UNIT 5 INWARD-LOOKING DEVELOPMENT STRATEGIES

Structure

5.1 INTRODUCTION

The 19th Century export-based development strategy in Latin America began to lose its momentum in the first three decades of 20th Century. In the first place, the First World War affected adversely their exports, disrupted their supply of essential imports mainly on the account of blocked trade routes. Second, the 'Great Depression' of 1930s gave another serious blow to the export earnings of most of the Latin American countries; and in the absence of adequate foreign exchange, these countries adopted a strategy of home production of importables. Forced by unprecedented circumstances, these countries marked a shift from outward-oriented commodity export-based development strategy to inward-looking internal market growth strategy. Thus, around 1930s, internationalism replaced nationalism, which swayed, and also emerged as the predominant development ideology. Components of this strategy included an interventionist nationalist state in power; protectionist policy regime to encourage domestically owned enterprises as against foreign controlled ones; pressure of emerging class of urban professional elites to undertake/follow modernisation on European and North American patterns and strive for industrialisation. Led by Getulio Vargas in Brazil (1930s) and Peron in Argentina (mid-1940s) and with the support of urban modernising professionals, they paved way for initiating import substitution industrialisation to stave off their crisis-ridden economies. Even in Mexico (1920s) the main tenets of nationalist preference for local ownership were reflected in i) exclusive state ownership of strategic or basic industries, ii) national ownership of industries in which domestic private sector produce efficiently and iii) foreign ownership to complement nationally owned industries. Subsequently in the aftermath of the Second World War, under the intellectual leadership of Raul Prebisch, the ECLA School of Thought emerged as the leading force to advocate inward-looking development strategy for Latin American and other developing countries. The cornerstone of this strategy was a phase of import substitution industrialisation under heavy state protection. However, as subsequent developments show, this strategy had its own pitfalls and failures and choice of either export-oriented or import substitution industrialisation was irrelevant from the perspective of long-term development of economy.

5.2 OUTWARD-ORIENTED AND INWARD-LOOKING DEVELOPMENT STRATEGIES

Structuralists led by Raul Prebisch, Celso Furtado, Anibal Pinto and H.W. Singer distinguished outward and inward directed development strategies. While they considered the 19th Century outward-oriented resource-based export-led development strategy for the Latin American countries as perpetuating underdevelopment and non-democratic forms of government, the inward directed development strategy was believed to lead to development and democratisation. In the second place, *laissez-faire* and free trade regimes of the 19th Century were held responsible for these countries' economic crises from time to time; inward-looking development strategy initiated in the interwar period encouraged industrial development based on indigenous raw materials, and production oriented towards internal market. Accordingly, rapid industrialisation was thought as a panacea to overcome the crisis of the continent. Third, in the export-oriented strategy, the role of the state remained passive and state association of free trade with colonial or neo-colonial regimes created distrust of free markets. As against, in inward-oriented development phase, the developmentalist state was conceived as a 'liberating, equalising and modernising' force in society.

5.3 WHY INWARD-LOOKING DEVELOPMENT?

In a highly simplified version, factors leading to the adoption of inward-looking development strategies in most of the Latin American countries included the blockade of trade routes in the First World War; the onset of Great Depression in 1929; and the Second World War disrupting the supply of essential imports; adverse terms of trade during 1929-34 and falling export earnings. More particularly in Argentina, for instance, mounting domestic pressure to delink from the international economy; blocking of sterling deposits in London during the Second World War and resentment against English Speaking foreign investors for political and social reasons were some of the factors which increasingly led to the production of 'home goods' domestically and economic policies started turning against exports, particularly those of the primary sector. These factors emerged in response to the immediate crises situations arising out of wars, Great Depression and response failure of outward-oriented development strategy to deal with the crisis. Another factor for the failure of outward-oriented development strategy was reflected in the fact that Great Britain was no longer a major economic power in 1920s; rather USA emerged as the potent economic power but remained relatively a closed economy.

Under the pioneering work of Raul Prebisch, structuralism/ECLA School of Thought or ECLA Theory of Development provided the most cogent intellectual arguments for inward-looking development strategies. According to this School, there existed market imperfections and distortions; lags in technological transfers and pricing mechanism predominant in the world economic system favouring the Centre at the cost of Periphery.

The classical dictum, 'Trade as an engine of growth', though true in some cases, did not necessarily offer similar rewarding effects for many developing economies. Mainly three factors seem to explain such a situation: one, the dualistic structure of the underdeveloped economy showing the co-existence of a well-developed export sector and a primitive domestic sector; second, the distribution of gains from trade between the developed and developing economies remained a much debated theme. Quite often, the flow of foreign capital moved into the most profitable export sectors and the resultant pattern of the economy of these countries was oriented to the needs of the developed economies and offered little scope for any technical progress or internal and external economies. The foreign enterprises could produce the goods at a low cost of production and reaped the benefits of trade. Even when productivity in particular enterprises was large, the benefits in the form of large returns accrued primarily to the residents of the developed countries; third, given the existence of dualistic structure and unfavourable distribution of gains from trade for such economies, they did not help increase domestic capital accumulation. When the demand for export products increased and export earnings rose correspondingly, these countries found it irresistible to use the incomes for further expanding the primary goods industries rather than to divert the earnings for importing capital goods or for investing in major industries.

Centre-Periphery Dilemma

A considerable volume of literature is available underlining the economic relations between the two types of economies, thanks to the pioneering efforts of Raul Prebisch and H.W. Singer and the subsequent scholarly writings on their theses.

The developed industrial countries exporting mainly manufactures and importing primary or semi-processed commodities are considered as the 'centre', while the less developed countries whose exports and import patterns are the reverse of the centre's, are labelled as the 'periphery'.

The basic problem is one of distribution of gains from trade between the centre and the periphery. To start with, Raul Prebisch challenges the classical view that trade tends to distribute the fruits of technical progress among all parties, as he believes that this classical view is incorrect. He believes that the classical arguments are theoretically sound, but he seriously questions the validity of assumptions upon which they are based. Prebisch says: "According to this assumption, the benefits of technical progress tend to be distributed alike over the whole community, either by the lowering of prices or the corresponding raising of incomes." The basic themes of the analysis revolve around the fact that there is a persistent deterioration in the periphery's terms of trade vis-à-vis the centre. To buttress his arguments, he stresses that the technical progress defined as the reduction of the value of inputs per unit of output is greater in the centre than in the periphery. Consequently, productivity increases at the centre tend to be fully absorbed by increased wages, because of the strong bargaining position of trade unions in economies with high employment, or by the increased profits of monopolistic supplies. Whereas, any increase in productivity tends to lower prices in the periphery because the labour market is very much competitive and displaced labour following technical progress exert further downward pressure on the wage rate. Thus the conclusion is obvious that there is a tendency for prices at the periphery to decline following the increase in productivity.

The nature of the export commodity/commodities from periphery to centre and vice-versa, contributes also to the declining terms of trade process. The centre's almost stagnant or reduced demand for food, excessive domestic protection to agriculture and constant fall in the use of raw materials thanks to substitutes such as synthetic products, make low price and income elasticities of demand for the imports supplied by the periphery.

In other words, the prices of primary products are more prone to fluctuations than those of manufactures because of lower price elasticity of demand, frequent shifts in their supply schedule and the long gestation periods of investments. Undoubtedly, in a period of industrial recovery at the centre, the prices of primary products tend to increase more than those of manufactures, profits are transferred to the periphery. In a downswing in the centre, the reverse happens, with primary product prices declining more than those of manufactures. The result is obvious that the losses in terms of trade of primary producers in the downswing are greater than their gains in the upswings.

Available empirical evidence supports Raul Prebisch and his analysis. In the historical relation between the more developed countries and underdeveloped countries, H.W. Singer's studies show two important effects of underdeveloped country's specialisation on primary products: one, the mechanism of international trade-cum-investment was not sufficient for growth in the periphery, because such trade-cum-investment was related more to the industrial or investing country. Second, there is diversion of the underdeveloped countries into types of activity offering less scope for technical progress.

Technical progress is desirable. But the obvious outcome of it has been the unequal distribution of gains arising out of it between primary producers and manufactured product producers. The gains are reflected either in the form of rising incomes to producers or in the form of falling prices to consumer. In case of developed countries, the producers have obtained higher incomes, while the food and raw material producers in underdeveloped countries have been confronted with lower prices.

Based upon his early post-war writings, Prebisch's chief policy recommendations were that exports could not be regarded as a major contributor to increasing the rate of economic growth in the periphery. Majority of developing countries rely on exports of relatively unprocessed primary commodities, which on the whole, face fluctuating markets and prices.

Developing countries cannot export manufactures or more highly processed primaries in significant quantities because of their own supply shortcomings and second, because of various kinds of barriers erected against their entry in importing countries. Manifold problems that confront the less developed countries in promoting export of manufactures are as follows: substantial degree of control exercised by multinational firms on marketing outlets for manufactured products in the developed countries; highly imperfect markets for the relevant technologies in the least developed countries (LDCs); homogeneous nature of exports from a number of LDCs towards developed countries; high tariff and non-tariff barriers against their manufactured exports in their major prospective markets; the absence of international conventions or rules to protect the LDCs against discriminatory treatment; the frequent practice of multinational corporations controlling the right to export from their subsidiaries and the right to sell technology; the weak administrative capacity and political power of the host government in LDCs which render difficult the process of effective bargaining, monitoring and control with respect to foreign agreements and Multi national Corporations (MNCs).

On the other hand, the demand of the LDCs for imports of goods and services vital for accelerated development grows at a rate in excess of their exports. Transfers of income from developed countries in the form of private investment and economic aid will not necessarily fill the gap and in any case generate a reverse flow of debt service, dividends, royalties, etc. A development strategy recommended for such countries is import substitution of manufactures, to be achieved by effective protection of domestic infant industries.

H.W. Singer supported further the case for industrial import substitution by arguing that traditionally the export sector of primary producers had been to a great extent in the hands of foreign companies that formed an enclave in the peripheral economy, providing little local benefit. He also stressed the indirect advantages of manufacturing industries to the host economy. Thus in matters of policy prescription, he advocated "some method of income absorption", whereby the results of technical progress may be retained in the developing countries. The primary producers should keep a greater proportion of profits. Progressive social legislation is necessary to provide for increases in real wages in these countries.

Yet Singer's views have been questioned. His acceptance of the 'historical fact' of the declining terms of trade of primary producers appears to be based solely on the evidence of a 1949 United Nations report. His innovation of the 'enclave' sector is a warning to the policy-makers in a number of less developed countries, but hardly an objective description of the primary producing sector in the majority of them.

Despite the obvious limitations pointed out time and again, Prebisch-Singer analysis seems to have attracted much attention among development economists in Latin America in the immediate post-war years. We may recall here the bitter experience of the world depression of 1930s in the context of peripheral countries and again the Second World War jeopardised the process of economic development of these countries. In this context, the immediate postwar years gave a ready audience to the writings of Prebisch and Singer. Thus the phase of import substitution industrialisation model was set in. The adoption of such a strategy for many developing countries emerged as a result of the suggestions of Economic Commission for Latin America (ECLA) guided by Prebisch thesis, the economic obstacles to the export of manufactures to developed countries and lastly high rates of population growth.

Hirschman discusses four distinct origins of import substitution strategy for developing countries-wars, balance of payments difficulties, growth of the domestic market (as a result of export growth) and official development policy.

A noteworthy feature of this period has been the export 'lagging' type of development since 1945 (except Korean War boom) among the developing countries. A considerable volume of literature starting from the writings of Ragnar Nurkse and A.K. Cairncross is available on the possible causal influences at work in the apparent association between industrialisation, the lag in the export sector of the economy and the slower rate of growth in export of these countries. The arguments centre round either on demand deficiency theory advocated by Ragnar Nurkse or supply deficiency theory put forth by A.K. Cairncross.

Thus opinions may differ, to a degree alone, among the authorities on economic development of developing countries in general and Latin America in particular, on the possible causes of import substitution. Nevertheless, the appropriate time for the writings of Raul Prebisch and available conditions in the context of these economies made import substitution strategy appear to be an appropriate policy as a step towards diversifying the economic structure of these countries.

5.4 POLICY MEASURES AND PERFORMANCE

5.4.1 Import Substitution Industrialisation Strategy: Meaning and Scope

Import substitution in the sense of replacement of imports by domestic production has various interpretations. One way to define and measure import substitution is the change in the proportion of imports in total supply (domestic production plus imports). Three causes of industrial growth can be seen in this way: (i) the substitution of domestic production for imports; (ii) growth in final use of industrial products and (iii) growth in intermediate demand stemming from (i) and (ii).

Development economists such as Hollis B. Chenery subscribe to this viewpoint that if domestic production rises faster than imports then import substitution is taking place. He attributes the growth of output to the growth of demand (intermediate and final, independently) holding the ratio of foreign to total supply constant. Then the residual change in output is attributed to the change in the supply ratio, which he calls import substitution. His cross section analysis of 51 countries suggests that changes in supply conditions are more important in explaining the growth of industry than are changes in demand.

A second way to look at import substitution is in terms of its stages. Briefly, it is a two-stage phenomenon. The first stage is the take- over of an existing market for consumption goods from the foreign supplier. The second and much more difficult stage, consists of extending production backward to intermediate goods, capital goods, raw materials and finally, breaking into the world market. This stage includes too many variables and does not reflect the real aim of import substitution. A third way to analyse import substitution is to refer to all arguments to the effect that developing countries cannot rely on exports as an engine of growth. In a narrow sense, it refers simply to the take over of an existing domestic market from the foreign producer by prohibiting his imports in one way or the other.

Whatever interpretation may be given to the term import substitution – it means generally the satisfaction of a greater proportion of a country's total demand for goods through its own domestic production. Domestic production, which relates to the replacements of imports, is quite obviously based upon easily identifiable investment opportunities. Thus, the domestic market is assured to the domestic producers either by way of curbing imports altogether or reducing them to a considerable extent.

In a period of balance of payments crisis, import substitution is introduced accompanied by import controls or high tariffs. During its first stage, domestic production of consumer goods grows very rapidly. This is made possible by relatively simple technology, less capital requirements and fairly existing demand. This results into rapid growth in industrial output and employment accompanied by a significant decline in the share of imports in total demand for manufactures. But it is often pointed out that the goods are of doubtful quality, produced in factories of uneconomic size and sold at high prices in the protected domestic market. As an illustrative measure, Johnson finds that the cost of import substitution may greatly exceed that implied by the difference between protective tariff rates and the foreign price of the goods produced. The high cost of import substitution may progressively absorb the increment in real income, which should accrue to capital and technical improvements, so that in addition to the consumption lost there may occur a substantial capital accumulation without any growth in real income per capita.

Rather, the first stage of import substitution should emphasise the use of domestic raw materials and intermediate products, which are or could soon become, competitive by international standards. Self-sufficiency in consumer goods should not be the ultimate goal. As Hirschman stressed: "Thus the sequential or staged character of the process is responsible not only for the ease with which it can be brought under way, but also for the lack of training in technological innovation and for the resistance to both backward linkage investments to exporting that are being encountered."

The next stage in the import substitution process relates to the domestic production of consumer durables followed by intermediate and capital goods. A highly unequal distribution of income due to the initial pattern of capital ownership, a series of controls over the distribution of scarce inputs such as capital and foreign exchange because of government policies and a sheltered profitable market, combine to facilitate this process. Often this stage is characterised by slow industrial growth, a sharp decline in employment opportunities and little further reduction or even an increase in the import component of total demand for manufactures. The last aspect of the effect is due to strong resistance against backward linkage investment on the part of private industrialists and public authorities.

Further, as the countries move on the higher stages of manufacturing the governments retain the old economic policies that are no longer applicable to the new phase of import substitution. Moreover, a strong push across-the-board, import substitution in all the sectors indiscriminately leads to the wastage of resources.

Thus the factors, which tend to initiate import substitution in consumer goods industries, are likely to perpetuate that trend. In the experience of many countries, import substitution has led to more import substitution and bigger controls. The first stage of import substitution goes easily, but industrial growth slows thereafter because the limit of the existing market has been reached. Analysts have pointed out that one or more of three other forms of demand should replace the already established consumption demand if growth is to continue. That is, (i) domestic market for new consumer goods must be found, (ii) manufactured goods must penetrate the export market or (iii) investments must move from finished consumer goods industries to capital goods production, intermediate goods or raw materials. More consumer goods output will inevitably be constrained unless supported by either (ii) or (iii).

5.4.2 Performance Indicators during ISI Phase

As already discussed, the First World War interrupted the industrial growth since it became difficult to import the much- needed capital goods and no capital goods industry existed in Latin America. In case of Brazil, there was the increased utilisation of the capacity in food and textiles industries. By 1919, production of textiles, clothing and shoes accounted for 50 per cent of the total value added. Further during 1920-29, the average rate of industrial growth was around 3 per cent as compared to 4.6 per cent in 1911-20. The decline was primarily due to heavy demand for capital goods and pent up demand in the internal market. In the Great Depression (1929-34) period, increase in the industrial production was based on increased utilisation of existing capacity in the presence of foreign exchange constraint. Thus, by 1939, the share of industrial production was 43 per cent as compared to 21 per cent in 1907 or 1919. Textiles, metal and paper products were the fast growing industrial products. Brazil attained self- sufficiency in consumer goods and met 80 per cent of its own intermediate goods and 50 per cent of its investment goods through its domestic production. Similarly in Argentina, during 1930s and the war years (1939-45), growth industries were those using local agricultural and primary inputs-foodstuffs, tobacco, textiles, and leather goods. By 1944, the value of manufactured products exceeded that of agricultural production. In Greater Buenos Aires, import-based industries such as rayon, synthetic rubber and pharmaceuticals showed tremendous growth during this period. Unemployment level in Argentina hardly reached 5 per cent during Depression period. Also in Brazil, the Second World War provided an opportunity for industrialisation based on import substitution and this process found a large market and natural advantage in the production of ferrous metals, metal products and chemicals. By 1945, manufacturing accounted for 20 per cent of gross domestic product (GDP).

In the postwar years, faced with the balance of payments difficulties, both Argentina and Brazil accelerated the process of import substitution industrialisation under protectionist policy. In Argentina, the government sought to increase the production of consumer durables with imported parts as the demand of which got stimulated by low food prices and high wage rate (under Peron's regime). In Brazil, the average annual growth rate of GDP stayed around 6 per cent during 1947-62. Taking however a shorter period of 1956-62, GDP grew by 7.8 per cent per annum, industry leading with 10.3 per cent and agriculture 5 per cent. Subsidised credit, low or negative real interest rates, tariff exemptions and lower exchange rate for imported capital goods and liberal profit remittances for foreign investors facilitated the attainment of two digit industrial growth rate in particular and high GDP growth in general. In Argentina too, capital goods, fuels and intermediate products were imported at a lower exchange rate. Much of the export earnings were used to subsidise the growing imports of fuel and raw materials required by industry.

In general, while major Latin American countries such as Brazil and Argentina weathered the storm of wars and Great Depression relatively well, the post war policy frame turned the terms of trade against their primary sector. It has been argued that industrial sector was unduly favoured with protectionist measures such as overvalued currency, high tariffs, import licensing, exchange control restrictions and subsidised credit. Rural sector was deprived of modern imported inputs and consequently their share of primary exports declined in the post war years.

5.5 INWARD-LOOKING DEVELOPMENT STRATEGIES: A CRITIQUE

However in the 1960s, the economic thinking in developing countries became increasingly critical of import substituting industrialisation for countries at a certain stage of development. It had become difficult to transform import demand into demand for domestically manufactured products.

It has been argued that external and internal problems had accumulated to the point where they acted as a brake on the dynamism to the process of import substitution industrialisation. The ISI strategy, which was largely adopted to relieve the foreign exchange bottleneck, ended up in aggravating the problem further and constraining the economic growth. These countries became vulnerable to the balance of payment problem as an increasing proportion of imports consisted of raw materials, spare parts machinery, which were essential for sustaining industrial production. ISI failed to absorb the surplus labour and improving the distribution of income thereby aggravating the phenomenon of structural duality. The widening gap between the subsistence sector and the capitalist sector constrained the development process. The major drawback, which the ISI faced, was that it targeted the internal demand and neglected the external demand.

Celso Furtado put forward the thesis of structural stagnation in relation to inward looking development process. According to him the underdeveloped economies are by nature pre-capitalist and characterised by small size market: thus, the benefits of economies of scale cannot be reaped. According to him, industrialisation within a dualist structure reproduces this dualism and underdevelopment leading to further stagnation.

Anibal Pinto, a leading ECLA economist argued that the stagnation of import substitution industrialisation was due to lack of mass market. Rather he argued that the development of industrial exports and agricultural modernisation could be a solution for the smallness of the internal market.

The import substituting industrialisation process came under strong criticism from both the neo-classical and dependency theorists. However structuralists themselves were among the first to analyse the limitations of import-substituting industrialisation. In this respect it is important to distinguish between the structuralists argument for ISI and the actual way of looking in which the policies were implemented and the industrialisation took place in Latin America. From this the process of industrialisation suffered from three flaws in Latin America.

i) All industrial activities were directed towards the domestic market; ii) the choice of industries to be established was based more on circumstantial reasons than on considerations of economic return; iii) industrialisation failed to overcome the external vulnerability of the Latin American countries.

By 1965 a number of ECLA studies were critical about the ISI strategy because of its failure to diversity exports. This inability to divert exports was seen as a major contradiction to ISI strategy. However Pinto saw this as an example of a failure in policy rather than an inherent flaw in the inward-directed development model. Import substitution had greatly changed the composition of imports in Latin America, their volume continued to increase due to growth in income but export earnings did not rise rapidly enough because of the deterioration in the commodity terms of trade.

ECLA's views became self-critical, as it was clearly dissatisfied with the failure of the inward-development process to live up to expectations. It cited various causes for this dissatisfaction; the persistence of foreign exchange problem, the inability of industrialisation to diffuse its benefits or give impetus to other economic activities the limited absorption of labour, the continued existence of marked inequalities in the distribution of income and finally the increasing control of the foreign capital.

5.6 SUMMARY

Failure of outward-oriented development strategy caused mainly by exogenous circumstances; upsurge in nationalist fervour created by populist leaders such as Vargas and Peron; rise of modernising class of professionals; and a developmentalist state conceived as a liberating, equalising and modernising force in society were responsible to initiate and pave way for an alternative strategy—popularly known as inward-looking development strategy. Under these circumstances in the postwar years, the ECLA led by Raul Prebisch provided the intellectual support to launch a phase of import substitution industrialisation in these countries which lasted in an intermittent way till 1980s. As a debt-ridden continent and with the Soviet regime collapse, they were faced with the adoption and implementation of unprecedented economic reforms. Despite that, as subsequent events show, the continent could not save itself from the fury of recurrent crises.

5.7 EXERCISES

1. Distinguish between Inward and Outward development Strategies. Analyse their merits and demerits.

2. Discuss some of the political and economic factors responsible for adopting inward development strategy.

3. Explain the term "Import Substitution Industrialisation"(ISI). What were the main limitations of this strategy in Latin America?