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15381

COMPARATIVE ADVANTAGE, EXTERNAL FINANCE

AND

THE VULNERABILITY OF INDUSTRIALIZATION.

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Book

## I. COMPARATIVE ADVANTAGE : STATIC AND DYNAMIC

In orthodox economic theory, the pattern of international division of labour is supposed to be guided by comparative economic advantages among nations. However, it has long been recognized that this comparative cost doctrine is too static a notion to be an adequate guide to policy. If countries always specialized on the basis of their existing comparative advantage, then Japan would perhaps still be exporting silk cloth and parasols instead of automobiles, television sets and semiconductors!

Specialization on the basis of existing comparative advantage reinforces the status quo in the pattern of international division of labour. Naturally, this appeals more to countries that benefit most from the existing pattern of international trade. It is by no means an accident that Britain in the nineteenth century as the foremost industrial power found comparative cost to be a most appealing doctrine. However, the virtues of comparative advantage was not equally appreciated then either by Germany or by the United States, as they were the "late-comer" countries industrializing to challenge the world-wide industrial supremacy of Britain.<sup>1/</sup> The classical argument about protecting "infant industries" from free trade articulated this tension between the ruling industrial power and other late-comers trying to industrialize. The historical context has changed now, but that tension still persists between the industrially developed nations and the developing nations seeking rapid industrialization to alter the existing pattern of international division of labour.

The argument for protecting "infant industries" can be intellectually justified by extending the same principle of comparative advantage beyond its limited, static context. Dynamic comparative advantage, however, is a much wider principle because, it intends to achieve comparative advantage through reduction in the cost of production over time. The accrual of dynamic comparative advantage to a country in certain branches of manufacturing can occur as a process through time in a variety of ways. It can occur due to increasing returns to scale i.e., the average production cost decreasing as the scale of operation increases. This is the classic case of industries characterised by "increasing returns", originally enunciated by Marshall. It has been given a sharper focus in recent years by the so-called "Kaldor - Verdoorn law" (Kaldor, 1966) which encompasses the notion of induced technological progress. Basing himself on the notion of cumulative causation, Kaldor argued that technical progress stimulates economic growth which, in turn, induces further technical progress. The net result is dynamic increasing returns associated with a higher rate of economic growth.<sup>2/</sup> The process of cost reduction through time may also come about due to "learning by doing" which can be looked upon as a special case of labour-productivity raising technical progress (Arrow, 1962). A somewhat different, but related line of argument was originally put forward in the "big push" theory of industrialization (e.g. Rosenstein Rodan, 1943; also Scitovsky, 1954) which concentrated more on the static aspect of how to exploit the

economies of scale in a developing economy. The argument emphasised the need to develop a range of interrelated industries more or less simultaneously through coordinated investment decisions in the form of a "big push" in order to exploit economies of scale that are external to each investment project, but internal to the economy as a whole.

From an analytical point of view therefore, the case for dynamic comparative advantage rests on increasing returns to scale, both in a static and in a dynamic sense. And, when increasing returns to scale operates, it is a well-known result of conventional economic theory that even the mythical world of perfect competition fails to allocate resources efficiently. Consequently, neither a general prescription for freer trade nor specialization in trade on the basis of current international prices can be intellectually justified even on the narrow ground of allocative efficiency, if increasing returns (indicating possibilities of dynamic comparative advantage) exist in some form or the other. In this context, two analytically distinct elements in the argument for deliberate industrialization, which may often run contrary to the static view of comparative advantage need to be distinguished. First, if dynamic comparative advantage operates, then even on grounds of allocative efficiency of (global) resources overtime, most developing countries would need to embark on a path of industrialization, protecting their particular "infant industries" whenever necessary. Secondly, considerations of allocative efficiency apart, the current pattern of international distribution of income

sustained by the existing international division of labour can be structurally altered, only if developing countries acquire greater industrial and technological capabilities over time. In a political vision of rapid industrialization shared by many developing countries, these two considerations of more efficient allocation of (local) resources over time and a more equitable pattern of income distribution among the nations through trade are often intertwined. These considerations, in turn, also provide a compelling logic to the need for industrialization of the developing world at a rapid and sustained rate beyond mere political rhetoric of North-South dialogue.

## II. PRE-CONDITIONS FOR SUSTAINED INDUSTRIALIZATION

An economic strategy intended at exploiting the dynamic increasing returns and comparative advantage would typically require substantial transformation of the economic structure of a developing country through a sustained process of industrialization. The longer-term content of the process of industrialization namely, which type of industrial structure to aim at, is guided in turn by the specific areas or types of increasing returns that the country intends to exploit over time. The empirical evidence surrounding the "Kaldor-Verdoon law" generally suggests that the accrual of dynamic increasing returns are usually significant when the manufacturing sector has a sustained, high rate of growth. This also provides some support to the logic of industrialization which places particular emphasis on the development of the manufacturing sector.

However, as the recent experiences of several developing countries under widely different individual circumstances have demonstrated, the ability to sustain a high rate of growth of the manufacturing sector over time is a complex and difficult task, both economically and politically.<sup>3/</sup> From an economic point of view, a whole configuration of economic factors has to be supportive of such an industrialization process. For analytical purposes, one can distinguish a set of these necessary (but not sufficient) conditions. First and perhaps most important is the requirement of an adequately high and rising level of

effective demand i.e., expanding markets for selling manufactured products. While much of the conventional academic discussion of import-substitution versus export-promotion strategies concentrates on questions of allocative efficiency and the associated production costs in the two strategies (which is basically an application of the static comparative cost principle), the choice for import substitution rather than export promotion has often been dictated in practice, by considerations of steady access to a secure market for selling manufactured products. Indeed, the size of the country and its home or domestic market is a crucially relevant consideration here. Because, a larger home market where import can be gradually substituted, increases the likelihood of such a strategy being more viable over time. In this context, it seems an over-simplification to suggest that an economic ideology of "self-reliant" nationalism is the dominant influence governing the import-substitution strategy of relatively "large" economies like China or India. In any case, the size of their potential domestic market would weigh heavily for placing greater reliance on the internal rather than on the external market during the process of development of their manufacturing sector.

Secondly, a related and certainly theoretically unresolved problem is that of market uncertainty. Arguments can be marshalled on both sides, either to show that greater reliance on the domestic or on the foreign market increases the degree of risk. For individual countries, it is largely an empirical question i.e., whether their



export market or their domestic market fluctuates more widely.<sup>4/</sup> Nevertheless, two reasonable generalizations are in order.

(i) To the extent, the developing countries seek to finance their industrialization process through export of primary commodities, the terms of trade between manufacturing and primary products is known to have a very strong cyclical bias. This means that the slow-down of industrial activities in the North depresses far more strongly the price level of primary products than that of manufactured products.<sup>5/</sup> Consequently, the relative price moves sharply in favour of manufacturing when industrial activity slows down in the OECD.

(ii) At least in principle, greater reliance on the domestic market by a developing country permits its government to try to manage domestic demand through a conventional set of fiscal and monetary policy instruments. The policy instruments at the disposal of the same government seem far less certain or effective, when heavy reliance is placed on the external market. These two considerations suggest that an inward-looking strategy, if otherwise viable, would probably be marked by a lower degree of market uncertainty.

Finally, there is the important question of both the source and the mechanism by which the financing of an industrialization process can be sustained over time.<sup>6/</sup> The historical evidence of the agrarian revolution preceding the industrial revolution, particularly in the case of Britain, has often been interpreted as providing evidence that an adequate level of agricultural development is a pre-condition

for rapid industrialization. There is certainly an essential element of truth in this historical interpretation insofar as agricultural surplus can play a crucial role in financing the process of industrialization. Nevertheless, the physical route to the transformation of agricultural surplus into industrial investment for increasing capacities is by no means an easy historical process. The easiest route to this transformation is, of course, through the intermediation of foreign trade, i.e., the developing country concerned sells its surplus agricultural produce to buy back machinery, equipment and industrial intermediate goods needed for industrialization. However, as already pointed out, this route of transformation of domestic agricultural surplus into industrial investment through foreign trade has been exceptionally vulnerable to an adverse terms of trade effect. In addition, it may also happen that there is an absolute limit to the size of the international market for selling agricultural produce. The operation of such quantity - and price-constraint may tend to make the financing of steady industrialization unsustainable over time.

From a longer term point of view, even more problematic is the question of generating agricultural surplus in the face of rising population pressure in many developing countries. Even when institutional reform of the agrarian system is carried out, its productivity-raising effect is likely to level off over time and, a developing country

trying to finance its process of industrialization through agricultural surplus is still confronted with the longer-run problem of how to raise agricultural output. This has almost a paradoxical aspect for policy formulation because, beyond a point, growth in agricultural productivity can only be maintained through application of higher doses of industrial inputs and mechanization of agriculture. But this in turn becomes feasible only if the country has been already industrialising at a reasonable pace.

However, the case should not be overstated on either side. On the one hand, a process of industrialization that is financed almost entirely through agricultural surplus via foreign trade is almost certain to run into serious problems over time, because of its vulnerability on account of constraints imposed by the terms of trade and by the limited size of the international market. But on the other hand, it is equally true that a country which does not have a dynamic agricultural sector, cannot usually maintain a steady and rapid pace of industrialization, except under very special circumstances.<sup>7/</sup> Not only the requirement of foreign exchange to meet domestic demand for food and agricultural raw materials may set up a binding constraint on the financing of industrialization, but even more importantly, the vulnerability of a developing country which is not reasonably self-sufficient in food must generally be considered to be exceptionally high, both in economic and in political terms. In short, the familiar theme of development economics that the forward

and backward linkages between industry and agriculture are far too strong to be neglected in a process of industrialisation continues to hold true as a general principle. The neglect of this general principle, especially due to an over-reliance on the transformation possibilities created by foreign trade or temporary access to foreign capital, can only make a process of industrialization exceptionally vulnerable to unpredictable developments on the international front.

.. p.11

III. INTERNATIONAL CAPITAL MOVEMENTS AND  
THE VULNERABILITY OF INDUSTRIALIZATION

So long as a developing country depends predominantly on its domestic savings or surplus to finance its level of industrial investment, net inflow of foreign capital plays a relatively minor role in the industrialization process. As already pointed out in the last section, the external vulnerability of the industrialization process under these circumstances depends mostly on the difficulties associated with the transformation of domestic savings into industrial investment due to such factors as an adverse terms of trade effect or limited export markets. However, the very mechanics of vulnerability changes significantly as the relative importance of net inflow of foreign capital increases for financing the process of industrialization.

Broadly speaking, until the first oil shock of 1973, the developing countries as a whole maintained relatively modest trade deficits, often through such policies as import and exchange control. Their current account deficits were largely financed through intergovernmental grants and official loans (including those from the international institutions) with direct foreign private investment playing a relatively minor role. For instance, during the decade of the 1950's, total official donations to the developing countries were of the order of \$ 2 billion per annum, with both official loans and direct private investment from

abroad on a even more limited scale. This pattern did change somewhat during the 1960s, especially as direct investment by American corporations began to rise perceptibly from the late 1950s. However, a large proportion of American corporate investment was directed to Europe and the broad pattern of the 1950s persisted in a modified form through most of the 1960s. It was also during this period that the Euro-currency market started its phenomenal growth which, in turn, spurred the growth of international banking. Along with the Euro-currency market, developed (though at a significantly lower rate) the long-term market in Euro-bonds. Such bonds were initially underwritten by British merchant banks and American investment banks, but the technique of financing soon became more broad-based and dominated by international loan syndications involving commercial banks of various nationalities. These rapid institutional changes in the international capital market set the stage for its subsequent development.

On the one hand, the emergence of significant payments surplus of OPEC following the first and second oil price rise (in 1973 and 1979 respectively) and the counterbalancing deficit most incurred by the non-oil exporting developing countries since 1973, brought about almost a mutation in the pattern of international capital flows. It is well-known that commercial bank lending to the developing countries largely "recycled" petro-dollars

to meet the payments deficit of the oil-importing developing countries. However, it is not always emphasised that commercial bank lending was concentrated to a small number of developing countries in conformity with the pattern of direct foreign private investment. For instance, developing countries with annual per capita GNP exceeding \$ 1,000 received 65 per cent of foreign investment from DAC countries during 1978-80, while during the same period, low income developing countries at annual per capita GNP of less than \$ 380 received less than 5 per cent of direct private investment from DAC.<sup>8/</sup> This pattern of concentration was even more pronounced in the case of commercial loans from private banks e.g. nine newly industrializing countries in the above-thousand-dollar per capita income category accounted for nearly 72 per cent of total Euro currency bank credit in 1979-81.<sup>9/</sup> Therefore, one crucial impact of the tendency towards privatization of the international capital market must be seen as quantity-rationing of almost all forms of private capital flows against the poorest developing countries, who had to depend almost entirely on the far more limited flow of official development assistance (ODA).<sup>10/</sup> Indeed, information available from the banks in the BIS reporting area suggest, that some of the poorest developing nations were net depositors during the 1978-81 period of heavy commercial lending.

while the poorest among developing countries were severely credit-rationed by the international commercial banking system, there was massive but selective expansion

in international commercial loans. The net external assets of banks in the BIS reporting area increased more than six times between 1973 and 1983. Of this increase in net credit from \$ 155 billion in end-1973 to \$ 1,020 billion in end-1983, almost half was accounted for by credit-receiving countries lying outside the BIS reporting area.<sup>11/</sup> However, already by the middle of 1982 and definitely by early 1983 the boom of net commercial lending, mostly to a selected group of middle-income, newly industrializing countries was over. For instance, during the years of high lending 1978-81, average annual net transfer to the developing countries was of the order of \$ 28 billion; it shrank to \$ 6.6 billion in 1982 and was thereafter negative of the order of \$ 11 billion in 1983 and over \$ 13 billion in 1984.<sup>12/</sup>

The short-lived boom in the transfer of net resources to selected developing countries followed by their subsequent problem of massive external indebtedness provides concrete illustration of how an industrialization process can become exceptionally vulnerable when it depends too heavily on foreign commercial borrowing to finance its industrial development. At least three distinct mechanisms overstrain their debt-servicing problem to set up a crippling constraint of external finance on the industrialization process can be identified. First, variation in the interest rate at which debt is contracted causes significant and arbitrary fluctuations in the debt servicing burden and therefore, in the available foreign exchange for industrialization. This is highlighted by the <sup>recent</sup> experience



of developing countries.

By 1983, their debt service payment exceeded capital inflow from all official and unofficial sources, forcing them all of a sudden to rely in effect solely on a fraction of their export earning. Total debt service payment was \$ 99.1 billion and interest payment was \$ 46.8 billion in 1983 alone by all the developing countries, while the major Latin American borrowers (Argentina, Brazil, Chile, Mexico, Peru and Venezuela) paid \$ 49.2 billion in debt services (i.e. 49.7% of the total) and \$ 24.2 billion in interest alone (i.e. 51.7% of the total). Again by 1983, each 1% increase in the basic interest rates (LIBOR and American prime rate) implied about \$ 4 billion in additional interest payment by the developing countries. Particularly vulnerable to higher interest rates were the heavy borrowers, not only because of the high level of their outstanding debt, but also because they tended to borrow a disproportionately large amount in floating-interest (e.g., variable LIBOR plus spread) arrangement. Thus, only four major borrowers namely, Argentina, Brazil, Mexico and South Korea accounted for 85 per cent of total variable interest debt which stood at \$ 150 billion in the first quarter of 1983. Such flexible interest arrangements on debt shift the entire burden of risk associated with interest variation to the borrowing countries. In turn, this has made them exceptionally sensitive to the monetary policies of developed countries, especially of the United States, in conducting their industrial development policies.

A second route to vulnerability of the heavily indebted countries has been the exchange rate variation, especially the continuing appreciation of the U.S. dollar in terms of other major currencies. For instance, during the boom years of commercial loan 1979-82, developing countries without oil borrowed the equivalent of \$ 137 billion from commercial banks and almost the entire loan was denominated in U.S. dollar. According to one estimate made by the Federal Reserve Bank of New York, if the developing countries had borrowed in a trade-weighted mix of currencies instead, the saving would have been of the order of \$ 16 billion in repayment obligations. Of the total, \$ 11.5 billion is accounted for by the appreciation of the dollar and the remaining saving of \$ 4.5 billion would have come from lower interest payment on mixed currency borrowing.<sup>13/</sup> Although the present system of predominantly dollar denominated debt provides some unique advantages to the United States, it must be recognised that the recent appreciating phase of the dollar (1980-March,1985) has increased the debt servicing burden of the developing countries by at least \$ 4 billion per annum on an average in addition to creating a negative "real balance effect" on the borrowing countries as net debtors. Its repercussion on the industrialization process has been to further tighten the external payments constraint, making it more vulnerable to exchange variations. It needs to be added in passing here that a subset of newly industrializing countries of far east Asia along with Japan gained perceptibly in terms of price competitiveness vis-a-vis

traditional American industries due to the appreciation of the dollar. But such advantage of higher levels of export to the United States accrued only to a handful of developing countries where the process of industrialization has already attained a relatively advanced stage.

The third and final aspect of vulnerability is often imbedded in the very economic structure of a developing country, which may become temporarily obscure due to relatively easy access to foreign capital. Such structural vulnerability has received wide attention in international debate only in its most obvious form, namely, the vulnerability of foreign exchange earning caused by fluctuations in the terms of trade for primary commodity exporting countries. However, the recent experience of a severe "foreign exchange crunch" in several relatively more industrialized Latin American countries and the various adjustment or stabilization programmes required for their renegotiation of debt<sup>14/</sup> have brought to surface a somewhat different issue of structural vulnerability. It relates in particular to the industrial structure rather than to the overall, general economic structure of some of these relatively more industrialized developing countries. Their industrial structure may be very "thin" in the sense that the "final" product of some crucial industries being not at all vertically integrated to the rest of the domestic industrial structure. This entails serious gaps in terms of backward and/or forward linkages in interindustrial flows. As a result,

these "final" product can only be produced through critical and heavy reliance on imported raw materials. Macro-economically, such imported raw materials, need to utilize already installed domestic industrial capacity, can be viewed as the total level of maintenance imports. A simple but telling statistical index in this context would be the ratio of maintenance imports to total export earning on the average and at the margin for these partly industrialized countries.<sup>15/</sup> Any sharp reduction in the availability of foreign exchange, whether through a terms of trade effect or rising interest rate or shrinking export market due to recession abroad, could trigger off serious supply side problems in this context in the developing country, as it fails to obtain adequate maintenance imports leading to sharp reduction in domestic capacity utilization. At the next round, such reduction in domestic capacity utilization could depress private investment and the overall level of effective demand through traditional Keynesian multiplier mechanism to precipitate acute demand side problems in a chain reaction.

Such vulnerability of the industrial structure also has a more subtle political aspect. Large "gaps" in the domestic interindustrial structure, as well as the underdeveloped state of the capital goods sector typically imply that, during periods of high growth mostly financed by easily available foreign capital,

disproportionately large amounts are spent on imported capital goods and intermediate goods. The consequent trade deficit leads to a reduction in the level of realized profits in domestic industries, as effective demand tends to leak out in the form of higher imports.<sup>16/</sup> Under these circumstances, even a period of high growth financed largely by higher inflow of foreign capital may not lead to adequate domestic profits and the consolidation of a class of domestic industrialists who are capable of carrying through a process of sustained industrialization over time. Such an underdeveloped capitalist economy then becomes vulnerable not only in terms of its maintenance-import-dependent industrial structure, but also in politico-sociological terms of not having a powerful enough class of independent domestic industrialists, capable of sustaining the industrialization process. Under these circumstances, there develops a sad but predictable response. Any serious difficulty relating to external finance does not merely interrupt the industrialization process but leads to large capital flights. This in turn further tightens the grip of the external financial constraint on industrial growth to set up a vicious circle of under-utilization of industrial capacity, capital flights and stagnation of industrial investment. The industrialization process in several developing countries, especially in Latin America has become acutely vulnerable in the sense of being continuously threatened by the operation of such a vicious circle.

## FOOTNOTES

- 1/. The proto-reserve currency status of the British sterling under the Gold Standard enabled the financial supremacy of Britain to reinforce her industrial supremacy prior to the first world war. Needless to add, this bears some analogy to the role of the U.S. dollar under the Bretton Woods system.
- 2/. For a lively discussion of various formulations relating to this topic, see also, Cripps and Tarling (1973) and Rowthorn (1975). The classic article elaborating the concept of dynamic increasing return is Young (1928).
- 3/. Some of the political difficulties associated with rapid industrialization have recently been analysed by Skouras (1985).
- 4/. Domestic and export market fluctuations may be linked through the operation of the foreign trade multiplier.
- 5/. Kalecki (1971) made the important distinction between cost-determined and demand-determined prices. Manufactured commodities have usually cost-determined prices that remain insensitive to variations in the level of demand. In contrast, primary products are sensitive to changes in demand. Consequently, the prices of primary products are far more strongly influenced by cyclical fluctuations in OECD than the prices of manufactured goods. Thus, Okun (1981) noticed that "with the exception of 1958, U.S. wholesale prices of domestically produced food-crops fell (absolutely) in every recession year since World War II" (p.136).

See Kaldor (1976) for use of this distinction between demand-determined and cost-determined price in the international context.

- 6/. See Kalecki (1972) for one of the most comprehensive analysis of this issue.
- 7/. Although until recently some of the oil-exporting countries may have been under these "very special circumstances". In this sense, the recent Mexican example should serve as an important qualification. From self-sufficiency, Mexico became a net importer of food, largely under its short-lived (1978-81) oil boom. Subsequent debt problem and falling oil prices worsened the international payments constraint which became even more severe due to the requirement of food import.
- 8/. See United Nations, Third Survey (1983), pp.28-29 for details.
- 9/. These nine countries are: Argentina, Brazil, Mexico, South Korea, Greece, Spain, Portugal, Yugoslavia and Taiwan.
- 10/. E.g., total ODA to developing countries during 1979-81 was slightly over \$ 100 billion, contrasted against an outstanding medium and long-term commercial loan of \$ 530 billion in 1982.
- 11/. BIS, (June 1983). Fiftythird Annual Report.
- 12/. Figures based on OECD, UNCTAD Morgan Guaranty sources, until 1983, these figures are also reported in Economist (18 February, 1984)

13/. See also Economist (11 February, 1984) p.100. Had the borrowers also refinanced their maturing dollar debt with an appropriate currency mixture, another additional \$ 14 billion could be saved, according to the above calculation.

14/. It may be recalled here that the number of cases of renegotiated debt jumped from only 12 in 1982 to 29 in 1983. While the amount renegotiated increased from \$ 4.7 billion to \$ 68.8 billion between 1982 and 1983.

15/. If maintenance import is  $Z$  and export earning is  $E$ , then the ratio of the marginal to average ratio i.e.  $\frac{\Delta Z}{Z E} \div \frac{Z}{E}$  defines the relevant elasticity as a measure of the degree of vulnerability through maintenance import requirement.

16/. This is the basis of Kalecki's well-known analysis, "Determinants of profits" in Kalecki (1971). According to that formula : realized gross profits = capitalists' consumption + gross investment - level of trade deficit. The formula holds for an open economy with balanced budget for the government and negligible savings out of wage income.



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