8 per cent respectively between the same period. The intra-trade between socialist countries has also shown substantial increase, from a mere 0.7 per cent of world exports before the war to 9.5 per cent in 1958.

This shows that if underdeveloped countries make vigorous efforts, they could be able to increase their exports for increasing import capacity for development. In case of India for example, one of the main reasons in the stagnation of exports is that the programme of exports was not regarded as an integral part of the country's development effort under the five year Plans (70).

Several measures could be taken to improve exports. To begin with, instead of confining only to traditional lines, the underdeveloped countries should diversify their exports and seek out for themselves the dynamic commodities with rising demand trends and with higher income and price elasticities. Diversification of exports will increase the bargaining power, minimise the risks of violent fluctuations of the prices of export goods and help in removing the rigidity in the economy of

(70) Third Five Year Plan, Government of India, Planning Commission, p.137.
underdeveloped countries which is a precondition for greater success in exploiting new opportunities in international trade. In case of India, for example, even after one decade of development, nearly one half of total exports consists of three traditional staples - tea, cotton textiles and jute manufactures. World trade in these items taken together seems unlikely to expand very rapidly in future. Exports of the three staples must be vigorously promoted; they are far too important to be neglected. But if the trade becomes heavily weighted in favour of products where world trade is growing fast, a rapid expansion of her exports will become less difficult.

Secondly, underdeveloped countries, instead of hanging around the major powers, should evolve for themselves a mutually coordinated plan of development. There are many commodities which can be traded with great advantage and on a large scale by the underdeveloped countries co-operating with one another. The supply of one country might meet the demand in the other and thus increase the pace of development. Thirdly, there should be emphasis on economic efficiency. Even if sufficient supplies are made available for export, they cannot be sold outside unless prices are competitive. Therefore, there should be all out effort to reduce cost and if necessary, export-goods may be produced in large plants in order to secure economies of scale. Then there might be direct and indirect subsidies and sales promotion by means of trade fairs and missions. In case of India, the Mudaliar Committee for export promotion has made many suggestions for assisting the country's drive for promoting exports. These include direct tax relief incentives, the ensuring of prompt and adequate supply of
essential raw materials at international prices to export-oriented industries, the setting up of an Export Stabilisation Board, a general rebate of about 25 per cent by the Railways on all goods put on board ship, the removal of certain difficulties in respect of obtaining draw back of import and excise duties and remission of sales tax entering into export costs. The same suggestions are applicable with regard to most of the underdeveloped countries for increasing exports.

But unless there is a radical change in the structure of the economy, these concessions and facilities may not be very helpful to increase exports considerably. Export drive would succeed only when the internal economy becomes flexible and responsive to these promotional measures. For example, export drive can be effective only if the economy responds to incentives thereby established and increases exportable surplus at short notice so as to take advantage of increased foreign demand. The fundamental factor to improve balance of trade in underdeveloped countries is, therefore, to create a flexible and responsive economy (71).

Summary and conclusion.

The foregoing analysis shows that foreign capital is inevitable in the process of development. But private foreign investment or foreign aid is not likely to make major contribution to the capital needs of underdeveloped countries. The traditional theory of factor proportions is that wherever capital is available in greater quantity, its marginal productivity is comparatively lower than in the countries where capital is scarce.

According to this theory, capital should flow from advanced countries where it is relatively abundant to underdeveloped countries where it is scarce. But this has not happened and is not likely to happen. Moreover, the capital that flows to underdeveloped countries does not have much relation to the economic needs of these countries. 'There is', as Myrdal has said, 'no longer in existence a competitive international capital market where supply meets demand but only a broken remnant of a market, where the movements are blocked and perverted' (72). Underdeveloped countries cannot, therefore, mainly rely on foreign capital to build their economies.

The underdeveloped countries would have to regulate imports in order to improve terms of trade and to provide incentives for increasing investment in domestic industries. Restriction of imports of consumption goods would also be desirable to increase the imports of capital goods, raw materials and other components for increasing capital formation. The failure to secure from abroad essential capital goods not produced within the country may upset the whole economic structure and stagger the process of growth. But if the restriction of imports of consumption goods is not followed up by a policy of increased saving in the home economy, internal resources may be diverted for the production of consumption goods and thus the advantages of import regulation may be frustrated. That means, as long as there is no increase in the supply of capital inside the country, import restriction cannot be adequate to increase the net capital formation of backward countries.

(72) An International Economy, op. cit., p. 113.
Export promotion may increase import capacity and enable an underdeveloped country to earn more foreign exchanges than what it is doing today. But this requires a flexible and adaptable economic system.

It follows, therefore, that although grants and loans from governmental and international institutions and import regulation and export promotion lay the foundation for the development of an underdeveloped country, they cannot by themselves lead to the growth of the economy as such. The underdeveloped countries will have to make a great effort in mobilising the internal resources for their development. This means that the countries in question should follow a suitable commercial policy, seek for foreign aid and invite private foreign investment, but ultimately economic development would depend upon internal measures. As a matter of fact, economic development cannot be imported and the rate of development will depend upon the degree of internal efforts made to transform the economy and the capacity to extract more saving out of national income.