

ECONOMIC DEVELOPMENT AND BALANCE OF PAYMENTS

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ECONOMIC development is a function of saving and investment. It is the degree of capital formation which determines the level of economic development in a progressive economy. In a Robinson Crusoe economy fishing is the only occupation and this is done through most primitive methods. Because the average productivity is very low, therefore, the ratio between work and leisure is at a very low margin. Now if within this choice of so many hours of work and so many hours of leisure it is possible to produce more than the need of consumption, and thus create a margin of saving in order to spend it on the improvements in the methods of fishing, then the introduction of this new element of capital in the shape of 'boat' and 'net' will result in a higher ratio between work and leisure and a better standard of living.

If we apply this idea to the development of modern nations, we realize how this process of capital formation affects every sphere of human activity. It is customary, now-a-days, to talk of 'Developed' as against 'Under-developed' coun-

tries. It is a somewhat misleading terminology. But if we keep in view this factor of capital formation, we can proceed with our analysis possibly on some tangible grounds.

The balance of payments has a two-fold importance for economic development. Firstly, it is an expression, in statistical terms, of the tempo of economic activity. Balance of payments is a link between two countries which enter into trade relationship and is influenced by the nature, composition, and the level of internal economy in both the countries. Secondly, balance of payments can occupy a very peculiar role in any plan of economic development, particularly, if it is financed by some external loans or by any other external sources.

Let us start with an isolated country. Suppose there is only one type of economic activity taking place, *i.e.* wheat production. What effects any change in its method of production will have on its economy? The country has no trade relations with the outside world, and therefore any change in the methods of production of wheat will give rise to more productivity per unit of the

factors of production and will thus contribute towards general prosperity. The benefits in real terms will increase, although the money gains would remain the same. Apart from a change in the value of money no other results would follow.

If this country, A, decides to open up trade relations with say, country B, then what effects a change in the methods of production will have on the balance of payments of A.¹ Let us take the same example again. Due to some reason there is increase in the productivity of wheat in A. This means that A would be able to offer the same quantity of wheat at a less price. If in B the demand for A's products is anywhere less than infinity the exports of A will rise and will cause an increase in the national income of A. This increase in the national income might create results re-acting in the form of increase in demand for B's goods. Thus the secondary effects on B's balance of payments may prove to be less unfavourable. Given the elasticities of demand, A's balance of payments will improve 1.

1. Prof. Meade says: "The increased productivity in A will cause the prices of A's products to fall relatively to those of B's products. If the sum of elasticities of demand for imports in A and in B is greater than one, this in itself will cause a net shift of total expenditure away from the more expensive products of B and on to the cheaper products of A. A surplus will appear on A's balance of trade and a deficit on B's.

Upto this point A is a wheat-producing country and is depending on B for its manufactured goods, say wheat products. Let us assume that B's only occupation is this manufacturing activity. Now it is quite possible that A decides to change the pattern of its economy because of some reason. It can be anything. The process of capital formation can be low in A due to the pressure of population on land and in order to get rid of this defect in the superstructure of her economy the Government decides to introduce some fundamental reforms in Agriculture. Naturally, the ratio of labour to land will have to be brought to the productive margin and the surplus population thus created will have to look for some other occupation. We do not assume any natural harmony of interests in the society and therefore the state has to play its role of regulating the 'free' economic activity. Under this policy, suppose it decides to encourage the development of a second occupation. Side by side with wheat production,

This net decrease in expenditure on B's products will cause a reduction in the demand for labour in B and some general slump in B, which will grow larger, (1) the smaller is B's home leakage, and (2) the smaller is B's marginal propensity to import” Balance of Payments, pp. 83.

In my argument the assumption is not of many products but of only one product.

wheat-manufacturing is also introduced. The surplus population is shifted over to this new source of employment. As a result of this change two consequences follow. Agriculture becomes a more profitable occupation and the new occupation contributes as well to the national income. The pattern and form of the economic activity is changed. What effects will it have on the balance of payments? There are two stages of economic development in A: one before the establishment of the new pattern of the economy and the other which starts after its establishment. Let us try to understand the possible effects of the development on the balance of payments with the help of the following diagram:²

(Receiving Countries)		(Spending Countries)		
		1	2	3
		A	B	National Income
a	A	5	3	8
b	B	3	5	8
c	Domestic Expenditure	8	8	

There are two countries A and B. Both are Receiving as well as Spending countries. They export as well as import from each other.

2. The idea has been borrowed from Professor Meade. The responsibility for the use of the figures and the diagram, however, is entirely mine.

The columns 1 and 2 show them as spending countries, *i.e.* the importing countries and the rows a and b show them as the receiving countries, *i.e.* the exporting countries. According to column 1 the country A spends 5 units on her own products and 3 units on B's products. 3 units worth is her import from B. Similarly for the rest of the diagram. Row a shows that the country A receives 5 units of income from the internal sources and 3 units from her exports to B. Her imports and exports are equal, therefore, the balance of payments is nil.

Because of the change in the Pattern of the economy of A there will be a change in the volume of imports from B. A herself has now started producing the commodities which she used to get from B. Suppose that the expenditure of A on B's products is reduced from 3 to 1½ units. There is a surplus of 1½ units in A's balance of payments. But since the exports from B have been cut, this effects B's national income and thus her demand for A's products. Some factors of production are rendered useless due to reduction in A's demand and thus in the export-goods industry. If B can find some other sources of employment for these factors of production then these consequences might not follow. But if B finds employment for these unsued factors

by encouraging wheat-producing activity and thus cutting off a few of its supplies from A, the position instead of improving deteriorates for both the countries. Equilibrium, if at all it is established, will be a sort of under-employment equilibrium.

The situation is extremely paradoxical for B. If there is no change in the economy of A then because of the already present defects in it there will start a tendency towards a deterioration in her national income which will effect her capacity to import from B. If on the other hand, A decides to improve her position, B has to be ready to bear its repercussions. B being more advanced country has to accept a greater share in the total responsibility. It is in fact incumbent on both the countries to co-operate in adjusting their economies to the changing conditions. The balance of payments position would be disturbed in either case. It is for the people at the helm of affairs in both the countries to see which form of disturbance is more desirable. Development in Under-developed countries is an international issue and cannot be solved merely by one-sided efforts.³

3. "Early in 1932 both Sweden and Denmark initiated easy money programs The rapidity and completeness of Sweden's recovery has so often been described that there is

We may mention, in passing, the corollary of the above conclusion from our analysis. It can be said that a fulfillment of a plan in an isolated economy would be easier than in an open economy. The trade can serve the purpose of a balancing force and this tendency can be regarded as undesirable under certain circumstances. With the rise in national income of A there is increase in the purchasing powers of the people and therefore in their demands for home-made goods as well as foreign goods. The imports will increase. If the rise in imports cannot be kept just at a level where they can serve as a check on the inflationary tendencies of the plan then the unfettered increase in them might swallow the whole momentum of the development plan.

Should a country, therefore, close its doors to other countries during the period of its plan? It seems to be difficult to bring the imports

no need to repeat the story here the British building boom created a demand for Swedish timber while German rearmament required large quantities of Swedish Iron ore.

Denmark's experience was less fortunate. The stimulus of easy money was concentrated largely on construction activity. Since the bulk of building material is imported, more construction required considerably higher imports But the international situation did not permit of any increase in imports." W. A. SALANT, Public Policy, Volume II (Cambridge, Massachusetts, U.S.A., 1941), pp. 203-231.

down to zero unless the factor-endowment of a country is such as would allow her to pursue this policy. For any development plan in U.S.A. or U.S.S.R. there might be less need for the import of capital or other goods than say in an under-developed country. If all the natural sources are available inside the country then it is only a matter of harnessing them on proper lines. But if they are not, as is generally the case, then it is like developing the textile industry on the basis of the import of textile machinery. It is quite an economic proposition.

Broadly speaking, imports can be of two kinds: consumption goods and productive goods. Higher ratio of the import of consumption goods is as much detrimental to the capital formation in a country as the high level of consumption of home-made goods. It reduces the margin of saving and thus of investment. These imports have to be kept as low as possible. A kind of a self-sacrifice on the part of the people is involved. But what about the import of productive goods? It depends upon two factors: first, the 'tempo' of the plan, and second, the availability of foreign exchange. The second factor again has two aspects. In the first place it depends on the level of trade which deter-

mines the foreign earnings of a country, and in the second place it can vary according to the supply of help from the outside world. Here we shall consider only this last mentioned aspect of the problem.

Let us suppose that some external financial aid is available to the country A. Now a loan by a country passes through three stages. In the first stage it is an import of capital, in the second stage it is an important part of the development plan, in execution, in the borrowing country, and in the third stage it involves the repayment of capital with interest and other charges. At this final stage the problem is to create export surplus in the long-run to meet that obligation to the creditor country. It is, therefore, not a matter of just an arbitrary decision by the borrowing country to fix up different targets. It has far-reaching consequences and can be justified only with the help of some criterion. Let us try to discover this criterion. Suppose that all the targets before the plan can be classified into four groups as follows:⁴

4. This classification is based almost wholly on Professor J. J. Polak, "Balance of Payments Problems of Countries Reconstructing with the Help of Foreign Loans", *Quarterly Journal of Economics*, Volume LVII, Pages 208-240. He, however, has dealt with only the First Third and Fourth Sectors. The line of argument also is different.

FIRST SECTOR: The manufacturer of goods and services for which the sources are available within the country, and which were being imported previously.

SECOND SECTOR: Manufacturing activity for which some major raw material has to be imported although other sources are available within the country.

THIRD SECTOR: The development of social services like public works plans for sanitations and sewage of city corporations which involve huge imports.

FOURTH SECTOR: Concentration on the efficiency of production of goods and services already being produced or their replacement by other types of goods due to a change in demand.

It is quite clear that an increased economic activity in the First Sector

will certainly, and in the Fourth Sector most probably, result in either increase or saving of foreign exchange. In the case of the Third Sector there will be a drain on the reserves. The expert opinions about the economic activity in the Second Sector might differ. Perhaps the final solution would depend on the circumstances of individual cases.

In short, what this analysis brings out is the fact that if a country makes its choice of targets of a plan in the light of the possible long-run tendencies in its balance of payment, consequent upon such a plan, then there should not be a "problem" of creating an export surplus for the sake of the liquidation of external debts.

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