

## **Nurkse and the Role of Finance in Development Economics**

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### **NURKSE, EARLY DEVELOPMENT THEORY, AND MODERN MONOECONOMICS<sup>2</sup>**

Ragnar Nurkse was part of a group of early theorists of economic development who questioned orthodox Ricardian trade theory as the basis for development policies: “In many of the less developed countries today the dominant practical question is whether the available investment funds ... should be used to provide activities specialized along lines of comparative advantage internationally or diversified so as to provide markets for each other locally.” He noted that this “clash of prescriptions on the policy plane reflects ... a gap between the neoclassical allocation economics and ...growth economics.”<sup>3</sup> The emphasis on growth economics engendered a debate over whether “balanced” or “unbalanced” growth was the best strategy for developing countries to support growth through industrialization. In difference from modern discussions of development, there was a general agreement amongst economists that industrialization was the most efficient means of supporting economic development.<sup>4</sup>

Ragnar Nurkse, along with Paul Rosenstein-Rodan, was the most important and influential advocate of “balanced” growth<sup>5</sup> as a means to support the industrialization of

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<sup>2</sup> The term was coined by Albert Hirschman in his *Essays in Trespassing* (1981) for those who believe a single economic approach—the neoclassical—applies to all economic problems.

<sup>3</sup> Nurkse (1961) “International Trade Theory and Development Policy.”

<sup>4</sup> Compare Hollis Chenery writing in 1955 “Industrialisation is the main hope of most poor countries trying to increase their levels of income. It is also the most controversial aspect of the problem of economic development.”

<sup>5</sup> They were countered by e.g., Paul Streeten (1959) and Albert O. Hirschman (1958). Hirschman shared Nurkse’s view that developing economies were not capital supply constrained, but expressed doubt that

“undeveloped” (to use Oscar Lange’s terminology)<sup>6</sup> economies. It was taken as given that a developed economy was an industrial economy. Nurkse and Rosenstein-Rodan supported balanced growth with what might be called “classical” arguments concerning long-run determinants of the interaction between demand and supply, in particular those advanced by Allyn Young and Josef Schumpeter in the 1920s, joined to an historical analysis of the changing structure of international trade and payments in the 20<sup>th</sup> century.

While borrowing from the then-novel Keynesian ideas, they were considered to apply primarily to the short-run problems facing industrialized developed economies, and thus, although correct, not directly relevant to the problems under consideration. They also considered reference to the development experiences of Latin America in the 19<sup>th</sup> century to be inappropriate in the changed international economic conditions that emerged after 1920. These early debates were in marked difference to current development discourse dominated by what Albert Hirschman has called “monoeconomics,”<sup>7</sup> the belief that there is a single correct economic analysis that can be applied to all economic problems—to developed and developing economies alike. The fact that it has become the basis of the so-called Washington Consensus, amplified in the “structural adjustment policies” that place conditionality on the loans of the multilateral financial institutions, suggests that Nurkse’s challenge to orthodoxy was lost and that the orthodox strategy based on optimal allocation through international market-driven comparative advantage in free and open trade and financial markets is generally accepted.

The Consensus gained support from the performance of the newly industrializing Asian economies in the 1980s (compared to the failure of the hyperinflating Latin American economies) and by the improved performance in the early-1990s of countries (such as Mexico, Brazil, and Argentina) that embraced the approach. However, the outbreak of financial crisis in Mexico in 1994, then in Asia in 1997, followed by Brazil in 1999, and Argentina in 2001 raised doubts about its theoretical underpinning. This has been reinforced by the decline in trend growth rates and sluggish employment creation that has accompanied the policy. In particular, the idea that countries could develop on

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they had the entrepreneurial capabilities to generate balanced growth. A balanced, but negative, assessment is given in Hans Singer (1960), who considers the approach “premature rather than wrong.”

<sup>6</sup> Oscar Lange (1946).

<sup>7</sup> This has a very different meaning depending on whether “mono” is interpreted as Greek or Spanish.

the basis of eliminating barriers to trade and liberalizing financial markets was based on a theoretical contradiction. As Nurkse pointed out in the earlier debates, in classical Ricardian trade theory the benefits from comparative advantage specialization that result from the static comparison of a country moving from autarchy to free trade presumes the full utilization of immobile productive factors such as capital and labor. It is not evident that it applies to trade in both goods and financial assets in a dynamic context. Additional theoretical justification is required to join the free flow of capital with the benefits of free trade in goods.<sup>8</sup>

The theoretical justification for the free international flow of productive capital is also based on the static analysis of the benefits obtained from an improved allocation of capital to its most productive uses across countries. However, it rests on the assumption that the market mechanism can identify and respond to differential rates of return created by international differences in factor intensities. In the context of developing countries, this requires not only that factor intensity can be calculated and compared across countries, but that intensity is higher in developed than in developing countries and that the return to capital is inversely related to capital intensity. After the capital theory debates of the 1960s, it is clear that none of these conditions are theoretically robust.

Further, the stylized facts of most developed countries show substantial and persistent unemployed resources and throughout the postwar period, capital flows have, in general, been from developing to developed countries rather than the opposite. This suggests that a review of Nurkse's theory might be beneficial in discovering the lacuna in the current monoeconomics of development. In particular, Nurkse's theory may help in assessing the benefits of a policy of directed industrialization that were taken as given in the earlier debates. It is interesting to note the current ignorance of these early debates, and in Nurkse's work in particular, exhibited by proponents of the modern monoeconomics. This is especially visible in criticisms of a recent book by Erik Reinert<sup>9</sup> advocating an approach to development via industrialization similar to that advanced by Nurkse and other early development economists. They suggest that his approach should be criticized as 19<sup>th</sup> century economics (although Nurkse rejected this approach) or as

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<sup>8</sup> Nurkse (1961), "International Trade Theory and Development Policy"

<sup>9</sup> Erik Reinert (2007).

inapplicable because it advocates protectionism (also rejected by Nurkse) or the failure of a particular form of industrialization through import substitution applied in Latin America (considered by Nurkse no longer feasible).<sup>10</sup>

Given this tendency to argue about slogans, rather than theory, in revisiting Nurkse's position on the question of the finance for development, I am going to suggest that a better way to understand the point that was under discussion would be to abandon the slogans of protection versus markets and instead draw a distinction between those such as Nurkse who believed that development was basically demand constrained, against his (and Reinert's) critics who believe development to be supply constrained.<sup>11</sup>

## **LEARNING FROM HISTORY AND GEOPOLITICAL CONDITIONS**

In contrast to the current monoeconomical view of trade and capital flows in the development process, Nurkse placed emphasis on the fact that both theory and policy were historically conditioned. An important example may be found in his recognition of different historical patterns of development. Nurkse refers to the unique nature of the 19<sup>th</sup> century experience of foreign investment. It was associated with the migration of people from Europe to the great "empty" plains in other temperate regions. Both capital and labor migrated in a complementary search for higher earnings in the new settlement, rich in natural resources. As others working in the area, he used Folke Hilgerdt's terminology—"regions of recent settlement," noting that they were favored by a rapidly expanding demand for their primary products.

This tended to raise real incomes directly by improving their barter terms of trade, which, in a time of reduced transport costs, was not incompatible with improving commodity terms of trade for the industrial centers as well. This gave comparatively advantageous employment to any increases in the domestic labor force or capital stock. It also tended to mobilize dormant resources and draw them into economic activity for

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<sup>10</sup> See the comments by Alan Winters, Anne Krueger, and others to the July 21, 2007 review of Reinert's book by Martin Wolfe in the *Financial Times*.

<sup>11</sup> Nurkse himself speaks of the difference between "allocation" and "mobilization" reflecting the confrontation between comparative advantage and growth. In Nurkse, op. cit 1961 the entire discussion is on the demand or mobilization aspect, and he takes supply not representing a constraint on the development problem. See his reply to his discussants, p. 272.

export production. It also helped by attracting to those areas a part of the increase in capital and labor that was taking place in the dominant centers of growth. Rapidly increasing external demand encouraged the application of capital and improved techniques to primary production for export, often including the creation of domestic infrastructure that was of benefit to the development of other sectors of the economy. This constituted what Nurkse, echoing Dennis Robertson's enunciation of *trade as the engine of growth*, identified as the 19<sup>th</sup> century pattern of development called *growth through trade*, a pattern that appears to lie behind the Washington Consensus.

### **DEVELOPMENT THEORY AND DEVELOPMENT REALITY: COGNITIVE DISSONANCE?**

Nurkse notes ironically that in this period when there were important flows of both capital and labor from Europe to other continents, Ricardo's static classical theory of comparative advantage, based on the immobility of productive factors, dominated academic discourse. While Nurkse admits that this cumulative, dynamic process by which growth in the center was transmitted to the periphery may have improved the international allocation of resources, it was the dynamic impact on growth that was dominant. By the end of the 1920s, this dynamic engine had started to stall and the industrial center was no longer transmitting its growth to the developing countries through an increase in the demand for their primary exports. Again, with irony, Nurkse notes that in the 1930s as the "classical assumption of international immobility of productive factors had become almost perfectly valid in fact,"<sup>12</sup> Bertil Ohlin was proposing the incorporation of international factor mobility into his theory of international trade. Nurkse concluded that "economic theory tends inevitably to lag behind the actual course of events."<sup>13</sup> It was for these reasons that he stressed the inapplicability of the static approach of classical trade theory, instead favoring a dynamic approach of cumulative causation based on the analysis of the evolution of international demand relative to the expanding resources of developing countries. He thus placed

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<sup>12</sup> Nurkse (1953).

<sup>13</sup> Nurkse (1953)

major emphasis on the continual increase in the productive or potentially productive resources in underdeveloped countries, believing that no useful purpose was served by continuing to discuss matters of trade and development on the classical assumption of a constant stock of productive factors. Development cannot be a question of the optimal distribution of scarce resources when developing countries are experiencing a continual expansion of their productive resources.

Although Nurkse believed that this 19<sup>th</sup> century process in which demand from the center supported exports of the periphery would always play a role in the development process, he was convinced that the industrial countries' demand for a wide range of primary commodities could not be maintained at a rate sufficient to absorb the expansion of labor and capital in developing countries. He thus believed that the major problem facing developing countries experiencing rapid growth in their labor force and capital stock would be the failure of external demand from the industrialized countries for primary exports to keep pace with the expansion of resources in developing countries. His particular concern was that international conditions had changed in the 20<sup>th</sup> century in ways that would prevent the continuation of this cumulative process as developed country's demand for primary exports slowed.

Similar to Hans Singer, Raul Prebisch, and Gunnar Myrdal, he reached the conclusion that in such conditions it would be useless to commit additional resources to increase production in the traditional export sectors given the inelastic demand that traditional exports were likely to meet. It was thus the changed international conditions of the postwar economy that made it imperative for developing countries to find an alternative strategy to exports of primary commodities determined by comparative advantage and financed by capital inflows from the industrialized countries.

Nurkse also notes that the success of the 19<sup>th</sup> century pattern of development was based on the fact that roughly two-thirds of global capital flows went to the "regions of recent settlement" and that they were drawn by the movement to these regions of largely European emigrants with a "capital-minded milieu, ... culturally prepared for the use of western equipment, methods, and technique."<sup>14</sup> He also notes that very high proportion of the foreign investments—"no less than three-quarters of the total was in public or public-

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<sup>14</sup>Nurkse (1954), p. 746.

utility investments,”<sup>15</sup> concentrated in “a process of capital widening.”<sup>16</sup> However, in the 20<sup>th</sup> century, when the United States took over as the source of international capital flows, they were largely to substitute for the movement of labor, not to complement it, and to be dominated by private flows concentrated in mineral extraction and other areas which responded to the demand of the capital exporting countries. This was basically because of the lack of profitability of investing in the domestic market due to its small size and development. He thus concludes that “it seems unlikely that direct investment alone can become anything like an adequate source of international finance for economic development.”<sup>17</sup>

In addition, he noted that the implementation of Keynesian policies in the 20<sup>th</sup> century had by and large eliminated the need for developed countries to use foreign lending as a means of supporting domestic demand. This meant that there was no longer any economic reason for capital to move from developed countries to provide finance for developing countries. Developing countries would thus face the problem of finding alternative sources of finance for the mobilization of their underemployed domestic resources. This raised the possibility that developing countries might best concentrate on policies that produced domestic demand creation without relying on external resources.

## **NEW CONDITIONS REQUIRE A NEW DEVELOPMENT THEORY**

Despite the success of the 19<sup>th</sup> century pattern of development, Nurkse took it as given that primary production for export could no longer provide support for development in the 20<sup>th</sup> century and that international capital flows could no longer play the supporting role that they had in the 19<sup>th</sup> century. Given this breakdown in the pattern of development that had prevailed in the 19<sup>th</sup> century, the question facing developing countries was how to mobilize their ever-growing labor force and capital resources.

Nurkse noted that one market-driven solution would be for factors of production to migrate from the less-developed countries to the centers of growth in the industrial economies where they would earn higher returns. While it seems quite clear that capital

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<sup>15</sup> Nurkse (1954), p. 747.

<sup>16</sup> Nurkse (1953), p. 748.

has in fact taken this path in many countries, after the 1930s this became increasingly difficult (if not impossible) for labor,<sup>18</sup> and thus, simply aggravated the mismatch between the growth of their primary exports and the growth of population.

### **THE OBVIOUS ANSWER: INTERNAL GROWTH THROUGH DOMESTIC INDUSTRIALIZATION**

Instead, he proposed what he considered a more realistic alternative. If demand conditions for a wide range of primary products were not conducive to growth and if external capital could not provide support for development, then, in addition to their primary exports, which (as noted above) he believed would always be part of a successful development strategy, developing countries should embark on a path of internally-led growth through domestic industrialization. He notes the existence of an influential school of thought in support of industrialization, today much expanded by the historical research of Erik Reinert, that suggests that this position has been dominant among successful industrializers since the 1600s, if not earlier.<sup>19</sup>

While this argument for industrialization is similar to that put forward by Prebisch and Singer, it is important to note that Nurkse places greater emphasis on the long-term shifts in international demand than on any trend decline in the terms of trade for developing countries. Indeed, he suggests that in the long run “a change in the terms of trade tends to induce shifts in production and in the distribution of resources, which will tend to reverse or counteract the changes in the terms of trade,” such that the “long-term trends in international demand need not be reflected fully, if at all in changes in the terms

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<sup>17</sup> Nurkse (1953), p. 754.

<sup>18</sup> Following Rosenstein-Rodan, he classified this as an “academic” solution, but today it does not in fact appear so academic.

<sup>19</sup> However, it is interesting to note that he proposed industrialization simply as a means to improve capital accumulation, and although he makes reference on occasion to the possibility of intensive (as well as extensive) capital accumulation, he does not appear to make use of the microeconomic supply-side explanation of increasing returns, but rather emphasizes the macro demand side—just as disguised unemployment represented potential savings, investments in industry represented potential gains in productivity that could only be realized in a balanced expansion—that is a higher level of overall activity, rather than economies of scale (see the discussion of the origin of these in the works of Allyn Young below).

of trade.”<sup>20</sup>

Facing a lack of sufficient demand for primary commodities and no necessary financial flows from developed countries, developing countries faced the problem of how they could achieve industrialization. For Nurkse, this could be reduced to the question of achieving a sufficient rate of capital accumulation. This leads to the basic question behind any strategy of industrialization—how to finance the required capital formation to support industrialization in the absence of sufficient external capital inflows? Nurkse notes that policies to support domestic industrialization depend on whether the domestic economy was similar to the former “regions of recent settlement,” with low domestic population growth, or whether it more resembled the former colonies with excess labor and rapid population growth. He concentrates on the latter, representing the majority of developing countries in Africa and Asia.

### **CAPITAL SUPPLY FOR INDUSTRIALIZATION—DISGUISED UNEMPLOYMENT**

In his simple and direct method of approach, Nurkse puts this question as follows: Where is the food to come from to feed the workers who will be employed to build the capital goods to create an industrial sector? While there is always some (and often much more than generally recognized) voluntary saving among the rich urban commercial and landowning classes of poor countries, this is unlikely to be sufficient to support industrialization.<sup>21</sup> These savings could be supplemented by measures to reduce the “conspicuous consumption” of these higher income classes through formal restrictions or fiscal policy measures, but these are likely to be difficult to enforce. Thus, given the shortfall of voluntary saving out of existing incomes, poor developing countries will be doomed to a vicious cycle of poverty unless they can find alternative sources. This has been the traditional approach to development that considers developing countries as supply constrained, and the way to lift this constraint has been to look for ways to attract

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<sup>20</sup> Nurkse (1961), pp. 243–4

<sup>21</sup> Nurkse (1953), p. 37. Keith Griffin questions the assumption that peasants cannot save because they are too poor. See Keith Griffin (1969). However, Nurkse’s argument is not that peasants cannot save, for implicitly they do when they support unproductive labor, it is that their savings cannot be directed to

an inflow of capital from abroad.

But Nurkse differs from the traditional approach, noting that external finance will not only be uncertain (for reasons already discussed above), it is likely to be inadequate to needs, especially given the experience of the poorest of developing countries in attracting foreign investment. Further, he notes that it may be unnecessary since there is a third potential source of resources to feed the workers on the new investment projects. Among a country's available domestic resources, Nurkse notes that the widespread existence of "disguised unemployment" also represents "disguised saving" potential.<sup>22</sup>

While disguised unemployment was introduced in the economic literature by Joan Robinson<sup>23</sup> in a discussion of the definition of unemployment in developed countries, Nurkse adapts the concept in providing the answer to the supposed supply constraint on the ability of developing countries to finance capital formation in support of industrialization.

## **CONSTRAINTS ON SUPPLY FOR INDUSTRIALIZATION**

In an analysis that follows the lead of Rosenstein-Rodan (and foreshadows the subsequent approach of "unlimited supplies of labor" proposed by Sir Arthur Lewis), but is closer to what became the Cambridge approach to growth and distribution, Nurkse explains the idea again in simple physical terms. If existing "unproductive" surplus laborers in the countryside are being supported by the "productive" laborers who produce more than they consume, then this difference only represents "virtual" saving from the

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development.

<sup>22</sup> The question of whether labor could be removed from agriculture without decreasing output has been the subject of much subsequent debate. In Nurkse (1957, p. 190), he notes that the Indian Second Five-Year Plan estimates that "one-fourth to one-third of the existing labor force in agriculture may be surplus to requirements."

<sup>23</sup> Joan Robinson (1936, p.226) assumes that a "decline in demand for the product of the general run of industries leads to a diversion of labor from occupations in which productivity is higher to others where it is lower. The cause of this diversion, a decline in effective demand, is exactly the same as the cause of unemployment in the ordinary sense, and it is natural to describe the adoption of inferior occupations by dismissed workers as disguised unemployment." Although never given as reference, Robinson's analysis of the concept appears to be the source of the term that seems to have been first introduced into the development literature by V.K.R.V. Rao in 1938 and popularized by Rosenstein-Rodan in his classic 1943 paper "Problems of Industrialisation of Eastern and South-Eastern Europe."

point of view of the economy as a whole because it is fully consumed by the “unproductive” workers. If the “unproductive” workers (who contribute nothing to total output) could be employed to produce new capital goods, then the “virtual” savings could be transformed into effective saving, and capital could be created without requiring any decrease in the overall level of consumption of any individual in the economy. The supply of “finance” for the accumulation of capital could then be provided internally simply by mobilizing the disguised unemployed into productive employment. No formal creation of finance or provision of ex ante savings is required other than the reallocation of underemployed labor to capital construction projects. The only condition is that there is disguised unemployed labor that can be employed in the production of capital goods without a fall in total agricultural output.

Nurkse highlights the difference between this proposition and traditional Keynesian theory, suggesting that it represents an intermediate position between the classical and the Keynesian analysis of the relation between saving and investment. Rather than an increase in the rate of capital formation requiring a reduction in consumption (as in the classical analysis that presumes full employment of resources) or an increase in investment expenditure producing an accompanying increase in saving via the multiplier to match it, the employment of disguised unemployed labor to increase capital formation creates capital without a reduction in consumption or an increase in saving via the multiplier.

The difference from Keynesian theory is important and often misunderstood. In difference from the multiplier analysis that is dynamic, Nurkse’s argument concerning the increased supply of saving is purely static. The higher level of saving is the result of the higher level of income that results from the increased output per head of the disguised workers when in productive employment, since both productive and unproductive workers consume as much as before; the average propensity to consume for all workers remains equal to unity,<sup>24</sup> but the propensity for personal consumption by productive

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<sup>24</sup> Note the similarity with the classical savings assumptions that would quickly appear in the work of the post-Keynesian growth and distribution theory. In Nurkse’s analysis, the workers in the agricultural (consumption) and capital goods sections have a unitary propensity to consume while the rest of the population has a propensity to save that is positive. Also note that one could interpret this analysis as similar to Lewis’s assumption concerning differing marginal productivity in agriculture and industry. This would not be correct, for in Nurkse’s analysis there need be no difference in the marginal product of labor

workers is below unity. The point of the argument is not to explain the relation between investment and saving, but simply to highlight an unexploited source of resources that can be costlessly made available for capital formation through a rearrangement of employment. Here Nurkse follows classical economists such as Hume (and Keynes as well) when he notes that in his view that “‘labor is the real source of wealth,’ and the supply of capital, we now see, can be increased by making use of unemployed labor. It can be increased, not only for extensive, but also for intensive investment for economic development.”<sup>25</sup>

Nurkse also highlights the difference between his approach and traditional discussions of excess population and high population growth creating an increased need for capital. In this approach, a calculation is made of the amount of capital “required” for the productive employment both of the annual increase in the labor force and of the existing surplus labor. The extremely large figures that result from such calculations lead to what appears to be the obvious conclusion that domestic saving capacity will be insufficient to needs and thus, external savings will be required. Consequently, this approach reaches the diametrically opposed conclusion to Nurkse—that developing countries will have almost exclusive reliance on external resources rather than focusing on the saving potential that is concealed in the existence of disguised unemployment.

But this discussion refers only to the supply side and supports the idea that the constraints on development are not to be found on the supply side. However, in order to make supply effective requires policy on the demand side or a discussion of the incentives to invest that will be capable of putting the disguised unemployed to work to produce capital goods. In his analysis of the demand side of the problem, Nurkse introduces the idea of balanced expansion.

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in agriculture and capital goods production. It is sufficient that the disguised unemployed have a marginal product that is equal to zero, and although he refers to the possibility of both extensive and intensive capital accumulation, differences in productivity between agriculture and industry do not appear to have played a significant role in his argument. Sir Arthur Lewis (1964) informs us that he came upon the idea of unlimited supplies of labor and increasing productivity in the industrial sector in August 1954 in Bangkok, while Nurkse’s ideas were set out in 1951 in lectures in Rio and Cairo, but published in summary in the *American Economic Review* Papers and Proceedings of 1952. It is interesting that in his recollections, Lewis discusses Nurkse’s ideas as a means to avoid the inflationary consequences of expanding production, but he seems not to have understood the proposal, presenting it as one in which the disguised unemployed labor works for no remuneration.

<sup>25</sup> Nurkse, 1953, p. 49.

## DEMAND CONSTRAINTS ON CAPITAL SUPPLY FOR INDUSTRIALIZATION

Those economists who argued in favor of industrialization through balanced growth based their discussion of the inducement to invest on Allyn Young's 1928 extension of Adam Smith's dictum that the division of labor depends on the extent of the market.<sup>26</sup> This position incorporates both demand and technical progress since Young points out that the "the principal economies which manifest themselves in increasing returns are the economies of capitalistic" production and the economies of more capital intensive methods of production, "even more than the other forms of the division of labor, depend upon the extent of the market—and that, of course, is why we discuss them under the heading of increasing returns."<sup>27</sup> He then notes that "under conditions of increasing returns and when the demand for each commodity is elastic, in the special sense that a small increase in its supply will be attended by an increase in the amount of other commodities which can be had in exchange for it, an increase in the supply of one commodity *is* an increase in the demand for other commodities, and it must be supposed that every increase in demand will evoke an increase in supply," thus ensuring a high level of demand across a range of industries will provide an increasing surplus due to increasing returns that will be available for capital accumulation. The problem is how to generate this generalized process of expansion.

Following an argument used by Rosenstein-Rodan, Nurkse notes that this cannot be done by an individual entrepreneur. With an argument that parallels that used by Keynes in establishing the possibility of underemployment equilibrium, it notes that if disguised unemployed workers are given employment producing shoes, but do not spend all their wages on shoes, then the shoe factory cannot recover its costs and will make losses; the higher level of employment will not be maintained. But, if "unemployed workers are taken from the land are put not into one industry, but into a whole series of industries which produce the bulk of the goods on which the workers spend their wages, what is not true in the case of one shoe factory would become true in the case of a whole

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<sup>26</sup> This article also had a profound impact on the ideas about cumulative causation found in the work of Nicholas Kaldor.

system of industries: it would create its own additional market, thus realizing expansion of the world output with the minimum of disturbance of the world markets.”<sup>28</sup>

This is the genesis of the idea of “balanced” expansion; investment in a range of activities will produce incentives in terms of sales and profits that would not be present if only a single entrepreneur were to start production.<sup>29</sup> In addition, initiating a range of activities produces scale economies that increase the surplus available for investment that would not be reaped if only a single entrepreneur was active.<sup>30</sup>

Although Nurkse adopts a similar argument to explain the need for balanced expansion, he does not support Rosenstein-Rodan’s extension of the idea to a “big push,”<sup>31</sup> instead he refers to developing countries with disguised unemployment as exhibiting “underdevelopment equilibrium,” a condition he considers analogous to the Keynesian “underemployment equilibrium.” Just as in Keynes’s theory, the problem is not on the supply side, nor is it a question of deficient savings, the problem is to create the inducements to mobilize the potential savings for capital accumulation locked in disguised unemployment. He considers the basic problem facing developing economies in generating balanced expansion to be the small size of the market due to the low level of income.

This creates problems for any individual entrepreneur seeking to employ disguised unemployed labor to produce capital goods since there will be no demand for them. However, following Young and Rosenstein-Rodan, Nurkse notes that this conundrum can be resolved if there is a more or less general application of capital to a range of different industries. This would result in an overall enlargement of the market, as people working with more and better tools in a number of complementary projects become each other’s customers.

This shifts the problem to the means by which an economy can achieve balanced expansion. Here Nurkse refers to Schumpeter’s *Theory of Economic Development* as the

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<sup>27</sup> Allyn Young (1928, p. 531)

<sup>28</sup> Rosenstein-Rodan (1943, pp. 205–6)

<sup>29</sup> Rosenstein-Rodan advocates a policy of treating the economy as if it were engaged in the planning of production within a single large firm. *Op. Cit.*

<sup>30</sup> Note that this is not the same as the increasing returns that result from the scale economies of physical consumption (e.g., the relation between volume and surface) since it requires both interdependence across industries and demand.

<sup>31</sup> See Nurkse (1961), “Further Comments on Professor Rosenstein-Rodan’s Paper.”

template for the general theory of economic expansion. In Schumpeter's theory, it is the individual entrepreneur that is at the center of the inducement to invest, but Nurkse notes that the success of new innovations depends on their propagation through the entire economy in a wave of new applications in sectors that are not directly connected with the initial innovation. The problem is that developing economies generally lack the entrepreneurial talent or the technical expertise to induce this type of Schumpeterian expansion.<sup>32</sup> Thus, while any substantial application of capital by an individual entrepreneur in any particular industry may be blocked or discouraged by the limitations of the preexisting markets, this problem can be overcome if there is a wave of capital investments in a number of different industries. In this way, the market difficulty (and the drag that it imposes on individual incentives to invest) is removed or, at any rate, alleviated by means of the dynamic expansion of the market through investment carried out in a number of different industries. Such balanced growth thus creates externalities, not only in terms of generating demand, but also in the form of Youngian technical progress that increases the productivity of capital.

While Nurkse grants that expansion in one area will have positive income and expenditure effects through the multiplier and induce expansion in other industries, if other producers are not also expanding autonomously this will slow down the expansion of the industry that took the initial act of expansion. Thus, it would be more expedient if every sector were expanding spontaneously without waiting for the demand signal to arrive from the rest of the system. Nurkse's principle of balanced expansion is then simply a means of accelerating the overall rate of output growth. He also notes that this simply amounts to promoting increases in output that are diversified in accordance with domestic income elasticities so as to provide markets internally for each sector of production, in contrast to output expansion for export, which is determined by international comparative advantage.

Here, Nurkse can be understood as setting out the requirements for a "virtuous circle" of development, in contrast to his description of the "vicious circle of poverty"<sup>33</sup>

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<sup>32</sup> A position that is echoed in both Hirschman's defense of unbalanced growth and Alice Amsden's (1989) description of the role of the state managers in Korean economic development in *Asia's Next Giant: South Korea and Late Industrialization*.

<sup>33</sup> Keith Griffin has criticized this approach as presuming that developing countries are poor because they

that Myrdal was to develop into a “cumulative theory of economic development.”<sup>34</sup>

Although he tends to favor analysis in real terms when discussing the supply side, when he deals with demand, Nurkse always argues in terms of value productivity, not physical productivity. He notes that an investment that is undertaken by a single entrepreneur may have a very low or even negative marginal value productivity, while the same investment undertaken in conditions of balanced growth may have a much higher positive marginal value productivity. Again, it is important to note the emphasis on the impact of the level of aggregate demand on productivity, but also that the process is not the same as would be found under the multiplier.

Finally, following the Keynesian lead, he believed that there was no independent market force that would bring about this result, making the State the obvious choice to promote balance expansion. Yet Nurkse had no inherent belief in any inherent superiority of the State in economic affairs. Indeed, in his writings he repeatedly stressed that he was indifferent to the way in which balanced growth was achieved, simply noting that it was required if the capital accumulation potential of disguised unemployment was to be achieved.

“How is this to be achieved? Autonomous advance involving capital investment in different branches simultaneously may come about through the infectious influence of business psychology, through the multiplier effects of investment anywhere which can create increased money demand elsewhere or through deliberate control and planning by public authorities. The widely held view that balanced growth necessarily calls for programming strikes me as dubious. Indeed, as a means of creating inducements to invest, balanced growth can be said to be relevant primarily to a private enterprise system.”<sup>35</sup>

He also noted that “the balance-growth principle can be and has been interpreted

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have always been poor, when, in fact, most developing countries had a developed past that was disrupted by conquest and colonization. Thus, the external factors that cause “undevelopment” are ignored in addressing the strategies to promote development. While this is undoubtedly correct, it seems that Nurkse and others who referred to the vicious circle of poverty were more interested in the idea of cumulative causation than to argue that the major problem facing developing countries was their history of poverty. See Keith Griffin (1969, p. 37).

<sup>34</sup>Myrdal notes the increasing divergence between the implications of trade theory and the actual increase in income disparities across countries as being associated with the term “vicious circle.” Myrdal cites Nurkse’s use of the term in his 1952 Cairo lectures as the stimulus for his own attempt at a virtuous “cumulative causation” theory. See Gunnar Myrdal (1956).

<sup>35</sup> Nurkse (1961), “International Trade Theory and Development Policy,” p. 247.

too literally. Producing a little of everything is not the key to progress.”<sup>36</sup> This position was reinforced in posthumously published notes commenting on an article proposing “unbalanced” growth:

“I am now inclined to think that it might be well to distinguish between balanced growth as a method and balanced growth as an outcome or objective. Even zigzag growth must have balance as its ultimate aim, in the sense of output expansion in accordance with national income elasticities of demand. I am inclined to be ‘liberal’, accepting as alternative possibilities: central planning; generally optimistic expectations, leading to spontaneous advance on a wide front; or the ‘disequilibrium’ method of zigzag growth in successive industries or sections, each tugging the other along by signals given by the price mechanism.”<sup>37</sup>

Finally, it is important to note that Nurkse made a sharp distinction between the balanced expansion support for the accumulation of productive capital and the investment in infrastructure. Nurkse notes that:

“The case for diversified investment [in balanced expansion] ... stands in sharp contrast, first of all, to the great concentrations of capital needed for public overhead facilities such as transport and electric power. The notion of balanced growth ... is a limited one, confined to the horizontal pattern of supply and demand for consumables. It is not applicable in any simple way to the relationship between the overhead facilities sector and the consumer goods sector, which is essentially a vertical relationship, since the basic services like transport and power are significant chiefly as producers’ services.”<sup>38</sup>

## **ALTERNATIVE PATHS OF DOMESTIC INDUSTRIALIZATION**

Thus, given the potential for capital accumulation inherent in the high level of disguised unemployment and the possibility of mobilizing it through balanced expansion, Nurkse notes there are at least two possible ways in which the capital may be employed in industrialization: to produce manufactures for export to the industrial countries or to

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<sup>36</sup> Nurkse (1961) “International Trade Theory and Development Policy,” p. 249.

<sup>37</sup> Nurkse (1959, p.296).

<sup>38</sup> Nurkse (1961, p. 250). In Nurkse (1954) he makes a strong case for foreign investment in providing such infrastructure investments, as he considered to have been the case in the 19<sup>th</sup> century. “There is no question that ample scope exists for international financing of public improvements in the poor countries today.”p. 755.

produce manufactures mainly for domestic markets. With premonition of the debates that would come to surround import substitution, he noted that neither strategy implied elimination or reduction of exports of the primary commodities that countries naturally produce.

## **INDUSTRIALIZATION FOR EXPORT**

Nurkse points out that industrialization to produce manufactures for export to developed, industrialized countries is to be recommended over production for domestic consumption because it relies on foreign demand and, thus, does not require the extensive improvements in productivity and incomes in domestic agriculture to support domestic demand. Further, it does not necessarily depend on expansion of total demand abroad for the type of goods to be exported because developing countries can initiate a Schumpeterian-type process in which they will be the low-cost producers that displace high-cost suppliers in the industrial countries, allowing them to move into more productive activities such as skilled services, engineering, and chemistry. However, he does note that this approach does have some serious drawbacks.

Even if there is substantial disguised labor, technical qualifications and work experience may not be appropriate to the creation of an industrial sector. There may be a wide gap, or discontinuity, between the traditional primary products and the new manufactured goods for export. Perhaps more serious is the necessity of the older industrial countries adopting commercial policies that support, or at least do not discriminate against, developing country exports of manufactures. But, Nurkse notes, such support cannot be relied upon with certainty. The difficulties encountered in providing such policies through the International Trade Organisation, and more recent experience in the WTO, suggests that this position was prescient.

As a result, developing countries seeking to build a base of manufacturing exports would be driven to concentrate on simple manufacturers, such as textiles, where resistance to new suppliers might be less robust. However, while this may solve one problem, it creates another; in industrialized economies these sectors are usually experiencing declining demand so that existing producers in the advanced economies

must of necessity be injured and displaced if such exports are to be increased. That export markets are found through displacement of existing high-cost suppliers in the industrialized countries also acts against introduction of supportive commercial policies in developed countries.

## **INDUSTRIALIZATION FOR DOMESTIC CONSUMPTION**

The possible resistance from developed countries to opening their markets suggests the alternative strategy—production of industrial output for domestic consumption. However, Nurkse notes that this approach may face even greater difficulty, since demand for the manufactured goods output of the new industrial sector will have to be generated internally, in particular from the agricultural sector, through increased productivity to improve purchasing power. Since in most underdeveloped countries agriculture is not an open, innovative sector, this transformation cannot be relied upon to happen in response to market incentives alone. He notes that the necessary improvement in agricultural organization, including land ownership policies, may require a revolution in the countryside, affecting the lives of the great mass of the people.

Domestic industrialization also requires an expansion of the concept of balanced expansion. The symbiosis between agricultural and manufacturing necessary to support domestic industrialization fits naturally with the concept of balanced growth. Nurkse first notes that the development of the manufacturing sector may be stymied by the failure of the agricultural sector to produce a marketable surplus. In just the same way as a single entrepreneur in manufacturing may fail because of an absence of the necessary inputs and purchasers of other entrepreneurs in other sectors, the same occurs if agricultural workers are too poor to buy the output of manufactures.

## **IS THIS IMPORT SUBSTITUTION INDUSTRIALIZATION?**

Nurkse recognizes that promoting the industrial production of manufactures for home consumption in underdeveloped countries will always be considered by critics as import substitution. However, he takes pains to counter this characterization by pointing out that

domestic output expansion can occur in the sectors producing domestic goods that do not normally enter into foreign trade, as well as in those areas that compete with imports from abroad. More importantly, he suggests that domestic industrialization can mean the substitution of capital goods imports for consumption goods imports. A country can still increase its imports of capital equipment by cutting down its imports of consumer goods without directly substituting them with domestic production.

### **INDUSTRIALIZATION WITH LIMITED SUPPLIES OF LABOR**

Nurkse's analysis is built around the concept of "disguised" unemployment in agriculture in countries with high rates of population growth. However, for completeness, he notes that not all poor developing countries face such conditions. For countries without a potential surplus to exploit, a different approach will be required. Of particular importance will be the ability of the agricultural sector to produce a surplus to provide demand for the industrial sector. If this cannot be achieved through the movement of labor between sectors, it will have to occur through technical progress in the agricultural sector. In the tradition of Singer, Prebisch, and Myrdal, he notes that it is not the case that there is no technical advance in agriculture. He refers to the impact of changes in crops and the introduction of crop rotation in England in its period of early industrialization—The Turnip Effect. However, he limits his recommendations to policies to improve agricultural productivity and does not follow the above-mentioned economists in suggesting policies to adjust the terms of trade facing primary commodity exporters.

### **DEMAND CONSTRAINTS—THE DEMONSTRATION EFFECT AND THE EXTERNAL FINANCE CONSTRAINT**

In the traditional view, the existence of an external constraint on a country's development is evidence of a scarcity of resources, a supply constraint. Nurkse takes a rather different view, emphasizing the impact of unequal wealth and income distribution between developed and developing countries on demand and the operation of the international adjustment mechanism. Even if a country succeeds in mobilizing its domestic resources

in support of capital accumulation for industrialization, the gap in income levels may create an autonomous increase in the domestic propensity to consume that diverts resources from capital accumulation. In an extension of Dusenberry's demonstration effect, Nurkse notes that developing countries will tend to have higher levels of consumption for equivalent levels of GDP than the already advanced economies experienced during similar stages in their development process. He argues that international income disparities will continually cause gaps in the balance of payments of developing countries that will tend to be financed by international income transfers rather than by measures to reduce imports of luxury consumption goods—this to the detriment of the ability of balanced expansion to support capital accumulation.

Further, he argued that since there is no automatic economic mechanism to ensure these compensating transfers, in the absence of governmental direction, there is no reason for private capital movements to meet a country's external financing needs. Indeed, chronic or recurrent balance of payments difficulties are likely to act as a deterrent to private inflows and may even cause movements that increase the financing gap. Nurkse notes that the gold standard was supposed, in theory, to produce an automatic adjustment mechanism for external imbalances, but it was employed mainly by the advanced industrial countries and thus did not provide a solution for developing countries. Since most developing countries were too poor to hold reserves balances sufficient to allow them to smooth cyclical, short-term fluctuations in payments balances, they found it difficult to apply the rules of the game of the gold standard system. Given the low priority developing countries place on holding sufficient international reserves, Nurkse identifies a natural tendency towards disequilibrium in the balance of payments between rich and poor countries that is not caused by differences in productivity, but by the difference between the poor countries' propensity to spend and its capacity to produce. He notes that in these circumstances, applying the classical gold standard prescription for balance of payments adjustment—to reduce demand to stop inflation accompanied by devaluation of the exchange rate—may not work because it has no impact on these structural factors. This creates a constraint on the ability of balanced expansion to support domestic resource mobilization because even if capital transfers automatically cover the external financing requirement, there is no guarantee that they will be used to support

capital formation.

## **SUPPLEMENTING DOMESTIC RESOURCES WITH EXTERNAL CAPITAL**

Despite his skepticism on the size and ability of external finance to supplement domestic resources, it would be a mistake to believe that Nurkse completely rejected that external investment could play a role in the development process. He considered that external investments could contribute, but only after the process of domestic mobilization of disguised unemployment resources had been initiated through balanced growth. It is thus instructive that he gave little importance to Hans Singer's argument that foreign investment was really an extension of the lender's economy and had little impact on the development of the recipient country by pointing out that private investment was the minor part of international investment, the majority being in government fixed-income lending to finance infrastructure.<sup>39</sup>

In support of his "academic" argument that it might be more efficient for underemployed resources in developing countries to move to developed countries, he notes that the rate of return on a single investment in isolation would be much lower than if it took place in conditions of balanced growth. Thus, returns on investment in an economy before the balanced growth process gets underway would be insufficient, except for monopoly rights for mineral extraction and the exploitation of primary products. However, once balanced expansion has been initiated, the expected marginal value product of investment projects will increase above those available in developed countries and provide attractive possibilities for foreign investors. He thus concludes that foreign investment can play little role in the process of mobilizing disguised unemployment into capital accumulation, but once this process takes place, foreign capital can make a contribution to the further development of the domestic manufacturing sector.

Nonetheless, Nurkse remained skeptical about the potential size of such flows. As noted above, although Keynesian analysis had shown the favorable income and employment effects of foreign investment upon the developed economy lender, it also

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<sup>39</sup> Nurkse (1953, 1954). Indeed, in the latter he calls for a revival of "public-utility type of international investment." p. 754.

showed how domestic borrowing could maintain a steady level of employment in any advanced industrial country without the need of foreign investment. Thus, industrialized countries no longer needed to transfer their surplus output to the world's poorer regions to achieve their domestic policy goals. He also notes that even if such transfers did occur, they would be determined by the domestic requirements of the lender, not by the needs of the recipient country, and might have a perverse impact on the less developed country recipients.

Nurkse thus argued that the economic case for the international transfer of resources through direct investment could not depend on its role in countercyclical policy, but should be made to stand on its contribution to development. He felt that the emphasis that was placed on functional finance in postwar Keynesian policies had cleared the way for the analysis of the developmental aspects of the international movement of capital.

## **A DEVELOPMENTAL APPROACH TO INTERNATIONAL CAPITAL MOVEMENTS**

Nurkse starts by noting that the development dimension of capital movements should focus on capital as a factor of production. The geographical redistribution of capital determined by the principle of real income maximization should thus cover both net investment and the redistribution of the existing capital stock. The analysis of mobility of capital as a factor production would then be based on recognition of the differences in capital-labor-land ratios in different countries, the technical forms which capital should assume in response to different relative factor endowments, the relations between capital movements, and population growth and migration.

Nurkse points out that while external investment may support the level of activity in the short run, in the long term the return flow of income and amortization may cause difficulty. He refers to Domar's theoretical analysis<sup>40</sup> of the problem that suggests that under certain conditions these difficulties may not exceed the benefits. However, he notes that Domar's analysis deals with debt service rather than distinguishing the different

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<sup>40</sup> Evsey Domar (1950).

impact of interest payments and amortization of capital on the development process.

As far as the capital account is concerned, Nurkse joins those who argue that from a development perspective, net repayment of capital should not be necessary, nor should it be expected<sup>41</sup> before the creditor and debtor countries have changed their place and their relative scale of economic development.<sup>42</sup> While individual loans will be repaid, if the economy is experiencing balanced expansion, an increasing amount of new loans will be granted so there will be a net increase in lending, not net repayment. Repayment of foreign loans would not take place until and unless the fundamental conditions of the two economies reversed themselves so that in the creditor economy the propensity to save falls short of domestic investment needs and the opposite occurs in the debtor economy.

After noting the reciprocal nature of the conditions facing the developed creditor and undeveloped debtor country, Nurkse follows the earlier discussion of the transfer problem, dividing the payment of interest by the debtor country into a budgetary or collection problem and a transfer problem. The budget problem requires a positive return in domestic currency of the country in which the investment has been made. This will depend directly or indirectly on the productivity of the investment and thus, on whether balanced expansion is taking place. Two conditions must be met to resolve the transfer problem.

The first is that the foreign loans finance productive investment that increases real national income and provides a return in domestic currency that covers interest. The second (and, in Nurkse's opinion, separate) condition is an export surplus to produce the foreign exchange necessary to service the loan. Nurkse points out that theoretically it is not necessary that the foreign investment lead directly to an increase in exports, or provides direct substitutes for import, in an amount equal to the interest charges. He argues that the foreign investment projects should be determined by their marginal productivity so that the as external capital becomes available it should be invested to yield the highest possible return, taking into account any external economies created by

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<sup>41</sup> An early proponent was J.M. Keynes (1946), "It is obvious that no country can go on forever covering by new lending a chronic surplus on current account without eventually forcing a default from the other parties."

<sup>42</sup> This reflects what was a dominant view in the period, even in official circles such as the IBRD. See Gerald M. Alter (1961). Alter was on the economic staff of the bank and appears to have started analysis of the problem. See also the analysis of Dragoslav Avramovic (1958).

the project, as well as the direct commercial yield. The particular goods that are exported to create the external surplus to allow the payment of interest should be determined by comparative advantage. No particular relation is required between the marginal productivity of capital schedule and the comparative costs schedule. On the presumption that there is no diversion of resources into additional consumption, there should be no difficulty in the servicing the lending.

“The people who buy the new product in the home market, as long as they buy out of their income and not from inflationary sources, must necessarily divert their expenditure from other goods, including imported goods. Therefore, even if the industry does not produce anything that replaces goods previously imported, but produces a net addition of new goods for sale in the domestic market, there is no inherent reason for the balance of payments difficulties to arise, always provided that the sale of the extra goods is not financed by means of inflation. There is no reason why foreign investment should be deliberately kept away from industries producing additional goods for the domestic market.”<sup>43</sup>

However, this solution also requires the cooperation of the creditor country that must be willing to adopt a liberal commercial policy that allows the debtor access to its markets. Nurkse also notes that a country that becomes dependent on external capital runs a risk of a change in sentiment or expectations leading to a financial crisis. Since a capital exporting country has no legal obligation to renew old loans or grant new loans, a simple decline in lending, combined with the legal amortization requirements on existing loans, may lead to a capital reversal that may be unrelated to any change in the real returns earned on the investments. The case is more risky in the case of short-term credits that can be withdrawn on demand or on short notice.

## **FOREIGN AID AS SUPPLEMENT TO DOMESTIC RESOURCES?**

Unilateral aid provides an alternative external source of resources. Nurkse confronts the problem of unilateral transfers from two points of view—resolving the problems associated with private investment flows and assuring that aid is used to support additional capital formation. He notes that in many cases, private flows have become international unilateral transfers because of subsequent default. However, he also notes

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<sup>43</sup> Nurske (1953, pp. 137–38)

that this is not a very efficient solution since default interferes with the continuity of the flow of capital and that their occurrence is not linked to development needs. Better to use unilateral grants in aid. However, he notes that intergovernmental grants are inevitably instruments of foreign policy and such transfers as may occur will be based on political expediency, expressing doubt that intergovernmental capital transfers are inherently more stable and reliable than the private capital movements.

In a reflection that foreshadows modern concerns for global governance, Nurkse points out that

“If we lived under a world government, automatic transfers from the richer to the poorer parts of the globe would occur as a matter of course through the fiscal mechanism. We have no world government. On the other hand, if we depart from the automatic market mechanism of private capital movements, or if this mechanism fails to function, there are no objective, nonpolitical criteria for guiding the flow of funds. The problem of devising a system of international grants is a political problem and, in the nature of the case, political considerations cannot be kept out of it. A system of international grants-in-aid does not stem from the economic mechanism of the market; nor does the principle of progressive taxation. Both are based, of necessity, on political value judgments.”<sup>44</sup>

Nurkse notes that the pattern for such judgments could be based on a mechanism that tends to automatically produce transfers of resources from the richer to the poorer regions within a given country. This fiscal mechanism represents a way in which economic development may be financed in the poorer regions of a given country. It depends on progressive taxation resulting in interregional income transfers that are accepted by taxpayers in the rich and the poorer regions.

They are acknowledged as a natural consequence of the principle of ability to pay and as part of the fiscal system in which this principle is embodied. Nurkse views unilateral income transfers as an imperfect approximation to redistribution that occurs within a country automatically and would take place across countries at different levels of development if they were under a world government.

Quite apart, however, from the inconvenient but inevitable political aspects of international gifts and grants, Nurkse questions whether such transfers provide a solution to the problem of capital accumulation in underdeveloped countries. Even if they fill the

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<sup>44</sup> Nurkse, 1953, p. 80.

gaps in the balances of payments of low-income countries, do they offset the handicap that the demonstration effect imposes on the domestic saving capacity of these countries? Such transfers may be desirable in general grounds. They spring, in part, from the tensions produced by the disparities in living levels and serve to mitigate these disparities. The question is whether they meet the needs of capital development.

In this respect, Nurkse stresses that a country's capacity to absorb foreign aid for investment may be much more limited than its unlimited ability to increase current consumption. The limits are due to a country's backwardness itself, from a lack of various overhead facilities in the early stages of development and the fact that capital development schemes usually require large movements of people, as well as of material goods. In underdeveloped countries, mobility is impeded by lack of transport, housing, and public facilities of all kinds—without deliberate efforts to extend the local bottlenecks, any added provision of external resources, even if directed into the investment sector in the first instance, will directly spillover into consumption. The earmarking of foreign loans or grants to specific investment projects may do something to ensure the productive use of funds, but is not by any means a sure remedy. Only where there is no domestic saving at all to start with will such earmarking be fully effective. It is not otherwise an infallible method of increasing the rate of investment, for it cannot prevent a substitution of external for domestic sources of finance.

## **NURKSE AND MODERN DEVELOPMENT ALTERNATIVES**

Nurkse provides a fresh alternative view to current monoeconomics that says that all that is required is getting the supply side right and the market will produce economic development. By placing the emphasis on the demand constraints to development, Nurkse provides an alternative perspective to elucidate many of the vexing problems of development. In some quarters, this approach is getting a second hearing. For example, his concern with mobilizing underutilized domestic labor resources is now reflected in official documents, such as the 2005 Global Summit Declaration. As economists come to recognize the failure of the market to transfer resources from developed to developing countries, well before real growth theory, Nurkse explained the reasons for low

productivity and low returns in investments that would lead to a market tendency to negative net transfers of resources. His skepticism concerning a possible return to the kind of capital flows that are largely directed by governments and focused on infrastructure, leads to the natural conclusion that the only road to development is through domestic industrialization based on mobilization of disguised labor resources. But this is not anti-trade or anti-market: “The traditional pattern of development through production for expanding export markets is not to be despised and not to be discouraged. ...all opportunities in this direction are [to be] fully exploited, [but] conditions for this type of growth do not... appear to be as promising as they were a hundred years ago.”<sup>45</sup>

Nurkse always allows for the forces of the market and international trade to play a role, but he also recognizes that international goods markets are not freely competitive and the market may not always work to the benefit of developing countries. In the tradition of Myrdal (and subsequently, Kaldor), he notes the importance of cumulative causation in the development process and the necessity for government to set that cumulative process in motion to create a virtuous circle of development. He further notes the paradox of the domestic transfer of resources from rich to poor, and the necessity of some form of global governance to ensure this transfer on a global basis. In the absence of such a global mechanism, governmental aid must take its place. But, he notes, even if it were to occur, weak domestic demand conditions make it difficult for aid to be other than palliative in the vicious circle of poverty.

There are alternative voices in the development debate that echo these themes. The Other Canon,<sup>46</sup> through the work of Erik Reinert, has stressed the importance of the rite of passage for developing countries of domestic industrialization. Nurkse enriches that discussion by reminding economists of an alternative source of increasing productivity that relies on externalities of market size that exist independently of those due to the exploitation of technical economies that are achieved at large scale. It is important to note that Nurkse took this as the obvious conclusion of his reading of the changed economic conditions after 1920—a position echoed in the work of Raul Prebisch.

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<sup>45</sup> Nurkse (1961), “International Trade Theory and Development Policy,” *Economic Development for Latin America.*, p. 239

Nurkse also followed Prebisch in drawing another conclusion from the change in geopolitical and historical conditions—the impact of the demonstration effect leading to excessively high consumption aspirations in the developing countries’ elites, reducing the incentive for increasing investment. For both, this was a structural problem that was difficult, if necessary, to resolve. Nurkse emphasizes the importance of directing disguised unemployment to the formation of capital goods, yet remains uncommitted regarding the institutional mechanism that should bring it about. It is clear that he recognized that market forces could not be relied upon to reach this goal. One possible mechanism has been proposed by The Center for Full Employment and Price Stability<sup>47</sup> through a statutory program of guaranteed government employment to ensure that the resources represented by the unemployed are mobilized for the good of the community. The benefits from these programs would result independently of the kind of socially useful activities they promote. They can be directed towards public infrastructure with high employment content, as in proposals made by the ILO, or towards rural development, as in the recent Indian government legislation to provide guaranteed minimum employment for workers in the rural sector. They can also be used to promote other goals, such as increasing the skill level of the labor force or promoting gender equality. In this broad sense of providing social and economic capital, the program would be precisely what Nurkse recommends to provide the basis for the use of disguised unemployment to support the capital accumulation required for domestic development.

Nurkse does not provide much technical discussion of the provision of finance for the implementation of the schemes to employ disguised unemployment. His discussions of the balance of payments adjustment mechanism do suggest that he is not in favor of fixed exchange rate policies for poor developing countries. His skepticism concerning the need for foreign savings, and likely size and ability of foreign aid or direct investment, suggests that he believes financing can be provided by internal means. In this respect, his approach may be considered to be close to the German Chartalist School of Knapp (recently amplified by Mosler and Wray)<sup>48</sup> that suggests that an economy that employs flexible exchange rates and eschews external borrowing may achieve a degree of

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<sup>46</sup> See [www.othercanon.org](http://www.othercanon.org) for background references.

<sup>47</sup> See [www.cfeps.org](http://www.cfeps.org) and [www.levy.org/forums](http://www.levy.org/forums) for references to the relevant literature.

monetary sovereignty that eliminates an external constraint on domestic demand. This frees the way for both a policy of balanced expansion and the guaranteed employment of disguised labor.

Finally, it is important to note Nurkse's preference for his strategy of industrialization for export, a policy that has been followed by most successful Asian developing countries. However, he also notes that after this strategy has been employed, it may be necessary to shift to a strategy more dependent on domestic market growth. This is precisely the problem that has plagued Asian countries, starting with Japan—how to shift from external demand driven growth to domestic demand driven growth, when high capital accumulation and savings are no longer necessary and Keynesian domestic demand policy becomes relevant.

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<sup>48</sup> Warren Mosler (1995) and L. Randall Wray (1998).

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