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THIRD SESSION

MEMORANDUM ON THE REPORT OF THE FIRST SESSION OF THE SUB-COMMISSION ON ECONOMIC DEVELOPMENT (DOCUMENT E/CN.1/47) SUBMITTED BY THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

(Item 8 of the Provisional Agenda, document E/CN.1/48)

The following communication containing comments on the Report of the First Session of the Sub-Commission on Economic Development was received from the International Bank for Reconstruction and Development:

INTERNATIONAL BANK FOR RECONSTRUCTION
AND DEVELOPMENT
Washington 6, D.C.

Office of the President

March 31, 1948

The Honorable
Trygve Lie
Secretary-General
United Nations
Lake Success, New York

Dear Mr. Lie:

I am enclosing herewith a memorandum dated March 31 prepared by the staff of the International Bank, and approved by the Bank's Executive Directors, containing certain comments on the Report of the First Session of the Sub-Commission on Economic Development of the United Nations Economic and Employment Commission.

I am sending this memorandum to you at this time so that it may be considered by the Economic and Employment Commission at its next session in conjunction with its consideration of the Report of the Economic Development Sub-Commission.

Sincerely yours,

(signed) John J. McCloy

Enclosure

/INTERNATIONAL

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

STAFF MEMORANDUM

31 March 1948

Analysis of Report of First Session of United Nations Sub-Commission on Economic Development

The staff of the Bank has carefully reviewed the Report prepared by the Sub-Commission on Economic Development of the United Nations Economic and Employment Commission, covering the Sub-Commission's First Session from 17 November to 16 December 1947. This Report requires serious consideration, because it constitutes the first comprehensive statement by an organ of the United Nations on the subject of economic development and will therefore doubtless have considerable influence on the future work of national governments and international agencies in this field.

The Bank's policy on the financing of economic development must, it is believed, be based on the assumption that the primary purpose of such development is to promote an increase in real income per capita, primarily within the country in question. The same concept of the objective of economic development is implied in the Sub-Commission's definition, contained in Part V, paragraph 2 of the Report. In outlining the principles which, in the Sub-Commission's view, will best promote this objective, the Report brings out a number of significant and valuable points. But it also includes some general statements which do not seem fully consistent with the Sub-Commission's initial formulation of its purpose, or which for other reasons appear to need some clarification. It may therefore prove useful to set forth certain views of the Bank's staff on some of the principal matters discussed in the Report, for consideration in conjunction with the Report.

A. The Pattern of Development

An increase in production, which will lead to the desired rise in real income per capita, depends basically upon the introduction of capital goods (tools, housing, transportation and communication facilities, etc.) in so-called "backward" areas. This increase in capital normally involves also an improvement in production techniques, resulting from more efficient organization and management of the production processes and better training of workers, as well as from the substitution of more mechanized for manual methods. The basic problems of economic development are those involved in obtaining capital and assuring its application in a way which will best contribute to increasing productivity and living standards.

/The application

The application of capital in under-developed areas may take place in many different forms - as shown by the varying patterns of historical development in different areas and countries. Thus development may involve principally the mechanization of agriculture and improvement of agricultural land through irrigation or fertilization, or the application of modern extractive methods in mining, or the use of more efficient processing methods for agricultural and mineral products, or the growth of light consumer goods industries, or the establishment of so-called heavy industries, or many other types of capitalization. Normally a major part of development capital will have to be devoted in any case to providing such basic facilities as housing, transportation, communications and power, but the exact nature and location of these facilities will vary widely according to the type of development that is undertaken.

All these forms of capitalization are comprised in the term "industrialization" in its broadest meaning. The more highly industrialized any country is, in the sense of the most effective equipment of labour with capital, the higher will be its standard of living and the greater its productivity. But this is true only if the industrialization proceeds along economic lines, which means that the type of development and its timing must be determined in the light of the natural resources of the country under development, the density of its population and their level of education or technical training, the world demand for the portion of its products which that country intends to export, the availability and cost of the necessary capital, etc.

In the case of some countries the most effective means of development may be the industrialization of agriculture and related activities - i.e. the production of agricultural tools and equipment, the processing of agricultural products, the necessary public utilities, etc. This is the pattern of development which has given New Zealand, for example, one of the highest standards of living in the world; Denmark is another case in point.

In other countries, notably those with excess rural population, with mostly unskilled labour and without resources peculiarly adapted to heavy industry, primary emphasis should normally be placed in the first instance upon the development of light consumer goods industries.* Such industries, by definition, employ small amounts of specialized capital

* The distinction between light and heavy industries, as used in this memorandum, is based on the amount of capital employed per head of worker. For example, many consumer goods and engineering industries are light, while smelting, steel mill, and also some food processing industries, are heavy, within the meaning of those words as here used.

/equipment

equipment per worker and usually contribute more than heavy industry to an immediate rise in the standard of living. They can build upon traditional craft skills in the introduction of mechanized techniques. The capital investment required for the mechanization of many consumption goods industries is not necessarily large - once the necessary transportation, power and other basic facilities are provided - and may often be within the reach of local initiative. The short-run result of this type of industrial development, therefore, is a relatively quick increase in simple consumption goods; this tends further to stimulate development by increasing the health and efficiency of the consumer population and by providing them with incentives for further productive effort. Given reasonably adequate public utilities, the scale of useful capital investment in light industries can be relatively continuous, requiring no very large single investment for a further increase of output.

In many cases, the development of heavy manufacturing industries may have to be delayed until after progress has been made in building up the simpler and more immediately productive light industries. This principle is, of course, subject to many individual exceptions, particularly where the existence of the requisite natural resources and the world demand situation indicate the advisability of proceeding promptly with the establishment of some particular heavy industry. Since, however, in most cases the capital required for investment in basic industries and public utilities which employ large amounts of capital per head of worker and are not directly remunerative may amount to as much as two-thirds of the total investment, it is important to allot the remaining third in such a way that the maximum number of workers can be profitably employed; this argues against the diversion of even more capital from light to heavy industry. One worker employed, for example, in smelting in an over-populated area may require as much capital as ten or more workers in light industries, or to put it in other terms, the cost of his employment may be the total or disguised unemployment of ten other workers. And finally, since the products of heavy industry are frequently not finished consumption goods, its development is relatively less effective in convincing the mass of the people of the advantages to them of further economic development.

Thus economic development must be conceived as a continuous process, in which each increase in capitalization will lead to a further increase. Moreover, it must be synchronized, so that the various aspects of the economy - agriculture, industry and public utilities - will develop

/simultaneously;

simultaneously; otherwise economic disequilibrium will be aggravated. The planning of development should not be confined to national lines, but should be effectively co-ordinated within major geographical areas. It should take account also of possibilities of migration - of moving manpower to resources.

Development, especially of heavy industry, should be so timed as to take account of world prices and other economic conditions. Deliberate anti-cyclical timing of heavy international investment is of great benefit to both capital-importing and capital-exporting countries. At present, the cost of capital equipment is unusually high, because of extraordinary demand and the low output of many normal producing countries. New heavy industries developed now, therefore, might be saddled with an exhorbitant capital cost which would undermine their economic strength and their ability to compete with other producers. Moreover, stimulation of new industries which would not be fully productive for some time to come would tend to aggravate inflationary pressures, both in the country from which the necessary equipment is purchased and, even more seriously, in the country under development. In some cases the urgent need or economic value of a certain type of industry may override these considerations and dictate its immediate development, but the difficulties should be clearly understood so that the merits of each case may be weighed intelligently.

The Sub-Commission's Report, although properly stressing that economic development must be thought of largely in terms of industrialization, does not, in our opinion, sufficiently analyze the nature of the industrialization process as sketched above, and in some places seems to over-simplify the issue by viewing industrialization as synonymous with the development of manufacturing plants, particularly heavy industries.

It is true that the Sub-Commission's emphasis on the development of factory industries is qualified in some degree by its recognition of "the need for due attention to the development of agriculture, particularly the production of food, in national development programmes". However, the general tenor of the Report might create the impression that the Sub-Commission was of the view that agriculture and the production of raw materials should be assigned a place subordinate to manufacturing. Yet it is precisely foodstuffs and certain basic raw materials which are now most seriously lacking throughout the world, and the deficiency in food is especially apparent in some of the least developed countries. Many of the most important resources of these products, actual and potential, are located in under-developed areas; it is essential, therefore, to consider in

/each case

each case whether development of such resources or of particular manufacturing projects would produce quicker and surer returns.

This is not to deny that sound economic development in many, if not most, countries will require growth of factory industries at an appropriate rate. Specifically they may be necessary even in largely agricultural countries to create effective demand for agricultural products and at the same time to increase incentives for agricultural production by making available manufactured consumption goods. But it is clear that the rising national income resulting from such development does not originate in factory industry as such. Rather it stems from the more efficient use of labour in all activities which become adequately capitalized. The economic "backwardness" of under-developed countries is due essentially to the fact that they do not have enough housing and equipment (especially public capital), and that they do not use modern types of capital equipment and technical methods, in all phases of production, not simply in manufacturing industries.

The necessity for a more analytical consideration of the concept of "industrialization" is reinforced by the Report's emphasis on

> the need for establishing key industries in the country, even though such industries may not satisfy strictly economic criteria in terms of comparative costs. Recent experience has demonstrated the dependence of political freedom and national security upon the economic independence of the country, particularly with respect to certain basic sectors of the economy. (Part V, paragraph 6 (b)).

If this paragraph is intended to stress the need for considering not only the direct financial return from a single enterprise, but also its contribution to the national and international economy as a whole, in deciding upon its soundness, it is clearly correct. It is subject to possible interpretation, however, as a blanket encouragement to each individual country to strive for a high degree of industrial self-sufficiency - that is, to develope its own steel industry, chemical industry, electrical equipment industry, machine tool industry, etc. - in order to insulate itself against the insecurities of the world market. If such a policy were generally followed the result would be to narrow rather than broaden the world economy, to waste precious capital and technical skills by devoting them to uneconomic enterprises, to forfeit in large measure the technological advantages of mass production and mass markets, and to require the more productive elements of the national economy to subsidize industries which cannot stand on their own feet.

/It is recognized,

It is recognized, of course, that certain measures of protection against foreign competition may be necessary for a time to allow industries which have good long-run prospects to get firmly established; but that is quite different from a general policy of establishing industries which do not "satisfy strictly economic criteria in terms of comparative costs". It is, of course, desirable to minimize the adverse effects of international economic instability, but not by encouraging the establishment of small inefficient national production units; rather this aim will be best achieved under a system of expanding, not contracting international trade - although the proportion of national income derived from such trade may gradually be falling as the income itself rises, since the bulk of any additional production will normally go into domestic markets. Finally, it is suggested that unless national development plans take adequate account of costs and efficiency, in terms of the "social net product", no very large flow of international development capital can be expected.

B. The Financing of Development

The Sub-Commission recognizes, in Part VI, paragraph 1, "that the finances required for economic development have to come largely from the efforts of the peoples concerned, from the improvement in their national economic structures, and from increasing national productivity"; but its principal stress is laid on the necessity for "a considerable measure of foreign financing.....in promoting economic development". It concludes, in Part VI, paragraph 4, that

> An examination of the main sources of international loans for development indicates that the total volume of available funds is entirely inadequate to the needs of development. If economic development is to progress more rapidly during the next few years, a larger and better regulated flow of foreign funds than is currently available will have to be promoted by and through international agencies working within the framework of the United Nations.

Part VI of the Report, entitled International Action in the Field of Economic Development, is basically a brief outlining the need for increased international financial assistance. Such a brief is valuable, for the need is unquestionably very great. It is not clear, however, to what agency or groups the Sub-Commission is addressing its final recommendation (Part VII, paragraph 3 A (5)) "that immediate international provision be made for those under-developed countries by way of finance, food and equipment" - nor how this recommendation is to be implemented.

/Financing

Financing through International Bank and inter-governmental channels can be especially useful in helping to provide the framework of public utilities and key industries required for sound development, which may require too heavy an initial outlay and may not be directly remunerative enough to attract private investors. But in general, under existing conditions, only private capital can be expected to provide financing in sufficient amounts for really large-scale development. Such capital, too, normally brings with it much-needed technical know-how and managerial skills. It is essential, therefore, that the under-developed countries do all that they can to promote their own development by stimulating local initiative and encouraging the mobilization of local capital for productive purposes, and that they take appropriate measures, consistent with adequate protection of their own interests, to attract foreign private capital. Consideration must also be given by the capital-exporting countries to the possibility of creating new techniques to encourage the flow of capital abroad.

Although foreign capital may play an indispensable role in stimulating development activity and may greatly ease the strains associated with the development process, nevertheless the major contribution to economic development must be made by local finance and initiative. The Sub-Commission properly stresses this fact in several places. It is important, therefore, that the governments of under-developed countries establish an atmosphere and develop financial mechanisms which will encourage the use of local capital to maximum effect. In some cases such capital is not now fully utilized - either because domestically-held funds are hoarded, or held abroad, or used for speculation or other non-productive purposes; or because there is no efficient machinery for channeling these funds into development activity. The methods appropriate to encourage productive investment of this local capital will vary according to differing national circumstances; the Sub-Commission correctly emphasized the desirability of "examination of a country's monetary, banking and fiscal machinery with a view to making it as effective as possible for development purposes". (Part V, paragraph 15 (c)). The creation of an active local capital market may be of great importance in promoting the efficient use of domestic capital and encouraging its continuing flow into development. In some countries the sums involved are quite substantial and their effective use at strategic points in the national economy will often greatly increase the rapidity of development, will reduce the problems associated with foreign financing and will, at the same time, help to attract the necessary foreign assistance.

The various national governments may also be able to help in promoting an increased flow of international development capital by removing, or at least mitigating, deterrents to foreign lending and investment. In some countries, for example, international lending and investment may be discouraged by an unsound domestic financial situation or by discriminatory regulation of foreign capital. In other cases defaults on past loans have impaired the public credit and prevented or delayed the granting of additional assistance; however, the original terms of some of these defaulted obligations are now manifestly too onerous and modifications should be negotiated. Where difficulties of this kind exist, they clearly have an important adverse effect on the availability of foreign capital, on interest rates, on the period of time for which loans are granted, on the conditions attached to such loans, and so on.

Lending countries also have a parallel responsibility to help in creating conditions and mechanisms which will encourage a greater flow of development capital on equitable terms. Certainly it is not to be expected that borrowing and lending methods in the twentieth century will take the same forms as the nineteenth; new forms and new institutions of private investment must be devised. To achieve a maximum flow of development capital on reasonable terms there must be a fair accommodation of the interests of both capital-exporting and capital-importing countries. Under present circumstances no international organization can compel the investment of capital abroad. There must be some inducement, or at least some assurance of security, to attract private funds, or to persuade responsible governments to make advances to foreign countries. Unless the plans and policies of under-developed countries inspire confidence in their economic soundness, such advances would be made only on political grounds and would be subject to the dangers mentioned in that connection by the Sub-Commission.

Moreover, with regard to direct private investment, it is worth noting that the financing of development by equity capital has some positive advantages from the standpoint of the under-developed countries; it permits a flexibility, initiative and efficiency which is often impossible for government organs; it ensures that unsound investments do not burden or impair the public credit; since its returns depend on actual profits it does not, in bad times, impose an inflexible burden on the public treasury or balance of payments of the "borrowing" country; and it often is

/accompanied

accompanied by managerial and technical assistance of a calibre that would be difficult to obtain in any other way. The Sub-Commission's Report notes, in Part V, paragraph 6 (d), the importance of stimulating "the spirit of enterprise - the spirit that, historically, has played so large a role in economic development;" that spirit, under proper regulation in the public interest, can be as beneficial in motivating foreign financing as in domestic business. Finally, there are certain types of development activity which - because of their experimental nature, or the risks involved, or their close affiliation with other fields of private commercial enterprise - are especially suited to the investment of private equity capital.

It is important, of course, to provide for necessary regulation of private enterprises to prevent waste of the resources of the country under development or abuse of the rights of its citizens. On the other hand, such safeguards should not be so restrictive as seriously to inhibit the flow of capital into productive channels. Foreign investors of equity capital must recognize also that withdrawal of earnings in very large amounts may often create serious balance of payments difficulties for the country in which the investment is located and that for this reason, and to promote further development it is desirable that there be substantial reinvestment of such earnings within the country.

It is important, however, that development programmes should not be so formulated or administered as to obstruct the continuance of emergence of an expert surplus, and the use of an appropriate part of this surplus for international debt service and re-payments. The Sub-Commission rightly observes (Part VI, paragraph 15) that, fundamentally, "it is technological advance and the accompanying increase in national productivity which enables a country to carry the burden of its loan charges and also to repay the loan". But it must not be overlooked in the context of international investment that these changes do not of themselves solve subsequent transfer problems in the international balance of payments. Development programmes which include assistance from foreign capital must take this consideration into account.

C. The Role of International Organs

The United Nations and the Specialized Agencies concerned with economic development have a special responsibility, and also an extraordinary opportunity, to give practical assistance to the under-developed countries in making the best possible use of the domestic resources of those countries and of the foreign aid which may be available. These agencies, because of

/their international

their international character, are in a position, when requested by member governments, to analyze objectively the most promising fields for development activity in various countries or regions, to determine which are likely to produce the most immediate and substantial results in the light of local and world requirements and resources. Such analyses could not, of course, take the place of national programmes, but they could help to provide an international perspective which is too often lacking in such programmes.

Some under-developed countries undoubtedly have an exaggerated impression of the amounts of foreign aid they are likely to receive or, indeed, are able to absorb, and a somewhat unrealistic conception of the conditions under which foreign financing will be available. It is important that they be able to obtain practical advice on these questions from objective international sources so that they may be able to make the best possible use of the funds available. They should be encouraged for the immediate future to concentrate on the essential public services which are necessary to any integrated economy - primarily transportation, communication and power facilities in the most promising areas - and, in most cases, on relatively small projects of assured productive value (some of which, at least, could be undertaken with local capital resources), and generally to postpone more expensive heavy industry until a more favourable time. Otherwise a good deal of precious time, money and enthusiasm may be wasted.

The international agencies should be ready to provide expert assistance to under-developed countries, primarily by heldping them to select and procure competent independent experts who can assist them in the preparation of technically sound national development plans and in putting domestic financial systems and policies on a firm basis.

Finally, the international agencies might well undertake an investigation of the obstacles which now hamper the flow of international capital in sufficient amounts, and of measures which might be taken to stimulate the flow. Despite the reluctance of many countries to accept the need for extensive participation by private capital in development, it remains true, as has already been pointed out, that the major part of any external financial assistance which may be available for development in the foreseeable future must come from private sources. The under-developed countries should be able to obtain sound and disinterested advice from the international agencies as to the measures they can take to stimulate the flow of such private capital on reasonable terms and at the same time

/protect

protect their own interests against abuses resulting from irresponsible private activities.

It seems necessary to comment briefly in conclusion on two specific references to the International Bank contained in the Report of the Sub-Commission. In Part VI, paragraph 7, it states: "There are certain dangers involved in having recourse to the International Bank". These "dangers" are not explained and in its present form the statement is clearly objectionable. In the footnote to paragraph 27, Part VI, it is stated that

> The majority of the Sub-Commission felt that the whole question (of the agreement between the Bank and the United Nations) required more thorough examination than has been given to it, with a view to suggesting an eventual revision of the agreement.....

There is no objection, of course, to any member of the United Nations proposing an examination of the agreement between the United Nations and the Bank, but the need for revision of that agreement should certainly not be prejudged.
