CHAPTER 1

INTRODUCTION

EXTERNAL LINKAGES THROUGH GLOBAL INTEGRATION : THE REQUIREMENTS OF GROWTH TODAY.

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The position that capital occupies in the economic theory of production and distribution is so dominant that it is quite natural to assume its equally important place in the theory of economic growth. That growth hinges on accumulation of capital and that additional capital would facilitate a more rapid rate of economic development even in situations where there is no shortage, is an implicit assumption in the theory. However, there seems no reason to presuppose that capital accumulation, by itself exercises so predominant an influence an economic development. The main impetus comes from factors more predominant than capital. It is quite unlikely that capital accumulation in the absence of other factors, would bring about a rapid increase in income. What one must seek to do is to look for the main influences which have governed the growth of real income per head in the advanced industrial countries. Of all the factors that caused incomes to grow in the nineteenth century - including industrialization, education, free trade, capital accumulation and growth of population the only major one today that has more powerfully influenced growth of income is technical progress. There has been a progressive narrowing down of the factors leaving the growth process dominated increasingly by technical progress and innovation. It is important to grasp the fact that provision of an adequate supply of capital cannot by itself do the job in the absence of technical know-how. At the same time, it is equally true that new techiques of production would not suffice without adequate capital. The difference is only one of degree of importance. The key to global development has been the diffusion of technological progress. New technology has facilitated resources to be used more productively, causing incomes to rise and quality of life to improve. Economic theory suggests that productivity and per capita incomes would converge across countries over time, assuming that the present day developing nations have access to the new technology introduced by the industrial nations. [1]

However, there may come a stage when a country fails to make use of technical knowledge available elsewhere and suddenly wakes up to the possibilities of applying that knowledge. Then, its requirements of capital tends to increase discontinuously and the additional capital which it requires to take advantage of the sudden enlightenment may be exceptionally huge. But if all development rested on the use of increasing amounts of capital, progress would be inevitably slow. It will be more rapid only if developing countries strive to accomplish more by changes in technique and by enterprise without large capital requirements. Of course, the growth of capital is not altogether unrelated to economic progress and as living standards improve, there would undoubtedly, be a need for more capital. But this is not to put capital in a dominating position over development. It is needed

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1.op.cit.,World Bank,World Development Report,1991,Pg.13

if only to catch up with the application of some forms of improved technology. The real need is for more rapid technical change and for action to encourage and promote innovation. In the western world, the great dynamic forces have been technical progress and a widening of markets giving rise to all the specialization and economies of scale, internal and external. Capital accumulation has allowed free rplay of these forces and conditioned the speed with which individual economies have responded but has rarely been the dominant influence. Like many other obstacles to growth, a shortage of finance has given way to the pressure of opportunity. The recent record of industrial countries (figure. A.) thus, offers support to the classical and neoclassical tradition whereby sustained growth was possible only through exogenous technological change and if countries had access to the same technology, growth rates would be expected to converge accross countries.

The growth rates of developing countries, however, seemed to have refuted this theory. If at all they have diverged which seems to be at odds with the proposition of convergence. Why ? What has gone into the making of such odds ? Why have the developing countries, that are not inherently incapable of mastering the techniques of modern industry, failed to transform themselves in line with the advanced economies or rather, failed to obtain from the advanced economies the resources that might have transformed them ? In practice technological change has not been equal, much less been exogenoulsy transmitted in most developing countries.

The modern growth theories note that technological change isendogenous and that it produces positive externalities or increasing returns[2]. A notion that has been generally put forward since early times is that a big push in an economy open to foreign technology can yield large gains, and propel it into self sustaining industrialization and rapid growth Similarly, Rostow (1960) envisaged a takeoff from a stationary state to growth in per capita[3].

The above postulates force one to consider the most crucial and significant aspect of developing economies requirements of technology and that is integration with the global economy. The notion of big push towards self-sustained growth and industrialization can be realized by the developing economies if and only if they are open to foreign technology. In the modern day thinking on development, openness has become the password to success in growth, it has become imperative to focus on the international economy within which national development takes place.

The experience of the advanced and recently developed economies brings out one fundamental aspect. When international flows of goods and services, capital, labor and technology have expanded rapidly, the pace of economic advancement has also been rapid. Openness to trade, investment and ideas has been at the core in encouraging domestic producers to cut down costs by introducing new technologies and to develop new and better products.

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2. World Bank : World Development Report, 1991. Pp 35

3. Ibid, Pp 35.

If all this is accepted, there are broadly three main lines of action open to developing countries that link them to the global economy. (1) Financial assistance (capital flows) (b) technical knowhow (technology flows) and (c) freer trade (commodity flows). All three, in the final analysis, determine the flow of foreign technology from the advanced industrial nations to the developing ones.

Integration with the global economy affects technological change in two ways-by improving the supply of new technology and by raising the demand for new technology. Openness increases the supply of new products and processes through technology embodied in imported inputs and capital goods, transmitted through direct foreign investment or contacts with foreign buyers. In a more competitive environment, firms respond to international competition striving increasingly to minimize costs. This leads to better use of already established technology or to efforts to acquire and adopt new technology.

Generally speaking, external resources, in whatever broad form mentioned above, are the main source which most underdeveloped and developing countries heavily depend up on in orde to attain an increase in their per capita income. The transfer of technical skills and skilled manpower through foreign assistance is equally important. In fact, such inflow of external resources has virtually gained the status of a separate factor of production which provides one of the core problems of modern development theory in terms of their productivity, efficiency and allocation[3]. In the past decade, countries like Taiwan, Greece, the Phillipines and Israel have demonstrated how rapid and sustained development can be secured by making effective use of foreign assistance. A substantial portion of investment was financed by foreign loans and grants which led to acceleration of growth in GNP. Moreover, this was followed by a steady decline in the dependence on foreign financing. Over and above this, foreign assistance also significantly increased the ability of each economy to sustain further development from its domestic resources by making possible their fuller use. This is because some of the potential bottlenects, mainly savings, skills or foreign exchange, can be relaxed temporarily by the addition of external resources which are not required to be repaid currently. Of course, what is even more important, as far as reducing the dependence on foreign assistance is concerned, is that the production of additional resources facilitated through more rapid growth must be so utilized that the deficiences (bottlenecks) which are temporarily being supplied from outside, are overcome.[4] Thus, in short, external resources enable developing countries to raise their growth rate by financing additional investment. In principle, external financing serves to get the economy out of a low-growth trap and thereby enables it to take-off.

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4. This view been put forward by Chenery and Strout (1966) in their famous two-gap model. See also technical note (5).

It would be more useful to look individually into each of the three forms of external resources listed earlier and analyse how they determine the rate of growth in the developing economies. Moreover the study of these external linkage might prove insightful in explaining why most developing nations failed to `take-off'. It is pertinent to note here that foreign assistance, as defined by the OECD Development Assistance Committee, includes public loans, grants (aid) as well as private investment. However, for the puspose of the present study these are separately differentiated into capital flows (loans and grants) and technology flows (foreign private investment) foreign capital,as understood in the present study, excludes foreign private investment and includes only the financial aspect of capital flows. The former is indentified as a separate and individual determinant. A detailed explanation of these concepts is presented in Chapter 3.

1.1. Capital flows :

Among all three forms of external linkages, capital flows have uptil now made the greatese demands on the developed countries whereby its principal contribution is towards an increase in the rate of capital formation. A striking contrast between history and present is the apparent ease with which today's industrialized countries obtained the necessary finance and the difficulty in raising capital abroad experienced by countries that are seeking to industrialize today. Obviously enough, the developing countries are strikingly lacking in real capital assets which they are powerless to overcome solely out of domestic savings. Investment in these assets that would effectively promote development cannot be financed since mobilising domestic capital become insufficient and usually falls short. In such situations, particularly at the points where the shortage is most severe, loans and grants by foreign countries can enlarge the resources available and facilitate a more rapid rate of capital acummulation.

A, further contribution of foreign capital is to cover any deficit in the balance of payments. Difficulties arise bacause of excessive dependence on imported capital goods. These difficulties can be avoided if these goods an be paid for out of foreign grants and loans. As Thorp succintly argues, "The capacity of a country to absorb foreign capital given the terms on which capital is to be had and ignoring the banance of payments problems, depends on a number of circumstances... (of which) domestically formed capital available for utilization with capital from abroad (is one) and.... the extent to which the imported capital may be accompained by entrepreneurial and other skilled personnel capable of putting the imported capital to effectivi use"[5] .Thus, the extent to which the country's technology improves and its domestic Capital stock increases in quantity and economic efficiency, determines the country's capacity to absorb foreign capital. It is quite obvious, that the **more rapid rate of development arrived at greater will be the**

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5. op.cit. Thorp William - "Trade,Aid or What ?",M.D., Baltimore,John Hopkins University Press, 1954,Pp.167 (paren theses added)

need for capital. This is true even if only because capital can be used to buy time. In the initial stages domestic savings will have to be necessarily supplemented out of foreign capital either by way of loans or grants. If a country is able to mobilize domistic capital, it would not like to depend on foreign capital for the same purpose. An important justification for foreign borrowing by developing countries is that it permits a higher rate of investment than could be supported by domestic savings alone. In this sense, foreign borrowing is chiefly undertaken as a complement to domestic savings.

More than overcoming the deficiency of real capital assets, an equally important function of foreign capital is that it permits the greater introduction of more foundabout methods of production as capital, in toto, becomes abundut.Additional capital may be required also to allow technical progress to take place by financing new techniques of production or adapting to the estabished ones.

It is, by now, clear and taken for granted that an acceleration of growth inflates capital requirements which domestic savings are unlikely to fulfil so that foreign capital becomes essential to fill the gap. However, there does remain an ambiguity regarding this approach. It is not clear whether acceleration of growh can occur in the absence of foreign borrowing. It is quite possible that growth may be stunted if the resulting capital requirements are not met. On the other hand, if growth is itself attributed to increased investment, foreign borrowing becomes a condition that would be indispensible for acceleration. Many of the advanced and recentiy developed nations such as Hungary, Yugoslavia, Phillippines, Denmark, Finland, Norway have achieved success in industrialization without much borrowing abroad.

Chenery & Strout (1966) distinguish two apparently distinct roles played by foreign capital and aid (a) it facilitates accumulation of goods by the LDCs without the home country mobilizing its saving necessary to finance the accumulation and (b) it relaxes the balance of payments constraint and makes possible a higher level of imports since capital also takes the form of transfer of foreign exchange to the LDC. In other words, foreign capital finances the gaps between savings and investment on the one hand and export-import or foreign exchange on the other. Though both these objectives can be met by foreign capital at any given time, one may be more urgent than the other. Thus, the effectiveness of foreign capital and aid would depend upon whether the country is constrained from achieving a faster rate of growth by a savings shortage or by a foreign exchange shortage. In the latter situation, the growth rate determined by foreign aid (the foreign exchange gap) would be lower than that determined by the savings-investment gap[6]. Thus it becomes clear that concessional aid is an important source of finance for the developing, low-income countries. It enables countries to alleviate poverty and increase long-run growth. However, at the same time, the volume of aid, the efficiency with which it is utilized and quality and quantity of aid are equally important factors governing the effectiveness of aid. Moreover, unless aid

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6. For a complete version of the two-gap model, see Chenery and Strout "Foreign Assistance and Economic Development", American Economic Review, Vol. 56, No.4., Part I, September,1966

is combined with domestic savings, it is very likely that loans in the form of aid may lead to the relaxation of domestic efforts at saving which would fail to add to the country's productive capacity.

Of late there is a considerable amount of debate as to whether the contributions to capital that is flowing from government channels to the developing countries, should take the form of grants or loans. The case for making a certain part of capital available in the form of grants has arisen largely due to the windespread belief that development requires such an enormous amount of capital that if it all took the form of loans, the burden of interest and ammortization charges would be much greater than the developing countries could support. In fact, history has shown that sometimes, the extent of borrowing from abroad increased so overwhelmingly that it became impossible for the borrower to service past loans from its own surplus so that borrowing became inevitable even for the servicing of such loans and for repayment of past capital. The case of United States during 1874 and 1897 exemplifies such a situation. The country had to eventually use the foreign exchange out of the fresh loans even for interest and dividend payment on old capital.

There is no guarantee that if a loan is benefical from the point of view of promoting development, it will be equally easy to be serviced in foreign currency. Ability to service loans, very essentially, depends on the conditions and policies in both the borrowing and the lending country which affect the balance of payments. Industrial countries share the responsibility equally with the developing countries to ensure that capital flows are is combined with domestic savings, it is very likely that loans in the form of aid may lead to the relaxation of domestic efforts at saving which would fail to add to the country's productive capacity.

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There is no guarantee that if a loan is benefical from the point of view of promoting development, it will be equally easy to be serviced in foreign currency. Ability to service loans, very essentially, depends on the conditions and policies in both the borrowing and the lending country which affect the balance of payments. Industrial countries share the responsibility equally with the developing countries to ensure that capital flows are investment and sustained growth was actually very little. Throughout the 1980s, as the crisis persisted many debtor countries experienced a reversal in the transfer of resources which, during the crisis, flowed backwards from developing to developed countries. Net transfers became negative in the second half of the 1980s with interest payments on past loans to the lender countries turning out to be greater than fresh inflows into the debtor countries. Moreover, both investment and growth declined. Displaying a great diversity inthe contribution that foreign capital made to the economic development of different countries. The complex mixture of policy errors of the developing countries (overvaluation of the exchang rates, export biases) and external shocks (rapid rise in interest rates, falling commodity prices and world recession)Further contributed to the crisis. Tables 1.1 and 1.2 exhibit the movement of capital flows towards the debt crisis.

TABLE 1.1

Indicators of external debt for developing economies, 1970-89.
(average percentage for period)

Economy Group	Total external debt[a]			Interest Payments[b]			Net Transfers.		
	1970-75	76-82	83-89	70-75	76-82	83-89	70-75	76-82	83-8
Low income	10.2	14.8	28.5	2.9	4.3	9.8	1.1	1.2	0.7
Low income excl. China & India	20.5	28.5	60.7	2.9	5.3	11.8	2.7	2.4	1.0
Middle income	18.6	34.6	54.9	5.1	11.0	15.4	1.9	1.9	-2.7
Argentina	20.1	46.1	80.3	14.1	17.9	41.6	-0.3	2.7	-5.4
Brazil	16.3	28.2	42.0	12.1	28.5	30.3	3.3	0.8	-2.5
Morocco	18.6	55.1	109.5	2.8	13.0	17.1	1.8	6.8	-1.7
Philippines	20.7	45.8	79.2	4.2	14.1	20.5	1.2	1.8	-3.4

Note : a As share of GNP.
b As share of total export earnings.

Source : adapted from World Bank, World Development Report, 1991, Pp 125.

TABLE : 1.2

External debt as percentage of GNP and Exports of goods and services, by income group.

	1970	1975	1976	1977
Low-Income countries				
1. Debt/GNP	18.1	22.2	24.3	23.6
a) Concessional Debt/GNP	13.5	16.1	17.3	16.8
b) Non-Concessional debt/GNP	4.6	6.1	7.0	6.8
2. Debt/Exports	213.6	180.3	178.6	171.3
Middle-Income countries				
1. Debt/GNP	15.0	16.9	18.8	20.3
a)	3.8	3.3	3.4	3.5
b)	11.2	13.6	15.4	16.8
2. Debt/Exports	73.1	64.5	68.4	74.5
All Developing countries				
1. Debt/GNP	15.8	17.8	19.6	20.8
a)	6.0	5.4	5.6	5.7
b)	9.8	12.4	14.0	15.1
2. Debt/Exports	87.5	74.4	77.9	82.8
India (1)	14.0[a]	15.5	14.8	
(2)	309.5[a]	194.8	187.7	
Rep. of Korea (1)	30.8[a]	28.8	28.6	
(2)	89.1[a]	74.4	67.7	
Brazil (1)	14.7[a]	18.8	19.5	
(2)	168.4[a]	238.8	235.0	

Note : a = figures are for 1973.
Source : Katz J.A. (1979), Pp.19,50.

The costs of borrowing are important since it is widely recognised that servicing past foreign debts of developing nations, especially the least developed, is a claim on their resources which are very scarce in the context of their overall development and therefore lowers their rate of economic growth.

Thus, on the whole, although grants and loans from governmental and international institutions can lay the foundation for development they cannot by themselves lead to the growth of the economy as such. Foreign capital can accelerate the process of economic development provided it is made available under appropriate conditions. Though there is a very real tendency to associate capital closely to economic development perhaps because its supply is thought to offer an element which is apparently controllable to operate, there are chiefly two grounds for skepticism as to its dominant place in promoting development. First, if it is foreign capital, payments have to be made abroad which may negate any increase in income that the inflows might have caused, perhaps, even turning income growth negative if the returns from foreign capital are lower than its servicing. Only when foreign capital increases the productivity of other factors, can it contribute positively through multiplier action. Second, the symptoms of rapid growth may undoubtendly have a tendency to show themselves simultaneously. However, though the processes of economic growth and capital accumulation are generally agreed to be closely interconnected, there is every reason to believe that dependence of growth on a high rate of capital formation is not entirely invariable. There may be circumstances in which efforts to increase capital formation may actually result in a slow-down in the progress of the economy whereby productivity and income are reduced instead of being raised. All said and done, it must be noted that his-torically no capitalist country existed which was in a posotion to develop rapidly with the amount of capital accumulated within it and that a great part of industrial development in almost all such countries owed itself to the influx of foreign capital. To sum up, though borrowing abroad allows a country to pursue development with additional resources beyond what it can supply itself, only if the added resources are so well invested as to cover the debt service and repayment costs, going into debt is likely to make perfect sense. It is to be realized that loans or grants is a bridge until such time that foreign investment or exports rise to a level higher than imports.

1.2 Technology Flows Through Direct Foreign Investment :

International or Direct Foreign Investment (DFI) is the second focal point which is of major importance in diffusing technological flows to developing countries.

Lall (1984a) identifies four items as technology imports viz. purchase of turn key projects from foreign engineering companies, inflow of direct foreign investment from abroad, licensing of foreign technology and the importation of foreign capital goods or purchase of foreign components for local production of capital goods[7]. The World Bank (1991) also classifies the same items and also includes contacts with foreign buyers through which technology is transmitted. Of these, the

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7. Lall S. - "Exports of Technology by Newly Industrializing Countries : An Overview", World Development 12,1984a,Pp.477.

present study attaches relevance to two : inflow of direct foreign investment from abroad and imports of cappital goods. Discussion on the latter will be taken up in the next subsection on trade, while this section focuses solely an direct foreign investment flows.

The record of the second half of this century does not provide any basis for enthusiastic foreign investment. In fact, untill very recently, foreign investment continued to be discussed with hardly more than a passing reference to its interconnection with domestic investment. Truly speaking, it was the relatively small share of DFI and the large share of private capital (debt to commercial banks) that resulted in the culmination of the debt crisis of the 1980s.

In the 1970s, although DFI in middle - income developing countries grew at greater rates in value terms than in the previous two decades and its share of total world DFI actually increased, commercial bank lending to these countries grew at much more rapid rates. Table 1.3 shows the consequent relative decline in the importance of DFI in total resource flows to the developing countries.

In the recent years, however, the collapse of other forms of international financial flows (aid and credit) has meant a renewal of attention of DFI as a means of international transfer of resources and has been popularly begun to be looked at as a source of increased external finance for development. DFI,in the form of equity, has the major advantage that lenders assume a greater share of risks than in the case of bank finance. Under the circumstances of the debt crisis, the argument now made was

TABLE 1.3

Total Resource flows to developing countries, by major types of flow, selected years, 1960-84[a]

	1960-61 $bln %	1970 $bln %	1979 $bln %	1984 $bln %
Official Development Assistance	19.5 (56)	22.2 (42)	32.9 (37)	35.8 (42)
Grants by Pvt. Voluntary Agencies	–	2.3 (4)	2.0 (2)	2.5 (3)
Non-concessional official flows	6.6 (19)	10.4 (20)	18.8 (21)	20.5 (24)
Private :				
Direct Investment	6.5 (19)	9.7 (18)	13.8 (16)	9.5 (11)
Bank sector	2.2 (6)	7.9 (15)	20.2 (23)	24.0 (20)
Bond lending	–	0.8 (2)	0.7 (1)	0.5 (1)
Resource flows (Total)	34.8 (100)	53.1 (100)	88.4 (100)	92.3 (100)

Note : a- At 1983 prices and exchange rates.
Source : Chenery H. and Srinivasan T.N. (1989), Vol.II, Pp.1448.

that DFI provided risk capital that did not raise debt levels and debt-services payments or create fixed obligations in foreign exchange and so it was preferable over bank landing. In case of loans, interest payment is due from day one irrespective of whether loan is used or not leave aside productivity or wastage. If it is DFI, a foreign investor acquires an equity interest in any investment venture. He/she has a stake in it at all levels. In case of loss, it has to be shared by the foreign investor whereas only if there are profits, can he/she can reap a part of it. In other words, since profits are earned only when returns earned by the investment are positive, part of the risk is borne by the foreign investor. Experince of other countries shows that if the investment climate remains attractive, only a small part of the profits are remitted, bulk being reinvested. A general climate for development of free enterprise is also important. Moreover, profit outflows are directly related to the success of a project financed with foreign resources. If foreign investment is confined to projects that contribute directly to foreign exchange earings or savings, there is an assurance that the capital will not be used for unproductive purposes. Such an assurance is also the result of the fact that DFI is taken in with a feeling of profit motive. A principal argument in its favour is that the package of capital and technological and managerial resources generally increases the real domestic income of the host country by more than the profits returned to the investor.

A major significance of DFI, especiallyfor developing countries, is that besides increasing capital and enterprise, it also brings with it modern superior technology and efficient managerial skill. This is important because even if a developing country could raise the capital domestically (which is rarely a genuine alternative), it often lacks the knowledge, skill and experience to manage enterprises of the kind run by foreigners. By bringing in scarce productive factors such as technical know-how, business experience and so on, it can make an important and continuing contribution to economic development. Apart from these contributions, DFI, by increasing competition in the host economy may induce the people to become more enterprising and stimulate local entre preneurship. If DFI enters into the export sectors, there is an added advantage in terms of foreign market access which originates from the know-how of foreign firms of selling in foreign markets or from their differencial ability to gain market access abroad. The presence of efficient firms that are competitive in world markets provide an important channel for transferring technological and managerial skills to host countries. In this manner, DFI may countribute longer-term advantages in terms of improved productivity and international competitiveness. Moreover, if the country operates an export industry by drawing on foreign firms rather than on its own, it may obtain larger gains form trade through economies of scale, provided the exports flowing from such enterprises must be more than sufficient to allow the transfer of the profits earned so that they are relatively attractive to the foreigner. The facility of taking away at least a reasonable part of the profits to its country should be assured if DFI is to participate in the process of economic development of a developing country. And it is important that DFI flows particularly into production for export rather than being heavily loaded in favour of domestic consumption growth. The pattern of DFI should be such as to rapidly generate exports.

On the other side, there are also grounds where DFI may lead to a lopsided economic development which may become a hindrance to further progress of the economy. Rather than contributing to closing the foreign exchange gap between savings and investment, the long-run impace might be to reduce foreign exchange earnings.DFI is often concentrated in import-substituting or export industries and the foreign trade performance of enterprises based on DFI are likely to haave a significant impact on the balance of payments (BoP) of the host country. An important way in which DFI affects the pattern of balance of payments is the initial investment in such industries which is often related to some importation. The current account balance would deteriorate owing to substantial importation of capital goods and intermediaries and repatriation of profits, interest, royalties and management fees would accentuate the problem. It may also happen that otherwise domestically usable 'surplus' is drained away and local entrepreneurial capacity is stifled. It would be better to work at the situation if foreign investment were not flowing. In an extreme case, without DFI, the machinery which appeas on the imports side of the balance-of-payments account would otherwise have not been there. It is doubtful, under any circumstance, if increased DFI will itself act directly as a potential remedial factor in any situation of dollar shortage for a particular country. Moreover, DFI can be very expensive if the domestic country does not have proper policies. It may earn negative returns because of import protection in most sectors so that not only domestic but even foreign investors prefer to sell in the domestic market rather than export which over the long run presents limited opportunity for growth. The absence of convertibility is also a formidable barrier to foreign investment mainly because such investments depend normally on transfer of interest and dividends through multilateral trade. In addition, fears of existing or emerging policies in the host country which interfere with the investment in various ways limiting the profitability of the enterprise m ay also affect the entry, operation and even continuing existence and competitive position of the enterprise. Therefore, it becomes necessary that incentives are provided and favourable conditions are created to attract DFI. Moreover, indigenous technological mastery is not acquired simply by passively importing technology. Local efforts and inputs to assimilate, adapt and make optimum use of technology transfers from abroad are critically important to achieve highest attainable returns from them.

The overall impact of DFI enterprises goes well beyond the direct transfer of capital and technology entialed by them. These enterprises also borrow in the host country and from abroad so that they affect a share of total resources that is much larger than the inflow of DFI. As a consequence, the actions of foreign-controlled affiliates or parent companies also significantly affect the achievement of development objectives. This might imply loss of local autonomy which many developing countries have been concerned about. The IMF very aptly summarized the arguments concerning the direct adverse effects of DFI on the host country-

"......foreign - controlled firms may adopt overly capital-intensive production techniques (which are available but inappropriate), make sufficient transfers of technology at too high a cost (to retain technological advantage), set artificially high transfer prices (to extract excessive profits) and exert strain on the balance of payments (because, as part of an enterprise with multinational production facilities they may be less able than firms under domestic control to expand exports and may be overly dependent on imports)" [8].

Thus, though DFI is a potentially important source of capital to supplement domestic investment, technology transfer and employment generation also, the patern of type of presence of DFI, is largely a consequence of the various and complex relationships between foreign interests on the one hand and host country government on the other and the extent to which DFI countributes to growth depends largely on the effectiveness of the policies of host countries.Improvement of polices affecting DFI remains the key to facilitating a steady flow of DFI to developing countries. Nonetheless, it is obvious that the more the contact there is with foreigners, the more rapid is the process of transformation from developing to developed, ceteris paribus. So, far as there is any movement of resources between industrial and develooping countries it mainly takes the form of

8. IMF - "Foreign Private Investment in Developing Countries", IMF Occasional 33, 1985,Washington D.C, Pp 11.

investment by the former in the latter and is calculated to narrow any divergence in growth rates, not to widen it.

1.3 Trade Flows

This last and final line of action, is perhaps the most important and significant for developing economies in the present day development theory. For most of them, international trade is of paramount and indispensable manifestation. The impasse that the developing countries find themselves in today is the result of not giving trade its due priority in the process of their development. The classical theory of international trade according to comparative advantage stands very little proof in the developing world. Trade cannot be analysed exclusively in terms of international specialization but is also a means by which growth is transmitted from the centres of economic expansion through rising demands to the peripheries. Economic growth is transmitted from one to another country both directly and indirectly. What trade does is much more than provide a market and encourage growth or reallocation of resources necessary in order to supply it. It also transmits experience and ideas, changes attitudes and wipes away obstacles to further development. The indirect benefits of trade include provision of capital through international investment, access to means of economic developmant in the form of raw materials, semifinished goods and machinery, access to knowledge, skill, managerial ability and overall foreign technology in general. Technology is embodied in many imported inputs and increasing trade allows countries to import capital goods. On the other hand, exporting exposes nations to international markets which keeps exporters informed of new products. Foreign buyers are an important ssource of informaton that can ben used to upgrade technology. Moreover, what the world buys from developing countries relieves their poverty since it presumably offers a better return than production for their own requirements. These direct and indirect benefits are likely to be much greater in the less advanced than in more highly industrial countries. In fact, the larger the indirect gains, the more reliable is growth of exports as a measure of growth. Even if exports remain modest, the chances that a small growth in exports will be multiplied into a more than proportionate growth in incomes will be greatest if the indirect benefits of trade are maximised. Historically, trade was crucial in diffusing technology. Countries have usually developed more quickly as part of the world economy than in isolation.

Inspite of the contribution that it has made to world economic development, international trade is not popularly accepted as the engine of growth. One of the reasons is at once obvious – the dependence on external forces that trade entails. This implies that the pace of development cannot be set by domestic policies but is determined by forces beyond the control of indigenous authorities. The further exports increase the higher the dependence mounts. More resources become tied to export requirements leaving less to meet the needs of the domestic market. Whether such thinking is justified or not, its very existence itself limits the scope for foreign trade and making use of future patterns of development that were important in the past. To be truthful, the relationship between developed and developing countries is one from which the latter gain much and lose little, if anything.

Dependence on foreign trade is not something which developing countries should regret. Although it may be true that it puts the country to the mercy of external events, it is also a price that any developing country must pay if it is to succeed. Foreign influence must be invited since the country needs foreign equipment, foreign capital and foreign ideas. Without earning foreign exchange by exporting, it cannot pay for these equipments nor can it allow the economy to be permeated with the ideas that are the seed of true development without the kind of contacts with foreigners that is automatically produced through trade. It is not mere exchange of goods, leas when it is between countries at different stages of development. Rather, it is trade that gives birth to the urge to develop, to the knowledge and experience that transform this urge into a successful reality, and to the means to accomplish it.

Trade manifests its importance particularly in counttries that lack the industrial base and are obliged to import nearly all their machinery. Exports, in such countries, easily become the limiting factor on productive investment and on successful development of the economy. A high level of exports enlarges the volume of imports of equipment without putting the balance of payments in jeopardy. In most of the developing countries, exports are clearly not large enough to give adequate room to play in financing new investment.

The problem faced by the developing nations today is not that exports are not large enough, but rather that all their exports mainly consists of primary (agricultural) products which face an inelastic world demand. They are highly dependent on a very narrow range of exports which moreover, suffer from a great variability in supply and low elasticity of supply. Added to this is the fact that nearly all plant and machinery equipment has to be imported. So that a shortage of foreign exchange frequently puts a sharp limit to further planning of investment. In the early phases of development, the foreign exchange requirements usually stem from this need of the developing countries to import capital goods. It may also be true that exports from these countries are governed less closely by the level of world demand than is usually supposed. When competition is directly with more advanced countries, their market share depends also on the terms on which they are able to compete. Earnings from such exports is largely a matter of luck and willingness to use foreign capital as a substitute. The more foreign exchange is felt to be a bottleneck, the more important it becomes to foster every possible way the limited range of activities from which foreign exchange can be derived. The issue, essentially, is the ability to finance a volume of goods and services that is considered necessary to achieve a certain level standard of living and that, it is feared, if such imports don't come forth due to such constraints as mentioned above, it will endanger the functioning of the economy and even reduce living standards to precariously low levels. Supporting foreign payments by drawing in reserves and by short-term borrowing may be feasible for short periods. To achieve a long term adjustment, domestic changes in production and consumption may be inevitable. In the process, it becomes suicidal to disregard developments in other countries. A country must recognise the reality that apart from enlarging export earnings by increased opportunities to sell abroad, even the present earnings may be threatended by factors such as an adverse shift in the terms of trade or reduction in foreign demand. Inadequacy of foreign exchange reserves means a drastic curtailment of imports which is sure to have severe repurcussions on countries at any stage of development. Reduction in borrowing, esp. aid, without curtailing trade (imports) is possible if it coincides with an increase in dollar earnings(exports). But if this increase is equal to the dollar that the country was receiving as aid and then aid is eliminated, the balance-of-payments problem still does not solve in any basic sense. The balance can be achieved either through a curtailment of imports (not advisable as argued above) or increasing export earnings greater than the volume of aid (certainly not impossible).

The above arguments, it is to be remembered, began with the disadvantages of primary exports. Coming back to them, it is commonly thought that manufacturing is the spearhead of economic development not only because it is the mark of an advanced country but mainly because experience in manufacturing throws open a wide field of opportunity. These opportunities in new directions of development are constantly arising because of a greaer range of technical knowledge that becomes available which cannot be the case with primary production. Moreover, manufacturing yields external economies with growth of one industry facilitating the development of others which either supply inputs or use its product for further processing. Experience of the recently developed countries sugests that the forces of growth rarely originate in the agricultural sector of the economy but rather it adopts itself to the growth of other sectors, and the driving force, in the long run, behind economic growth rests upon growth in manufacturing since productivity expands faster in the manufacturing sector and the resulting expansion in productivity helps other sectors to expand through the backward and forward linkages.

1.3.1 Trade Strategies for Development

During the Second World War and the Great Depression, the ability of developing countries to import manufactured goods was reduced due to precipitious declines in the prices of their primary exports and increased real burden of foreign debt servicing which affected them very badly because of their excessive dependence on foreign markets. These experiences coupled with accumulation of reserves after the war, induced in the developing countries,a strong desire for self - sufficiency and economic independence and hence industrialization.The desire was also influenced by the possible benefits to be derived from external economies mentioned earlier and by the rising standards of living that industrialization entails. It began to be recognised that industrialization is the mainspring of economic growth through its effects in promoting development of skills, application of technology and to improvement through research.

There is always an element of external trade in every development strategy that has been devised. Imports and import substitution play central roles in industrial and overall development under any sort of trade regime. In a world that is becoming even more rapidly interdependent, it has become clear by now that autakrky is neither possible nor imperative. Trade policy is partly a matter of selecting and implementing a strategy and overall approach to take full advantage of the potential benefits, limit the disruptions and cultivate learnig opportunities, taking into account a country's particular situation and resources. A distinction is usually drawn between two trade-related strategies of development or growth strategies as they are alternatively referred to : import-substituting inward-oriented growth strategy and export-promoting outward-oriented or outward-looking growth strategy.

An inward-oriented trade or growth strategy is concerned with production for the domestic market of manufactured goods that were previously imported. It is in this sense that it is also known as import - substitution (IS) strategy. A country adopting this s trategy is less open to the outside world with respect to trade flows. Sales in the domestic market is preferred over sales in foreign markets. In other words, an in ward - oriented strategy tends to minimize the benefits of participation in international division of labor by encouraging expansion of production to serve domestic needs and favouring it over both imports and exports. Industrialization in the developing countries has,typically, taken the form of substituting domestic production for imports of consumer as well as capital goods. In fact, support for such a growth strategy came from pioneers of development economists no less than Ragnar Nurkse and Raul Prebisch who believed that such a strategy was a corollary of domestic development. Prebisch postulated that the terms of trade of developing countries have a tendency to deteriorate over time no matter what policies they pursued. Following such a doctrine many countries shifted their economic socus to the domestic marke.

So far as the issue of converting GNP-poor countries in the image of GNP-rich countries is concerned, import substitution can be said to be "a development strategy that seeks to accomplish both the objectives of learning from and in general, gaining from advanced countries, at the same time protecting the domestic economy from the power of these countries.... It is a matter of creating an economy that is so sufficiently fiexible, diversified and responsive that it can weather shocks, can respond to and indeed create opportunities for growth....The basic rationale for an inward-loking strategy is that the poor country needs protection, at least for a while, to convert over its economy in the image of the rich ".[9]

IS thus becomes a matter of two transitions - first, from a system characteized by lack of growth to a flexible responsive system in which living standards are continuousl rising which takes place behind some form of protection and second, from protection to participation on a more equal footing in the world economy. It is between these two transitions that the process lies, by which the metamorphosis from non-growth to growth is achieved.

IS is necessarily initiated in the final stages of production with the replacement of imports of non-durable consumer goods by

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9. Bruton H. - "Import Substitution ", in Chenery, H. and Srinivasan, T.N.(ed.),"Handbook of Development Economics",Vol. II,1989,North Holland, Amsterdam,Pp.1602-03.

domestic production since these commodities suit the conditions exxisting in the developing countries that are at the beginning of the process of industrialization. Moreover, the commodities are unskilled-labor-intensive and their production does not involve the use of sophisticated technology and large inputs from ancillary industries. Therefore, the first industries to be established are always those that assemble parts and components and turn out finished consumer goods. This is commonly called the first "easy" stage of IS. In the course of this first-stage of IS, domestic production rises more rapidly than domestic consumption. This is because such prodction not only satisfies consumption increases but also replaces imports.Thus, IS, in a narrow sense, is only the initial production replacing imports, whereas the subsequent expansion is a product of domestic demand growth coupled with expanding supply capabilities. As such, this stage may not entail substantial economic costs.

Once this process of IS has been completed, rate of growth of output will decline relative to that of consumption. Maintaining high industrial growth rates entails moving IS to the second stage. This involves replacement of intermediate goods imports and producer and consumer durables by domestic production. Such a process differs from the first stage in that such goods tend to be highly capital intensive and subject to important economies of scale requiring similar inputs from other industries. Moreover, these goods have higher technological and skill requirements so that unit costs are substantially higher at lower output levels unlike the first stage. Given the relative scarcity of physical and human capital in developing countries that complete the first easy stage of IS, they are at a disadvantage in the manufacture of highly physical-capital and skill-intensive intermediate, producer and consumer durables. Such a process is limited, also by the domestic market once the first stage of IS is diffused. Consequently, inward orientation is characterized by the parallel development of a wide range of industries. By aiming at limiting imports to goods which are not produced at home or not available in sufficient quantities, countries disregard comparative advantage. Excess capacities develop in these industries. Products cannot be exported due to non-competitiveness and local demends are also limited. Moreover, in order to maintain economic growth at previous levels extending IS to the second stage entails an even increasing use of capital per unit of producion.

There are three important consequences among others, of this tendency of IS to create a demand for new and different types of imports. First of all paradoxically enough, the economy's dependence on imports is increased. As it becomes more nearly self-sufficient, availablility of goods it still has to import becomes more crucial for the economy's smooth functioning. Occasional inability to obtain or pay for such imports (either finished or intermediate goods), lowers the standard of living by making them unavailable. Second, it creates further scope for more IS, through the demand for imports it generates in new import-substitute industries and finally the basic consequence is the failure of the IS strategy to increase the economy's self-sufficiency, except very slowly and only in the long run since it is no quick means of reducing the economy's import requirements.The rise in incomes is likely to raise the developing countries propensity to import. Moreover, increased demand for capital good imports in the attempts to industrialize rapidly, inevitably puts an initial strain on the balance of payments.

A principle devise used in the policy of such an inward-oriented strategy of industrialization is restriction of imports of manufactured goods by means of protection to domestic industries in the form of tariffs, quotas or quantitative restrictions (QRs) ib such imports. In fact, relative incentives to IS and exports, also provide a basis for classifying development strategies as inward or outward oriented - whether there is absense or presence of an antiexport bias. In an iward - oriented strategy, such a bias is predominant. The objectives behind adopting protection can be various. Firstly, because in the initial stages, development process is always accompainied with balance of payments deficits (due to the need to import capital goods), the country tries to preserve foreign exchange by putting restrictions on imports, unless of course, there is a substantial inflow of foreign capital. But, then too, servicing foreign borrowing and repayment poses difficulties without adequate foreign exchange so that preserving foreign exchange at the cost of critical imports becomes imperative. Secondly, there is the objective of shifting the demand for certain imported commodities to those manufactured at home. Finally, and whichis widely accepted to be a justifiable argument, in th eabsence of an industrial base, protection needs to be given to certain domestic industries in order to establish the base.

Simultaneously there is the presence of an anti-export bias and a common argument against IS is that it penalizes exports. Very little incentive are provided to exports and the large domestic market dessuads the producers to sell abroad. A powerful and simple instrument to promote industrialization around the home market which also affects exports is the exchange-rate policy. An inward-oriented strategy is characterised by overvalued and multiple exchange rates which adds to the element of non-competitiveness. There are certain solid reasons for overvaluation. One, world demand for exports of primary products is rather inelastic which means that a lower exchange rate lowers the price for the economy's most vital source of foreign exchange without much stimulating its sales. Second, overvalued currencies mean undervalued imports i.e. import prices that understate the cost to the economy of obtaining them. This enables the government to subsidize by adopting the importation of goods that it wants to encourage, duty free. Really speaking, the major source of capital accumulation under an inward-looking strategy is derived from the high profits aceruing to the importers who receive foreign exchange at a rate lower than its scarcity price in the domestic economy. An overvalued exchange rate also subsidizes capital. Because manufacturers get a low price for their exports combined with the high import cost, an overvalued exchange rate regime discriminates against manufactured exports by making them unprofitable. At any rate, there is little incentive to export as long as safe domestic outlets are provided through protection against foreign competition. Thus, in general, there exists different effective exchanges rates for exports as well as imports. Such overvalued exchange rates tend to depress the rate of economic activity.

The slowdown in primary export growth and lack of emergence of manufactured exports deprives the economy of the valuable foreign exchange necessary for rapid growth. At the same time, net savings of foreign exchange by way of import protection declines because of increasing needs for foreign inputs and technological know-how. As a result economic growth is increasingly constrained by limitations in foreign exchange availability and intermittent foreign exchange crises as the economy is made to expand at rates exceeding that permited by growth of export earnings. An inward-looking strategy may make possible a period of rapid growth but these factors evetually necessitate increasing efforts for additional increaments in output so that unless there is a compensating rise in the share of investments in GNP, a decelearation takes place in the rate of economic growth. If export plans are frusttrated, the likely results will be lower GNP growth and larger debt burden because substantial relative shift towards IS will be costly in terms of foreign exchange and investment resources.Moreover, reduction of export earnings reduces imports and prices of such inputs would rise which, although stimulates IS industries, leads to inflation.

It would be useful to compare the IS strategy with its most obvious alternative-an outward-looking export-oriented strategy. Countries adopting such a strategy are more open to trade, both imports and exports. Such an approach to growth and development owes itsefl to the realization that the external sector is an important element in any drive to increase efficiency. Modernization is viable only through access to import of new equipment and technology. The external sector provides markets for laborintensive industries and could also complement domestic policies to increase competition by exposing industries to foreign competition. Moreover, it interacts with the overall macroeconomic situation in a number of ways. Exports, obviously contribute to aggregate demand and imports provide critical inputs to production for both domestic as well as foreign markets. Besides these roles, there is also the requirement to generate net foreign exchange to meet debt obligations. In fact, the economy's actual and prospective export performance measured against its import requirements affects a country's creditworthiness for commercial borrwoing. Exports, besides argumenting import capacity, add to the country's borrowing and debt servicing capacity and unless a country has a growing pool of export income to draw upon, a short fall in investment growth will create a foreign exchange crisis.

An outward-looking strategy does not create a bias against imports and does not discriminate between domestic and foreign sales. Rather than an anti-export bias, there is ample encouragement given to exports through various incentives. A significant encouragement is in the form of an adequately valued exchange rate i.e. even though it may not be undervalued it is certainty not overvalued but is maintained at realistic levels which meanstying the price system to international prices. Since the price of foreign currency in terms of domestic currency is high, exports become profitable and the incentive to export is maintained and simultan eously, imports are naturally restricted through the price mechanism instead of deliberate measures like QRs or quotas. There is a gradual liberalization of protection in the form of low and uniform tariffs. Such a strategy, However, does not imply favouring exports over IS. Both are critical for growth as noted earlier. Rather, it is characterized by providing similar incentives to production for domestic and export markets. A substantially beneficial aspect of an outward-looking strategy is that the amount of IS that takes place, and how fast, depends on export success and overall growth even more than on direct efforts to implement IS. This is because growth of imports is limited by capacity to import which is increased by the export success which leads to increased imports and foster a 'natural' process of IS. Availability of foreign exchange which augments availability of critical imports for growth, esp. capital goods, is the most important advantage of this strategy. It relaxes the foreign exchange constraint on growth (referredin the two-gap model earlier). All in all, economies that are open to all imports receive the cheapest available goods, imported as well as domestic which are priced to compete with imports. This reduces costs to consumers who then have more funds for other purposes.Open economies are also best for countries that want to export. Components cost tha world price which is essential in order to manufacture internationally competitive products for export. Protection is a m eans of forcing domestic consumers to buy high-cost domestically produced goods instead of lower-cost imports thereby subsidizing the inefficient use of natural resources.

A strong argument against the policy of outward orientation that is generally put forward is that it makes a country vulnerable to external shocks that originate from events in the international economy which are beyond their control. Moreover, since the inward-oriented countries are basically less depedent on the external economy, they are in this sense at an advantage over the former countries. However, experience does not corroborate the argument. Amongst the developing economies, countries that adopted outward-looking strategies, esp. the East Asian economies of South Korea, Singapore, Taiwan and Hong Kong were able to cope with such shocks in a better manner than countries like India, Chile, Argentina etc., which stuck to their inward-oriented policies.

A background study for the World Bank by Balassa reveals that the NICs responded to adverse external shocks through domestic adjustment policies viz., maintaining realistic exchange rates, export promotion, IS and a temporary slowdown in economic growth whereas the LDCs supported overvalued exchange rates by placing heavy reliance largely on foreign borrowing[10].

The outward-oriented economies within both the NICs and LDCs were able to make a more successful domestic adjustment by way of increases in export shares and IS as compared to the inward-oriented ones. Correspondingly, economic growth, after an initial slowdown, accelerated in the former group whereas the latter

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10. Balassa - "Adjustment to External shocks in Development Economies", World Bank,Staff Working paper 472, 1981b, World Bank Washington D.C.

group experienced the opposite. Moreover, the maintenance of realistic exchange rates furthered IS in outward-oriented as compared to inward-oriented economies. Because of heavy reliance on foreign borrowing, the debt service ratios of the latter countries nearly doubled between 1973 and 1978 reaching 43 percent of exports while it remained at 12 percent inthe former countries. Their high indebtedness did not permit the inward-oriented countries to continue reliance an ~~foreign~~ borrowing to finance the BoP effecs of external shocks. Nor did they adopt output increasing policies of export promotion and IS.

A major difference between the two kinds of strategies is that under an outward-looking regime, imports extend from raw materials to final consumer goods including goods competing with domestic production whereas under the former strategy imports competing with domestic production are precluded and are limited to inputs and machinery. Comequently, in case of any external shocks like recession, decline in terms of trade or reduction of capital flows, there is a greater flexibility to reduce imports under the latter strategy than under the former. The loss of production, due to fall in import capacity tends to be larger in the former than in the latter strategy.

Balassa makes a striking observation of the beneficial impact of the outward-looking strategy by way of increased exports.

"Continued IS behind high protection......involves travelling up the staircase" by undertaking production of commodities that involve higher domestic cost per unit of foreign exchange saved. By contrast, exporting involves "extending a lower step on the staircase" by increasing production of commodities in which the country has a comparative advantage with low domestic resource costs per unit of foreign exchange (earned)[11]. It is no wonder then, that the strategy is also aptly referred to as the "exportled" growth strategy since exports are the driving force behind such growth.

An even greater superiority of outward orientation is the exposure to foreign competition which provides a stimulus for technological change. Efforts to export, particularly manufactures, bring forth advice and technical assistance from foreign buyers on matters ranging widely from product design to production. Pressures from international competition by way of imports proves a major source of motivation for actually mastering the techniques and meeting international standards. There is a strong effort to remain in touch and absorb the latest

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11. Balassa (1980b) - "The process of Industrial Development and Alternative Development strategies in World Bank Staff Working paper 438, World Bank, Wash D.C.,Pp 24.

technology, catch up and become competitive with the most advanced countries so that any element of hopeless inefficiency is eliminated automatically.

There are major dynamic advantages of trade through greater innovation new techniques and product knowledge. Particularly important is that which arises from increasing returns to scale. With growth in exports, scale of production also increases with its attendent economies, which leads to continuous increase in the efficiency with which resources are utilized. It allows better use of resources by permitting specialization according to comparative advantage and also application of large-scale methods of production. In short, exports are relevant not only to enable imports but as a means of increasing the productivity of available resources and of importing technical knowledge. Moreover, a country adopting an outward-looking strategy can strive to export manufactures very early in the process. Basically, such a strategy emphasizes the quality and direction of industrial development rather than its absolute magnitude. It must be noted that foreign borrowing may finance any deficiet for a time particularly when real interest rates are low. But this form is inherently unstable. If the ability of economies to generate the requisite export surpluses to service high-debt interest costs is limited through policy-induced distortions inhibiting exports, the debt-service rate becomes unviable. Foreign lending can cease abruptly leading to the kind of debt crisis which plaged Latin America in the 1980s. It would be a delusion to hope to postpone any adjustment through foreign borrowing. Only exports can do the trick under an outward-looking strategy.

Besides, large scale inflow of DFI reflects the outward-looking strategy. When developing countries establish open trading regimes, they attract DFI for the right reason. Foreign investors see opportunities to create internationally competitive enterprises. Its efficiency, therefore, in promoting economic growth will be greater over the long run than under the former strategy. With its lack of descrimination against foreign markets an outward-looking strategy is likely to attract a greater magnitude of DFI whereas by creating "artificial" inducement to invest via tariffs of QRs or both, one gets `tariff-jumping' DFI oriented to the home market alone under the inward-looking strategy and in turn, provides an artificially limited incentive to invest in the country. Such protection-induced capital flow being capital-intensive actually reduces incomes in the recipient countries since the primary objective is to take advantage of protected markets.

Thus, to sum up, an outward-looking strategy becomes a necessary condition for developing countries to get out from the `low-growth' trap and achieve sustained rapid growth ove any long period of time. The success of an outward-looking strategy which permits further economic gains provides the momentum and impetus for any liberalization process that is initiated. Export expansion is the only way to reconcile additional borrowing abroad with declining debt-export ratio whereas IS cannot be forever relied upon to reduce the import-GNP ratio.