PROBLEMS OF THE EXTERNAL SECTOR OF DEVELOPING COUNTRIES

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It is an incontrovertible fact that economically underdeveloped countries, as defined, say, in terms of a relatively low level of per capita income,[1] are, by and large, far more dependent on external economic relationships than their more advanced sister nations. Nowhere is this dependence more immediately apparent than in the importance of international commodity trade to developing countries, whether measured by the large proportion of exports in national product,[2] the considerable importance of imported capital goods in the annual increase of development capital,[3] or by the often substantial amount of imported agricultural staples in domestic consumption.[4] This dependence is more subtle though hardly less extensive in terms of key foreign-owned resources at work in the economy. Even if the annual flow, in whatever form, of "foreign aid," so-called, is discounted, the continuing viability of much of the present structure of agriculture and the industry in the developing countries, particularly in the export sector, is far more closely tied to the presence of private foreign capital and managerial and other skills than is true of countries generally understood as developed,[5] despite the mounting concern in many of these over the real or imaginary threat of foreign economic domination.

The purpose of this paper is to explore in depth some of the more important characteristics and less fortunate economic consequences of the external orientation and dependence of typically developing countries. No claim is made to originality in exposing or analyzing the problems discussed

1 See, for example, the listing of per capita incomes of generally less developed countries in all quarters of the globe in Appendix 2 of L. J. Walinsky, *The Planning and Execution of Economic Development,* New York, 1963.

2 See Simon Kuznets, "Quantitative Aspects of the Economic Growth of Nations: IX Level and Structure of Foreign Trade—Comparisons for Recent Years," *Economic Development and Cultural Change* XIII, No. 1, Part II (Oct. 1964), Table 2, pp. 9–10.

3 See, for example, the foreign-exchange component of various categories of total investment for India's Third Plan in G. M. Meier, *Leading Issues in Development Economics,* New York, 1964, p. 143.

4 Continuing shipments of grain by the U.S. under its Public Law 480 program to India, and even to other underdeveloped countries such as Turkey, is a quite dramatic example of this type of dependence on external economic relationships.

5 An excellent treatment of the role of foreign capital is contained in C. Wolf and S. C. Sufrin, *Capital Formation and Foreign Investment in Underdeveloped Areas,* Syracuse, N. Y., 1955.

below, although certain observations made here have received little or no attention in the professional literature. Rather, it is hoped that by bringing together and systematically treating the more prominent problems scattered throughout the literature, some contribution will have been made to a better understanding of their origins and to a greater appreciation of their seriousness and the need for effectively dealing with them.

It is probably wise to indicate at the outset that these problems only are partly a legacy of colonialism. It must be recalled that even developing nations with no past as a colony—Turkey and Thailand, for example—bear the same characteristics with regard to the external sector as do former colonies. In the former cases, it may have been the short-run attractiveness of foreign commerce, utilizing the oceans as highways, that may have been responsible for the neglect of investment in means of internal communication, which could have more closely bound up the nation and laid the foundation for a wider domestic market. Thus, excessive dependence on foreign markets might have been avoided. Hence, political independence is no guarantee of economic sovereignty. But however important other considerations may be in the origin and development of these problems of the external sector, they will be treated here on narrowly economic grounds.

I. INSTABILITY OF EXPORT PRICES AND EARNINGS

Perhaps the most often heard plea of the developing countries in world councils debating matters of international commodity trade is for some effective trading arrangement with the industrially-advanced nations—their principal export markets—which would lessen or eliminate the frequent and sometimes violent fluctuations in prices of their chief export commodities, which invariably produce fluctuations of about the same order of magnitude in export earning.[6] Most of the international arrangements proposed, which date back at least several decades, have been of the form of so-called "commodity-stabilization" schemes, aimed at controlling (i. e., regulating) world market prices of key staple commodities, often by means of highly elaborate procedures. The producing countries have hoped that these means would effectively stabilize export proceeds. By and large, these proposals have failed to be implemented because of a lack of agreement over methods of regulating price that would appear equitable to all parties concerned under various world market conditions. In the few instances where agreements were reached, they have generally proved short-lived, foundering with major shifts in world demand or supply that have made irresistable the advantage to supplying (underdeveloped) or purchasing (advanced) countries of either unilaterally abrogating the agreements or achieving the same end by demand-

6 Similar cyclical and long-term fluctuations of export prices and proceeds is the general conclusion of a United Nations study covering a fifty-year period. See United Nations, Department of Economic Affairs, *Instability in Export Markets of Under-Developed Countries,* New York, 1952.

ing alternative arrangements. Thus, only a few such international commodity agreements currently survive,[7] the present attempts at commodity stabilization being mainly confined to *national* action in the form of private, government-sanctioned or government-decreed price-fixing arrangements.[8] Other proposals have sought a guarantee of a minimum level of export earnings from basic commodities for developing countries by means of international contributions regarded as compensatory financing, but they have been considered income subsidies by the advanced countries and have never gotten off the ground.[9]

It is small wonder, then, that the developing countries have tended to redirect their efforts at achieving stability in the balance of payments as well as a higher rate of internal growth by seeking to diversify production and thereby decreasing their dependence on at least certain consumer-good import categories. But for the immediately forseeable future, the composition of their export trade will remain essentially unaltered, i. e., will remain remarkably highly concentrated not simply in the general category of "primary" commodities, or the unprocessed or semi-processed products of agriculture, husbandry, forestry, fishing and mining, but in an extremely small number of such commodities.[10] Thus, the level of income in these countries will continue to be highly sensitive to changes in world market prices of merely a handful of primary commodities for as long as these exports continue to comprise a substantial portion of domestic production.

Probably the most important single cause of instability in prices and earnings of primary commodity exports is low price elasticities on the side of both world demand and domestic supply, widely recognized characteristics of primary commodities in general. A lack of substitutes in consumption, a low real-income elasticity of final demand and a small fraction of income devoted to such products suffice to explain the low price elasticity of demand.[11] The seasonal or other gestation period of production of many primary commodities and frequently-encountered sharply diminishing physical returns to additional investments of labor and capital mainly contribute to the low price elasticity of supply. Hence, only a slight shift in world demand, with domestic supply unchanged, or a slight shift in domestic supply (when it is large enough to affect the world price) with world demand unchanged,

7 G. M. Meier, *op. cit.*, p. 396. The International Wheat Agreement is one of the best-known of these.

8 *Ibid.*, p. 390.

9 See United Nations, Department of Economic and Social Affairs, *International Compensation for Fluctuations in Commodity Trade* (Report by a Committee of Experts, document E/CN. 13/40), New York, 1961, pp. 66–73.

10 See, for example, the proportion of total exports accounted for by a single commodity for each of a number of generally underdeveloped countries in Appendix 2 of L. J. Walinsky, *op. cit.*

11 Of course, the price elasticity of demand for a given such commodity from a *particular* country will tend to be somewhat greater than that of the world demand for the commodity in general. It will be infinitely large when the country has no influence on the world price.

is necessary to bring about a substantial change in price with relatively little effect on output. Export revenues will then fluctuate directly with price. A somewhat poor or above-average harvest, a slight weakening or strengthening of demand in overseas markets, are therefore all sufficient causes of a major impact on the level of living and employment in developing countries. The change in exports makes itself felt not only on the level of production it directly represents, but on ancillary output also and, probably most important of all, on imports and domestic investment. Given the relatively homogeneous, or standardized, nature of the export commodity in question, all developing countries exporting the commodity experience these effects of relatively minor changes in market conditions, whether or not their individual output is large enough to affect the world price.

A less often recognized factor with a significant potential for destabilizing export prices and proceeds is a possible lag of marketed supply behind current market prices, which is particularly likely for the products of agriculture, husbandry and forestry. Here, long gestation periods create problems of anticipating market requirements in the future and the general uncertainty may be aggravated by a lack of information on the extent, say, of current planting. If the best estimate of future price on which to base the extent of cultivation is the current price, expectations are likely to be frustrated when the crop is marketed, affecting the amount to be planted over the next growing season and thus initiating a recurring cycle of price fluctuations. The larger the gestation period involved, which can extend over a number of years for timber or tree or bush crops and even marketable animals, the more prolonged the period of excessively high or low prices. No demand shifts between, say, planting and harvest need occur to produce this phenomenon if the initial price on which planting is based is not an equilibrium price. Price will then fluctuate around the equilibrium level season after season in the so-called "cob-web effect," moving further from the equilibrium level if the slope of the market demand schedule is steeper than that of supply in the neighborhood of equilibrium. Given the low price elasticity of demand characterizing primary products in general, only a more elastic supply is required to make such ever-widening fluctuations a distinct possibility.

Instability of export prices and earnings of developing countries is, of course, also attributable in large measure to instability of world demand for primary products and, to a smaller extent, to instability in domestic supply. Fluctuations in world demand, whether the result of cyclical changes in demand for raw materials by the more industrialized countries or to changes in the requirements of these countries for raw materials and foodstuffs as a result of shifts in their own production of these commodities, or of domestic substitutes, or of changes in stockpiling policies, will tend to drive price and output in the same direction, producing a magnified effect on earnings. On the other hand, an abundant harvest, discovery of a new mineral source or similar expansion of primary commodity output in developing countries with a marketable surplus large enough to affect the world price will likewise force

down both price and export earnings for all countries exporting the commodity, given the inelasticity of world demand, while a contraction of output in countries with an impact on world price will produce opposite results. Thus, whatever the cause of instability of export prices of developing countries, export proceeds will be equally or more unstable than prices as they fluctuate in the same manner.

II. SECULAR DETERIORATION OF THE TERMS OF TRADE

It is hardly a matter of contention that, for an indefinite future, developing countries must maintain and even expand commodity exports in order to obtain the wherewithal for establishing an industrial base that can provide a higher standard of life as well as a reduced dependence on the uncertainties of foreign markets. Basic raw materials as well as capital goods are often unavailable at home in developing countries and can only be obtained by importation. With this reality to face, the strongly suggestive evidence that the long-term terms of trade have tended to move against primary commodities and in favor of manufactured goods[12] must be profoundly disturbing to those in charge of development programs in underdeveloped countries everywhere. The overwhelming implication is that the ability of these countries to finance their own development through means and patterns of their own choice is severely limited. Economic sovereignty may therefore be obtainable only at whatever cost to political sovereignty may be required by dependence on foreign public and even private aid for development, if that aid can be assured at all. And if the latter sovereignty is necessary for the former, the goal of truly independent economic choice in the drive for higher living standards may be continually frustrated.

Of course, faults can be found with both the economic evidence of the secular worsening of the terms of trade of developing countries, as economic evidence is seldom absolutely conclusive, and in the emphasis on one concept of the terms of trade. The terms of trade referred to is known more specifically as the net barter, or commodity, terms of trade and measures the import purchasing power of a unit of exports. It is formally derived by dividing an index of export prices by an index of import prices. The evidence suggests that prices of primary commodities, the overwhelming exports of underdeveloped countries, have declined relatively to prices of manufactured goods, the predominant exports of more advanced countries, over the long run.

12 The main evidence is the secular rise in Britain's net barter terms of trade since the late 19th century, such that a unit of primary commodities could purchase only about 60% of the quantity of manufactured goods in 1946–47 as it could in 1876–80. See United Nations, Department of Economic Affairs, *Relative Prices of Exports and Imports of Underdeveloped Countries,* New York, 1949, p. 72. Additional evidence of a somewhat shorter-term nature is the improvement of Europe's terms of trade with the poorer countries by as much as 55% between 1913 and 1952. See C. P. Kindleberger, *The Terms of Trade: A European Case Study,* New York, 1956, p. 234.

Clearly, any price index will tend to average possibly widely differing movements for different commodities. But as long as the commodities grouped and averaged are related to each other in some meaningful way, as obviously exports and imports, primary and manufactured commodities are, then the use of an index is justified. It may be of interest to learn whether export prices of, say, mineral output have declined or advanced relative to prices of manufactured goods in comparison, say, to prices of certain agricultural staples. But as long as both mineral output and agricultural staples are both in general exported by underdeveloped countries, comparison of changes in an average of export prices of primary products generally to changes in import prices of manufactured goods generally (as is reflected in one main piece of evidence—for the United Kingdom) is misleading only to the extent that the deterioration of the terms of trade will vary somewhat from one underdeveloped country to another. This is no less true even when it is recognized that the advanced countries also export some primary products and the developing countries also import some. Criticisms of averages in these respects hardly diminish their validity in indicating *general* tendencies, not precise quantitative changes, especially in view of the fact that the early records on which any long-run analysis is based is almost always subject to question concerning reliability.[18]

The fact that price indexes of themselves cannot reflect quality changes that are not accompanied by corresponding price changes cannot be viewed as heavily damaging to the evidence pointing to secular deterioration of the terms of trade of developing countries, even if it is granted that technological advancement has been more in the advanced countries. Quality is a very elusive, highly subjective concept and, of course, it is not difficult to enlist some opinion in the argument that, in certain instances at least, quality has deteriorated with so-called "industrial progress." Moreover, it is misleading to think only in terms of the economies as a whole of underdeveloped countries in drawing inferences concerning the bias in export and import price indexes resulting from technological progress. It is quite doubtful that the technology employed in the export sector of developing countries generally, especially where foreign capital and management are much in evidence (as is often the case), is or has been distinctly inferior to the technology of the export sectors of the advanced countries. That primary commodities, generally, are not necessarily subject to a lower level of technology than manufactured goods is amply demonstrated by the high rate of productivity growth achieved in primary industries in the advanced nations.

It has also been argued that the long-run reduction in the cost of ocean freight, given that only exports are valued at cost (at point of embarkation),

18 Criticisms of the empirical basis of the terms-of-trade secular-deterioration thesis have been made extensively by G.M. Meier in considering the British date in his *International Trade and Development,* New York, 1963, pp. 58–60. Unfortunately, the significance of the data is distorted by what verges on sophistry in his arguments, as the above paragraphs strive to make clear.

produced a greater relative fall in the United Kingdom's long-term index of import prices than would have occurred if imports were valued on the same basis as exports, thus lending an upward bias to the improvement in her terms of trade.[14] But this is true only if the supply price of Britain's merchandise imports declined by less than the cost of ocean freight, for which evidence is lacking. In any case, it is not at all evident that correction for the change in transportation cost would have reversed the trend of the United Kingdom's terms of trade. It is noteworthy that Prof. Kindleberger's data for the 1913–1952 period, which are corrected for transportation cost, still show a deterioration in the terms of trade for the underdeveloped ("poorer") countries as a group and vis-a-vis Europe as a whole, not just Britain.[15]

Other concepts of the terms of trade that generally appear relevant are the income and single factoral terms of trade and neither need change in the same direction or to the same extent as the net barter terms. The income terms of trade is the net barter terms multiplied by a quantity index of exports and thus determines what has been called the "capacity to import," i. e., what can be financed by exports alone.

In most discussions of the terms of trade, it is quite correctly pointed out that any reduction of the gain from trade on a unit basis, as indicated by the change in the net barter terms of trade, need not indicate a reduction of the total gain if the volume of exports increases sufficiently. But to argue thus, as some writers appear to do,[16] that a deterioration of the net barter terms need not be a serious consequence for developing countries if their income terms improve apparently ignores the particular situation in which underdeveloped countries are placed, namely a shortage of domestic resources for development, especially capital. In order to keep the income terms of trade from deteriorating if the net barter terms do, additional resources, which must include some amount of scarce capital, may have to be diverted from the purely domestic sector, where presumably they are meeting development needs, to the export sector, in order to maintain an inflow of capital goods and other essential items which cannot be produced at home. It cannot be implicitly assumed in the absence of concrete evidence that an expansion of exports in the developing countries can be brought about at little or no opportunity cost because of the existence of idle resources. Even so, capital, which is certainly not one of these resources, is likely to be complementary to a degree with other resources for any expansion of exports, and with some short-run immobility of labor in underdeveloped countries, much capital may be required for any given rise in export volume. Unless it can be assumed that all of this additional capital can be imported as required, which begs the whole question of the development problem of underdeveloped countries,

14 *Ibid.*, p. 60.

15 See footnote 12, above.

16 G. M. Meier, *International Trade and Development, op. cit.*, p. 62. See also G. Haberler, "Terms of Trade and Economic Development" in H. S. Ellis, ed., *Economic Development for Latin America,* New York, 1961, pp. 275–297.

the adverse implications of a deterioration of the net barter terms of trade for these countries are hardly mitigated by the apparently fortunate occurrence of an improvement of their income terms of trade.

What is clear in this case is that the maintenance of the "capacity to import" may come at the expense of a worsening of some sort of "resources terms of trade" on the part of countries least able to afford this kind of reversal. This situation also carries with it the implication of some disruption of development plans and a slower rate of growth than would have occurred in the absence of the worsening of the net barter terms of trade.

The single factoral terms of trade is the net barter terms multiplied by an index of productivity in the export industries and measures the import purchasing power of a unit of input. An improvement in the single factoral terms of trade, despite a deterioration of the net barter terms, would suggest an improvement in welfare, but this judgment is again too facile when developing countries are considered. For example, if the input considered is labor, the rise in productivity may have resulted from a diversion of capital from the domestic to the external sector, increasing capital per worker in the latter, in order to maintain the "capacity to import" in the face of deteriorating commodity terms. Thus, the improvement in the single factoral terms of trade may have been merely a by product of a situation basically adverse to domestic economic growth. Furthermore, it must be remembered that the improvement in real purchasing power which the gain in the single factoral terms represents is measured only in terms of foreign goods, and for labor this means foreign wage goods only. Therefore, this gain may be more of an illusion than a reality if consumer goods imports are substantially curtailed, as tends to be true in many developing countries. When this is not the case, the improvement in the single factoral terms may serve to widen real income differences within the country, since export-sector workers often represent the labor elite in underdeveloped countries. The nation's gain when the commodity terms of trade deteriorates is thus rendered further dubious.

If, on the other hand, the increase in productivity is limited to capital, the gain in welfare implied by the improvement in the single factoral terms of trade accrues only to the owners of capital, who in developing countries tend to represent foreign interests to a substantial extent. But whether capital is largely native- or foreign-owned, it is far from certain that this increased command over foreign goods would induce increased investment in the country unless the improvement is in terms of goods in general, as reflected in a rise in the rate of return.

If, therefore, the evidence of secularly deteriorating net barter terms of trade for developing countries cannot be dismissed out of hand, and if this remains a relevant measure of the loss of international purchasing power despite possible improvements in other indexes of trading gains, what then are the factors that may have contributed to this phenomenon? Those cited below must be understood only as elements of the problem; they do not necessarily exhaust the range of possibilities nor is it possible to attach any

set of weights to them.

The international operation of Engel's Law is invariable advanced as one such cause. Just as when incomes increase nationally, the proportion allotted to food tends to decline, so also does the demand for primary commodities from the developing countries by the advanced countries grow less rapidly with respect to income growth than the demand for manufactured imports by developing countries. Raw materials are obviously not included in the operation of this Law unless they are used in the production of foodstuffs, and the commodities that are most heavily affected by the Law are those for which demand is a more important determinant of price than supply.

For raw materials, the important factors are the various technological trends in the advanced countries which have led to the development of synthetic substitutes for many agricultural raw materials and, in the case of minerals, to increased efficiency in industrial consumption and methods of scrap collection and utilization. Though the nature of technological progress is not essentially short run, it must be granted that much of the spur to the development of synthetics and more efficient utilization of mineral ores can be traced to external crises, particularly the Second World War. Nevertheless, as hinted above, technological developments, however initiated, once set in motion develop a momentum of their own and the relative ease with which the advanced countries have been able to produce acceptable substitutes for foreign raw materials has undoubtedly widened the search for means of utilizing common local materials for the production of synthetics even superior to the natural products.[17] This process, together with the increased emphasis on the discovery of mineral resources within one's own national boundaries and under territorial waters, can only be accelerated by a state of continual global tension or conflict, which appears to have been the world's lot for at least the past quarter century and seems the grim prospect for an indefinite future. These techno-political downward pressures on raw material prices would therefore appear as inexorable and secular a force as the operation of Engel's Law.

A matter of greater dispute than either of the two cited above in the analysis of the causes of the apparent secular deterioration of the terms of trade of the developing countries is the alleged insensitivity of prices to advances in productivity in advanced countries as compared to underdeveloped nations. Since a long-run rate of productivity advance greater in the more developed countries can be taken as axiomatic, it would follow that prices have, nevertheless, fallen more or risen less in relation to whatever productivity growth occurred in the developing countries than in the advanced countries. Thus, the contention arises that monopolistic conditions

17 The development of synthetic substitutes for imported raw materials in the advanced countries has undoubtedly increased the elasticity of world demand for natural raw materials and, to that extent, has probably exerted a stabilizing influence on their prices. But reduced fluctuations around a more steeply declining price trend is likely to be of small consolation to the developing countries.

prevailing in commodity and input markets in the advanced countries as a whole have prevented an improvement in the (net barter) terms of trade of the underdeveloped countries that would have occurred had prices moved similarly in accordance with productivity growth in both sets of countries. Rising profits and money wages are claimed to absorb increases in productivity in the advanced countries while prices fall in accordance with productivity growth in the developing countries. A more refined version of this argument is that while prices of manufactured goods rise less than prices of primary commodities during cyclical upswings in global economic conditions, greater resistance to falls in money wages and profits lead to a far smaller decline in prices in advanced countries during downswings, so that the relative improvement in prices of manufactured goods tends to grow with successive cycles.[18]

While this entire argument may have considerable appeal, there is little evidence for its implications of monopoly in product and input markets generally for advanced countries, particularly when the frequently intense competition in manufactured goods among the advanced countries themselves, which are their own best customers, is taken into account. Nor can it be readily conceded that export industries in developing countries tend to be less monopolistic, especially when virtual world monopolies are held by certain underdeveloped countries or groups of countries in certain primary products (e.g., coffee, tea, rubber), a situation not likely to be matched for even narrow categories of manufactured commodities.

Given the existence and knowledge of at least some of the probable causes of secular deterioration of the terms of trade of developing countries, the presumption has been that a policy of deliberate industrialization can overcome this handicap. But the causes of the declining terms of trade have yet to be thoroughly searched, analyzed and established such that planned industrialization is clearly suggested as the best means of coping with this problem, aside from others, or one for which the costs incurred would not exceed the benefits to be realized.

III. INSTABILITY OF FOREIGN INVESTMENT

The literature on the costs, benefits, problems—economic, social, political—of foreign investment in developing countries is far too voluminous to attempt to summarize here. Rather, the following discussion concentrates on a relatively neglected and yet not unimportant aspect of foreign investment, namely its potentially destabilizing nature. This element of cost must also be weighed against potential benefits in the evaluation of foreign investment from the viewpoint of domestic development.

Investment of any kind, foreign or domestic, seeks a market for its output. In developing countries by and large, the low purchasing power of the

[18] R. Prebisch, "The Economic Development of Latin America and Its Principal Problems," *Economic Bulletin for Latin America* (Feb. 1962), pp. 4–6.

populace, reflecting the low level of productivity, inhibits private investment. It is hardly surprising then that the foreigner's investment in underdeveloped countries ordinarily tends to settle in the export industries. Yet, one may argue that a longer-term perspective would reveal the ultimate profitability of foreign investment which caters to a slowly expanding domestic market, with all the advantages of privileged position and consumer loyalty that accrue to the early entrant.

But it should be clear that investment here tends to be more promising to the domestic entrepreneur than to the foreign. The foreigner is still a foreigner, and even if very special incentives are offered for his partnership in strictly local enterprise, he still must adjust to the customs, institutions, business and tax regulations governing his investment, all of which are likely to be strange and different from the methods of doing business that he is accustomed to, and he must still make allowances for the risks of expropriation and civil disorder, or which he becomes aware from the greater political instability in developing countries than he has witnessed at home. Thus, in his overseas dealings, he tends to choose investments which promise to repay themselves even more rapidly than those which he makes at home. And, in the developing countries, these profitable "short-run" investments can only be found in the export sector.

Primary products, however, are the overwhelmingly important commodity category of exports from developing countries and, for reasons explored earlier in this paper, both their prices and the proceeds realized from them are subject to frequent and sharp fluctuations. These fluctuations cannot fail to disturb the time pattern of investment in these export industries. Periods of exceptionally high prices encourage considerable extensions of capacity; periods of exceptionally low prices lead to a shift of investment back to the home country or to other parts of the world. Thus, to the already destabilizing effects of fluctuating export prices and proceeds on the level of national income and employment must be superimposed the effects on both of a fluctuating rate of foreign investment. The export cycle becomes an investment cycle as well, and the foreign exchange needed for the importation of capital goods and other essentials for domestic development suffers additionally from the drying up of private capital funds from abroad.

Since the export industries in developing countries are cyclically sensitive, it might appear that investment behavior in these industries would not be much different if they were dominated by native rather than foreign entrepreneurs. But this assumes that native capital is as mobile internally as foreign capital is internationally, an assumption which would not appear to have much support. And the fact that cyclical phases are likely to correspond in both advanced and developing countries does not suggest that foreign investment is just as likely to remain where it is. Given the narrowness of investment alternatives for foreign capital in underdeveloped countries, even in times of economic recession more alternatives are likely to be open to the foreign capitalist at home or elsewhere abroad, even if in only financial

investments. Hence, to some extent, investment fluctuations in the export industries of developing countries are aggravated by the dominance of foreign capital.

A general comment concerning the stability of foreign investment in developing countries also seems appropriate. Much has been made, with good cause, of the deterrent to foreign investment that political instability in the developing countries poses. But virtually nothing is ever said about the possible effects on foreign investment in such countries of a kind of political instability in advanced countries which takes the form of great-power struggles, whether amounting to "hot" or "cold" war. Considerable instability in foreign investment appears to be an inexorable consequence of such global instability.

War, of course, means the virtual cessation of further investment in areas beyond the effective control of the warring parties. This investment loss is hardly likely to be incurred gradually. But global political tensions also create instability in overseas investments. On the one hand, they may lead to an intensification of the search for domestic substitues for imported foodstuffs, both of which suggest diminished overseas investments in primary commodity production. But if tensions ease and are followed by protracted periods of relative world tranquility, a reversal of this trend of foreign investment in developing countries may ensue. Or, a distant threat of conflict may lead to increased investment abroad as a by product of stockpiling policies, policies which may be relaxed when the threat fades. And even greatpower wars, if waged on a small scale, can increase the rate of foreign investment in developing countries not distant from the conflict as the belligerents seek to reduce the costs of supplying their armed forces. Thus, the very instability inherent in real or threatened armed conflict must produce instability in the world distribution of investment and thereby hinder the realization of the aspirations of developing nations.

IV. LACK OF SPREAD EFFECTS FROM TRADE

Contrary to what the classical economists believed to be the outcome for all countries, international commodity trade has not proved to be an engine of economic expansion for the less developed countries. Despite an export performance that was markedly high upon their entrance into the world economy and a continuing expansion since, though possibly lagging behind the growth of world trade,[19] the export sector has remained an enclave of modern production, marketing and management techniques within an otherwise backward economy utilizing primitive, inefficient productive methods of long standing and geared to provide only for a very limited market. This contrast between the export, or modern, sector and the rest of the economy remains so marked in typically underdeveloped countries that they have become increasingly described as having a "dual economy" or exhibiting

19 G. M. Meier, *Leading Issues in Development Economics, op. cit.*, p. 371.

"technological dualism." Clearly, the prosperity enjoyed by the export sector has not penetrated to the economy at large; rather, with the passage of time, prosperity has reinforced the growing isolation of the export sector from the economy to which it is gradually becoming only politically attached.

Numerous, complex and subtle causes can be adduced for the growth of "dualism" in underdeveloped countries and they cannot be exhaustively treated in a limited space. But they can be divided into two general categories—those which are intrinsic in the nature and characteristics of the export sector itself and those which emanate from the economy in general—and at least the major elements of each can be described.

One general characteristic of the export sector which clearly sets it apart from the remainder of the economy is the relatively large amount of capital employed per worker. As long as this is indicative of a relative inflexibility of the proportions in which labor and capital can be used, it suggests that the export industries by themselves are incapable of becoming nearly as important employers, especially of unskilled labor, as their economic importance might otherwise suggest. Limited employment, particularly of unskilled labor which developing countries are abundantly endowed with, means limited consumption and only the slow and limited growth of domestic consumption goods of an industrial nature.

The greater the amount of capital employed per worker in the export industries, the greater the share of profits in the value of production tends to be. While such profits tend to be reinvested somewhere, the aversion of capitalists, particularly foreign, to investments that would serve only a limited domestic market (at least initially) with greater comparable risks than are present in export production must certainly operate to the detriment of investment outside the export sector. If foreign ownership of capital in the export sector is dominant, and prospects even in the export sector are not promising for the time being, much or all of the profits may leave the country as repatriated interest and dividend earnings.

But neither of these factors are as crucial as the nature of primary production itself. By definition, this is production that not only makes use of natural resources, but which is not far removed from the mere gathering of cultivation of these resources. The smaller the extent to which the primary products are processed prior to export, the less the demand by exporting industries for non-human, non-capital inputs of animal, vegetable or mineral origin that could be supplied domestically. Packaging materials may be a case in point, for the more refined the export product, the greater the volume and variety of packaging materials required. Hence, primary product export industries often lack so-called "backward linkages," i. e., lack dependence on local input-supplying industries which could share the prosperity of the export industries and offer expanding opportunities for employment and investment.

There is a particularly vicious cycle involved in this lack of domestic input-supplying industries which suggests that technological considerations are not the main determinants of whether they do or do not exist for any par-

ticular export industry. By and large, the more processing the export industries do, the proportionately more employment they can offer and the more skilled can the work force become, since processing tends to be more labor-intensive than is true, for example, of mining or even plantation agriculture at times. But the more processing the export industries do, the more they are dependent on domestic suppliers of intermediary products, as costs of importation of these products are likely to be prohibitive even without tariffs, given their bulk relative to their value. Thus, the more processing of exports carried on, the greater the importance in the economy of domestic producers of intermediary products. However, it these supplying firms do not exist, then the export industries may not be able to make the required investments in processing materials themselves, say, for lack of sufficient investment funds, inclination to branch out, knowledge of sources of local materials, inadequate transportation facilities, etc., and thus would not be able to process the primary product to the extent, and offer employment on the scale, that would otherwise be possible. Employment in the export industries, therefore, may itself be dependent on investment (and employment) in industries that cater to export industries. Perhaps even more important than the expanded employment is the reliance on new production techniques, the greater technical knowledge, the better training of labor and the improved organizational forms that may accrue as further benefits of the processing of raw material and foodstuffs exports, the so-called "external economies" of economic theory.

The preceding paragraph contains a hint that hindrances to the transmission of export gains may reside in aspects of the generally underdeveloped nature of the economy. In this respect, perhaps the most important factor is the relative lack of social overhead capital, the railroads, highways, bridges, telephone and telegraph communications, educational and training facilities and similar undertakings necessary to support the development and expansion of modern industry. One cannot very well expect private initiative alone, whether native or foreign, to accomplish these works, not only because they represent extremely long-term investments and so may repay themselves only in a distant and highly uncertain future, which would be sufficient reason alone, but also because the benefits that they bring are substantially external to the firms undertaking their construction and so cannot be completely recouped by them in the prices they charge. Thus, the benefit of educational facilities, for example, even if constructed and operated under private sponsorship, accrue also to those business firms that employ the graduates of the schools, as they also profit from the enhanced capabilities of their employees. It is ordinarily not possible for the managers of the educational institutions to extract a fee *per se* from business managers for the benefits received by the latter from better-educated employees. These benefits are classic examples of "external economies."

A central government which lacks the necessary resources, or the will to see projects through to completion, or the imagination to perceive the benefits of a program of construction of social overhead capital which could provide

the economy with an "infrastructure" will, therefore, continue to administer a country with lopsided economic development, incapable of other-wise establishing or generalzing the benefits of a balanced industrial base. The crucial importance of social overhead capital is apparent even in considerations which, at first glance, may not seem related to it. For example, the lack of domestic suppliers of intermediary products to the export sector, which forces primary production to leave the country in unprocessed or semiprocessed form and thereby denies employment and income to workers who could otherwise be employed in either industry, may be traceable to a poor or nonexistent transportation network if the processing materials required by the export industries are located in a region remote from them. Even the lack of "backward linkages" or, for that matter, of "forward linkages," that is, industries to which the industry in question is an intermediate-good supplier, may thus be related only to the absence of enough "infrastructure" to make possible the establishment of industry on a reasonably economic basis. Infrastructure is a necessary though not sufficient condition for industrialism.

Other aspects of the typically underdeveloped economy also pose obstacles to the spread of rising incomes, productivity and employment from the focal point that the export sector represents. With the "wave of rising expectations" of peoples throughout the world following the close of the last world war came a strong demand for the industrial consumer products of Western civilization and a corresponding drain on the meager international reserves of developing countries until controls were instituted. The greater the preference of the local population for imported consumer goods, i.e., the greater is Prof. Nurkse's "demonstration effect," the greater the handicap under which the development of a domestic mass consumer-goods industry must labor, especially if import restrictions are lax or if smuggling is considerable. Another obstacle may be found in an excessive attachment to the soil or to the locale of one's birth and rearing when opportunities for more lucrative employment exist under a seemingly disciplinarian factory regime or in apparently less hospitable or remote regions. As long as it is not possible or profitable always to bring industry to where the people are, region-wide depression and permanent stagnation may be the inevitable consequence when people cannot or are not willing to relocate.

This list of obstacles does not end here by any means. The hostility of certain religions, cusoms or mores to a more materialistic outlook and to the emphasis on individual rather than clan action and enterprise, the widespread prevalence of monopolistic practices in local industry, including labor union restrictions on membership, the system of bonded indebtedness perpetuated by usurious, ruthless rural money lenders, are just some others that come easily to mind. An exhaustive treatment, however, is not necessary for one to gain an appreciation of the range and severity of these domestic impediments to progress.

Just as the above-mentioned obstacles to the spread of benefits arising in the export sector is hardly a complete list, also incomplete is the types of

problems of developing countries involving their external sectors that this paper has addressed itself to. No attempt has been made here, for example, to treat the problem of capital flight, or of smuggling, or of determining the appropriate degree of tariff or other protection for local industry, and even this list can be further elaborated. But greater appreciation of at least some of the more important economic problems is as much as might be achieved by a paper of this length.