Revisiting the Debate over Import-substituting versus Export-led Industrialization

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A large part of development debate is centered on the domestic process of industrialization in the developing countries. With the growing importance of foreign trade, the debate gives a background for trade policy orientation towards industrialization and growth in these economies. The paper explores the main arguments of the debate and evaluates the importance of the policy mix to step up the process of growth and development in the developing countries.

JEL Classification: F13; F14; O14; O24.

Keywords: Trade Policies; Import-substitution; Export-promotion; Export-pessimism; Balance of Payments.

1. Introduction

For the majority of the developing countries, industrialization is a fundamental objective, which is considered necessary to achieve sustained economic growth, create employment opportunities and lead to diversification and modernization of their economies. However there are alternative trade policies, which play different role in the process and pattern of industrialization in these countries.

Given the existing stage of development and resource endowments trade policies make significant impact on the pace and pattern of industrialization in the developing countries. The trade measures adopted by these countries are varied and often characterized by periodical shifts in policy measures and the associated trade and industrial performances are also varied.

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In the post-war industrialization of the developing countries, three decades have been identified as another industrial revolution, since it has transformed the world economy radically. During the period 1960 to 1981 LDCs’ (Less Developed Country) industrial output (mining, manufacturing, power generation and construction) grew faster than GDP in these countries. At the same time manufacturing output in the LDCs grew faster than the developed countries. However within the LDCs’ top ten countries accounted for 70% of all LDCs’ manufacturing value added.

The increasing importance of LDCs’ industrial activities is also reflected in changing pattern of commodity trade. Between 1960 and 1981 LDCs’ share of world export of manufactured goods increased from 3.9% to 9.2%. In addition, the share of manufactures in total LDC exports rose from 9.2% in 1960 to 22.9% in 1982. However, 10 largest LDC exporters including Hong Kong, Republic of Korea and Singapore accounted for 60% of total LDCs’ manufactured exports.

The period from 1930 to 1960 observed an antagonistic trend against free trade doctrine among the policy makers on three basic grounds. First, there was a negative reaction against the colonial or 19th century pattern of trade and international specialization. Secondly, there was increasing acceptance of the role of manufacturing sector in the process of economic growth replacing the ‘Trade as an Engine of Growth’ doctrine. Finally, there was a tendency of declining faith in the functioning of the market forces along with an increasing reliance on State planning process.

At the theoretical level, it has been argued that the static equilibrium analysis of the traditional theory is insufficient to interpret the inherently dynamic problems of development. In the historical context it has been argued that the very forces of international trade have induced comparatively little internal development in poor countries and actually operated as a mechanism of international inequality.

Against this backdrop, we can distinguish between two trade-related industrialization strategies, namely, Import-substituting Industrialization (ISI) and Export-oriented Industrialization (EOI). In the first case we consider production of previously imported goods for the domestic market and in the second case production of manufactured goods are directed towards external markets. In practice, most LDCs have used elements of both the strategies with shifting relative importance over time.

Figure 1 offers a diagrammatic approach to distinguish between these strategies. Assuming neutral strategy price-ratio as $p^*$ (the world market price), if the effective price ratio is lower than this, $p^{IS} < p^*$ ($p^{IS}$ is the effective consumer price), we have an Import Substitution (IS) regime while if $p^{EP} > p^*$, where $p^{EP}$ is the effective producer price, we have an Export Promotion (EP)
regime. Thus the effective price ratio prevailing in the state of autarky will determine the direction of the incentive structure. According to the Bhagwati (1988) terminology, a trade-neutral or bias-free strategy is really an Export Promoting strategy. For Import Substitution strategy, $p_{IS}^* < p^*$ and $p_{UEP}^* > p^*$ denotes an Ultra-export Promotion (UEP) strategy ($p_{UEP}^*$ is the effective producer price under Ultra-export Promotion strategy).

If we trace the trade policy experiences of different developing countries, we observe that in the 1950s and 1960s ISI-dominated trade policy was adopted in larger Latin American countries (such as Brazil, Argentina, Mexico), South and South-east Asian countries (such as India, Pakistan, Philippines) and sub-Saharan African economies (such as Nigeria, Kenya, Ghana, Zambia). Subsequently it was adopted in smaller Latin American countries and South-east Asian countries. However, since the mid 60’s an increasing number of LDCs have adopted EOI strategies, starting with Republic of Korea, Taiwan, Singapore, Hong Kong, a number of semi-industrialized LDCs followed the path with a corresponding shift in strategy.

2. Import-Substituting Industrialization (ISI)

The observed trend in initial adoption of ISI was stimulated by three major factors. First of all, in the face of chronic BOP (Balance of Payments) crisis, it appeared easier to save foreign currency through ISI than to earn it by exporting manufactured goods. Secondly, these motivations were
reinforced by external circumstances like severe decline in export earnings from primary products during the inter-war period along with wartime shortage of imports. Finally, in the post-war liberalization phase a new structure of capital exports to the LDCs emerged with direct investment by the TNCs (Trans-national Corporations). This played a crucial role in shaping the post-war ISI process.

At a more theoretical level ISI strategy along with its correlatives were proposed on two grounds. First, the unfavorable world market demand faced by the traditional LDC exports originating from short run instability and long run inelastic and stagnant nature. Secondly, as a follow-up, protectionism was argued for on the ground of infant industry criterion. However, a closer scrutiny reveals that the first argument is grossly exaggerated and the ‘export pessimism’ view has been proved to be unfounded. The argument justifying protection of infant industry on the ground of the high cost at the initial stage is not a sufficient ground for protection. As long as the initial losses are more than compensated by later profit generation, private investors will engage in investment provided an efficient capital market exists. Therefore, the arguments favouring economic development through domestic industrialization with import substitution do not stand up to critical scrutiny.

During 1960s and early 1970s, despite considerable achievements in terms of growth of industrial output and structural changes in the LDCs a series of criticisms regarding the implementation and outcome of ISI came forth. After an initial period of growth, ISI loses momentum as further import substitution becomes increasingly more difficult, and the capacity to export becomes a constraint on growth. There was a large consensus that ISI had been a failure.

The main arguments run as follows. The neoclassical attack on ISI was initiated by Balassa (1971), Bhagwati (1978) and Krueger (1978). A number of generalizations can be made on the structure of protectionism. First of all the average levels of effective protection exceeded the normal tariff level. Secondly, the effective protection was higher in the industries with lower rates of investment and intermediate goods compared to consumer goods. Finally, within each category there were also considerable variations in the level of protections given to particular activities. The impact of protectionist policy was supplemented by the estimates of high domestic resource cost as well as visible bias in the trade regimes.

The literature also explores various adverse economic effects originating from ISI strategy. First of all, it implies a redistribution of income towards industrial profit leading to increased income inequality within the LDCs. The strategy is also heavily dependent on relatively capital incentive technologies imported from abroad. This in turn leads to creation of limit on expansion of
employment within new manufacturing sector. In addition, we also have a bias against agricultural sector as manufacturing prices rise faster than the agricultural prices in the home market. A policy of overvalued exchange rate also depresses export demand from abroad. Finally, protection also leads to underutilization of capacities in the industrial sector.

The structuralist-radical interpretation of ISI experience is different from the neoclassical school and traces the sources of failure in the productive structure and social class formation in the LDCs. The market-based ISI strategy was heavily dependent on foreign inputs (technology and product specification) and primarily engaged in the production of high-income goods and services. In addition, direct foreign investment through local subsidiaries of MNCs (Multinational Corporations) enjoyed the protected market behind tariff barriers and monopolistic market structure. It was also observed that the imported foreign technologies were inappropriate to local conditions and led to severe capital outflows in the form of royalty payments and profit remittances. Finally, from the radical perspective, ISI strategy was interpreted as the result of a nexus of interests of MNCs, domestic capital and State in a mutually supporting fashion. Thus, the process of ISI yielded positive benefits to certain groups at the cost of lower national welfare.

However there is a broad agreement among different schools that ISI has typically created a highly protected, inefficient manufacturing sector, oligopolistic or monopolistic in nature with substantial underutilization of capacity, dependent capital-intensive technology with low employment generation potential. Furthermore, the process of industrialization has been pursued at the cost of agricultural sector, along with a significant bias against exports of both primary and manufactured goods. The dependence on imports has not been reduced; indeed a shift in the composition towards intermediate and capital goods has increased the vulnerability to foreign exchange crisis. After an initial phase of ‘easy import substitution’, further substitution becomes increasingly difficult and the capacity to import becomes a binding constraint and further import substitution growth possibilities.

These two schools offer different policy suggestions arising from alternative interpretation of ISI. According to the neoclassical school, the appropriate policy is to relax trade restrictions and make adjustments so that the producers face the correct price signal. This will lead to more efficient import substitution as well as encourage production of exports on a ground of equal incentives. The structuralist school on the other hand, stresses the need for significant changes in the structure of the country. They also advocate for a planned strategy of industrial development with import substitution in combination with strategies directed towards the development of agriculture and export sector.
3. Export Oriented Industrialization (EOI)

The origin of EOI can be traced in the apparent failure of the ISI strategy and consequently strengthening of the case for the adoption of more external-looking-export-oriented industrialization in the LDCs. It is also justified by the neoclassical economists on the ground of allocative efficiency and economic growth. Balassa (1971) argued that the export oriented policies, which provide equal incentives to sales in domestic as well as foreign market lead to resource allocation in the line of comparative advantage, allow for greater capacity utilization, permit the exploitation of economies of scale, generate technological improvement in response to foreign competition and in labour surplus countries contribute to increased employment.

The case for EOI was boosted by the performance of the Newly Industrialized Countries (NICs) which adopted EOI policies during the 60’s. However, the forms of EOI adopted by different NICs were varied. The larger NICs of Latin America exported manufacturing goods produced by the industries established during their second phase of import substitution. The Asian NICs with smaller domestic markets switched over from first phase of import substitution to the production of manufactures primarily for external markets. By the 70’s, both the Asian and Latin American countries appeared to have reached to the same position with a diversified industrial structure and substantial export of labour intensive manufactured goods. However, the result of different paths taken was reflected by the fact the Asian NICs were internationally competitive, while the Latin American NICs suffered from high cost and required subsidies to push out imports of manufactures along with tariff and quota protection for the domestic market.

3.1 Experiences with EOI

In spite of an impressive export performance and increasing adoption of outward-looking strategy among the LDCs, export success is obviously an inadequate index of development achievements in these countries. Studies identifying separate phases of ISI and EOI in different countries and comparing growth performances (Bhagwati, 1979, Krueger, 1978, 1983) suggest that countries that lowered the bias against imports registered acceleration in GDP growth rate along with improved export performance.

In terms of employment effects, we observe that the smaller Asian NICs experienced a near full employment during EOI stage. However, for the majority of the LDCs the growth of manufacturing exports is unlikely to reduce unemployment as manufacturing exports constitute a small fraction of total manufacturing production. However, in general it can be argued that export production is more labour intensive than import-substituting production if we include indirect employment effects (Krueger, 1983).
EOI may increase LDCs’ dependence on imported technology and inhibit development of domestic technology capacity. In addition export oriented trade liberalization will inevitably intensify imitative tendencies in domestic consumption pattern. Some of the neoclassicists have argued that an EOI strategy based on labour intensive manufactures also leads to improvements in income distributions (Balassa, 1982, Fields, 1984, Ranis, 1985). In general, it can be stated that there is no short run poverty alleviating or distribution improving impact of EOI strategy taken in isolation.

Even if we accept the argument that EOI has resulted in superior performance in the NICs the claim that the success can be attributed to the neoclassical policy frame has been contended on two basic grounds. Firstly, the NIC’s success crucially depended on the government regulation and intervention towards facilitating market process of getting right prices as well as shaping the pattern of comparative advantage of a country. Apart from Hong Kong, an important element of the success of Asian NICs has been the active role of state planning and regulations. A dual policy of import control and export incentive on the basis of selective import substitution and export promotion was adopted in those countries. The role of government regulation was more prominent in labour market policy. Strong government was responsible for maintaining a competitive wage in the labour market enabling the producers to export with profitability in these countries.

The second comes from the fact that the specificity of NICs’ experience limits the replication possibility of the NIC model among other LDCs. This is even more true with the changing features of the international economy.

Another factor contributing to the rapid growth of the NICs’ was the easy access to international finance. Rapid expansion of multinational banking operation and lending by DCs and oil-exporting countries led to massive increase in NIC borrowing and the economies maintained high growth rate through debt-led growth. Subsequent decline in DC lending in the late 1970s and early 1980s and debt crisis was eased by opening access to the multinational private capital market.

In addition, increasing ‘world sourcing’ activities of MNCs during the ‘60s in the form of specialization of relatively labour-intensive processing activities in low-wage LDCs also contributed to the growth of manufactured exports in these countries. This process was given further boost by the DCs preferential tariff structure on imports incorporating domestically originated components, i.e. the tariff was imposed only to the value-added in the assembly and manufacturing process undertaken overseas.
Despite the diversity of experience in EOI, it is possible to draw a number of conclusions from the NICs’ experiences. First of all, the export success was not due to adoption of free trade regime but considerable state action was involved in the form of economic incentives to promote exports. Secondly, the necessary condition for successful EOI was guaranteed by an efficient administration and strong government. Finally, the period of spectacular success coincided with exceptionally favourable external market conditions.

Many authors empirically tested the export-growth linkage growth of developing countries from various aspects (for a survey see Hotchkiss et al, 1994). However, most successful results are obtained in cross-section studies. Long run time series studies did not yield good results. However, export led growth is meaningful if export causes growth. This is possible if investments respond to higher export growth and stimulates multiplier effect. In case regulations or inertia prevents investment to pick up growth caters domestic market and the residual is pushed out as exports. Here GDP growth appears to cause export.

3.2 Experience with India and comparison with China

India’s share in world exports, which had declined from 2 percent at Independence to 0.5 percent in the mid-1980s, bounced back to 0.8 per cent in 2002. Thus, since mid-1980s, India’s exports have grown faster than the world exports. Table 1 offers an overview of the evolution of India’s external sector during the 1980s and 1990s in relation to China. The table leaves little doubt that the impact of the more significant liberalization in the 1990s than 1980s on trade has also been more significant. While one can still complain that trade has performed less spectacularly in India than China, the claim by some that 1990s did not see a perceptible shift in the growth of exports and imports is simply wrong.

From Table 1, exports of goods and services grew 7.4 percent in 1980s but 10.7 percent during 1990s. The pace also picked up on the imports side with the growth rate rising from 5.9 percent in 1980s to 9.2 percent in 1990s. Thus, we have a shift of 3.3 percentage points in the growth rate of both exports and imports. Nevertheless, these growth rates are substantially lower than those experienced by China since that country opened up to the world economy. China’s Exports of goods and services grew at 12.9 percent during 1980s and 15.2 percent during 1990s (see lower half of Table 1). Likewise, imports grew at 10.3 percent during 1980s and 16.3 percent during 1990s. These higher growth rates are reflected in the higher degree of openness achieved by China in terms of trade-to-GDP ratio.

According to Table 2, the ratio of total exports of goods and services to GDP in India nearly doubled between 1990 and 2000 rising from 7.3 percent to 14 percent. The rise was less
dramatic on the import side but still significant: from 9.9 percent in 1990 to 16.6 percent in 2000. Within ten years, the ratio of total goods and services trade to GDP has risen from 17.2 percent to 30.6 percent. Though this is substantially lower than the corresponding ratio of 49.3 percent for China in 2000 (see lower half of Table 2), it is comparable to the latter’s ratio 12 years after its opening up which stood at 34 percent in 1990.

4. New developments

The patterns of world trade have undergone several changes in the last two decades (1970-90). Some of these findings are listed in the UNCTAD (United Nations Conference on Trade and Development) trade and development report (2002). The share of developing countries in the total world trade has gone up from 1/4th to 1/3rd. Share of manufactures in total exports for these countries has increased from 20% to 70%. The share of agricultural exports has gone down from 20% to 10% in the same period. At the same time the share of the developed countries in world income has risen from 73% to 77% while the share of developing countries remained constant at 20% (1980-99). These points to a concentration of exports in the hands of the NICs in the developing world and a probable adverse movement of terms of trade of manufactures against the developing countries (Maizels, 1998).

From the earlier debate over efficiency of export led growth vs. import led industrialization the emphasis shifted to poverty eradication and income distribution. A similar debate evolved about the impact of globalization for the developing countries. From a large data set Dollar and Kraay (2001) obtained three findings. First, globalizes have an increase in trade to GDP ratio from 16% to 33% between 1970-1990. Second, which globalizes experienced faster growth in the decades of 1980s and 90s compared to non-globalizes and other rich OPEC countries. Among the spectacular cases the growth between 1980-84 and 1995-97 of Argentina (8.4%) China (3.9%) Mexico (6.5%) and Philippines (6.2). Finally, globalization and income inequality has mixed results where it worsened in China but improved in India, Malaysia and Thailand.

Other major observations as covered in the UNCTAD report, 2003 are as follows. Though the developing countries are exporting a larger share of their product, the share in skill-intensive product is still low. These are the fastest growing products in the world trade and very few developing countries have been able to penetrate this group. Thus we observe a large participation in readymade garments or leather goods export while a few countries could participate in the export of electronics and computer related products. Another observation seemed to have emerged regarding the interrelationship among domestic savings, foreign assistance and growth. The East Asian countries have high rate of domestic savings and required less foreign assistance and they have experienced high growth rate. In contrast, the South Asian
countries had lower savings rate coupled with higher official foreign assistance along with lower growth rate. Thus, it appears that high rate of domestic savings can not be substituted by foreign aid. It is also observed that the countries experiencing highest growth rates are having low foreign aid also. At the same time better performers are not those countries who devote a higher proportion of their GDP (Gross Domestic Product) in R&D (Research and Development) activities but those who have a high proportion of their imports devoted to machinery and equipments imports from North (Yeats, 1998). Thus it follows that trade in intermediate products (including machinery and equipments) which embody fruits of R&D from North do promote growth in the developing countries. This is aptly concluded that the developing countries should shift their emphasis from increasing human and capital investment to increasing technology adaptation (Easterly, 1998). Finally, the movement of terms of trade in the present decade has one dimensional difference from what Prebisch-Singer thesis asserted. The manufacturing terms of trade has declined during 1980-1994 for the developing countries globally.

The issue of trade policy and industrialization in the developing countries has been explored extensively in both theoretical and empirical grounds. The industrialization and growth process in these countries followed a diverse pattern and trade policy is a sub-component of the overall policy framework adopted in those economies. The understanding of the fact whether and when trade acts as the engine, the handmaiden, the brake or the offspring of growth is still far from complete.

5. Conclusions

The debate centered on the efficiency of export led growth versus import led substitution has been frequently presented in terms of mutually exclusive strategies. However, such a dichotomy between ISI and EOI is quite misleading. In a longer time horizon, ISI and EOI can be seen as sequential phases in the development process of the different LDCs. The issue becomes one of the optimal sequencing of ISI and EOI phases in the development process rather than the relative merits of ISI and EOI as alternative and competing strategies.

Most of the observers however, favored the NIC pattern of a relatively short-lived phase of ISI followed by an early EOI to secondary ISI on the basis of improved economic efficiency, employment opportunity and income distribution. The counter argument favoring Latin American NICs, with extended ISI strategy, claims that the economic inefficiencies must be weighed against the gains from the establishment of a balanced industrial sector, reduction in foreign ownership and control, creation of indigenous technological capacity and a more diversified pattern of manufactured exports.
A second observation is that much of the criticisms on the LDC’s trade policies find faults with ISI policies, which is not a result of misallocation of resources between alternative policies but from inefficient use of resources allocated to the objective of import substitution itself. Inefficiency in export production can occur as readily as in import substitution activities. Conversely, IS production can be as efficient as EO activities. The economic performance of the industrial sector is crucially guided by the effectiveness of the state’s management of the economy. At the same time, policy makers have accepted the crucial role of price mechanism in the market economy. It is also possible to appreciate a third possible position, where prices are considered to be crucial but market cannot set them right, in the backdrop of the debate on prices, markets and macro-management which has been polarized between ‘prices do not matter’ and ‘liberalized market sets correct prices’ point of view.

References:


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**Table 1: Exports and Imports of India and China (1980-2000)**

<table>
<thead>
<tr>
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<th>Annual Growth Rate (%)</th>
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<tr>
<td><strong>India</strong></td>
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<td>Total exports (fob)</td>
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*Source: World Development Indicators, 2002.*
**Table 2: Indicators of Trade openness for India and China**

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*Source: World Development Indicators, 2002.*