

FOREIGN CAPITAL IN THE ECONOMIC DEVELOPMENT OF CEYLON*

S. KANESATHASAN

At the outset itself a reference may be made to the current practice, which unfortunately is only too common, of using the term foreign aid in a sense synonymous with foreign capital. The term "aid" carries the connotation that an element of subsidy is involved. Such a definition would exclude certain categories of foreign capital, which are of significance to underdeveloped countries — particularly, private foreign capital. The more general term "foreign capital" is therefore preferable, and this paper covers the role of foreign capital of all types in the economic development of Ceylon. However, this is not to underrate the importance of foreign capital of the subsidised variety (consisting of grants and the so-called soft loans). In fact, one of the main conclusions of this paper is that foreign capital inflow to underdeveloped countries will in future predominantly need to be of the subsidised variety and be therefore on a governmental basis.

It is probably true that every one of the present industrially advanced countries has benefited in the early stages of its economic growth by the inflow of foreign capital. Even in the case of the U.S.S.R. there was a considerable volume of foreign capital which was invested in Russia in pre-Revolution days when Russia had already made substantial progress towards industrialisation. Even Soviet Russia was keen on getting foreign capital on acceptable terms, but this was rendered impossible by political developments and she was thereby forced into a phase of economic expansion where the needed foreign exchange for capital goods was squeezed out the hard way by drastically curtailing the consumption of the people.

Therefore, foreign capital has had, and still has, a crucial role to play in the economic growth of nations. It may be useful to analyse why this is so, and what the needs and prospects of foreign capital are in Ceylon's case. This paper observes the following pattern. Firstly, it analyses the impact of rapid growth on the balance of payments and the role of foreign capital in meeting the balance of payments problem. Secondly, it makes a rough assessment of Ceylon's need for foreign capital. Thirdly, it discusses the different forms of

*Revised version of a paper presented at a Seminar on the Drive to Rapid Economic Growth organised by Section F of the Ceylon Association for the Advancement of Science.

foreign capital and their impact on the balance of payments and on the implementation of the development programme. And finally, it makes a few comments on the prospects for foreign private capital.

Economic Development Programmes and the Balance of Payments

It will be useful at the outset to emphasise the fact that any intensified development programme must inevitably produce a strain on the balance of payments. This would be so in every case, except in an entirely closed economy, even where the entire developmental expenditure is financed out of domestic savings, i.e. without resort to any inflationary financing.¹ Let us take a simple example, where the Government suddenly steps up its investment by 100 units but finances the new investment entirely from tax revenue. Let us assume that 40 units of the investment programme immediately get spent on capital goods imports needed for the programme. This means that the programme results in 60 units being put back into the domestic income stream, while 40 units have immediately leaked out. The total import bill would be 40 of direct imports *plus* the induced (i.e. secondary) imports from the 60 units put back into the income stream. The latter would depend principally on the propensity to import.² If, on the other hand, the investment programme had not been implemented, the tax would not have been raised and the public would have retained control over the 100 units, which would have induced an inflow of imports depending on the same import propensity. In so far as 60 units are concerned therefore, there would be no difference in imports, in the two situations. The difference would arise only in regard to the 40 units, the whole of which is spent on imports when the investment programme is launched, and only a part of which, depending on the import propensity, is spent on imports in the alternative situation.

It is clear therefore that, even where the investment programme is financed from current domestic savings, imports would increase whatever the ratio of capital goods imports to the investment expenditure and wherever the propensity to import consumer goods is less than unity. However, the deterioration

1. This is in contrast with Mr. Hicks' analysis in "Papers by visiting Economists" (National Planning Council). Suppose that the proportion of investment expenditure according to the best available plan, that must go on imports, is $X\%$; that the proportion of saving (private and governmental) which is at the expense of imports (the proportion, which would have been spent on imports, of the consumption that would have occurred if the saving had not been made) is $Y\%$; the balance of payments will then be deteriorated by the saving and investment if X is greater than Y , improved if Y is greater than X (P. 15).
2. Not allowing for lags. For a relatively simple analysis in monetary terms of the relationship between income and imports, allowing for lags, see Polak "Monetary Analysis of Income Formation and Payments Problems", I.M.F. Staff Papers, Nov. 1957. A number of papers published subsequently in the I.M.F. Staff Papers have dealt with the statistical application of the Polak analysis.

in imports would be greater, the higher the proportion of capital goods imports to investment and the smaller the propensity to import consumer goods.

The deterioration in the balance of payments would be still greater where a part or whole of the investment programme is financed from inflationary financing; in such a case both the direct and the induced import effects that follow, would be the measure of the deterioration in the balance of payments.

The final impact of the investment programme on the balance of payments will also depend to a substantial extent on the direction of the investment, whether it promotes the production of exports and of import substitutes. The promotion of exports would provide a *direct* relief to the balance of payments of equal amount³ less any secondary imports arising from the increased income from exports. On the other hand the production of import substitutes of the same amount would provide the same *direct* reduction in imports and a smaller offsetting increase in secondary imports, because it is likely that the propensity to import itself would be reduced by the production of import substitutes. In other words, the relief to the balance of payments gained from the production of import substitutes would be greater than from the production of an equal amount of increased exports. Moreover, increased production of import substitutes may be much easier to achieve. Thus Ceylon, with her high level of consumer imports which can be replaced by domestic products and her high level of exports earnings, can be considered advantageously placed vis-a-vis those countries which would have to earn the foreign exchange needed for import of capital goods, through new exports.

The deterioration in the balance of payments as a result of the implementation of the development programme will depend, therefore, on the following factors:

- (a) the extent of inflationary financing,
- (b) the import content of the investment programme,
- (c) the propensity to import and its variability over the Plan period,
- (d) the nature of the investment, i.e. whether it adds to exports and import substitutes. The production of an adequate level of import substitutes may even reduce the propensity to import consumer goods, e.g., if the present pattern of consumption of goods is more or less preserved, and the production of those goods which are presently imported more than keeps pace with the demand for them caused by the increased incomes, then the import ratio will fall. The import ratio will not fall by as much if the consumption pattern also changes with, as is usually the case, newer imported items taking the place of the ones locally produced.

3. To be precise, the direct relief to the balance of payments would be equal to the net exports, i.e. the increased exports less the import content (e.g. in raw materials etc.) in them. Likewise in the case of production of import substitutes.

Assessing the Need for Foreign Assistance

Therefore, given the size and pattern of the investment programme governed, for example, by a target level of increase in per capita income, as in the Ten Year Plan,* the ensuing balance of payment deficit can be computed by means of the above variables. The same variables also constitute the means for meeting the balance of payments deficit.

One of the primary targets of economic planning is to achieve economic growth whilst preserving a reasonable balance in the external balance of payments. If a given level of investment is to be achieved, whilst keeping the balance of payments deficit within manageable limits, the following policy approaches are possible:—

- (a) domestic savings can be stepped up;
- (b) exports or the inflow of capital may be increased;
- (c) the import component of the investment programme may be reduced, by concentrating on projects with low import content;
- (d) the propensity to import may be lowered, both by the higher production of import substitutes and by the imposition of tight import controls; and
- (e) the investment may be more concentrated in the production of exports and import substitutes.

All of these, except increased capital inflow, call for additional sacrifices from the people and will need to be used in combination. Amongst these measures some would provide a greater immediate relief to the balance of payments. The most preferable approach would be to increase exports or import substitutes. However, this would take time to produce, especially if the investment programme has already given the maximum possible weightage to such industries. So will it be in the case of additional savings. Moreover, in order to effect a saving in imports of one unit, savings will need to be increased about threefold, given an import ratio of approximately 30%, as in Ceylon. On the other hand some of these measures would create a greater immediate stress on the economy than the others. This would in particular be the case with import restrictions. Import restrictions create inflationary pressures within the economy and though they may provide the quickest relief to the balance of payments position, if they are sufficiently broadbased, they do not constitute a satisfactory long range solution unless they result in the production of import substitutes by giving temporary protection to industries.

* The Ten Year Plan for 1958-1968 is still in operation. The Short Term Implementation Programme prepared recently by the Planning Secretariat, is a detailed programme for the three years 1961/62 to 1963/64, within the broad framework of the Ten Year Plan.

Compared to all others, the least demanding approach is the utilisation of foreign capital. By making possible an unrequited inflow of goods and services, it also provides immediate relief to the balance of payments without demanding any immediate sacrifice from the people.

The need for all these remedial measures and for foreign assistance would be reduced if there were accumulated reserves or if there was normally an export surplus at the time of the launching of the Plan, or if there occurs a substantial favourable movement in the external terms of trade during the course of the Plan. In the past, we in Ceylon have tended to take a fairly complacent view of the balance of payments, because Ceylon has normally enjoyed an export surplus, and was relatively favourably placed as regards external reserves, ignoring the periodical phases of reserves shortage caused by cyclical export declines. Both these advantages have now been lost, without any significant increase in investment or import of capital goods to show for it. On the other hand, we have been saddled with a declining rate of domestic savings and an increasing ratio of imports of consumer goods to G.N.P.

These trends are in complete contrast to the assumptions made in the Ten Year Plan, and make the balance of payments projections in it completely unrealisable. The Plan Report does not have balance of payments forecasts for the whole Plan period. It gives the balance of payments data for only 1957 (as realised) and for 1968 (as forecast at 1957 prices). The most significant features of the balance of payments projections for 1968 are as follows:—

- (a) There will be a substantial increase (33%) in export earnings from Rs. 1800 million in 1957 to Rs. 2400 million in 1968.
- (b) there will be a considerable increase in capital goods imports from Rs. 150 million to Rs. 450 million and in invisible payments from Rs. 380 million to Rs. 550 million.
- (c) however, the import value of consumer and intermediate goods (including raw materials) *will remain unchanged at Rs. 1550 million.*
- (d) the overall effect is that a merchandise deficit in 1957 is converted into a merchandise surplus, and an overall balance of payments deficit of Rs. 305 million in 1957, which was met entirely out of the accumulated reserves, (there having been no net receipt of foreign capital) will be reduced to an overall deficit of Rs. 150 million, which will be met through a net foreign assistance of the same amount.

It is significant to note that between 1957 and 1968, the Gross Domestic Product is expected to approximately double (from Rs. 5000 million to Rs. 9500 million at 1957 prices) and gross investment approximately treble (from approximately Rs. 700 million to Rs. 2050 million). It is a reasonable assumption

that the import of consumer goods (and intermediate goods) is a function of the G.N.P. and the import of capital goods a function of investment. Firstly, capital goods are expected to keep pace with investment, trebling from Rs. 150 million to Rs. 450 million. This is a reasonable projection considering that Ceylon is not likely to go to any large extent for the production of capital goods, within the Plan period. In contrast the estimate of the imports of consumer goods in 1968 which is expected to remain unchanged at the 1957 levels, despite the fact that G.D.P. has doubled seems unrealistic. In other words, the import ratio for consumer goods is expected to drop from 30% to 16%. Such a projection can be justified only on two grounds:—

- (a) that there is a very large increase in import substitutes, enough to meet the increased demand for them arising from the increased disposable incomes, as spent according to the projected consumption pattern in 1968.
- (b) that there are strict import controls which restrict the ability of the new income earners to spend on imported goods.

As regards the second, the Plan does not envisage the use of import restrictions except, of course, as a measure of protection. This was presumably justified on the grounds that the planned expenditure was to be met entirely out of non-inflationary sources, viz. domestic savings and external assistance. This therefore necessarily means that the entire explanation for the containing of the imports at the 1957 levels, rests with the production of import substitutes, (estimated in this Plan approximately Rs. 1000 million of agricultural goods and Rs. 600 million of industrial products) adequate to meet the increased demand for such commodities by 1968. The projected increase in the gross domestic product between 1957 and 1968 can, for present purposes, be broken up into three broad components — exports, import substitutes and other domestically produced goods, and services for home consumption. Of the total projected increase in the G.D.P. of Rs. 4,500 million, exports are expected to account for Rs. 600 million, import substitutes for Rs. 1,600 million and the balance Rs. 2,300 million being in other goods and services. The estimate of consumer goods imports in 1968 depends firstly, on the demand for such goods based on the projected incomes and on the projected consumption pattern in 1968, and secondly, on the production locally of import substitutes to meet the increased demand. The gap between the two would be the measure of residual imports in 1968. The demand for imports would be under-stated to the extent that the overall demand for consumer goods is under-stated and the domestic supply of import substitutes is over-stated. An under-statement of the demand for consumer goods imports would result from an optimistic assessment of savings and by the projection of the consumption pattern in such a way as to understate its import component. The supply side could be over-stated by an optimistic assumption of the level of investment, the investment output ratio,

the elasticity of factors of production etc. Such an over-statement of domestic supply would, in addition to keeping the estimate of imports down, also overstate the gross domestic product by the same amount. Thus if the production of import substitutes is estimated at Rs. 1,200 million instead of Rs. 1,600 million, then the G.D.P. in 1968 would be not Rs. 9,500 million but Rs. 9,100 million. There is no reason to assume that the production of exports and of other goods for domestic consumption would also need to be scaled down. On the other hand, the under-statement of the import component in the consumption pattern over the Plan period would have the effect not only of under-stating the demand for imports but also of over-stating the growth in the G.D.P. The higher the import ratio, the lower would be the domestic income multiplier. Therefore, if a higher import ratio is allowed for in the consumption pattern during the Plan period, the G.D.P. projected for 1968 would very likely be less than Rs. 9,500 million. In other words a correction for the under-estimation of the import component in the consumption pattern and the over-estimation of the growth of domestic supply over the Plan period would have the effect of increasing the level of imports in 1968 from the Rs. 1,500 million estimated in the Plan and of reducing the G.D.P. in 1968 from the Rs. 9,500 million projected in the Plan. The ratio of total imports to the G.D.P. in 1968 would rise from the approximately 16 per cent as projected in the Plan to a higher and more realistic level closer to the 30 per cent prevailing in 1957.

The import estimates of consumer goods in the Plan seem to be based on very optimistic assumptions regarding the factors which govern the demand for imports and the domestic supply of import substitutes, mentioned in the preceding paragraph. Taken individually, the element of error in each one of these factors may be small. However, it appears that the elements of error have all been biased in one direction. In addition some of them also produce a cumulative error* over the Plan period. These result in the patently unlikely estimate of consumer imports remaining unchanged whilst the G.D.P. doubles, with the ratio of consumer imports to the G.D.P. being approximately halved from 30% to approximately 16 per cent, without the assistance of the import restrictions. Some drop in the overall import ratio in the initial stages of the country's growth, concentrated on the production of imports substitutes, is not unlikely. However, it has also to be recognised that one of the well-known features of international economic growth has been that it has not resulted in a curtailment of the importance of international trade. Without hazarding a guess regarding the likely consumer import ratio in 1968 it would be sufficient to point out that even if the ratio was 20 per cent rather than 16 per cent and G.N.P. lower than Rs. 9,500 million, consumer imports in 1968 would be considerably higher

*As for example, the assumption of a low import leakage inflates the secondary income increase from investment. The process of income generation being cumulative this will tend to exaggerate the income growth as each income period is over.

than what is forecast in the Plan and the balance of payments deficit considerably more than the Rs. 150 million forecast in the Plan.

The larger the estimated balance of payments deficit the larger the amount of the net external assistance which will be required to implement the Plan. It is important to emphasise the word *net*, because where there are repayments of foreign loans, etc. involved, the gross assistance required will need to be still higher. Obviously it is difficult to conceive, in the present circumstances, of Ceylon receiving foreign assistance of this magnitude. Moreover, no country should be dependent to that degree on foreign capital. Net foreign capital should be only marginal and should, in fact, progressively decrease in importance as the country's development gathers momentum and repayments fall due. Also, it is important to appreciate that it takes also the right approach to the problem of development and the efficient use of resources by the recipient country, to increase the amount of external assistance that will be forthcoming. To take an extreme case, it would not contribute to the permanent economic growth of a very backward country to pump in massive doses of foreign assistance, beyond its capacity to use it fruitfully. We have heard of the experience of several backward societies in the Pacific islands which underwent similar experiences during the war with the net result that economically they are still just as backward as before but with their traditional social fabric and the old system of production undermined. This is only by way of illustration of the point which applies to a much lesser degree in the case of Ceylon—viz. the limitation on a country's ability to absorb foreign capital without waste. This will depend on the ability of the economy to organise the efficient execution of the investment programme of which the foreign finance is a part, and on the ability of the economy to provide the supplementary domestic savings and other factors that are needed for the investment programme. Judged by these standards one has to admit that absorptive capacity of Ceylon has been found wanting in relation to the targets set for it in the Ten Year Plan.

One has only to look at three indexes in this context. Firstly, the large inflationary budget deficits incurred by the Government, which reveal the economy's inability to raise adequate domestic savings for the programme. Secondly, the relatively low rate of growth in capital formation and the recurrent under-expenditures of capital account in the public sector, and thirdly the non-utilisation of the foreign assistance which has actually been made available to Ceylon. The lack of the absorptive capacity is a reflection of the shortage of various complementary factors of production which have to be combined with the available foreign assistance to result in capital investment. Besides the inadequacy of domestic savings, it also reflects the short-comings in the machinery for the implementation of the investment programme. This is most evident in the case of the short-fall in the utilisation of the available foreign assistance as a result of the lack of integration of the foreign assistance

received in kind, with individual projects in the development programme. This no doubt has been due in part to the form in which the assistance has been offered in some cases. As will be seen later the close integration of the foreign assistance with development is particularly necessary where it is received in highly "specific" forms—i.e. linked to particular projects or to purchases only from the donor countries or in the form of particular goods and services.

The existence of an adequate machinery for the implementation of the development programme not only will result in the more efficient utilisation of the already available foreign assistance, but will in fact promote the offer of new aid. There has been in recent years a growing tendency for donor countries to offer aid on more liberal terms to countries with efficient development programmes, e.g., to India rather than to others. In a recent article* Rosenstein Rodan has categorised Ceylon among the low growth countries. The reason for the low growth is attributed to "a high increase in population and a relatively low capacity to organise development". It is not difficult to see that a donor country will not be too enthusiastic about providing assistance for a country whose development efforts have been judged in this manner. The only exception will be where the assistance is clearly of political nature. Countries and international institutions providing normal types of economic assistance will be interested in ensuring that the funds are properly utilized in a manner which will add, in the case of loans, to the recipient country's ability to meet the amortisation and interest rate commitments in due course.

Apart from its absorptive capacity, the ability of the recipient country to repay foreign loans in due course is therefore another important consideration in determining a country's "need" for foreign assistance. The capacity to repay means the creation of an export surplus at the due date to effect the transfer of an equivalent amount of goods and services to the creditor country. Ceylon, so long as she had a traditional merchandise surplus was in an advantageous position as regards its ability to repay foreign loans. However, the surplus is no longer there. Moreover, we have seen that there may in fact be a larger deficit in the current account as the Plan progresses. This could be the situation even after the greatest weight had been given, quite correctly, in the Ten Year Plan for the production of exports and of imports substitutes. It has to be remembered that even the projections of the balance of payments in the Plan for 1968 allow for a *net* foreign assistance of Rs. 150 million. To this figure had to be added therefore the commitments on interest and amortization of foreign debt for that year, in order to arrive at the figure of the gross external capital required. It has to be borne in mind that continuous resort to foreign capital will progressively enlarge the annual commitment in interest and amortisation.

*P.N. Rosenstein Rodan, "Foreign assistance to underdeveloped countries" (*Review of Economics and Statistics*, May, 1961).

It is also of particular importance from the point of view of the servicing burden of external debt that the inflow of capital should follow a regular pattern. If the capital inflow is erratic it could be more of a hindrance than a help. The disequilibrating nature of capital flows has been more commonly a feature of short-term capital. However, the problem can arise even in the case of long-term capital if the inflow is erratic, especially if it slackens at a time when capital payments in amortization of previous debts are falling due.

All this means that Ceylon has to give serious consideration to her ability to repay and look particularly for foreign assistance which either produces the least amount of external burden (i.e., grants and the so-called soft loans) or adds to the productive capacity of the exports and import substitute sectors. In regard to the promotion of exports to which the Plan already gives maximum emphasis, a more favourable environment perhaps may be created by means of a scheme for the integration of the development programmes and trade patterns of the South-East Asian region as a whole. Apart from this it is absolutely essential that Ceylon will have to resort to a rationalised system of import tariffs and controls. This indicates that import controls and higher tariffs on imports have come to stay in Ceylon for a very long time to come.

The form of foreign capital

Up to this point foreign capital has been treated as homogeneous in its impact on the balance of payments and on economic development. This is in fact not true and different forms of foreign capital inflow, whether on private or public account, produce different impacts on the balance of payments. The most significant distinction would be of course, between loans and grants. Grants do not add to the burden of interest and amortization of the recipient country and would therefore constitute the most desirable form of foreign capital. However, even foreign grants may suffer from the drawback, arising from the fact that they are commonly offered in the form of goods produced in the donor country, that their real worth may be overstated by their not being valued at competitive world market prices. This inflation of the extent of aid may present a false picture in regard to the additional imports that are being provided by foreign assistance. A second problem in regard to grants in kind is that the goods offered may not be of a kind that can be fitted readily into the development programme. The same comments would apply in respect of loans in kind. It would of course be a far more serious objection if the loans offered in kind are valued at higher than world market prices, since that would increase the real cost of the external debt to an extent that may make the loan not worthwhile, unless as is usually the case it is offset by the offer of assistance simultaneously in the form of grants or of low rates of interest and attractive repayment terms. Loans in kind may also suffer from the drawback that the goods offered may be of such a specific nature, as to be difficult to fit into a

development programme. As a rule, therefore, the offer of capital in foreign exchange is preferable for the recipient country. To take concrete examples, if the aid is offered in the form of a particular type of equipment usable only in a particular project, its utilisation will have to await the execution of the project. On the other hand, if the goods offered are of a less specific kind (for example, foodstuffs, cement, etc.) they would provide immediate relief to the balance of payments. However, the disadvantage arising from the specific nature of the aid can to a large extent be minimised if it was closely integrated with the development programme in respect of its different projects and different phases.

Another type of specificity in foreign assistance arises when it is offered in relation to a particular project and thereby its utilisation is dependent on the rate of execution of the project concerned. Such loans are usually offered for projects selected on the basis that their production would provide the foreign exchange for the servicing and amortization of the loan. The loan is also commonly extended (for example, in the case of the IBRD) to cover only the foreign exchange cost of the project, with the complementary local finance being raised locally. If the domestic expenditure is financed out of non-inflationary sources, no additional strain on the balance of payments arises because of the foreign capital received. If on the other hand, the local expenditure is financed from inflationary sources the impact on imports will be greater than the foreign finance available and the balance of payments would have suffered a set-back. The balance of payments would, on the other hand, be improved if the total cost and not only foreign exchange expenditure component of the project is matched by a foreign loan.

There is now a growing realisation that project loans of a self-liquidating nature, particularly those financing the foreign exchange costs of the project do not meet the problem of capital shortage of underdeveloped countries. This is so because of two reasons. Firstly, self-liquidating projects would not include the broad category of infra-structure investment which would constitute a substantial proportion of the total investment in underdeveloped countries. Secondly the provision of foreign exchange to cover only the foreign exchange cost of the project does not relieve the recipient country of the entire, or in fact in some cases even the major part of, the balance of payments burden arising from the investment. Therefore there has been a gradual shift in the external assistance towards the so-called soft loans related to the broad economic programme, from loans covering only the foreign expenditure of individual projects. Soft loans are distinguished from hard loans or bankable loans in that they involve an element of international subsidy. The subsidy normally takes the form of very low rates of interest, a grant component in the loan, and long terms of repayment and provision for repayment in the currencies of the recipient countries themselves. The main category of such loans so far have been

the loans under United States P.L. 480. Recently facilities for the granting of such loans on an international (as apart from a bilateral) basis have been established—namely through the I.D.A.* and the U.N. Special Fund. There is also provision for the I.D.A. to provide such loans not only for individual projects, but as support for overall development programmes as well. This reflects the growing appreciation that the projects comprising a development programme are interdependent for their successful operation and that it is therefore impossible to judge the soundness of any project without a knowledge of the whole program of which it is a part. A 'program approach' and not a 'project approach', therefore, must determine the self-liquidating use of capital.

Therefore, judged from the angle of the extent of relief provided to the balance of payments, four main criteria emerge. Firstly the less specific the type of capital, whether gifts or loans, the more advantageous it would be. Secondly the higher the proportion of the foreign capital to the total planned expenditure the better it would be. Thirdly, as a general rule, outright grants are to be preferred to loans, and soft loans to be preferred to hard loans. Fourthly, the foreign assistance should be available in a steady stream, and not in spurts, and preferably should be geared to the foreign exchange burden (direct and indirect) of the entire programme in its different phases.

This may be a convenient place to make a passing reference to the question of the relative merits of external capital being made available on a bilateral or an international basis. There is a growing body of opinion that the provision of capital aid (here the word aid is used advisedly) through international organisations is to be preferred. From the point of view of the recipient countries this approach has found favour except among a few who have exploited their political position to get liberal aid on a bilateral basis. On the other hand the reaction of the donor countries has by and large not been favourable. However even there a number of observers feel that foreign assistance would be better used if channelled through an international agency. This arises from two factors. An international organisation is better placed to offer critical comment on the use of its resources by a member. Secondly all the other members of the organisation would also have a direct interest in ensuring the best use of the organisation's resources. In any event, it seems that one has to accept as a fact of life that the bulk of foreign assistance will continue to be on a bilateral basis for many years to come.

The role of private foreign capital

So far the role of foreign capital has been referred to almost entirely in terms of its receipt by the public sector and of its balance of payments impact. In the course of the previous discussion various reasons had been mentioned why foreign capital to underdeveloped countries will in future have to be

*International Development Agency—a subsidiary of the I.B.R.D.

predominantly on a governmental basis, rather than in the form of private enterprise capital. In this section I wish to support this contention with positive evidence based on the actual experience in recent years. This is not to deny that foreign private capital has a role to play in the economic development of these countries. However, it will probably have to take new forms which accord with the altered conditions. Secondly, the economic contribution of foreign private capital cannot be evaluated solely in terms of the balance of payments impact. It has a most valuable contribution to make in the form of industrial and managerial expertise and commercial contacts.

Recent studies of the international flow of private capital by the U.N. Secretariat* and others have made certain facts clear. In order of magnitude, advanced industrial countries (including Japan) which offer each other markets and investment opportunities have had the main share of the foreign private capital inflow. Next in order were the rapidly expanding countries with a substantial industrial sector—e.g. Australia, Canada, Mexico, Brazil and Argentina. Then followed low income countries with natural resources, mostly in the form of oil and non-ferrous metals. And finally are the low income countries which have neither important resources nor markets, like Ceylon, which received very little capital. In this context, it may be useful to point out that the recovery of European economies has not resulted in any significant increase in the outflow of capital to under-developed countries. By an large, the recovery of industrial countries has stimulated the flow of capital amongst themselves. With the creation of the European Common Market, this trend is expected to be strengthened.

The U.N. Report on international capital movements also makes the point that the direction of even private development capital flows has to a considerable extent been influenced by special political ties that existed between the capital exporting and importing countries, like membership of the Commonwealth, French Community, etc. This has served to compartmentalise the capital flows and thereby to limit their free flow.

The limited reliance that can be placed on private foreign capital in the economic development of Ceylon is also evidenced by the statistics of the net outflow of long term private capital from Ceylon in every one of the last ten years, as revealed by published balance of payments data.

There are however two significant developments in the field of capital flow to the private sector, which hold out encouraging prospects. Firstly, there is a growing tendency to use the government and specialised agencies as channels, for the flow of foreign assistance to private enterprise. International institutions (e.g. I.B.R.D., I.F.C.) and other public and private lending institutions in the

*For example, "The International Flow of Private Capital — 1956-58"—U.N. (1959).

developed countries (e.g. the U.S. Export-Import Bank, the Development Loan Fund) are extending an increasing volume of foreign currency loans to the private sectors of underdeveloped countries via such development banks and corporations. In fact in India, the major part of the gross capital inflow (including re-invested profits) into the private sector has been in this form in recent years.* If the figures of net capital inflow were taken, this form of capital inflow (through official institutions) into the private sector, was almost equal to the total net inflow. The second development is the growing importance of short term manufacturers' credits extended by industrialists in developed countries to the purchasers of their machinery and of consumer goods. The need in an underdeveloped country is not only for long term capital but also for short term working capital. Further, although the capital offered may be short-term in so far as individual projects and purchasers are concerned, it may actually operate like a long term credit if it constitutes a revolving fund for the whole economy.

Conclusions

The main conclusions which emerge are as follows :—

- (1) That any intensified development programme will produce a strain on the balance of payments. The strain would be higher, the higher the extent of inflationary financing, the higher the import ratio and the higher the imported capital goods component of the programme.
- (2) Given the magnitude and pattern of the investment programme the remedies for the balance of payments problem have to be sought simultaneously through the concentration of the new investment in increased production of exports and import substitutes, increased domestic savings, import restrictions and the receipt of foreign capital. Of these the last has decisive advantages over the others, where it is available.
- (3) The forecasts of the balance of payments for Ceylon made in the Ten Year Development Plan are highly optimistic and underrate the need for foreign capital, even without taking account of the actual developments since the framing of the plan. If these subsequent developments are taken into account the forecasts appear to be quite unrealistic, except with the assistance of stringent import controls.

*See "Foreign Investments in India—1959-1960" in the *Reserve Bank of India Bulletin*, May, 1961.

- (4) Whilst the need for foreign capital on the basis of the revised balance of payments forecasts appears very large, there are three important considerations which have also to be taken into account. Firstly, no country should depend too heavily on foreign capital for its investment programme. The role of foreign capital should be marginal and be in the nature of a catalyst and should progressively decline in importance as development gathers momentum. Secondly, there are evident limitations on the present capacity of the Ceylon economy to absorb foreign capital without wastage. In regard to this, steps will have to be urgently taken to streamline the whole machinery of the implementation of the plan and in particular to integrate foreign aid with the programme in respect of its different projects and different phases. Thirdly, the problem of the repayment capacity of the Ceylon economy has to be given serious consideration. We have hitherto tended to take a far too complacent attitude about this.
- (5) Of the different forms of foreign capital the most advantageous to the recipient country would be outright grants and soft loans. Also the less specific the nature of the capital the better it would be. Further in view of the fact that a considerable portion of the investment undertaken in under-developed countries will not be of the directly self-liquidating type, a substantial part of the foreign capital will need to take the form of aid on a government to government basis. Further, in view of the interdependence of the projects that make up the overall development programme, a programme approach and not a project approach must determine the self liquidating use of foreign capital.
- (6) Private foreign capital has a useful role to play more in Ceylon, but in a qualitative rather than in a quantitative sense. The main contribution of private capital will be in the form of industrial and managerial expertise and commercial contacts. Expertise in other fields will be concentrated in the form of technical assistance offered through official channels. Quantitatively, private capital will be considerably less than foreign capital received through governmental channels. In fact an important development in recent years has been a growth of capital inflow even for the use of the private sector, through official channels.