U.S. FOREIGN INVESTMENT IN UNDERDEVELOPED AREAS

THE DISTRIBUTION OF GAINS BETWEEN INVESTING AND BORROWING COUNTRIES[1]

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International trade is of very considerable importance to underdeveloped countries, and the benefits which they derive from trade and any variations in their trade affect their national incomes very deeply. The opposite view, which is frequent among economists, namely, that trade is less important to the underdeveloped countries than it is to industrialized countries, may be said to derive from a logical confusion —very easy to slip into—between the absolute amount of foreign trade which is known to be an increasing function of national income, and the ratio of foreign trade to national income. Foreign trade tends to be proportionately most important when incomes are lowest. Secondly, fluctuations in the volume and value of foreign trade tend to be proportionately more violent in that of underdeveloped countries and therefore *a fortiori* also more important in relation to national income. Thirdly, and *a fortissimo,* fluctuations in foreign trade tend to be immensely more important for underdeveloped countries in relation to that small margin of income over subsistence needs which forms the source of capital formation, for which they often depend on export surpluses over consumption goods required from abroad.

In addition to the logical confusion mentioned above, the great importance of foreign trade to underdeveloped countries may also have been obscured by a second factor; namely, by the great discrepancy in the productivity of labor in the underdeveloped countries as between the industries and occupations catering for export and those catering for domestic production. The export industries in underdeveloped countries, whether they be metal mines, plantations, etc., are often highly capital-intensive industries supported by a great deal of imported foreign technology. By contrast, production for domestic use, specially of food and clothing, is often of a very primitive subsistence

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nature. Thus the economy of the underdeveloped countries often presents the spectacle of a dualistic economic structure: a high productivity sector producing for export coexisting with a low productivity sector producing for the domestic market. Hence employment statistics in underdeveloped countries do not adequately reflect the importance of foreign trade, since the productivity of each person employed in the export sector tends to be a multiple of that of each person employed in the domestic sector. Since, however, employment statistics for underdeveloped countries are notoriously easier to compile than national income statistics, it is again easy to slip, from the fact that the proportion of persons employed in export trade is often lower in underdeveloped countries than in industrialized countries, to the conclusion that foreign trade is less important to them. This conclusion is fallacious, since it implicitly assumes rough equivalence of productivity in the export and domestic sectors. This equivalence may be safely assumed in the industrialized countries but not in the underdeveloped countries.

A third factor which has contributed to the view that foreign trade is unimportant in underdeveloped countries is the indisputable fact that in many underdeveloped countries there are large self-contained groups which are outside the monetary economy altogether and are therefore not affected by any changes in foreign trade. In industrialized countries, by contrast, it is true that repercussions from changes in foreign trade are more widely spread; but they are also more thinly spread.[2]

The previously mentioned fact, namely, the higher productivity of the foreign trade sector in underdeveloped countries might, at first sight, be considered as a cogent argument in favor of the view that foreign trade has been particularly beneficial to underdeveloped countries in raising their general standards of productivity, changing their economies in the direction of a monetary economy, and spreading knowledge of more capital-intensive methods of production and modern technology. That, however, is much less clearly established than might be thought. The question of ownership as well as of opportunity costs enters at this point. The productive facilities for producing export goods in underdeveloped countries are often foreign owned as a result of previous investment in these countries. Again we must beware of hasty conclusions. Our first reaction would be to argue that this fact further enhances the importance and benefits of trade to underdeveloped coun-

[2] A more statistical factor might be mentioned. Some underdeveloped countries—Iran would be an illustration—exclude important parts of their exports and imports from their foreign trade statistics insofar as the transactions of foreign companies operating in the underdeveloped country are concerned. This is a tangible recognition of the fact that these pieces of foreign investments and their doings are not an integral part of the underdeveloped economy.

tries since trade has also led to foreign investment in those countries and has promoted capital formation with its cumulative and multiplier effects. This is also how the matter is looked at in the economic textbooks—certainly those written by nonsocialist economists of the industrialized countries. That view, however, has never been really accepted by the more articulate economists in the underdeveloped countries themselves, not to mention popular opinion in those countries; and it seems to the present writer that there is much more in their view than is allowed for by the economic textbooks.

Can it be possible that we economists have become slaves to the geographers? Could it not be that in many cases the productive facilities for export from underdeveloped countries, which were so largely a result of foreign investment, never became a part of the internal economic structure of those underdeveloped countries themselves, except in the purely geographical and physical sense? Economically speaking, they were really an outpost of the economies of the more developed investing countries. The main secondary multiplier effects, which the textbooks tell us to expect from investment, took place not where the investment was physically or geographically located but (to the extent that the results of these investments returned directly home) they took place where the investment came from.[3] I would suggest that if the proper economic test of investment is the multiplier effect in the form of cumulative additions to income, employment, capital, technical knowledge, and growth of external economies, then a good deal of the investment in underdeveloped countries which we used to consider as "foreign" should in fact be considered as domestic investment on the part of the industrialized countries.

Where the purpose and effect of the investments was to open up new sources of food for the people and for the machines of industrialized countries, we have strictly domestic investment in the relevant economic sense, although for reasons of physical geography, climate, etc., it had to be made overseas. Thus the fact that the opening up of underdeveloped countries for trade has led to or been made possible by foreign investment in those countries does not seem a generally valid proof that this combination has been of particular benefit to those countries. The very differential in productivity between the export sectors and the domestic sectors of the underdeveloped countries, which was previously mentioned as an indication of the importance of foreign trade to underdeveloped countries, is also itself an indication that the more productive export sectors—often foreign owned—have not become a real part of the economies of underdeveloped countries.

[3] Often underdeveloped countries had the chance, by the judicious use of royalties or other income from foreign investment, to use them for the transformation of their internal economic structure—a chance more often missed than caught by the forelock!

We may go even further. If we apply the principle of opportunity costs to the development of nations, the import of capital into underdeveloped countries for the purpose of making them into providers of food and raw materials for the industrialized countries may have been not only rather ineffective in giving them the normal benefits of investment and trade but may have been positively harmful. The tea plantations of Ceylon, the oil wells of Iran, the copper mines of Chile, and the cocoa industry of the Gold Coast may all be more productive than domestic agriculture in these countries; but they may well be less productive than domestic industries in those countries which might have developed if those countries had not become specialized to the degree in which they now are to the export of food and raw materials, thus providing the means of producing manufactured goods elsewhere with superior efficiency. Admittedly, it is a matter of speculation whether in the absence of such highly specialized "export" development, any other kind of development would have taken its place. But the possibility cannot be assumed away. Could it be that the export development has absorbed what little entrepreneurial initiative and domestic investment there was, and even tempted domestic savings abroad? We must compare, not what is with what was, but what is with what would have been otherwise—a tantalizingly inconclusive business. All we can say is that the process of traditional investment taken by itself seems to have been insufficient to initiate domestic development, unless it appeared in the form of migration of persons.

The principle of specialization along the lines of static comparative advantages has never been generally accepted in the underdeveloped countries, and not even generally intellectually accepted in the industrialized countries themselves. Again it is difficult not to feel that there is more to be said on the subject than most of the textbooks will admit. In the economic life of a country and in its economic history, a most important element is the mechanism by which "one thing leads to another," and the most important contribution of an industry is not its immediate product (as is perforce assumed by economists and statisticians) and not even its effects on other industries and immediate social benefits (thus far economists have been led by Marshall and Pigou to go) but perhaps even further its effect on the general level of education, skill, way of life, inventiveness, habits, store of technology, creation of new demand, etc. And this is perhaps precisely the reason why manufacturing industries are so universally desired by underdeveloped countries; namely, that they provide the growing points for increased technical knowledge, urban education, the dynamism and resilience that goes with urban civilization, as well as the direct Marshallian external economies. No doubt under different circumstances commerce, farming, and plantation agriculture have proved capable of being such "growing points," but manufacturing industry is unmatched in our present age.

By specializing on exports of food and raw materials and thus making the underdeveloped countries further contribute to the concentration of industry in the already industrialized countries, foreign trade and the foreign investment which went with it may have spread present static benefits fairly over both. It may have had very different effects if we think of it not from the point of view of static comparative advantages but of the flow of history of a country. Of this latter school of thought the "infant" argument for protection is but a sickly and often illegitimate offspring.

To summarize, then, the position reached thus far, the specialization of underdeveloped countries on export of food and raw materials to industrialized countries, largely as a result of investment by the latter, has been unfortunate for the underdeveloped countries for two reasons: (*a*) because it removed most of the secondary and cumulative effects of investment from the country in which the investment took place to the investing country; and (*b*) because it diverted the underdeveloped countries into types of activity offering less scope for technical progress, internal and external economies taken by themselves, and withheld from the course of their economic history a central factor of dynamic radiation which has revolutionized society in the industrialized countries. But there is a third factor of perhaps even greater importance which has reduced the benefits to underdeveloped countries of foreign trade-*cum*-investment based on export specialization on food and raw materials. This third factor relates to terms of trade.

It is a matter of historical fact that ever since the seventies the trend of prices has been heavily against sellers of food and raw materials and in favor of the sellers of manufactured articles. The statistics are open to doubt and to objection in detail, but the general story which they tell is unmistakable.[4] What is the meaning of these changing price relations?

The possibility that these changing price relations simply reflect relative changes in the real costs of the manufactured exports of the industrialized countries to those of the food and primary materials of the underdeveloped countries can be dismissed. All the evidence is that productivity has increased if anything less fast in the production of food and raw materials, even in the industrialized countries[5] but

[4] Reference may be made here to the publication by the Economic Affairs Department of the United Nations on "Relative Prices of Exports and Imports of Under-developed Countries."

[5] According to U.S. data of the WPA research project, output per wage earner in a sample of 54 manufacturing industries increased by 57 per cent during the twenty years,

most certainly in the underdeveloped countries, than has productivity in the manufacturing industries of the industrialized countries. The possibility that changing price relations could merely reflect relative trends in productivity may be considered as disposed of by the very fact that standards of living in industrialized countries (largely governed by productivity in manufacturing industries) have risen demonstrably faster than standards of living in underdeveloped countries (generally governed by productivity in agriculture and primary production) over the last sixty or seventy years. However important foreign trade may be to underdeveloped countries, if deteriorated terms of trade (from the point of view of the underdeveloped countries) reflected relative trends of productivity, this could most assuredly not have failed to show in relative levels of internal real incomes as well.

Dismissing, then, changes in productivity as a governing factor in changing terms of trade, the following explanation presents itself: the fruits of technical progress may be distributed either to producers (in the form of rising incomes) or to consumers (in the form of lower prices). In the case of manufactured commodities produced in more developed countries, the former method, i.e., distribution to producers through higher incomes, was much more important relatively to the second method, while the second method prevailed more in the case of food and raw material production in the underdeveloped countries. Generalizing, we may say that technical progress in manufacturing industries showed in a rise in incomes while technical progress in the production of food and raw materials in underdeveloped countries showed in a fall in prices. Now, in the general case, there is no reason why one or the other method should be generally preferable. There may, indeed, be different employment, monetary, or distributive effects of the two methods; but this is not a matter which concerns us in the present argument where we are not concerned with internal income distribution. In a closed economy the general body of producers and the general body of consumers can be considered as identical, and the two methods of distributing the fruits of technical progress appear merely as two formally different ways of increasing real incomes.

When we consider foreign trade, however, the position is fundamentally changed. The producers and the consumers can no longer be con-

1919-39; over the same period, agriculture increased only by 23 per cent, anthracite coal mining by 15 per cent, and bituminous coal mining by 35 per cent. In the various fields of mineral mining, however, progress was as fast as in manufacturing. According to data of the National Bureau of Economic Research, the rate of increase in output per worker was 1.8 per cent p.a. in manufacturing industries (1899-1939) but only 1.6 per cent in agriculture (1890-1940) and in mining, excluding petroleum (1902-39). In petroleum production, however, it was faster than in manufacturing.

sidered as the same body of people. The producers are at home; the consumers are abroad. Rising incomes of home producers to the extent that they are in excess of increased productivity are an absolute burden on the foreign consumer. Even if the rise in the income of home producers is offset by increases in productivity so that prices remain constant or even fall by less than the gain in productivity, this is still a relative burden on foreign consumers, in the sense that they lose part or all of the potential fruits of technical progress in the form of lower prices. On the other hand, where the fruits of technical progress are passed on by reduced prices, the foreign consumer benefits alongside with the home consumer. Nor can it be said, in view of the notorious inelasticity of demand for primary commodities, that the fall in their relative prices has been compensated by its total revenue effects.

Other factors have also contributed to the falling long-term trend of prices of primary products in terms of manufactures, apart from the absence of pressure of producers for higher incomes. Technical progress, while it operates unequivocally in favor of manufactures—since the rise in real incomes generates a more than proportionate increase in the demand for manufactures—has not the same effect on the demand for food and raw materials. In the case of food, demand is not very sensitive to rises in real income, and in the case of raw materials, technical progress in manufacturing actually largely consists of a reduction in the amount of raw materials used per unit of output, which may compensate or even overcompensate the increase in the volume of manufacturing output. This lack of an automatic multiplication in demand, coupled with the low price elasticity of demand for both raw materials and food, results in large price falls, not only cyclical but also structural.

Thus it may be said that foreign investment of the traditional type which sought its repayment in the direct stimulation of exports of primary commodities either to the investing country directly or indirectly through multilateral relations, had not only its beneficial cumulative effects in the investing country, but the people of the latter, in their capacity as consumers, also enjoyed the fruits of technical progress in the manufacture of primary commodities thus stimulated, and at the same time in their capacity as producers also enjoyed the fruits of technical progress in the production of manufactured commodities. The industrialized countries have had the best of both worlds, both as consumers of primary commodities and as producers of manufactured articles, whereas the underdeveloped countries had the worst of both worlds, as consumers of manufactures and as producers of raw materials. This perhaps is the legitimate germ of truth in the charge that foreign investment of the traditional type formed part of a system of "economic imperialism" and of "exploitation."

Even if we disregard the theory of deliberately sinister machinations, there may be legitimate grounds in the arguments set out above on which it could be maintained that the benefits of foreign trade and investment have not been equally shared between the two groups of countries. The capital-exporting countries have received their repayment many times over in the following five forms: (*a*) possibility of building up exports of manufactures and thus transferring their population from low-productivity occupations to high-productivity occupations; (*b*) enjoyment of the internal economies of expanded manufacturing industries; (*c*) enjoyment of the general dynamic impulse radiating from industries in a progressive society; (*d*) enjoyment of the fruits of technical progress in primary production as main consumers of primary commodities; (*e*) enjoyment of a contribution from foreign consumers of manufactured articles, representing as it were their contribution to the rising incomes of the producers of manufactured articles.

By contrast, what the underdeveloped countries have to show cannot compare with this formidable list of benefits derived by the industrialized countries from the traditional trading-*cum*-investment system. Perhaps the widespread though inarticulate feeling in the underdeveloped countries that the dice have been loaded against them was not so devoid of foundation after all as the pure theory of exchange might have led one to believe.

It is, of course, true that there are transfer difficulties on the part of the underdeveloped countries which are avoided by production for export directly to the investing countries, but the above analysis may perhaps make a contribution to understanding why this traditional investment system broke down so rapidly and so irreparably in 1929 and 1930. The industrialized countries had already received real repayment from their foreign investments in the five forms described above, and in these ways they may have collected a pretty good return on their investments. When on top of the returns received in those five forms they also tried to "get their money back," they may perhaps have been asking (in the economic, though not in the legal, sense) for double payment; they may have been trying to get a quart out of a pint bottle.

There is a fairly widespread impression that this traditional trend towards deteriorating price relations for primary producers has been sharply reversed since prewar days, although this impression is not as strong now as it was in the middle of 1948. Even if we take that point of time, which represents the peak of postwar primary commodity prices up till now, a detailed analysis does not bear out the impression that terms of trade have significantly improved in favor of the underdeveloped countries since prewar days.[6]

It may be suggested that the impression that price relations have sharply improved for primary producers can be attributed partly to the abnormal composition of primary commodity imports into the U.S. where coffee plays a predominating part (coffee prices have increased particularly heavily in the immediate postwar period), and also specially to the widespread idea that foreign trade between underdeveloped countries and industrialized countries is an exchange of the primary commodities of the former for the capital goods of the latter. In fact, among the imports of the underdeveloped countries capital goods do not generally form the largest category, mainly because the import of capital goods from abroad requires a great deal of complementary domestic investment in those countries for which the domestic finance does not exist or is not mobilized.

The major proportion of the imports of the underdeveloped countries is in fact made up of manufactured food (especially in overpopulated underdeveloped countries), textile manufactures, and manufactured consumer goods. The prices of the type of food imported by the underdeveloped countries, and particularly the prices of textile manufactures, have risen so heavily in the immediate postwar period that any advantage which the underdeveloped countries might have enjoyed in the postwar period from favorable prices realized on primary commodities and low prices of capital goods has been wiped out.

A further factor which has contributed to the impression that relative price trends have turned sharply in favor of primary producers since the war is the deterioration in British terms of trade and the publicity which this deterioration has received because of the strategic importance of the British balance of payments in the network of world trade. It should, however, not be forgotten that the changes in British postwar terms of trade do not merely represent *ceteris paribus* price changes but reflect considerable quantum changes; namely, an increase in the quantity exported and a decrease in the quantity imported. It may be suggested, perhaps, that these quantum changes rather than underlying price changes account for the adverse trend before devaluation of British terms of trade. Unless it is to be assumed that the elasticity of demand for British exports is infinite, it is obvious that an expansion in the volume of total exports of manufactured goods by almost 100 per cent will be reflected in lower unit prices for British exports; conversely, the reduction in the quantity of British imports is also reflected in higher prices paid than would otherwise have been the case,

[6] For details see the above mentioned study of "Relative Prices of Exports and Imports of Under-developed Countries" (Economic Affairs Department of the United Nations).

partly as a reflection of the diminishing bargaining strength of Britain in consequence of lower imports and partly as a necessary political concession to primary producers to enable them to maintain their incomes in the face of lower quantities sold. The supposition that the changed quantity relations in British trade (as well as deliberate colonial development policies) are largely responsible for the adverse trend in British terms of trade rather than price changes in world markets is greatly strengthened by the fact that other Western European exporters of manufactured goods did not only fail to experience any deterioration in their terms of trade, but on the contrary showed improved terms of trade.[7] The effect of quantum changes on British terms of trade is of course difficult to disentangle statistically. It is more in the nature of a gain missed through inability of exploiting the postwar sellers' market price-wise to the full. It is surely a remarkable fact that in a world hungry for capital goods, and with her two most important direct industrial competitors eliminated, England should have experienced adverse terms of trade in the years 1945 to 1948.

At this point it might be worth noting the curious ambivalence which price relations in foreign trade play for the underdeveloped countries. Good prices for their primary commodities, specially if coupled with a rise in quantities sold, as they are in a boom, give to the underdeveloped countries the necessary means for importing capital goods and financing their own industrial development; yet at the same time they take away the incentive to do so, and investment, both foreign and domestic, is directed into an expansion of primary commodity production, thus leaving no room for the domestic investment which is the required complement of any import of capital goods. Conversely, when the prices and sales of primary commodities fall off, the desire for industrialization is suddenly sharpened. Yet, at the same time, the means for carrying it out are sharply reduced. Here again it seems that the underdeveloped countries are in danger of falling between two stools: failing to industrialize in a boom because things are as good as they are, and failing to industrialize in a slump because things are as bad as they are.[8] It is no doubt true that failure to utilize high boom exports proceeds more determinedly for capital formation because of purely temporary price relations shows a deplorable lack of foresight, but this is hardly very apposite criticism of those underdeveloped countries which rely mainly on private development. All private activity tends to be governed by the price relations of the day.

[7] *Economic Survey of Europe in 1948* (United Nations, Department of Economic Affairs), pp. 93-106, especially 97, 98 and 99.

[8] This ambivalence of changing terms of trade has also been stressed in a different context by Professor Lloyd Metzler in his important article on "Tariffs, Terms of Trade and Distribution of National Income," in the *Journal of Political Economy,* February, 1949.

If our view is accepted (namely, that the traditional type of foreign investment as it was known prior to 1929 was "foreign" only in the geographical sense and not in the relevant economic sense) does it then follow that foreign investment has failed to fulfill one of the functions traditionally ascribed to it (and hoped for from it for the future); i.e., to spread industrialization more widely and more evenly throughout the world? It would be premature to jump to this conclusion. What has been maintained in the preceding part of this argument is that past foreign investment, and the type of foreign trade which went with it, failed to spread industrialization to the countries in which the investment took place. It may be, however, that for a full understanding of the process we have to consider not merely the investing and the invested countries but a third group of countries as well.

It is an interesting speculation that European investment overseas was the instrument by which industrialization was brought to North America. Roughly speaking, the supplies of food and raw materials pouring into Europe as the result of the investment-*cum*-trade system and the favorable terms of trade engendered by this system enabled Europe to feed, clothe, educate, train, and equip large numbers of emigrants sent overseas, principally to the United States and Canada. Thus the benefits to the investing countries of Europe arising out of the system described above were in turn passed on to the United States—the converse of the Marshall Plan—and were the main foundation of the enormous capital formation the result of which is now to be observed in North America. This "macroeconomic" analysis is, of course, in no way contradicted by the fact that the individual migrant was motivated by the prospect of raising his standards of living by the transfer.

Attention may be drawn to the interesting statistical computation of Corrado Gini that even the enormous capital stock characteristic of the United States economy is not more than the equivalent of the burden in consumption goods and in such services as health, education, and other provision for the immigrants—a burden which the United States was enabled to save by shifting it to the European mother countries of the immigrants. Perhaps in the final result it may be said that the ultimate benefits of the traditional investment-*cum*-trade system were not with the investing countries of Europe but with the new industrial countries of North America.[9]

If this analysis is correct, the industrialization of North America was made possible by the combination of migration and the opening up of

[9] In more recent years, specially since 1924, U.S. capital accumulation had of course become quite independent from the original stimulus supplied by immigration, and proceeded without any visible check in spite of a heavy reduction in immigration. The argument put forward here is meant as a historical explanation rather than an analysis of the present sources of capital investment.

underdeveloped overseas countries through European investment and trade. To that extent, Point Four and technical assistance on the part of the United States would be a gesture of historical justice and return of benefits received in the past.

It may be useful, rather than end on a wild historical speculation, to summarize the type of economic measures and economic policies which would result from the analysis presented in this paper. The first conclusion would be that in the interest of the underdeveloped countries, of world national income, and perhaps ultimately of the industrialized countries themselves, the purposes of foreign investment and foreign trade ought perhaps to be redefined as producing gradual changes in the structure of comparative advantages and of the comparative endowment of the different countries rather than to develop a world trading system based on existing comparative advantages and existing distribution of endowments. This perhaps is the real significance of the present movement towards giving technical assistance to underdeveloped countries not necessarily linked with actual trade or investment. The emphasis on technical assistance may be interpreted as a recognition that the present structure of comparative advantages and endowments is not such that it should be considered as a permanent basis for a future international division of labor.

Insofar as the underdeveloped countries continue to be the source of food and primary materials and insofar as trade, investment, and technical assistance are working in that direction by expanding primary production, the main requirement of underdeveloped countries would seem to be to provide for some method of income absorption to ensure that the results of technical progress are retained in the underdeveloped countries in a manner analogous to what occurs in the industrialized countries. Perhaps the most important measure required in this field is the reinvestment of profits in the underdeveloped countries themselves, or else the absorption of profits by fiscal measures and their utilization for the finance of economic development, and the absorption of rising productivity in primary production in rising real wages and other real incomes, provided that the increment is utilized for an increase in domestic savings and the growth of markets of a kind suitable for the development of domestic industries. Perhaps this last argument, namely, the necessity of some form of domestic absorption of the fruits of technical progress in primary production, provides the rationale for the concern which the underdeveloped countries show for the introduction of progressive social legislation. Higher standards of wages and social welfare, however, are not a highly commendable cure for bad terms of trade, except where the increment leads to domestic savings and investment. Where higher wages and social services are prematurely introduced and indiscriminately applied to export and domestic industries, they may in the end turn out a retarding factor in economic development and undermine the international bargaining strength of the primary producers. Absorption of the fruits of technical progress in primary production is not enough; what is wanted is absorption for reinvestment.

Finally, the argument put forward in this paper would point the lesson that a flow of international investment into the underdeveloped countries will contribute to their economic development only if it is absorbed into their economic system; i.e., if a good deal of complementary domestic investment is generated and the requisite domestic resources are found.