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RFD. 139

Board of Governors of the Federal Reserve System  
Division of Research and Statistics  
International Sections

REVIEW OF FOREIGN DEVELOPMENTS

May 23, 1950

Some Financial Problems in the Advancement of Underdeveloped  
Countries  
By Lewis N. Dembitz . . . . . 11 pages

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May 23, 1950

SOME FINANCIAL PROBLEMS IN THE  
ADVANCEMENT OF UNDERDEVELOPED COUNTRIES\*

Lewis N. Dembitz

The purpose of this paper is to outline some of the basic financial problems that are involved in the economic development of underdeveloped countries. These problems deal with both the raising of investment funds from without and the mobilizing of domestic savings within the underdeveloped country itself.

Public attention tends naturally to be directed toward the raising of outside capital because the flow of such capital consists primarily of large and conspicuous transactions, often appearing to have political significance. Out of the total amount of investment that a country needs, however, domestic savings are likely to constitute a larger proportion, and the developing of such savings presents serious and important problems.

This paper deals first with the place of investment in a development program, and with the magnitude of the amounts involved. It then surveys the availability of funds from abroad, which under present circumstances centers on dollar funds from the United States; there is included some investigation of reasons why private capital outflow has remained low, and of the possibilities of expansion. This is followed by a brief outline of the problem of mobilizing domestic savings within an underdeveloped country.

Financing of Economic Development

The process of developing an underdeveloped economy ordinarily requires investment in capital assets to increase the country's productive capacity and efficiency. Any capital investment necessarily corresponds to the accumulation of savings by somebody, somewhere, in the sense that somewhere current consumption of goods and services has been less than current production by the amount devoted to creating the capital assets. A country embarking on a program of economic development may rely exclusively upon savings within the country itself or domestic savings may be supplemented from abroad.

If a country depends wholly on its own savings, it will use these savings to mobilize and put to work its own labor, materials, and equipment. It will import only that volume of goods and services which it can finance with the part of its savings which is in the form of an exportable surplus. Economic development on this basis, however, would be difficult for many underdeveloped countries, because of their low levels of subsistence and productivity.

Most countries prefer, therefore, to supplement the resources

\* This article, written for the "Columbia Journal of International Affairs", is appearing in its 1950 spring issue.

financed by domestic savings (including the imports paid for with exports) by borrowing abroad or by permitting the entrance of foreign enterprises. The additional resources thus made available facilitate the process of economic development by putting the developing country in a better position to maintain a faster rate of progress, to keep inflationary pressures in check, and to allow for increases in the standard of living during the initial stages.

Nevertheless, it is important to observe that the construction or improvement of a country's capital assets will generally require a much larger amount of domestic materials and labor than of imported resources. The Export-Import Bank and the International Bank for Reconstruction and Development ("World Bank") have each had a general policy of lending only to cover the costs of imported goods and services, expecting the borrowing country to mobilize domestic savings to pay for the domestic resources needed. It is also possible, however, for foreign capital to finance the use of domestic resources, as can be brought out by examining the function of foreign capital in an underdeveloped country.

The basic function is to bring to the recipient country either imported goods and services or funds with which imported goods and services can be bought. The goods that are imported are often for use directly in carrying out a particular project in which the foreign investor is interested -- as has occurred with Export-Import Bank and World Bank loans. But there is no necessary direct relation between specific investment projects undertaken and the imports which the foreign funds may finance. A project being financed by a foreign loan or investment may require resources drawn from the country's own economy, rather than imported from abroad. In this case, the effect of the loan or investment is to supply the country with dollars (or other foreign currency) which may be used to finance whatever imports are needed by the country's economy. The relationship may, in fact, be merely that a high level of investment is taking place within the country, absorbing large amounts of resources and thereby leading to the need of a loan to finance increased imports. Thus, regardless of the form that the investment takes and of its relationship to any particular development project, the result is to provide the recipient country with additional imported goods and services, over and above what its exports could finance, or with the means to buy the imports.

At the same time, foreign capital may also serve to supplement the underdeveloped country's own money markets in mobilizing capital to finance a particular project or enterprise. In many underdeveloped countries there is difficulty in mobilizing domestic funds for particular purposes, and the entry of foreign capital may obviate this need.

Amounts involved. -- One factor limiting the rate of investment during the 1950's will be the amount of savings available; this involves both the rate of savings that the underdeveloped countries themselves can generate, in their own domestic economies, and the rate at which they can

obtain the use of the savings generated in the United States and other capital-exporting countries. Entirely apart from financial considerations, however, technical, managerial, and engineering skills are also needed in order to convert savings into useful investments. The availability of such skills, rather than of funds, may well prove to be the factor that limits the rate of economic development during the next few years. 1/

The Food and Agriculture Organization made a compilation in 1949 of the development plans that were under contemplation by countries throughout the world. From these plans, the FAO estimates that the total need for investment for development purposes, for all the world outside the United States and Canada, amounted to \$43 billion a year for the next four years, of which \$8.5 billion a year would call for external financing. For Latin America, southern Europe, Asia, and Africa -- corresponding very roughly to the underdeveloped areas of the world outside the Soviet Union and eastern Europe -- the FAO figures lead to a rate of \$9.4 billion of annual investment of which \$3.9 billion would represent external financing and the remaining \$5.5 billion a year would constitute the complementary savings of the underdeveloped countries themselves. 2/

One cannot draw from these figures an expectation that investment will actually proceed at these rates. Many of the individual countries' plans naturally tended to represent targets rather than forecasts. The total amount of funds that would be required annually from the United States and other outside sources is considerably more than has been forthcoming in any single year. Also, as the FAO Report points out, domestic savings in underdeveloped countries have been at less than half of the rate suggested by the countries' plans. Nevertheless, the FAO compilation has value in indicating the magnitude of the potential demand for investment funds for economic development.

#### Sources of Dollar Funds

To the extent that a country's development is financed by the bringing in of dollar capital, the funds may come either from a U. S. Government agency or from the World Bank or from private (i.e., non-governmental) investors. The United States Government has favored the meeting of dollar

1/ Cf. "Fourth Annual Report of the International Bank for Reconstruction and Development (1949)", pages 7 - 14, which suggests that the Bank's lending operations up to now have been limited by a shortage of well-prepared and well-planned projects, rather than by a shortage of loanable funds.

2/ Food and Agriculture Organization of the United Nations, "Report on International Investment and Financing Facilities" (Washington, 1949).

financing needs from private investment sources to the greatest possible extent. <sup>3/</sup> In connection with the "Point Four" program, with its new emphasis on the providing of technical knowledge to countries needing it, foreign investment by American business enterprises constitutes an important means of transmitting many kinds of technical knowledge. The providing of Government funds to finance foreign needs, therefore, represents an operation which the U. S. Government would like to diminish to the extent that it can be replaced by financing from other sources.

The actual net outflow of U. S. private capital during the years 1946 through 1949 reached an average rate of about \$600 million a year, consisting mostly of direct investments by American businesses in foreign subsidiaries or affiliates. <sup>4/</sup> If there were added the undistributed earnings of American enterprises abroad which were reinvested <sup>5/</sup>, a total annual investment of about \$1 billion would be reached. These outflows represented the first sizeable exports of American private capital since the early 'thirties. However, they are small in comparison with the demands for capital as indicated in the FAO compilation cited above. Furthermore, although a majority of the private capital in these years went to underdeveloped areas, this was mostly for the single purpose of petroleum development, concentrated in Venezuela and in Arabia. The net flow of capital to Latin America, Africa, and Asia for all other purposes was around \$100 million a year (plus the reinvestment of undistributed earnings).

If the flow of private U. S. funds into investments abroad were to bear the same ratio to U. S. national income that existed during the 1920's, it would now amount to some \$2.4 billion a year. <sup>6/</sup> Such a flow would be substantial in relation to the total investment requirements of foreign countries, but it is not likely to be achieved unless circumstances become much more propitious to foreign investment.

Even if there should occur a large increase in United States private investment in enterprises abroad, there would also be a continuing need of investment in projects of foreign governments. For example, public health and education projects and the building or improving of roads and

<sup>3/</sup> E.g., the Export-Import Bank Act (sec. 2b) provides that the Bank should "supplement and encourage and not compete with private capital". Similarly, the World Bank, under its Articles of Agreement (Art. III, sec. 4), may lend only if the borrower would otherwise be unable, in the prevailing market conditions, to obtain the loan on reasonable terms.

<sup>4/</sup> U. S. Department of Commerce, "Balance of International Payments of the U. S., 1946-48" (Washington, 1950); and Survey of Current Business, March 1950, pages 4 - 7.

<sup>5/</sup> See Abelson, "Private U. S. Direct Investments Abroad", Survey of Current Business, November 1949, pages 20 - 21.

<sup>6/</sup> National Association of Manufacturers, "Capital Export Potentialities After 1952" (New York, 1949).

harbors could hardly be financed except as governmental projects. This, however, does not necessarily mean that dollar financing requirements must be met by U. S. Government assistance. Should there be a return of investor confidence, such undertakings could conceivably be financed by the sale of foreign government bonds in this country.

With relatively little private capital actually going abroad, foreign lending by the U. S. Government has continued. The larger part of these loans has been for postwar reconstruction in Western Europe, but some funds have been provided to underdeveloped areas by the Export-Import Bank, the Foreign Liquidation Commissioner, and other U. S. Government lending agencies. The World Bank began in 1949 to provide such funds. There have also been large grants of U. S. aid under various programs; among those affecting underdeveloped areas have been rehabilitation and relief programs in China, and the European Recovery Program affecting Southern Europe, Turkey, and various colonial areas.

Net disbursements on U. S. Government and World Bank credits since the war to Latin America, Africa, and Asia have totalled about \$160 million a year. As of April 30, 1950, the Export-Import Bank and the World Bank had further credit authorizations totalling \$534 million outstanding to these areas. The accompanying table summarizes these credits.

There was also a flow of capital from Great Britain, and in smaller amounts from other European countries, to underdeveloped areas with which those countries have special ties. Since Great Britain was receiving capital from the United States during this period, the financing of development in these other countries from British sources was in some ways equivalent to indirect American aid for their development.

Deterrents to private investment. -- In general, the outflow of private investment funds has been limited by the investors' lack of conviction that they are likely to earn a greater net return from such investments than from keeping their funds at home. There are many factors, both political and economic, which have in recent years added to the element of risk in foreign investments and have detracted from the probable returns. Because of these risks, there has developed a psychological factor which probably causes many investors to reject even those foreign investments which on careful examination might prove very attractive.

Some of the risks are due primarily to political or economic factors which are outside the control of the particular country that is seeking capital. Others arise largely from the attitude of the government or people of the underdeveloped country itself.

One risk that belongs partly in each of these categories is the risk that the investor (whether a company which expands abroad or an individual who buys foreign securities) may later be unable to convert his

## CREDITS FROM U. S. GOVERNMENT AGENCIES AND FROM WORLD BANK TO

## LATIN AMERICA, ASIA, AND AFRICA

(July 1, 1945 to April 30, 1950)

(In millions of dollars)

Area and Country	Disbursements (less repayments)				Undisbursed commitments as of April 30, 1950	
	Total	By Export-Import Bank	By other U.S. <sup>a/</sup> Agencies	By World Bank	Export-Import Bank	World Bank <sup>c/</sup>
Total for these areas	796	264	452	80	383	151
Total, Latin America	286	224	11	51	132	118
Brazil	93	52	9	32	6	42
Chile	68	63	-	5	21	11
Mexico	74	63	-	11	27	49
Total, Asia	485	32	424	29	245	33
China	120	-11 <sup>b/</sup>	131	-	15	-
India	72	-	43	29	-	33
Indonesia	62	-	62	-	100	-
Israel	22	22	-	-	78	-
Philippines	65	-	65	-	<sup>d/</sup>	-
Turkey	41	17	24	-	12	-
Total, Africa	25	8	17	-	5	-

<sup>a/</sup> July 1, 1945 through December 31, 1949, only.<sup>b/</sup> Repayments exceeded disbursements.<sup>c/</sup> Includes loans granted but not yet effective.<sup>d/</sup> Less than \$500,000.

Sources: National Advisory Council on International Monetary and Financial Problems, Semiannual Report for period to September 30, 1949 (Washington, 1950); reports of Export-Import Bank, International Bank and Clearing Office for Foreign Transactions.

interest or profits from a foreign currency into U. S. dollars, or to liquidate his investment and reconvert his capital into dollars. In part, of course, this depends on the ability of the foreign country to sell its exports for dollars and thereby obtain the dollars to make such conversions possible. This is related to the whole problem of developing international monetary and trade relationships that will be conducive to free multilateral trade. Importance also attaches, however, to decisions of the authorities in the particular country: the extent to which its economic policies will be directed to the promoting of production for export (rather than for domestic uses), and the extent to which the country will let its supply of dollars be used for meeting the claims of foreign investors as distinguished from being allocated to more imports.

The U. S. Government has undertaken to negotiate treaties with foreign countries to assure equitable treatment for investors. It seems clear, however, that specific and binding provisions relating to all possible future situations cannot be formulated. Thus, while treaties may be helpful, the more important assurance to the investor would be an attitude of fairness and friendliness among the people of the country to which he is sending his funds.

Similar considerations apply to other kinds of risks affecting a foreign investment. For example, investment in an enterprise abroad calls for some assurance that the laws and regulations of the foreign country will not place unfair obstacles in the way of operating at a profit. This cannot really be assured in advance by the terms of a contract or treaty. Any real assurance of such treatment can come only from the existence of influential public opinion favoring such treatment in the recipient country.

The developing of such public opinion takes time. It may be hoped that the working out of the Point Four program -- demonstrating the advantages which foreign technology accompanied by private capital can bring to receptive countries, and demonstrating the cooperative attitude which such countries can expect from investors coming within their borders -- will gradually help to develop public attitudes of the kind that will encourage more investment.

Governmental moves to get this process started <sup>7/</sup> include not only the negotiating of investment treaties (as mentioned above) but also the bills now before Congress to set up a guaranty system. Under these bills the Export-Import Bank would be empowered to issue guaranties against risks peculiar to foreign investment. Such guaranties might assure the investor of being able to convert his profits and reconvert his capital, up to agreed limits, into U. S. dollars. He would thus be protected against losses arising

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<sup>7/</sup> A Department of State document "Point Four" (Washington, 1950 -- 167 pages) gives a full presentation of the program.

either from arbitrary action of a foreign country, in refusing to make dollars available, or to economic difficulties which might make it impossible for the foreign country (no matter how friendly its attitude) to provide him with dollars.

The guaranties might also cover losses due to the seizure or expropriation of property without prompt compensation in dollars. It may prove difficult, however, to draw up a satisfactory definition that would distinguish "expropriation" from other kinds of actions which, while detrimental to the foreign enterprise, could hardly call for compensation under a U. S. Government guaranty. 8/

Regardless of such Government guaranties or of possible changes in foreign attitudes, there remains for prospective U. S. investors the outstanding problem of whether a greater net return (after allowances for risks of loss) can be expected from foreign than from domestic investment. During recent years the return on domestic equity investments in the United States has been high -- so high that an investor has relatively little incentive to seek other fields for earning an attractive return. Should there be a decline in the return available from equity investments in the United States -- especially if this decline should occur through a rise in the price of equity securities rather than through a decline in companies' earnings and dividends -- this might radically change the relative attractiveness of foreign investment.

Even with an increased degree of public confidence in foreign investments, there would still be serious practical problems in the making of foreign investments by most investors. The average individual is not in a position to judge the merits of one foreign enterprise as against another. Furthermore, there would be the problem of liquidity. In recent decades American investors have shown an increasing preference for securities that are readily marketable or convertible into cash. This preference would be an obstacle to the making of foreign investments except in bonds of foreign governments or shares of very large enterprises.

Under these circumstances there could develop an important function for investment trusts which can bring together the funds of numerous individuals and can undertake the investigations that are a prerequisite to intelligent investment in equities abroad. Investment trusts would also provide the liquidity desired by American investors. While the investments held by a trust might have varying degrees of marketability, the shares of the trust itself would be saleable for dollars.

8/ Further discussion of this difficulty appears in an article by Wu, "Government Guaranties and Private Foreign Investment", American Economic Review, March 1950, pp. 67 - 69.

This would not necessarily call for investment companies that would specialize in foreign investment. Under the assumption of a more favorable relationship between the returns available from foreign and from domestic investments, existing investment trusts might well decide that they could best serve their shareholders by undertaking to examine propositions in the foreign field and investing some part of their funds there. "Open end" trusts, which undertake to repurchase on short notice any shares that a shareholder may wish to liquidate, would of course have to continue keeping a large part of their portfolio in readily marketable securities. It does not appear impossible, however, for them to invest some part of their funds in items of less liquidity.

### Problem of Mobilizing Domestic Savings

As indicated earlier in this paper, the mobilizing of a country's own domestic savings is a most important part of the financing of its economic development. Countries borrowing money or receiving investment funds from abroad incur a future obligation to remit funds abroad, in order to repay or service the investment; to the extent that they can finance their development with domestic funds, they avoid such obligations. Therefore, even if unlimited dollar loans were available to underdeveloped countries, it would be to those countries' interest to maximize domestic savings and channel them into useful investments.

The generating of a maximum rate of domestic savings requires that use be made of the country's existing resources, both manpower and material, so as to produce greater amounts of useful goods and services. At the same time there must be measures to channel as much as possible of the country's increased income into the kinds of savings that will further the development program -- rather than into increased current consumption or into less useful forms of savings and investment. Such measures require both technical and administrative competence on the part of the country's authorities, and they also require political strength.

Technically, the developing and mobilizing of savings require a set of measures that will encourage increases in production and will, at the same time, limit or postpone the improvements in living standards that would otherwise be associated with increases in production. In most countries this calls for measures in the fields of taxation and credit control, as well as the devising of financial mechanisms in other fields adapted to the particular country. Drawing up such measures, and reconciling them with each other, is not easy. Putting them into effect involves real administrative problems; these become especially difficult if they involve attempts to change abruptly from established methods and procedures of doing business. Politically, the authorities must be able to convince the population that the limiting of immediate increases in living standards will really redound to the country's long-term benefit.

Because such measures are so difficult to carry out, an underdeveloped

country may try to bring about investment in desirable projects without having savings in sight to finance it. This can be done by having the country's banking system create more money or credit. This is, of course, inflationary, since it results in a situation where the development project will be bidding against current consumption demands for a supply of resources that is inadequate to cover both. This leads to shortages and price rises, followed by demands for wage rises and the likelihood of an inflationary spiral. Nevertheless, it is a way whereby useful capital assets can be brought into existence.

Only extremely skillful management can maintain economic progress under these circumstances. Otherwise, progress is likely to be stopped by pervasive dislocations of the country's economic life, particularly the diversion of investment into assets likely to appreciate in value rather than those that will help development, and the further disappearance of domestic savings. This in turn would lead to the country's losing the confidence of foreign sources of investment funds. 9/

### Conclusions

In order to speed their economic advancement, underdeveloped countries need both a greater flow of capital from outside and the mobilizing of more savings at home. In addition, they need an adequate supply of technical skills to use these funds effectively. Each of these requirements presents difficult problems.

As to the raising of outside funds, a large potential source is U. S. private capital. In fact, however, except for the investing of private U. S. capital in petroleum development abroad, the present flow of dollar capital is largely from U. S. Government sources and from the World Bank, and only a minority of funds from these sources has been going to underdeveloped areas.

Any large increase in the outflow of U. S. private funds is prevented by a combination of economic and political factors. On the economic side, high returns are available on equity investments in the United States while present international economic problems add to the

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9/ The mobilizing of domestic savings (and general problems of economic development) are discussed in documents of the U. N. Department of Economic Affairs and in the proceedings of the U. N. Economic and Social Council. See especially "Methods of Financing Economic Development in Underdeveloped Countries" (Lake Success, 1949) and "Methods of Increasing Domestic Savings and of Ensuring Their Most Advantageous Use..." (1949).

uncertainty of foreign investments. Apart from such economic considerations, however, a larger flow of private capital would require that there exist in the recipient countries the kind of public opinion that would really assure fair treatment to such investments. Such changes in public opinion take time.

Finally, even if there were a new confidence in foreign investments, the individual investor would still have difficulty in buying foreign securities intelligently. Foreign investment by investment trusts might be an answer.

The mobilizing of a country's domestic savings calls for measures that are often hard to formulate and to carry out, but the benefits are so important that countries have a great incentive to undertake such measures.