



Balance Of Payment Crises In Developing Countries: Causes And Consequences

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ABSTRACT

This paper delves into the multifaceted challenges faced by developing countries for their economic development and the implications of these challenges on their Balance of Payment (BOP). The primary focus is to explore the potential strategies for overcoming these obstacles. Along with prevailing handicaps in developing countries the research also scrutinizes the per capita real income in developing countries compared to more advanced economies like USA, Canada, Australia and Western Europe. The study also highlights the persistent BOP problems arising from fluctuations in terms of trade, instability of export earnings, unpredictability of foreign capital inflows and inefficiency in domestic policies and institutions. These issues demand a comprehensive and coordinated approach to stabilize BOP and promote long-term economic growth. The paper sheds light on the importance of a balanced approach to policy-making, emphasizing domestic resource utilization while judiciously leveraging both foreign and domestic capital. By adopting comprehensive strategies that enhance productivity, efficiency and competitiveness, developing countries can achieve higher economic growth and bridge the economic gap with advanced nations. These efforts will not only contribute to their own prosperity but also promote global economic integration and equality among nations.

Keywords: Balance of Payment, Developing Countries, Development

Introduction

Poverty in developing countries is the outcome of many handicaps from which these countries suffer even at present. Social cleavage, rigid class system, illiteracy, overpopulation, use of primitive methods of production, excessive dependence upon agriculture, inadequate irrigation facilities, absence of banking facilities, inadequate or no saving, lack of transport facilities, inadequacy of markets are some of the evils which have cumulatively resulted in lower per-capita income and the misery to the millions. "Underdeveloped countries are characterized by low average levels of per capita, low enough to raise the question how the population manages to survive."¹

According to the U.N. experts the per capita real income in developing countries is comparatively low to the incomes of the U.S.A., Canada, Australia and Western Europe. As per UN only, in 2020, only 35 countries were considered "developed." All developed countries were located in either North America, Europe, or "Developed Asia and Pacific."² The main reasons may be summed up as (a) rapidly increasing population, (b) excessive dependence on agriculture resulting in underemployment, (c) seasonal unemployment and (d) deficiency of resources in land and capital in relation to available supply of labour resulting in underemployment.³ Same view was expressed by Ragnar Nurkse who described the underdeveloped areas as those low-income countries which are "underequipped with capital in relation to their population and natural resources."⁴

Inevitable BOP crises

Balance of payment (BOP) is a record of all the transactions between a country and the rest of the world in a given period of time. It includes the trade of goods and services, the movement of capital and financial assets, and the transfers of aid and remittances. A BOP problem occurs when a country faces a persistent deficit or surplus in its current account, which measures the net flow of income from trade and factor services. A BOP

deficit means that a country is spending more foreign currency than it is earning, while a BOP surplus means that a country is earning more foreign currency than it is spending.

Developing countries often face BOP problems due to various factors, such as:

- The volatility and deterioration of their terms of trade, which means the ratio of export prices to import prices. Developing countries tend to export primary commodities and import manufactured goods, which makes them vulnerable to fluctuations in global demand and supply, as well as price shocks and protectionist policies by developed countries.
- The inadequacy and instability of their export earnings, which depend on the quantity and quality of their products, the competitiveness of their markets, and the access to foreign exchange. Developing countries often face difficulties in diversifying their export base, upgrading their technology and skills, and overcoming trade barriers imposed by developed countries.
- The insufficiency and unpredictability of their foreign capital inflows, which include foreign direct investment (FDI), portfolio investment, loans, grants, and remittances. Developing countries need foreign capital to finance their development projects, such as infrastructure, education, health, and industrialization. However, they often face challenges in attracting and retaining FDI, accessing international financial markets, managing their external debt, and coping with capital flight and sudden reversals.
- The rigidity and inefficiency of their domestic policies and institutions, which affect their ability to adjust to external shocks and to promote economic growth and development. Developing countries often suffer from macroeconomic imbalances, such as high inflation, fiscal deficits, and exchange rate misalignments, which undermine their external competitiveness and stability. They also face structural problems, such as low productivity, weak governance, corruption, poverty, inequality, and social unrest, which hamper their economic potential and performance.

These factors can interact and reinforce each other, creating a vicious cycle of BOP problems for developing countries.

Considering the above-mentioned handicaps of these countries it is but natural that their balance of payments position is far from satisfactory. There is always a deficit in the balance of payments because of the preponderance of primary production which constitutes the exports. These primary products have an inelastic demand with respect to price. A reduction in the price of these products does not increase their demand but decreases the yield from the exports affecting the balance of payments position adversely. Apart from it the demand for the raw materials, which constitute the exports, is income-elastic. If there is a fall in the incomes of the importing countries, it will result in more than a proportionate fall in the demand of these products and consequently in the decline of the exports of the supplying countries which are underdeveloped. So, if there is recession in its export market, an underdeveloped country will suffer from a decline in its national income and an imbalance in its balance of payments. The external balance can be established at a lower level, but it will not be a desirable phenomenon.

The bargaining power of these countries is very weak which results in double loss. The sales i.e., the export yield is very low. Primary commodities are not standardized and hence buyers have the upper hand and these commodities fetch low prices. The purchase i.e., imports, consist of capital goods and manufactured articles and here the seller has the dominant voice with the result that the importers have to pay a comparatively higher price for their purchases. This double loss in the visible trade items of underdeveloped countries is another factor which affects their balance of payments adversely.

Apart from it the prices of the primary goods are often subjected to fluctuations due to speculative activities as well as due to the fact that the exports of underdeveloped countries constitute only a marginal supply to the importing country. If there is any fall in the demand for the exports of underdeveloped countries then these exports are exposed to proportionately drastic cuts. Due to lack of diversification of their dependence upon the exports (which are composed of only one or two commodities) the earnings from exports of these countries are always subjected to fluctuations.

“A developing country has powerful reasons for maximizing the total value of its exports, for its ability to export will always be the main determinant of its capacity to import the capital goods which it needs in order to build up, *inter alia*, its manufacturing industries⁵.”

The terms of trade of these countries are thus unfavorable and there is a strong argument to improve it when we find that the “exports of primary goods account for nearly 90 percent of the foreign exchange earned by underdeveloped countries⁶.” Unfavorable terms of trade are the main cause of the existing tension between the developing countries and industrially advanced nations. The former is not satisfied with the size of their export's proceeds. On the one hand they have to pay a high price for their imports, and on the other, their exports fetch less price. Under such a condition their balance of payments position can be anything but sound. According to a United Nation Study⁷ there was a secular downtrend in the prices of primary goods relative to the prices of the manufactured goods.

Thus, we find that there is a constant strain on the balance of payments of the developing countries due to inherent handicaps in their economies. A change from economic stagnation to economic prosperity is being witnessed in many countries. Those which are politically emancipated are now trying to gain economic

freedom and are making their development plans to raise their per capita incomes and thus the living standard of their people. The sharp contrast between the standard of living of backward and advanced countries, consciousness of their potentialities, suffering due to depressions, imposition of exchange restrictions and direct controls, advancement of science in advanced nations have created an unrest in these countries to make ceaseless efforts to achieve a position of equality and dignity among the free nations of the world.

The developing world

Advanced nations of the world realized long time ago the need to help the LDCs in implementing their development programs. They realized that the investment in these regions may offer them more remunerative outlets than those available internally. Moreover, trade can benefit exporting country only when its customers are affluent. Imppecunious neighbours are imppecunious customers. Hence in order to derive the maximum benefits from the trade, it is all the more necessary that the standard of living in the underdeveloped countries be raised and the gulf of extreme economic inequality between nations be bridged.⁸ The object of 'expanding world economy' will only be realized with the help of a continuous international flow of investment funds:

"Only when all these underprivileged nations with their great multitude of people with different facial features, color of skin, religions, folklores, and cultural heritages, have risen to equality of opportunity will the world become integrated."⁹

Economic Development and Balance of Payment

"Economic development may be defined as an increase in the productive capacity and production of a country at a rate higher than the increase in its production.... from a technical point of view, it is a task involving national education, necessitating a rapid and intensive incorporation of the technical knowledge of other countries. From an economic point of view, it means adequate planning, overcoming inertia, stimulating the initiative of the private entrepreneur and setting up industries that may substitute for importing of foreign goods without too much harm to the domestic consumers. And, from the financial point of view it means a gradual growth in investment, in the money supply and in monetary income in line with the increase in productivity."¹⁰

The main object of any economic development program is to raise the level of national income through increased per capita output so that every individual consumes more than before. This object can be attained in various ways. In particular, the remedy lies in the development of a country's natural resources, acquisition of technical skill and improvement in its capital equipment. Any action that increases the productivity of labour will add to the development of the economy and attainment of higher standard of life.

The essence of economic development is the creation of economic and social overhead capitals, which leads to increase in national output through creation of employment opportunities and reduction of vicious circle of poverty both from the demand side and supply side. Economic development is sine qua non and is not normally achieved in the short run rather in the long run, where the citizenries of per se country could match up with the 21st century trends relatively to economies of the world. The discovered problems that are responsible for the emerging economies are resulting from low capital formation.¹¹

Capital shortage is a characteristic phenomenon in underdeveloped countries, "sometimes relative in the sense that labour and land could be made productive if more capital were available, sometimes absolute in the sense that the supply of capital is insufficient to employ the population fully even in the least capital-intensive activities¹². It is obvious that for the attainment of rapid growth the need for capital will be very heavy. Industrialization demands a substantially high rate of capital formation (because the cost of industrialization to the ratio of National Income varies inversely with national income *per capita*.) In LDCs the process of capital formation is hindered in its initial stage. The average low-income level hardly leaves any margin for savings. In addition to it, where consumption standards are already too low, any further curtailment of consumption is not only undesirable but also impediment in the development program. Under such circumstances the cost of capital formation will have to be borne by the higher income group which in these countries is like the morning stars.

The problem is how to get over this initial difficulty. There are two major sources of capital formation. (I) Domestic Saving and (II) Foreign Borrowing. Capital formation with the help of first method is a long process and consists of three stages-

- (I) **Creation of savings**- surplus resulting from an excess of income over expenditure.
- (II) **Canalization of savings**- conversion of savings into funds for investments.
- (III) **Investment of savings**- resulting in creation of capital goods.

This long process is dependent upon the current level of income, propensity to consume and finally-what is the most crucial factor-entrepreneurial enterprise. Initiative and ability in the community to force national savings up to the level of investments is a very difficult task. It is all the more difficult in the case where the level of income is so low.

Foreign borrowing involves many uncertainties and great risks. It is always better to bank more on its domestic resources and less on foreign capital according to the United Nations Sub-Committee on Economic Development. "The development of the national industry of economically underdeveloped countries and

territories should be implemented primarily through the maximum use of their own resources. The bulk of the financial resources required for this development have necessarily to come from the countries themselves¹³. The borrowing country is put in great balance of payments difficulties and has to face the situation when it has to repay the loan and even at times when interest has to be paid. The situation becomes worse progressively with the continuance of borrowings. In order to avoid the balance of payments problem a country must bank more on its domestic resources for the economic development outlay.

According to the 2021 IDS report the total external debt of DSSI-eligible countries climbed 9.5% to a record \$744 billion in 2019 from the previous year highlighting an urgent need for creditors and borrowers alike to collaborate to stave off the growing risk of sovereign-debt crises triggered by the COVID-19 pandemic. The pace of debt accumulation for these countries was nearly twice the rate of other low- and middle-income countries in 2019.¹⁴ The data 2021 deferrals for DSSI and Participating Countries is given below:

Table 1 2021 Defferals for DSSI-eligible and Participating countries

S.No.	Debtor	Total Amount outstanding (US\$ thousand)	S.No.	Debtor	Total Amount outstanding (US\$ thousand)
1	Afghanistan	988,724	8	Maldives	1,340,502
2	Bangladesh	23,701,439	9	Medagaskar	611,696
3	Bhutan	2,141,334	10	Myanmar	7,019,049
4	Congo Demo. Rep	3,938,085	11	Nepal	1,043,679
5	Congo Republic	2,895,702	12	Nigeria	4,523,935
6	Ethiopia	8,050,222	13	Pakistan	37,233,734
	Ghana	3,233,494	14	Taijikistan	1,268,440

Source: official website of The World Bank, <https://www.worldbank.org/en/programs/debt-statistics>

It is generally advocated that in developing economies balance of payments must be under watchful eyes of the government and must be controlled. This is because planned economic development outlay exerts a great strain on both the debt and credit sides of BOP. Firstly, it is seen that due to development programs more raw materials are used internally. This affects the exports of that country. It is not able to export even that much of primary goods which it used to export before the implementation of the development program. At the same time due to inflationary conditions as a result of development expenditure, the exports get a further setback in the competitive market. Consequently, there is a fall in its exports and the imports become unduly augmented because the country requires more and more raw materials, foreign skills and capital goods at the initial stages. Thus, the country in question faces the problem of both internal and external financing. It is generally seen that a country can start with some reserves of foreign exchange then the problem of external financing will not be so severe, but at present all the developing countries are deficient of foreign exchange reserves. Besides a certain amount of foreign exchange must be preserved to meet temporary or emergent situations like cessation of foreign demand for an important foreign exchange earning article, crop failure, necessitating imports etc. After meeting these reserves, it is very difficult for any underdeveloped country to have further reserves to finance imports of additional essential raw materials and capital goods. Thus, it is found that hardly any underdeveloped country can proceed with its development program concentrating purely on domestic resources.

It is no doubt a safe policy to depend less on the foreign borrowing but we cannot rule out its absence in a development program. "And yet, external resources at strategic points and stages can be of so much assistance in a period of rapid development that it is desirable consistently with other objectives, to create conditions favorable to their inflow"¹⁵. A country should utilize the foreign capital for its development program, but utilize it very cautiously and economically lest it may create a serious problem at the time of financing the debt.

The degree of dependence upon foreign capital is governed by the size of the development program and the amount of domestic capital available for the purpose. But at the same time, it is also subject to the availability of the foreign capital. "From all the available indications the prospects for most underdeveloped countries of securing foreign capital on an adequate scale, whether private investors, governments or international agencies, do not seem to be bright."¹⁶ The problem of foreign capital acquisition has become more or less global in character because of rapid spread of development process. Under such a circumstance the available foreign capital should be invested in those industries which may help to lessen the payment problem.

But as regards those projects which require heavy capital and which necessitate foreign borrowing, a country must decide first the volume of investment which it should undertake in order that it may not be faced with balance of payments problems. It is quite obvious then that the size of the program will be more or less dependent upon the size of the available foreign capital. The first factor in this context is the condition on which the funds are obtained. It needs to be seen whether the funds are in the form of grants, in which there is no problem of any debt service or whether they are loans which require the payment of interest or of direct investment calling for the remittance of dividends. It will also depend upon the fact whether the loan is obtained from a private investor or government or an international institution like I.B.R.D. This factor will

affect the duration of the investment. With a private investor the time-limit of loan is supposed to be the longest (unless some unforeseen adverse policy in regard to foreign capital is adopted by the borrowing country which may necessitate the withdrawal of the loan). A government-loan may be withdrawn at a short-notice if the tax-payers of that country demand the withdrawal. An international institution may fix a time-limit as a condition for loan and may keep its capital revolving from country to country to give an equal opportunity to all its members.

Reforms- The alternative mechanism

The initial basic development mentioned above must be financed with the help of domestic resources. Not all the basic developments require capital, some of them require reforms. "One can promote economic development often just as quickly and much more cheaply, by an improvement in economic institutions, rather than by capital expenditure by a project.

The first step in the development program always should be to see, before we start spending capital, before we start spending money what are the improvements, we can do without spending money. Quite often the institutional improvements, which cost no money at all, or very little money, may provide an extra output that will help greatly to get to the stage when you can contemplate larger projects."

Direction and Ratio of Investment

The next important factor is the direction of investment, which is related with the ability of the borrowing country to earn a foreign exchange surplus to make the required payments. If the foreign loan is invested in such industries which can either augment export surplus or reduce import surplus, the means of repayment is guaranteed. Hence it is very essential for a borrowing country to consider the direction of its investments. The borrowing country should invest the funds in such industries through which it can earn certain amount of surplus to make necessary payments. The investments can be made in the export industries as well as in industries where the output replaces the former imports. By doing so the country can earn more from the increased exports and at the same time it will have to pay less to the foreigners due to the decreased imports. Thus, it can enjoy a surplus, with the help of which it can repay the debt. Hence, a proper direction of the investment is the first condition for the avoidance of balance of payment difficulties.

The next step which a borrowing country should take is to decide the optimum expansion ratio during the period of investment. Even if the funds are received in the form of grants, yet there is possibility that the country may face balance of payment difficulties. In case the investment programs are too large and too ambitious in relation to the supply of foreign assistance on which the reliance is made then either the speed of the program will be slowed down or the fixed targets will not be achieved. The size of the program should not exceed the sum total of domestic and foreign resources.

In case of grants where the servicing of the foreign debt does not arise, the balance of payment difficulty can be experienced. Multiplier effect in income during investment stimulates the imports so much that they exceed the amount of foreign exchange available for the purpose. Owing to the inherent poverty in the underdeveloped countries it is quite obvious that the residents of these countries save less and spend more due to increased incomes during the program of development. Imports of manufactured articles increases. Export prices go high due to inflationary tendencies and thus there is a fall in the volume of exports also and consequently the export proceeds decline. Both these factors worsen the balance of payments problem and retard the progress of the development program. Even if it is not a case of grant but of a loan similar difficulty arises. In the later stages, it is usually hoped that the development program will enable the country to export more. The increased income from increased exports is also exposed to the same risk. The government must somehow manage to curb the increased expenditure either by taxation or by inducing people to save more, then only the balance of payments difficulties will be solved. Increased incomes can be channelized for further investments for the creation of capital goods. Capital should be created in the process of development so that means for servicing the debt are created. "An improvement in the terms of trade will make no significant contribution to capital formation unless the increment in export proceeds and hence in people's income, is directed into saving, voluntary or involuntary¹⁷."

Policy adoption debate

There is a difference of opinion regarding the type of policy which a developing country should adopt at the time of its economic development. Should it primarily aim at maintaining equilibrium in its balance of payments or should it concentrate more on its fiscal and monetary policies in order to tap its domestic resources and get more out of them and leave the balance of payments position to adjust for itself? If the country in question attaches more importance to external balance, it means that much of the nations' wealth will be blocked in reserves consisting of foreign currencies. This unnecessarily delays the speed of development. If it takes the latter course, it is certain that it will have to adopt inflationary measures, devaluations, and import restrictions in order to avoid balance of payments difficulties. Here also the progress of the development program slows down. Inflationary methods discourage savings, devaluation discourages foreign investment, and import restriction leads to high cost of production at home. Under such circumstances it will have to choose the lesser of the two evils.

Any development program should not be implemented if its size is large enough to strain the economy of the country unduly and excessively. A large program in the short run will put a very heavy pressure on the balance of payments in many ways. First, the import of capital goods and raw materials will increase and what was previously exported will also decline. Secondly, with increased income at home there will be an increase in the expenditure on imported goods. Thirdly, the increased income will be spent on such goods which would have been otherwise exported. Fourthly, the increased demand would raise the prices of the commodities which in turn will raise the cost structure of the development program through wage-price spiral. At the same time the increased cost structure will make the competitive position of the exports very weak. The prices of the domestic goods will be higher than the imported goods, with the result that there will be an increase in the imports of the country. As mentioned above unless the increased demand is curbed by taxation or import-restrictions, any over-ambitious program will worsen the balance of payments positions in short run. In the longer run, however, it can ease the balance of payments problem provided, of course (I) if the country in question designs its additional investment to earn or save foreign exchange or, (ii) if the increased productivity helps to check the increase in prices and costs.

Thus, it does not imply necessarily that a cautious policy which reduces the size of the development program can avoid the balance of payments difficulties. In the longer run, such a policy will bring more harm than good. If the country in question fails to curb completely the rising wages and money incomes, the productivity of the country will be affected adversely. Slowing down the growth in real-incomes can result in the curtailment of additional investment, which means that the source of earning the foreign exchange will dry up.

Cutting down the development projects in order that balance of payments problem may be avoided is also exposed to other risks. If the curtailment in the development program reduces the total demand of the country, it would mean an underemployment of domestic resources which could have been utilized profitably for development purposes. Hence a country must adopt a policy which does not affect the prospects of its increased productivity and additional investment.

The country must also keep in view the effects of price changes and structural changes on the balance of payments position. If the changes in the general price level of the country are faster than that of the rest of the world, the balance of payments position will be affected adversely. Assuming that the price changes in the domestic market are in line with the foreign prices and that there is full employment in the country, the structural changes may cause a higher rise in imports than exports. This will also affect the balance of payments. Although a fall in the price level is desirable from the balance of payments point of view but the full employment position will make it difficult. Under such a case the country in question will have to adopt a very cautious policy. It can either change the pattern of its development program or give more emphasis on some projects that could earn and save foreign exchange or it can cut the size of the program to eliminate the risk of balance of payments as mentioned above.

The latter action will present balance of payment difficulties in future. In such a case the government can meet the situation either by deflation or import-restrictions or currency devaluation or with the help of monetary reserves.

To overcome these problems, developing countries need to adopt a comprehensive and coordinated approach that involves both short-term measures to stabilize their BOP position and long-term strategies to enhance their BOP sustainability. Some possible measures include:

- Improving their export performance by diversifying their products and markets, increasing their value addition and quality standards, enhancing their competitiveness and innovation capabilities, and expanding their regional and global integration.
- Mobilizing more foreign capital by creating a conducive environment for FDI, improving their creditworthiness and access to international financial markets, managing their external debt prudently and responsibly, and leveraging the potential of remittances and diaspora networks.
- Implementing sound macroeconomic policies by maintaining price stability, fiscal discipline, and exchange rate flexibility, as well as strengthening their monetary and fiscal institutions and frameworks.
- Pursuing structural reforms by improving their productivity and efficiency across sectors, fostering good governance and transparency in public administration, combating corruption and illicit financial flows, reducing poverty and inequality, and enhancing social cohesion and inclusion.

These measures require strong political will and commitment from developing countries themselves, as well as support and cooperation from developed countries and international organizations. By addressing their BOP problems effectively, developing countries can achieve higher economic growth and development outcomes for themselves and for the world at large.

Due to foreign control and management of the existing population in these countries and also due to the exploitation of their mineral resources by foreign investors without being used as a basis of industrialization, there is always the lack of desirable balance in their trade with the rest of the world. Foreigners invested their capital in mines, plantation, railways and other primary activities producing raw materials so that their industrial centers could get a regular and comparatively cheap supply of raw materials. Hence the exports of

these countries were composed of primary commodities and their imports constituted the manufactured goods from those very centers to which they exported.

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Also compare: -
"Since the development of an economy like that of India requires initially imports on a large scale of machinery, capital equipment and other producers' goods as well as of consumer goods like food grains, foreign exchange is bound to be a bottleneck for some time to come. What has to be ensured is, on the one hand, that the development program is so framed as to increase the potential exportable surpluses and decrease the import requirements of the country and, on the other that the pressure on foreign exchange is kept within manageable limits."
Cf. "**The First Five Year Plan**", Government of India, p. 63.
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