PROLOGUE

THE CHALLENGE OF DEVELOPMENT

Adam Smith, two hundred years ago, while trying to synchronize his thoughts on economic development chose to title his exposition as "The Wealth of Nations".Today, if he where expounding the same theme, it would probably have been rechristened "The Wealth of Poverty of Nations". Today, as it was in Smith's time,bringing to light the forces that determine the economic growth and development of nations remains the most challenging conundrum confronting economists; in fact the entire human race.

However, today it has become imperative, even more than it was in 1776, to consider the conundrum in comparative terms and ask oneselves why growth should be more rapid in one country than another, whether the gap in living standards between the rich and the poor countries is likely to widen or narrow and what needs to be done to promote a greater measure of international equality.The roots of such introspective quests lie in the late 1940s. As the Second World War came to a dusty finale and the dust settled, a sharp consciousness dawned on the international community.The world became acutely aware of the reality that a relatively small number of nations and a small proportion of world's population had access to a greatly large quantity of goods and sevices per individual as compared to most other nations of the world. What was even more fundamental was the fact that in most countries a large part of the people lived in abject poverty. During the past forty years many developing countries have succeeded in achieving progress at a remarkable speed in terms of wealth and education. But what has been extraordinary by historical standards is the rate of progress observed in their average incomes which registered a fivefold rise over the period. These countries showed that if nothing else was certain at least rapid and sustained development was no hopeless dream but a reality that could be achieved.

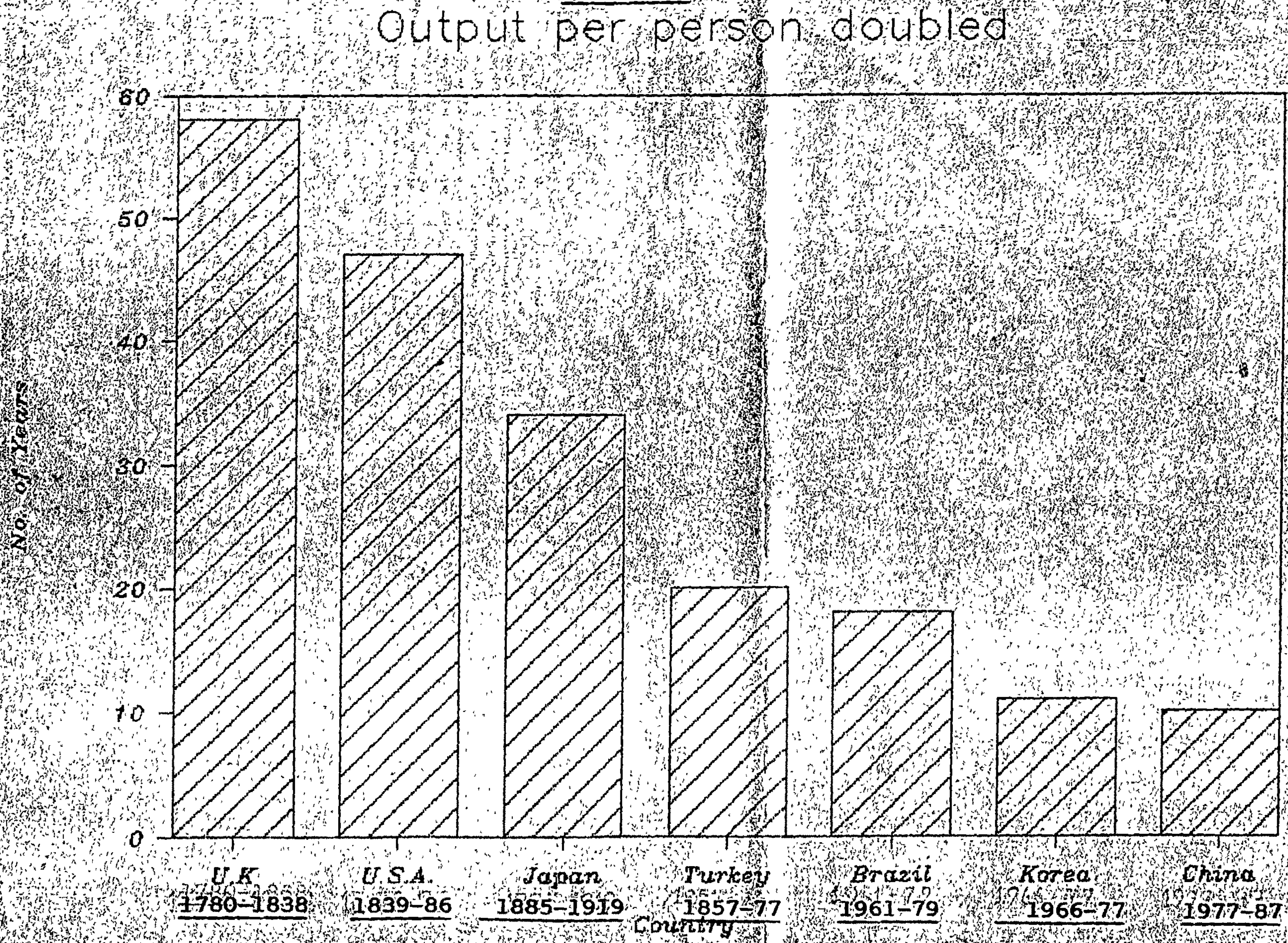
Nonetheless, many nations have performed poorly and in some, standards of living have actually fallen during the past thirty years.Concern over economic development arose because of the existence of such wide disparities of per capita income in different parts of the world with the resultant problems of standards of living.The obvious question which has remained ever since is : Why does this difference in per capita income prevail? and simultaneously : Can the countries which are GNP - poor modify their economies such as to cause increase in incomes and welfare, consequent upon the routine functioning of the economy? Perhaps such chronic quests for enlightenment led to the emergence of development economics as a separate discipline. As defined by Lewis (1984), development economics is the study of the economic structure and behaviour of poor or less developed nations. There has been a general consensus that 'development' encompasses the reduction of poverty, increase in productive capacity as well as rising per capita incomes and improvements in the health and education of the teeming millions.

If one takes the average income per head i.e. per capita income as a broad measure of the difference between rich and poor countries,one would find a small number of countries at one extreme with per capita incomes of $1000 or over.The other extreme is marked with a long list of countries which altogether form half the population of the world with per capita incomes of $100 or less. Moreover, this gap in their standards of living is a growing one. Even if the under developed and developing countries are able to improve their incomes ten times as rapidly as the advanced developed countries, the gap would still widen. A ten percent increse in the developing or under developed countries would add only about $10 to the average whereas the same rate of increse would add $100 to the average of the developed countries. In fact, the irony in the case is that the developed countries have not been showing a faster rate of growth than the developing countries.The latter have, no doubt, maintained remarkably high rates of growth over the past three to four decades.Nonetheless, since the average itself is relatively low for the developing and under developed nations, it becomes equivalent to whatever slow rate that the developed countries have exhibited with their high averages.

An obvious answer to the questions posed earlier, at once evident, would be to make the GNP - poor countries in the image of the GNP - rich countries. The latter seem to offer an example to be followed or to be learned from. The existence of rich countries created a world environment quite distinct from that which prevailed while they were developing. They were obliged to find their way in the absence of equivalent rich countries to copy from or a world environment that was volatile enough to learn from.Economic history has showed, as noted earlier, that it is not an unachievable task for modern day developing countries to develop rapidly and indeed for many countries the pace of change has accelerated. However, at the same time, history has also showed that many more countries have developed more slowly, if at all. The key to development, obviously, is to fathom what makes the range of experience so wide.

Over the centuries, the time required for significant changes in growth and living standards has shrunk steadily (See figure A).The United Kingdom, beginning in 1780, was able to double its output per capita in fifty eight years. Starting in 1839, the United States achieved it in forty seven years. Japan,starting in the 1880s,in thirty four years. The post-World War II era saw per capita output doubling even more rapidly in many countries - Brazil in eighteen years, Indonesia in seventeen,Republic of Korea in eleven and China in ten. Such change in pace indicates that though it was over a long period that industrial revolution gained momentum, catching up has been a more and more rapid process. However, the modern developing countries, have to achieve the metamorphosis of their economies, from non - growth to growth, in a world dominated by a relatively small number of already rich and still growing economies. In such a scenario, the developing countries need to recognise the fact that they must seek to learn from the advanced countries. They have this advantage over the already advanced countries during their time which did not have any example to follow or learn from. This becomes evident from the trend exhibited in figure A. By now it is obvious that even though substantial development is needed if only to offset the population factor,much more rapid progress needs to be made if per capita incomes are to be actually increased perceptibly and a degree of change so created which

FIGURE A


Output per person doubled
No. of Years
60
50
40
30
20
10
0
U.K
1780-1838
U.S.A.
1839-86
Japan
1885-1919
Turkey
1857-77
Brazil
1961-79
Korea
1966-77
China
1977-87
Country

will set a cumulative process in motion in line with countries shown in the figure. Today for most countries, economic growth is one of the most important objectives of policy whether it is viewed from the aspect of economic welfare or political stability.

Rationale of the Study :

In recent years there has been an unprecedented growth of economic interdependence between nations in production,trade and finance particularly during the past decade and a half. The role of transnational corporations has increased.The world is also witnessing what can be called a process of international liberalization. Inward - oriented development strategies are more and more being replaced by outward - oriented ones.

The overall developments in the world economy have brought to fore important trends that have left no nations unaffected and have increased the degree of interdependence. In the process of development in the post - World War II era,the growth of countries has turned out to be uneven. Countries that began developing together in a similar world environment, chose separate paths to development and along the way, digressed. What resulted was success for a few, failure for most. As witnessed during the early 80s, recovery in industrial nations did not automatically speed up growth and development in the developing world. In the case of the latter, as a whole , GDP and per capita incomes have declined in the past few the years. The gap between the developed and the developing nations has widened and is widening.

A major and significant area of concern is the persisting debt crisis of the developing world. These countries became much more dependent on private external financing for their development plans than they were before. Both public and private sectors started borrowing heavily in the world capital markets. The burden has crippled their development programmes. The malfunctioning of the international economic system has been an equally important contributor to the crisis. Nonetheless, the debt overhang now constitutes the most formidable deterrant to revival of growth particularly in Latin America.The total long - term outstanding debt of the Third World stood at $1.3 trillion in 1990.The cost of repaying the debt has become crippling and capital is now flowing from the developing to the advanced First World.

Another major area of change has been the international trade environment. Though the value and volume of world trade have been growing since 1984,most of the growth has occured in the developed world with growth in manufactures leading the increase while exports of developing countries as a whole slowed down.They remained unaffected by the surge in world trade. Major inherent bottlenecks in improving trade in manufactures have been the developing nations' tehonological backwardness, lack of resources and distorted trade pattern of primary exports and capital and manufactured imports. The latter has also served to deteriorate their terms of trade during the 80s with expensive imports and cheaper exports. On top of this,two major developments have emerged which have severe implications particularly for the Third

World developing economies in the 90s : the signing of the Uruguay Round of GATT talks and the European integration.

Amongst the entire gamut of countries,the Third World presents a mixed picture of development. On the one side,there is the dismal failure of India to rise to expectations ; on the other is the spectacular success of the NICs in rising much beyond expectations.Particularly remakable is the contrasting rise of South Korea and Brazil.

India's paricipation in the world economy has been very selective and with its inward - looking policies its scope to be an important player in the world markets became limited over time.Its dependence on the external sector has been very small. In the 60s and 70s, India had missed a bundle of opportunities which had swept many Asian economies and suffered the consequences for the periods thereafter. Growth has been relatively slow because of among other factors a dismal export performance and imprudent external policies.

South Korea, in 1960, was a poor developing nation with a small manufacturing sector and heavy dependence on foreign aid.Prospects to increase and maintain high growth rates were few. However, with its increasing outward orientation, between 1965 and 1979, Korea achieved a real GDP growth of 9 % p.a. on an average. In 1981, Korea was the fourth largest debtor in the world and there were widespread concerns about the country's ability to meet its debt obligations.By 1986,the economy was booming again with substantial trade surpluses.In addition to meeting all dabt-service obligations,South Korea had begun repaying the principal on its external debt.

Brazil is often cited as an example of successful import-substitution policies.Between 1960 to 1987, its average growth rate was an impressive 6.6 % p.a. There was, of course , a major policy shift in the mid-60s from an inward-looking to an outward-looking regime which was responsible for the heightened pace of economic growth,and a reversal to import substitution after a decade.Simultaneously, today,Brazil also has the 'honour' of being one of the most heavily indebted country with a debt of over $100 billion in 1990 and concerns over its debt servicing and management are becoming stronger. Nonetheless, its per capita income of US$2540, (1991) ranks amongst one of the highest in the group of upper midle-income countries of the world.If Brazil could succeed despite the odds,there seems no reason why India cannot.

The 1990s present mixed prospects for developing countries. The NICs of Asia foresee living standards on par with industrialized countries.For Latin American countries, the battle will be to reverse declining or stagnating living standards.In continental Asia, particularly in countries like India, the challenge will be to lift economic growth above population growth.

Main Theme of the Study :

The experience of the NICs and other developing countries reveals that they rejected the inward-looking approach to development after trying it when it failed to work,but India pursued it.These countries became more open to the international economy over time and placed their thrust on exports,earning foreign exchange for technology imports which helped them modernize.It is now accepted that substantial increases of aid will not provide the solutions in the developing world and the importance of encouraging new markets is appreciated more widely. Increasing the export markets would not only generate the income upon which growth should be based but would also reduce the percentage of export earnings that has to be earmarked for debt service.To sell into global markets, in turn, it becames imperative to produce at the competitiveness of global standards.Equally true is the fact that without liberalization development will languish.It is in the interest of developing countries to opt for open economies and adopt aggressive outward - looking policies. This would be the case also if growth of world markets is slow and if exports need to expand rapidly enough to even maintain debt - servicing capacity. It has been observed that too many trade reforms begin with import liberalization which is a mistake. Export expansion will lead naturally to import liberalization and as long as exports are artificially small and capital is `ready' to flee, liberalization becomes untimely and unwise.Imports become easier to liberalize when a comfortable foreign exchange position has already reduced the risks. Then it becomes easier also to absorb resources released by liberalization. As Wolf rightly observes,"the least risk strategy is clearly to get exports up and then to liberalize imports."[1] In cases where liberalization has been accompanied by public or private capital inflows there has been an appreciation of the real exchange rate. This hurts

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1. Op.cit. Wolf Martin (1982) -"India's Exports". Oxford University Press, New York, Pp.133

potential export growth so that when capital inflows diminish there is a BoP problem and the liberalization process is reversed.

Furthermore, in order to provide a cushion for undertaking the necessary reforms, developing economies may also increase reliance on foreign borrowing to ease any adjustment to external shocks.However, if the debt-service burden is not to increase unduly, such borrowing should be channelized into productive investments which are able to earn economic rates of return at least equal to real interest paid on the loans. In the process, a country can even afford to a secrifice growth in the short run because over the long run the productive investments are bound to earn high rates of return contributing to enhanced growth.

Moreover, since direct foreign investment (DFI) offers a low - risk strategy of growth, it is preferable to borrowing as the risk,to a large extent, is borne by the foreign investor.However,it is not only the volume but direction of DFI that is of paramount importance. While DFI in export industries does contribute to growth, DFI in industries operating behind high protection entails a net loss of foreign exchange for the host country, particularly if the foreign exchange cost of materials and machinery exceeds the c.i.f. import value of the product.

The experience the NICs finally show that no developing country can or should isolate itself from the world economy but should take advantage of the possibilities of international trade and capital flows. Of course,it is quite true that by linking itself to the world economy, a country also exposes itself to external shocks and experiences disturbances that originate outside the country.It is the coping with such shocks that is the most crucial test for the country.After all, any development program that does not contribute to growth or detracts seriously from growth becomes self - defeating.

Objective of the Study :

The present study proposes to provide an insight into the externally - related sources of a growth of country under alternative regimes of development strategy. In the process, it tries to analyse the positive or negative impact of these external linkages which may enable the researcher to put forward any policy implications that may emerge upon the conclusion of the study.It is quite possible that the same factors which emerge strong under one development regime may turn out to be weak in enhancing growth under alternative regime.

The specific objective of the present study is to test major hypotheses relating to various aspects of a country's orientation to the outside world and its impact on growth.These hypotheses are :

[1] Foreign capital in the form of loans and aid will have a positive impact on the borrower country's growth under an outward-looking development regime and negative impact under an inward-looking one.

[2] Direct foreign investment will earn a positive return and raise the level of growth in an outward-looking economy and negative return and lower growth in a protection-induced inward-

looking economy.

[3] Increase in the proportion of exports in domestic production (GDP) in the initial stages of development entails a net loss of growth to the economy.

[4] Growth in the developed world will, over time ,`trickle down' to the developing world through trade,capital and technology flows which, in turn, will stimulate growth in the latter.

Methodology :

Openness, as defined and understood in the present study, is an access not only to trade but also technology and capital flows,particularly in the form of direct foreign investment.Following this definition, an externally - oriented model of economic growth is framed which incorporates, besides capital, all those sources of growth that flow from outside the country i.e. foreign sources. The model does not include labour since it is assumed to be exogenous i.e. determined by demographic factors whereas capital is considered to be endogenous i.e. determined by the working of the economic system itself[2]. Furthermore, growth is understood to be that as measured by the rate of growth of real GNP per capita. The major foreign sources that flow into a country are identified under three classifications :

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2. For a more lucid argument refer chapter an `Research Methodology' , note 1.

[1] Trade flows :

A country's trade flows consist chiefly of exports and imports of goods - final as well as intermediate. These include manufactured, primary as well as capital goods.

[2] Capital flows (Financial) :

The model incorporates all kinds of financial capital inflows of a country viz. borrowing in the form of loans and aid.Basically all forms of financial flows on government account are included-concessional as well as non-concessional.

[3] Technology flows :

The present study identifies two major forms of technology flows-direct foreign investment and import of capital goods-final and intermediate and thus incorporates the same in the model.It is to be noted that only import of capital goods are considered as technology flows and not the total imports.It is in terms of a wider participation in the international economy mainly with respect to [1] and [3], that outward orientation and openness are alternatively used in the present study.

After having identified the major foreign sources,the model sets out to incorporate them through various equations. The traditional model of growth with capital and labor is modified to include all such foreign inflows excluding labor on grounds specified earlier.

Thus,

$$g = f\ (kd, x, m, fb, fa, dfi) \qquad (1)$$

where

g = rate of growth of real GNP per capita

kd = gross fixed capital formation as a proportion of Gross Domestic Product (GDP) at current prices.

x = growth rate of exports at constant prices.

m = growth rate of imports at constant prices.

fb = foreign borrowing which constitutes the debt obligations of the country viz. non-concessional loans as a proportion of Gross National Product (GNP) at current prices.

fa = foreign aid or grants i.e. concessional borrowing as a proportion of GNP at current prices.

dfi = direct foreign investment as a proportion of GDP.

The aggregate growth equation is then disaggregated to analyse the determinants of the growth variables of equation. (1) These determinants are called the intermediate or disaggregated determinants of growth. Firstly, the major determinants of a country's capital formation (kd) are identified as foreign borrowing(fb), foreign aid(fa), direct foreign investment(dfi) and import of capital goods. Thus,

$$kd = f(fb, fa, dfi, mk) \quad (2)$$

where

mk = capital imports as a proportion of total imports (percentage).

Secondly, the major determinants of exports are gross domestic output, export price, real exchange rate and foreign demand for domestic country's exports i.e.

$$x = f(gd, Px, R, Yic) \quad (3)$$

where

gd = growth rate of GDP at constant prices.

Px = Export unit value index taken as a proxy for export price.

R = Real exchange rate.

Yic = growth rate of index of GDP of industrial countries identified as foreign demand for domestic country's exports.

Thirdly, the determinants of imports are identified as

$$m = f(gd, Pm/P, R, FER) \quad (4)$$

Where gd and R are as defined in equation (3)

Pm/P = Import unit value deflated by the wholesale price index (WPI) taken as a proxy for real import price.

FER = Foreign exchange reserves identified as import capacity of the domestic country.

Equation (3) and (4) are also tested by replacing Px and Pm/P with the net barter and income terms of trade, Tn and Ti respectively. Thus the additional forms of equations (3) and (4) are

$$x = f(gd, Tn, R, Yic) \quad (3.1)$$

and

$$m = f(gd, Ti, R, FER) \quad (4.1)$$

Since Tn mainly affects exports it is incorporated in equation (3) for exports whereas Ti, more commonly also defined as purchasing power of exports (amount of imports available for a given volume of exports) is incorporated only in equation (4) for imports.

All the above equations (1) to (4.1) which are in linear forms are tested using the ordinary least squares (OLS) method of multiple regression analysis.

Since the aim is to compare the results under alternative development regimes, two countries are selected as comparative indicators to India. These are (a) South Korea, which is taken as a representative of outward-looking policy regimes with equal favours to export promotion as well as import substitution and (b) Brazil, which is an example of a successful import - substitution strategy.

Equations (3) and (4) are also tested in their logarithmic forms so that the coefficients can be interpreted as elasticities. The time period of the study stretches from 1950 to 1989 so as to analyse the countries' four decades of development process from inception to the present which is further divided into sub - periods on the basis of shifts in policy orientation for all three countries.

The data for majority of the variables are obtained from various issues of International Financal Statistics Yearbooks for all three countries. As far as possible, local statistical publications for India are deliberately not used except where certain data are not available, so as to maintain consistency and comparability of results. Moreover, all figures are converted to US dollar year-end official exchange rates (for foreign debt and aid) and period-average offical exchange rates (for all other variables.)