IMPORT SUBSTITUTING INDUSTRIALIZATION (ISI) AND SOME OF ITS CONSEQUENCES

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What is ISI

According to the conventional wisdom of international economics, countries should trade freely with one another. And the international prices of goods determined by market forces of free trade will show which goods will be produced in a country according to the factors endowment and the comperative advantage of that country. But the teaching of classical economics caused frustrations for many countries of the world which aspired to produce industrial goods, to develop and to become more independent. These frustrations became the source of interference by goverments to the free play of international market forces.

In theory, comparative advantages being considered in a dynamic way that is future comparative advantages became important. In practice industrialization has been conceived by governments as a major aspiration to achieve and also considered to be the basic strategy of an over all development.

Additionally a particular type of industrialization that is 'import substituting industrialization' (ISI) has become a widespread policy, which can be defined as the domestic production of goods previously imported. The simplest mechanism of this policy in a market economy is to impose limitations on imports. ISI can also be considered as a subset of more general orthodox 'inward-looking' development strategies.

Why ISI is Chosen

There are several reasons for the preferance of ISI strategy. First of all this calls for keeping out imports, which is a task mcst goverments can accomplish easily.

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Secondly, balance of payments difficulties adds to the attractiveness of this approach. In general the saving of foreign exchange through IS has been seen as an 'easier option' than the earning of additional foreign exchange through manufactured goods exports which require breaking into new markets and the devising and implementation of successful export promotion policies. This course of action is not impossible but is more difficult than ISI.

Thirdly, ISI will create investment opportunities in the economy, because keeping out previously imported goods will encourage their domestic production (1).

Fourthly, ISI avoids the uncertainties of estimating and the hazards of creating new markets for the new industries to be established; for, by shutting off imports, it secures an already established market of known dimentions for the industries to be created. Infact it is the growth of imports which subsequently induces domestic production; in offering proof that a market exists, the imports can fulfill the important function of demand formation and demand reconnaissance for the country's entrepreneurs (2).

Lastly, support for import substitution comes partly from an appeal to the experience of industrialized countries. Historical studies of some countries show that not only the share of industrial output rises with development, but also that the growth of industries based on import substitution accounts for a large proportion of the total rise in industry (3).

ISI is not a strategy in the sense of a carefully planned approach, but rather a situation into which a country tends to find itself as the development effort ise made. So to a very large extent it was arrived by default and ease of initiation, because if a country decided on an export-promotion strategy, however, it is not so evident how to begin. Similarly to build a development strategy around industrialization without ISI does not lend itself to an obvious set of policies (4).

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(1) Henry J. Bruton, «The Import-Substitution Strategy of Economic Development.: A Survey», **Pakistan Development Review**, Summer 1970, Vol. 10, p. 127.

(2) A.O. Hirschman, **The Strategy of Economic Development**, New Haven 1958, p. 123.

(3) Gerald M. Meier, **Leading Issues in Economic Development**, Oxford University Press, New York 1976, p. 648.

(4) Bruton, Op. Cit., p. 126-7.

ISI In Hitorical Perspective

The distinction between ISI as a historical phenomenon and a deliberately implemented development strategy has not always been made clear in the literature. But we can in general say that untill the second World War it was a historical phenomenon, after the war it became a more deliberate policy and since then has been used as a conscious development strategy in many less developed market economies. The exceptions to this generalization are generally taken to be Hong Kong, Singapore, South Korea and Taiwan, all of which are regarded as having parsued 'outward-looking' development strategies.

For instance, in many Latin American countries ISI was initiated as a response to the disruption caused by World War I, the economic depression of the 1930s and World War II, when either imports were not generally available, or there was insufficient foreign exchange to pay for them and thus demostically produced goods had to be substituted for those previously imported. But in the post-1945 world ISI became more widespread development policy (5).

Historically import substitution has always accompanied economic growth. But this does not tell us whether a deliberate ISI strategy is of relevance to today's LDCs and will provide the basis of a long-run development strategy. Infact the policy has been vigorously criticised after consecutive failures in LDCs where it is followed during 1960s and 1970s.

Expectations From ISI

LDCs have many problems. Income per head is low, rate of unemployment (both open and disguised) is high, accumulated capital is small and rate of saving is low. The number of skilled personnel and accumulated technical knowledge are small. Balance of payments constraint is one of the majer obstacles for development. And as a result of all these the economy is dependent on central economies.

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(5) D. Colman, F. Nixson, **Economics of Change In Less Developed Countries, Philip Allan Pub. Lmt., Oxford 1978, p. 188.**

So ISI was seen in LDCs as a necessary condition for the creation of greater employment opportunities, the stimulation of capital accumulation, the removal or alleviation of the balance of payments constraint and the securing and anchoring within the economy of the benefits of technical progress. It was expected to do all these both by spurting indigenous investment and by inducing foreign capital behind protective walls.

How ISI Proceeds

One may visualize the origines of ISI in the following way : policy makers become aware that conventional optimizing criteria can not lead to policies that produce as rapid a rate of growth as desirable either because the need for en explicit prime mover or because the existing structure of the system is alien to growth. Then ISI strategy is likely to be selected, if a number of strategies examined, because it is easy to implement simply by shutting off imports (6).

Under the ISI regime the planner will usually consider a product suitable for domestic production if the domestic market, as given by the value or volume of imports of that product, is aqual to, or greater than, the minimum economic output of a single manufacturing unit. Then protection will be given for the domestic production of that product, against foreign competitors. Consequently protection will usually force transnational corporations or local enterprises (most likely those previously engaged in the import of these goods) to establish domestic production facilities in order to protect their market position.

Consumer goods ore the first products to produce and to protect against foreign competition in almost all countries. There are several reasons for this; First of all cost disadvantage between domestically produced and imported consumer goods is less than for capital goods or for intermediate goods. Secondly, there is an obvious demand for these goods and finally, consumer goods are universally deemed inessential to development, and an increase in their prices assumed to be less harmful than increases in the prices of capital goods (7).

After deciding on the goods to be produced, the following steps are envisaged; At first the country may import semifinished materials and components and perform domestically the 'final

(6) Bruton, Op. Cit., p. 127.
(7) Ibd., p. 129.

touches' of converting or assembling the almost-finished industrial imports into final products, in the hope of proceeding to 'industrialize from the top downwards' through the ultimate production of the intermediate products and capital goods. Such that, with the growth in demand for the final product, a point may be reached at which the import demand for intermediate components is sufficiently high to warrant investment in their production at home; the market has become sufficiently large to reach a domestic production threshold (8).

These possibilities of step-by-step gradul import substitution have been recognized in most countries and their exploitation attempted (especially in the motor-car industry). The typical pattern was to require a newly established manufacturer to buy a certain minimum percentage of his inputs in the domestic market, and to increase this required minimum percentage progressively, year after year, thereby creating an assured and expanding domestic market for sub-contractors and the suppliers of parts and materials (9).

As it is seen the ISI process was at one time characterised as 'industrialization by tightly seperated stages' that is it was seen as a sequential process whereby countries would begin with the domestic production of consumer goods and then move to intermediate goods and finally to capital goods production. However such a sequence is extremely difficult to realize in practice. Majority of the LDCs have tended to 'get stuck' at the first stage.

Some Consequences of ISI

The excessive protection, permitting or encouraging the overdevelopment of ISI creates several consequences in the economy which eventually lead to the failure of the policy.

First of all the most pervasive impact of ISI policies has been that it distorts the economy, and these distortions do not, except in rare instances, correct themselves. The distortion issue is a most strategic concept, strategic to the point that to ignore it is to court failure. Indeed economies became increasingly distorted as the ISI process continues. Excessive protection, permitting or encouraging the overdevelopment of ISI, violates the principal of comperative

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(8) Hirschman, Op. Cit., p. 114.

(9) I. Little, T. Scitovsky, M. Scott, **Industry and Trade in Some Developing Countries : A Comperative Study**, Oxford University Press, London 1971, p. 61.

advantage and creates new, and aggravates existing distortions in domestic factor and product markets. Labor is relatively overpriced, the domestic currency is over-valued in terms of foreign currencies and capital is relatively underpriced. Capital-intensive technologies are the result of such factor market imperfections and as a result unemployment is exacerbated.

Secondly, it is also argued that ISI has worsened existing inequalities in the distribution of income, redistributing income from agriculture to industry and within the industrial sector itself, from labour to capital.

Thirdly, ISI creates aliennes. That is, ISI seems to create activities that are broadly alien to the economic and social environment of the community (10). Also inconsistency among the various sectors of the economy breaks as the mechanisms for creating and maintaining structural consistency have been destroyed by the IS policies (11).

Fourthly, conventional approach to IS creates conditions that dampens productivity growth, and rapid productivity growth is essential to a successful ISI. Evidence seems to indicate that productivity growth is more likely to reach acceptable rates in economies where distortions and alienness are at a minimum (12).

Lastly, due to the concentration of income ,the growth of demand for industrial products may not be sufficient to maintain the initial ISI momentum. What makes the situation worse is the lumpiness of many ISI industries. Because of indivisibilities, many industries were forced to build substantially ahead of demand. Thus the existence of excess capacity which is not being rapidly filled by growing demand dampens the incentive to invest (13).

ISI and Foreign Economic Relations

The original advocates of ISI had hoped that their policy would lead LDCs to greater selfsufficiency and would make their economies more independent of the vicissitudes of international trade. There is little evidence that even hints that the trade balance improves as a consequence of IS policies. This is surely the case

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(10) Bruton, Op. Cit., p. 140.

(11) Ibid., p. 133.

(12) Ibid., p. 141.

(13) Werner Baer, «Import Substitution and Industrialization in Latin America : Experiences and Interpretations», **Latin American Research Review, Spring** 1972, p. 107.

in the short run, but seems true as well in the longer run. This is partly explained by the widespread tendency of IS policies to discriminate against exports, but also by the failure of IS to reduce imports or import-GNP ratios, i.e., IS policies do not reduce the demand fro imports (14). Because the establishment of industries producing final consumers' goods creates demand for a variety of new imports, such as the materials, parts, and components, assembled in the newly established assembly plants, the manufacturing equipment used in them, and other imported consumers' goods as well if the new manufacturing activities succeed in raising real income and so raise consumers' demand (15). Thus, if ISI succeeds in raising the real income consumers' demand for imported goods will also rise.

Additionally the redistribution of income that occurs during the ISI process may favour those sectors or classes within the economy which have a high marginal propensity to consume imported goods. Thus the very success of ISI in creating additional income aggravates the balance of payments problem.

So, ISI tends, paradoxically enough, to increase the economy's dependence on imports. Complete self-sufficiency is probably an unattainable goal; and as the economy becomes more nearly self-sufficient, it also becomes more import dependent, in the sense that the availability of the goods it still has to import becomes more crucial for the smooth functioning of the economy. As long as an economy imports finished goods, its occasional inability to obtain or pay for these imports lowers the standart of living by making the imports unavailable. When the economy produces the same goods domestically but with the aid of some imported materials, parts, or equipment, an occasional inability to import these will also cause work stoppages, unemployment, and a fall in the income generated by domestic manufacturing. For example, curtailing the imports of 1000 dollars of shirts will have less impact on an economy than will the curtailing of 1000 dollars of chemical cellulose used in manufacture of shirt material (16).

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(14) Bruton, Op. Cit., p. 136.

(15) Little et al., Op. Cit., p. 59.

(16) Bruton, Op. Cit., p. 136.

İmport substitution is no quick means of reducing a country's need for imports; and statistics that show the proportion of total imports in GDP give little or no indication of the extent and success of import substitution policies as will be seen in the table below (17).

Imports as per cent of GDP

Country	1950-2	1957-9	1964-6
Argenite	9	11	7
Brasil	12	10	8
Mexico	12	11	8
India	8	7	7
Pakistan	8	7	10
Philippines	14	13	19
Taiwan	13	14	19

On the other hand the neglect of exports during the ISI period, that is, the failure to stimulate traditional exports and to diversify the export structure, could deteriorate the balance of payments difficulties. It is thus ironic that the net result of ISI has been to place LDCs in a new and more dangerous dependency relationship with the more advanced industrial countries. In former times, a decline in export receipts acted as a stimulus to ISI. Under the circumstances, as ISI process increases the domestic value added dependent on imports, a decline in export receipts, not counterbalanced by capital inflows, can result in forced import curtailments which, in turn, could cause an industrial recession (18).

Particularly, if the sequence gets 'stuck' at the cosumer goods stage, the LDC will not experience an alleviation of its balance of payments constraint. So the dependence of the economy on foreign trade, and its vulnerability to fluctuations in foreign exchange receipts will not be significantly reduced.

(17) Little et al., Op. Cit., p. 62-3.

(18) Baer, Op. Cit., p. 106.

The chronic foreign-exchange shortage of many developing countries is partly due to an underestimation of the tendency of import substitution to generate demand for imports and consequent over-optimism about its ability to reduce the economy's dependence on imports (19).

Turkey is the latest example facing the harsh realities of this overoptimism. When She adopted First Five Year Development Plan mainly based on ISI policy "continued development at the 7% rate without further foreign assistance, by 1977 at the latest" was the target. But since 1977 the development of the country came to a complete halt with a huge foreign dept mainly as a result of ISI policies. (Other factors, such as the rise in oil prices also played a role in this result.)

Conclusions

As we have seen so far, ISI may create income and, to a lesser extent employment, but its apparent inability to save foreign exchange will force the economy to become increasingly dependent on inflows of foreign capital (both private and public) to maintain the real capacity to import, assuming that export earnings cannot be significantly increased.

The inability of ISI to sustain a long run rate of growth of national income in excess of the capacity to import has become apparent. After a brief period of growth, ISI appears to lose momentum, IS opportunities apper to become 'exhausted' and the goreign exchange constraint once again becomes dominant.

ISI has been dependent on foreign capital, technology and expertise, it has been based on the consumption patterns, tastes, marketing techniques, etc., of the developed capitalist economies and the changes in the import structure and the failure to alleviate the balance of payment constraint have exacerbated the dependence of the IS economy on the external sector.

In the and, more private foreign capital may be invited and external aid may be claimed on the grounds that if the specific

(19) Little et al., Op. Cit., p. 63.

shortage of foreign resource is relieved than the capacity made idle by that shortage will be brought into use and the economy will begin to grow very rapidly. But this will make the economy to continue to function despite the existence of the distortions, and may hinder the corrections of the distortions or even knowledge of their existence.

Sometimes even aid may not be available. Under these difficult situations to get aid countries are asked to surrender to the conditions imposed by IMF and those conditions may be irrelevant to the realities of LDCs.

Aid used to permit corrections of the cources of distortions will have a much more permanent effect on the growth capacity. In order to use aid in this way, however, the distortions must be barred, their origines understood, and their method of elimination known.

Whatever the exact combinations of factors, there seems to be clear evidence from a number of countries (for example, Brazil, Argentine, Pakistan and recently Turkey) indicating the loss of momentum of the ISI process and in the extreme, the collaps of the strategy amid growing social and political conflict. In some countries the collapse of ISI is marked by a change of government (often the result of a military coup) and the implementation of new economic policies.