

Import Substitution and Export Promotion as Development Strategies

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Introduction

Why do some countries develop more than others? Do their strategies in regard to international trade have a role to play? In this paper, two alternative industrialisation strategies, viz. import substituting industrialisation (IS) and export promoting industrialisation (EP), are discussed and compared in terms of their potential for facilitating rapid economic development of a country. This is done through an analysis of the experiences of various countries.

During the 1950s and 1960s, developing countries experienced a decline in world markets for their primary products, deterioration in terms of trade and growing deficits in their balance of payments. Given the general belief in the efficacy of industrialisation, the developing countries had to choose between competing modes of industrialisation: import substitution (IS) and export promotion (EP).

The common terminology of import substitution and export promotion can be misleading. The former may be interpreted correctly as identifying policies that are directed towards the reduction of imports (by for instance tariffs) and their substitution by domestic production. The latter term however does not imply that the policies followed seek to expand exports by the use of, for example, export subsidies. 'Export promotion' is in fact the term applied to policies that are *neutral* towards trade. More recently, economists have preferred to use the term 'inward-oriented' to refer to policies which promote domestic production at the expense of imports, and 'outward oriented' to those which do not discriminate against imports (or in favour of exports).

However, the use of the ISI/EP distinction is now so deeply embedded in the literature that both terminologies must be kept in mind. Given the problems in the external accounts mentioned earlier and the supposed advocacy of the IS strategy by Raul Prebisch and Hans Singer, these countries turned to the use of the IS strategy. They

developed this hypothesis independently in the 1950s, which is based on the argument that the primary product exporting orientation of developing countries results in a decline in their *terms of trade* and a loss of income. (See Raul Prebisch, *The Economic Development of Latin America and the Principal Problems* (New York: United Nations, 1950), and Hans W Singer, "The distribution of gains between borrowing and investing countries," *American Economic Review* 40 (May 1950): 473-485)

Promotion of Infant Industry: A Case for IS Strategy

The IS strategy is an attempt to replace commodities that are being imported, usually manufactured consumer goods, with domestic sources of production and supply. The typical strategy is first to erect tariff barriers or quotas on certain imported commodities, then to try to set up a local industry to produce these goods (for instance, radios, bicycles, or household electrical appliances). This might or might not involve joint ventures with foreign companies, which are encouraged to set up their plants behind the protective wall.

Although initial costs of production may be higher than former import prices, the economic rationale put forward for the establishment of import substituting manufacturing operations is either that the industry will eventually be able to reap the benefits of large-scale production and lower costs (the so-called infant industry argument for tariff protection) or that the balance of payments will improve due to imports of fewer consumer goods. Often a combination of both arguments is advanced. Eventually, it is hoped, the infant industry will grow up and be able to compete in world markets. It will then be able to generate net foreign exchange earnings once it has lowered its average cost of production.

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The German economist and politician Friedrich List (1841) was perhaps the first to put forward the infant industry argument. Infant industries may be defined as production activities that generate external economies in the form of learning-by-doing at the early (infant) stage of establishment. Infant industries may also include exporting activities. Procuring commodities in domestic markets and selling them at international markets can generate substantial (time-limited) external economies in the form of learning-by-doing.

An IS strategy has two major advantages, which explain the support from both policy makers (political bosses as well as bureaucrats) and entrepreneurs. First, the market for the relevant industrial products already exists prior to the IS strategy, as evidenced by imports of these commodities, so that risks are reduced in setting up an industry to replace imports. Second, it is easier for developing nations to protect their domestic market against foreign competition than to persuade developed nations to lower trade barriers against their manufactured or primary exports.

Against these advantages are the following disadvantages: domestic industries can grow accustomed to protection from foreign competition and have no incentive to become more efficient; and import substitution can lead to inefficient industries because of the smallness of the domestic market in many developing countries does not allow them take advantage of scale economies. Moreover, after certain simple manufactured imports are replaced by domestic production, further import substitution of more advanced products becomes more and more difficult and costly in terms of requirements for technology and capital.

Efficiency and Scale economies: A Case for EP Strategy

The benefits of the EP strategy lie in its ability to do away with the drawbacks of IS. The main advantages of EP strategy are: it overcomes the smallness of the domestic market and allows a developing country to take advantage of scale economies; production of manufactured goods for export requires and stimulates efficiency throughout the economy; and last, the expansion of manufactured exports is not limited (as in the case of import substitution) by the growth of domestic market.

On the other hand, there are two very serious disadvantages of this strategy: it may be very difficult for a developing country to establish exporting industries because of competition from the more established and efficient developed countries; developed nations often provide very high level of effective protection to their industries producing simple labour-intensive commodities in which developing countries already have or can soon acquire comparative advantage.

A Comparison between IS and EP strategies for Development

We assume that a resource poor developing country has comparative advantage in labour-intensive production vis-à-vis the advanced industrial country. If we further assume that external economies exist in the production processes of these labour-intensive industries (and/or in their exporting activities), however, the so-called comparative advantages might merely remain only a potential advantage, unless the government intervenes with tax subsidy measures to take advantage of such external economies (Little, Scitovsky and Scott, 1970).

In principle, economic theories justify the promotion of infant industries. The best means of promoting them, however, is not clear. The government may promote infant industry through an outward-looking/export-oriented growth strategy or through an inward looking/import substitution oriented growth strategy. If the government adopts the former approach, the promotion of infant export (sale) activities has to be included. Otherwise, domestically produced labour intensive commodities may sell in domestic markets but not in foreign markets. If the latter approach is adopted, however, then there is no plan to promote infant export activities in such a country, export marketing would remain poorly developed.

In this case, even if by chance the country produces some labour-intensive commodities at low cost, it is unlikely that they would be exported, because the people would not know how to sell them abroad. Furthermore, Keesing (1967) and Bhagwati-Krueger (1973) argue that these countries would, at any rate, never be able to produce those labour-intensive commodities at low cost. The potential comparative advantages will fail to materialise because of unexploited economies of scale and even very keen foreign buyers would fail to find anything worthwhile to purchase from the country.

Keesing (1967) and Bhagwati-Krueger (1973) have argued that under an EP regime, international competition forces domestic entrepreneurs to pay close attention to the possibilities of innovations and speeding up the learning processes. Exporting firms must face price and quality competition in international markets, and consequently the survival and success of each exporter depends on active absorption of up-to-date production techniques and adaptive innovations based on imported technologies. Furthermore, the EP strategy naturally enables an economy to take full advantage of scale economies.

Keesing (1967) adds that under an IS regime, policy makers accept protectionism as a legitimate major instrument to promote industrialisation; every industry is spurred to demonstrate its need to be sheltered from the cruelties of foreign competition, and eventually the country ends up with a system allowing each industry protection according

to its inefficiency. An EP regime is therefore less likely to be constrained by foreign exchange requirements than an ISI regime. Furthermore, any industry that is promoted to become an export sector can automatically substitute imports, but the reverse does not necessarily hold.

Most importantly, the innovative entrepreneurial class nurtured through the internationally competing EP regime purportedly is more conducive to generating sustained high economic growth in the long-run than the lackadaisical entrepreneurial class produced under the ISI regime based on monopolistic rents (Bhagwati, 1990). A consideration of patterns of import substitution leads to conclusions such as those of Gerald Helleiner (1992), whose views seem to reflect a consensus among development economists. The IS strategy pursued by developing countries has often given undue emphasis on consumer goods, insufficient attention to long term comparative advantages, employed unsuitable capital intensive technologies, all those resulted into inefficient industrial sector operating far below capacity, creating very little employment, generating very little foreign exchange savings, and little prospects for further productivity growth.

Helleiner advocates that the object of policy must now be gradually to bring incentive structures and thus the relative efficiencies of various industrial activities into some sort of balance, thereby encouraging domestic manufacture of intermediate and capital goods at the expense of importable consumer goods and the development of eventually of manufacture of export.

Most observers agree that the IS strategy of industrialisation has been largely unsuccessful. Eventually, therefore many developing countries have embarked on the export promotion strategy of industrialisation. According to Corden (1971), the opening of an economy to trade generates “static” efficiency gains that are very similar to “once and for all” technical progress in raising the absorption-possibility frontier of a country at the given factor supplies. The “static” efficiency gains may be interpreted broadly to include the Keasing (1967), Bhagwati (1973) Krueger (1981) type of positive effects: intensified international competition affecting the quality of domestic entrepreneurship, the realization of internal scale economies, and exploitation of external economies that arise from the “infant” export-production activities.

Furthermore, with a given constant propensity to save, the static gains will induce the rate of capital accumulation to rise and consequently will raise the growth rate of the economy. This may

be described as the “induced growth gains” from trade. If investment goods are mostly imported, then these induced growth gains will also include the effect of reduced prices of investment goods.

Grossman and Helpman (1991), Barro and Sala-I-Martin (1995), Romer (1992), and Edwards (1998) have argued that economies which open up to international trade acquire greater capacity to absorb advanced technologies available internationally and reap the benefits of scale economies due to access to world markets.

The Empirical Evidence Regarding IS and EP strategies

As stated above, both strategies of development are not fool proof and have potential harmful effects on implementing countries. The failure of the ISI strategy gave impetus to the revival of a new orthodoxy in trade liberalisation in the late 1970s with trade being visualized as an “engine of growth”. Starting with the 1980s, many developing countries that had earlier followed the IS strategy of industrialisation began to liberalise trade and adopt an outward orientation. The trade policy reforms were spurred by the debt crisis that began in 1982 and the evident success of the outward oriented countries. The debt as a percent of GNP (gross national product) for all developing countries taken together was estimated at 21 percent in 1980 rose to 34 percent in 1990 and further up to 37 percent in 1998. For Sub-Saharan Africa the ratio stood at 24, 65, 68 percent respectively. While for South Asia the ratio was 20, 35, and 28 percent respectively.

Table 1 shows that an outward orientation was generally associated with a higher average annual growth rate of real GDP than an inward orientation during 1963-73, 1973-1985, and 1985-1998 for the majority of countries in Latin America, Africa and Asia which attempted some measures of trade liberalisation during these periods.

Table 1: Growth according to Trade Orientation, 1963-1998

Trade Orientation	Average Annual Growth Rate (%)		
	1963-1973	1973-1985	1985-1998
Strongly outward	6.9	5.9	6.8
Moderately Outward	4.9	1.6	2.4
Moderately Inward	4.0	1.7	-0.1
Strongly Inward	1.6	-0.1	-0.2

Source: World Bank, World Development Report, 1987 and 1999/2000

Note: The World Bank defines strong outward orientation as the absence or near absence of trade controls. Moderate outward orientation refers to an overall incentive structure that is only moderately biased in favour of production for domestic rather than export markets. With moderate inward orientation, the overall incentive structure distinctly favours production for the domestic rather than for export markets, while with a strong inward orientation the overall incentive structure strongly favours domestic production over production for export.

More recently a study was undertaken by CUTS International (2008) under CUTS-TDP Project to assess the success/failure of the policy initiatives undertaken by 13 African and Asian countries under alternative trade regimes. The 13 countries chosen for the study were 8 from Asia and 5 from Africa. They are: Bangladesh, Cambodia, China, India, Nepal, Pakistan, Sri Lanka, Vietnam, Kenya, South Africa, Tanzania, Uganda, and Zambia. (Trade-Development-Poverty Linkages: Some Reflections from Selected Asian and Sub-Saharan African Countries” Volume I-Country Case Studies (2008), edited by Mohammad A. Razzaque and Selim Raihan, published by CUTS-International, Jaipur (India).

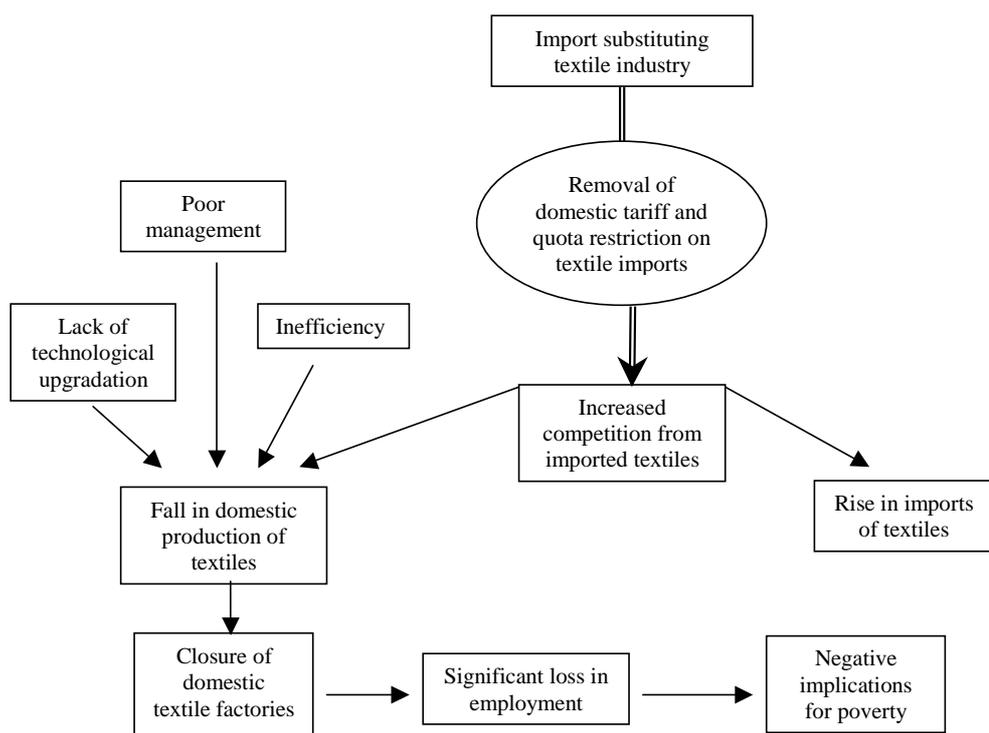
These countries include large developing countries (India and China); small countries (Sri Lanka, Nepal and Zambia), and landlocked (Nepal, Uganda, Zambia) and island country (Sri Lanka). The development experience of these countries, which pursued IS strategy almost since with the beginning of their political independence to develop domestic industries under a protective wall of tariff and non-tariff barriers, has been varied. Most of these economies have faced severe BoP (balance of payments) crisis at one point of time or the other and their growth path has been extremely uneven and tortuous, as clearly mentioned by Razzaque and Raihan: “... Most of these countries started experiencing serious economic crises caused by both internal and external factors since the mid-1970s. Import substitution policies in the form of widespread quantitative restrictions (QRs), high tariffs and overvalued exchange rates caused substantial discrimination against production for export and in favour

of import competing sectors. The policy induced ‘anti-export’ bias inhibited export growth prospects.”

As stated earlier the ISI strategy is infant-industry supportive only temporarily and in long run it gives rise to inefficiency, uncompetitiveness and unprofitability, which are unearthed as soon as the sector/industry exposed to competition especially from the foreign ones. Figure 1 shows it clearly. Trade liberalisation in textile and clothing industry in Sri Lanka, Tanzania, Zambia, South Africa and Kenya, hitherto comfortable under protective wall of tariff and non-tariff barriers and also benefiting from favorable international markets, especially benefited by quotas from the US and the EU, resulted into a fall in domestic production of textiles due to closure of domestic factories and significant loss of employment.

These countries attempted gradual and moderate trade liberalisation towards the beginning of the 1980s and accelerated the speed of such liberalisation throughout the 1990s. As a consequence, there was a significant reduction in both tariff and non-tariff barriers, which opened up, trade in hitherto restricted items. Such trade openness has led to mixed experiences: some of these countries have sustained high economic growth (like China, India, Cambodia), while some have struggled through erratic growth performance (like Nepal, Kenya, Zambia). Similarly, some other countries have shown remarkable export growth (like Vietnam and Cambodia) in contrast to some that have recorded dismal performance (e.g. Nepal and Zambia).

Figure 1: TDP Linkages in the Import-substituting Textile Industry



Source: Adopted from CUTS-TDP Country Case Study, Vol. II (mimeo)

The policy of openness, in addition to promoting exports, is supposed to result in better resource allocation and acquisition of improved technologies and inputs. The CUTS study reports that the effects of liberalisation on growth have been disputed in most countries chosen for the study. According to the study: "...it becomes apparent that apart from Bangladesh and Tanzania, growth rates since the 1990s do not show a sustained increase over the previous decade, although for almost all countries average tariffs decline quite remarkably. For China, India and Vietnam, high economic growth appears to have emerged within policy regimes characterised by high tariffs. In the cases of Nepal, Kenya and Sri Lanka significant lowering of tariffs around 2000 did not accompany invigorated growth. Again, the figures for South Africa, Uganda, and Zambia hardly reveal any association between changes in tariffs and overall economic activity."

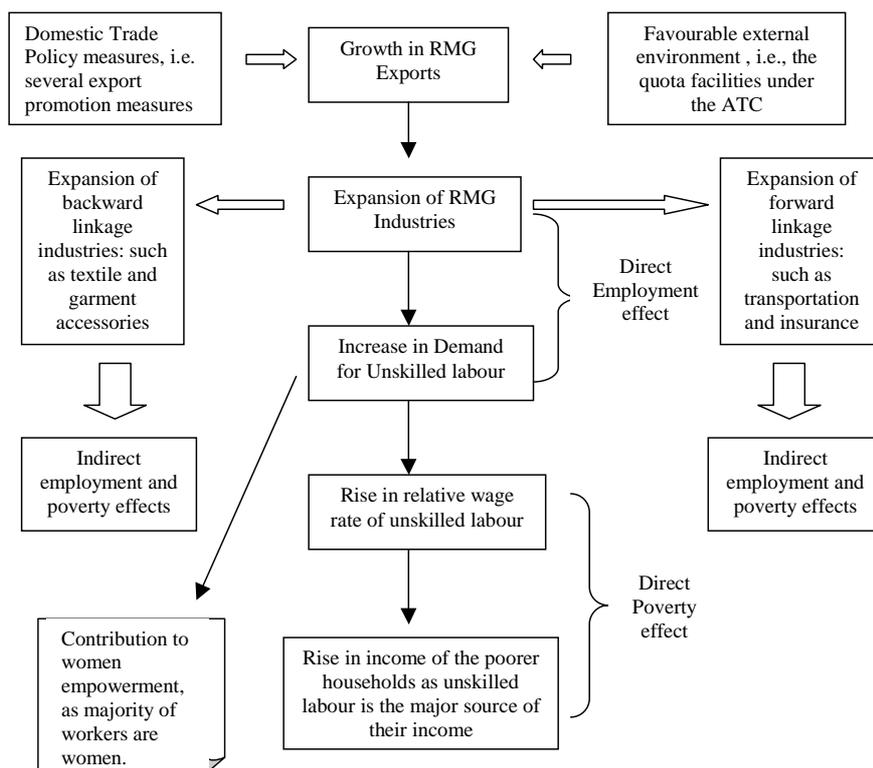
The export promotion strategy is more successful at the sectoral level, which along with reductions in trade barriers coupled with some important export promotion measures undertaken by the government and a favorable external environment (such duty-free and quota-free market access provided by the EU, and some other developed countries to the ready-made garment (RMG) exports from Bangladesh, Cambodia, Nepal etc) have helped the growth of such sectors. These countries have also put in place a number of important export-promotion measures, which helped reduce the anti-export bias in the domestic trade regimes of these countries.

The export-led RMG sector of Bangladesh provides such an example where export promotion measures by the government assisted the exporters to increase their exports of RMG and thereby creating employment (especially to women), generating incomes for poverty-ridden rural population. The backward and forward linkages of this highly labour-intensive RMG sector in Bangladesh (see Figure 2) has created a favorable impact on the economic conditions of the rural poor as well as foreign exchange earnings for the country.

Veena Jha's paper reviews the Diagnostic Trade Integration Studies (DTIS) conducted by the six international agencies under the integrated framework with focus on the agro and agro industrial sectors of these LDCs. The countries included are: Benin, Burkina Faso, Burundi, Cambodia, Ethiopia, Lao PDR, Lesotho, Madagascar, Malawi, Mali, Mauritania, Nepal, Rwanda, Senegal, Sierra Leone, Tanzania, Uganda, Yemen and Zambia (Veena Jha, 2008, "Import Substitution versus Export Promotion in the DTIS for LDCs).

After reviewing the demand side and supply side constraints she analyses various policy instruments employed by these countries in pursuing IS and EP strategies. Although the DTIS have in general favoured an export promotion strategy and a stress on elimination of QRs, Jha emphasises that the two strategies are intrinsically linked. Countries develop their productive capacities and food security behind tariff walls. As their

Figure 2: TDP Linkages in the RMG Industry



Source: Adopted from CUTS-TDP Country Case Study, Vol. II (mimeo)

competitiveness increases and they meet their objectives of food security they begin to liberalise their economies. This very trend can also be observed in NICs (newly industrialised countries) and Asian economies in their industrialisation process.

Jha further writes, “Finding the right balance between import substitution in some crops and exports to regional and global markets in other crops is a real challenge for LDCs. If there is unmet domestic demand, import substitution can help fill that gap. However, in small LDCs this may be done quickly and from thereon the LDC would depend on population growth and increased consumption per capita (as income grows). Does this give enough room to exploit some competitive advantage? At this point of time the LDC would have to move to export promotion”

Conclusion

It is amply clear from the experiences of reviewed developing countries that they, pursued an IS strategy in their early development process; subsequently, the failure of such policies forced them to embark on an EP strategy. However, the overall lessons from country experiences would suggest that neither strategy can bring desired results when pursued in isolation. Rather, strategies have to be fine tuned to economic, social and political reality of the country in question. Indeed, the CUTS-TDP study country cases clearly exhibit that, ‘the one-size-fits-all’ philosophy has failed to deliver the envisaged results. “There is now a general recognition that the policy of liberalisation alone can hardly render benefits, and that there are other critical issues that require urgent attention for promoting trade and development.”

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This Briefing Paper is developed mainly from two recent empirical studies covering a large number of developing countries from Africa, Asia and Far East. They are: “Trade-Development-Poverty Linkages: Reflections from Selected Asian and Sub-Saharan African Countries” Volume I: Country Case Studies, edited by Mohammad A. Razzaque and Selim Raihan, published by CUTS International, 2008; and “Import Substitution versus Export Promotion in the DTIS for LDCs, Veena Jha, 2008, mimeo

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