CHAPTER II

IMPORT SUBSTITUTING INDUSTRIALIZATION -
ITS NATURE AND SCOPE

1. STRATEGY OF DEVELOPMENT - AN OVERVIEW

Rethinking on the problem of economic development reflects
the great changes in the world's political and economic conditions
which have taken place since World War II. One of the most
important changes has been the creation of many new nations
from the colonial empires and dependent territories of the major
European powers. These new states, along with the older states
of Latin America comprised the less developed world. Most of
the economists have observed that foreign trade and investment
have adverse effect on the economic growth of the poor countries
and on the distribution of world income between rich and poor
nations. One of the central problems facing a developing country
is whether the classical trade theory or modern growth theory
is operationally more useful and relevant as the development
strategy. Transition from a traditional economy to a modern
manufacturing economy is a pre-condition of economic and social
growth in developing economies. Export promotion and import
substitution are the two strategies basic to the developmental
policies of the underdeveloped countries. Efforts have been
made to re-examine the development strategies adopted by backward
countries in the context of economic development. A historical
approach has been followed in dealing with problems of trade
and growth in developing economies.
Development strategies have played a dominant role in structuring the economic progress of developing countries. Economic growth depends largely on the dynamic forces involved in the developmental process. The economic history of the industrial countries reveals that dynamic changes brought about by industrialization and trade policies were primarily responsible for development in various stages of growth.

The doctrine of comparative advantages advocated by classical economists as the best policy for the gain from trade, was adopted by developing and developed economies till the nineteenth century. The comparative cost theory is applicable to static changes only. Modern economists have favoured the dynamic changes relevant for development. The comparative cost doctrine accords with the tradition of developing countries exporting raw material and importing manufactured goods.

Haberler advocates the classical idea of trade and development. He has tried to explain the importance of gains from trade. He has criticised the classical economists for their narrow-minded views on gains from trade. He has distinguished between two kinds of changes relevant to development - those that take place independently of international trade and those that are induced by trade or trade policy. The first set

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of changes are autonomous changes gradual improvement in skill, education, and training and improvements resulting from innovations discoveries and from the accumulation of capital. These changes are helpful in bringing about gradual increase in output and therefore, in the comparative cost advantage of the economy. These strategic changes were argued by the classical theorists. The other group of changes were argued by Haberler, as being due to trade-induced growth. These are dynamic changes. Haberler has mentioned four ways in which indirect gains from trade can be obtained. First, trade produces material means indispensible for economic development. Secondly trade is a means for the transmission of ideas, technological knowledge and entrepreneurship. Thirdly, trade is also the vehicle for the international movement of capital, especially from the developed to the underdeveloped countries. Fourthly, great benefits can be gained from free trade. These factors are complementary to the static theory of comparative advantage.

On the other hand, Kindleberger observes that capacity of transformation in developing country determines the development process in the economy. Gains from trade not only depend on comparative advantage but also on the capacity to transform. He

says, comparative advantage does not imply increment of resources coming into existence should be invested in exports because the export industries are on the average more beneficial than import competing industry. Resources should be invested so that they earn the same profits at the margin in all industries; additional resources should be invested in export, import competing or domestic industries depending upon the relative rates of return in each of them. A non-transforming society, however, will go on investing the incremental resources of a given sector in the same sector regardless of relative prices and this may lead to net loss. If the resources are not suitable in one sector, they should be shifted to another which is more beneficial sector. If the developing countries are not able to bring about this type of transformation, it means that their capacity to transform is weak. The inability to transfer resources from export sector to another more profitable sector was one of the reasons of adverse terms of trade of the developing countries.

Economies with incapacity to transform cannot exist under the free trade policy as advocated by classical trade theorists. Therefore tariff policy was recommended for the protection of import competing industries. In an interesting theoretical modification of the theory of international trade, Gottfried Haberler has suggested that trade could hurt a country if the

normal classical assumption of full employment is discarded, and if resources previously engaged in the import competing sector are unable to shift to other industries; would become unemployed. In this case the loss through unemployment might be greater than the gains from trade, and a tariff would be justified.

From the above discussion it is clear that most of the developing economies are incapable to transforming and cannot survive under the classical theory of trade based on free trade policy. This is true especially to import competing industries which are the relevant instruments in reducing the imports and in bridging the widening trade gap. Such industries can only survive under tariff protection.

The weak capacity of production of reallocate the resources among industries leads to resulting increase in output in one sector. This will continue until they saturates markets in the importing countries. If price elasticity is low, the terms of trade would become adverse, and may even deteriorate to the point where they make the country worse off as a result of expansion. Jagdish Bhagwati's model of "immiserizing growth" in which a country is worse off after growing than before, due to the fact that loss out of trade outweighs the gains from

increased productivity, has struck many commentators on a curiosity rather than the serious representation of a real case.

Most of the developing countries were affected by the immiserising growth in the early twentieth century. Immiserizing growth has especially occurred in Latin America and for-eastern countries. From the above analysis one can conclude that application of the classical theory of trade and development was not able to transform the traditional structure of economy into a dynamic one. The policy of free trade conflicted with the import competing sector which was also an essential condition of development. The high priority given to export sector adversely affected the capacity of the countries which were applying, comparative cost as their developmental strategy has led to immiserizing growth.

The causes of adverse terms of trade and deteriorating conditions of developing countries were analysed by development economists. They proposed their own concepts of growth strategies for developing economies. Development economists Lewis, Nurkse, 5 Nurkse, 6


Myrdal, Hirschman, Rostow, Dobb, and Rosenstein Rodan have focused their attention on diversification of the home market of developing countries underplaying the condition of general equilibrium and emphasized the dynamic aspect of growth, production, and factors used by the domestic sector. Most of the writers recognize balanced growth as a strategy of development. Nurkse and Rosenstein Rodan are strong advocates of balanced growth.

Nurkse argues that "trade was working as engine of growth of developing countries in the nineteenth century". This was due to the increasing demand for traditional exports of raw material and foodstuffs by the developing countries. During this period the developing countries were following export oriented growth as their developmental strategy. This type of growth was beneficial in attracting foreign investment and the sufficient quantity of imports of manufactured goods.

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The pattern of foreign trade changed in the twentieth century due to structural change in the trade and industry of developed as well as developing economies. It therefore changed the pattern as well as development in general and strategy of development in particular. The terms of trade of developing countries were not favourable and they deteriorated during the twentieth century. The major factor responsible for this change were the declining of demand for export and the leading to a fall in export prices. Ragnar Nurkse has listed six factors responsible for decline in export earnings of developing economies. They are:

i) Changes in industrial structure in favour of heavy industries with a low content of imported raw material;

ii) Rising share of services in the total output of advanced countries;

iii) Low income elasticity of consumer demand for many agricultural products;

iv) Agricultural protectionism in developing countries;

v) Economies in the use of raw material i.e., through reprocessing of scrap materials in developed countries;

vi) Introduction of synthetic material substitution.

Due to the above mentioned factors the export earnings of developing countries declined substantially and therefore
their terms of trade deteriorated. The economic depression of the 1930's affected the whole world and prices came down, but the prices of traditional commodities were reduced much more rapidly than those of the manufactured goods. Therefore Nurkse maintained that international trade was not working as an engine of growth in the twentieth century. Nurkse advocates a restructuring of indigenous industries and further investment in the manufacturing sector in developing countries. He favoured balanced growth to break the vicious circle of poverty. He advised import substitution strategy of development. These measures are calculated to help in reducing the trade gap on the one hand and in producing manufacturing goods which can increase export earnings on the other. In this way imbalances in terms of trade can be corrected.

Similar conclusions can be drawn from the Prebisch-Singer12 thesis. It states that poor countries have suffered a long-term deterioration in their commodity terms of trade and this has hindered their development. Terms of Trade mostly favour industrial countries. This is because monopolistic elements in their products and factor market have allowed industrial countries the benefit of their technological progress in the form of rising factor prices, whereas in primary producing countries the gains in productivity result in price reduction.

Myrdal\textsuperscript{13} also believes that international market forces are unfavourable for the poor countries by creating a highly unbalanced economy and by causing a secular deterioration in the terms of trade. He favours industrial protection in underdeveloped countries. He argued in favour of import substitution strategy of development.

The deteriorating economic condition of developing countries has been blamed on the policies of developed countries. It has been discussed in the reports of ECLA and in the writings of Prebisch.\textsuperscript{14} In 1961, at the General session of Assembly of U.N., it was stated by member countries that developing countries were lagging far behind in the achievement of their economic goals. The main problems before the developing countries were their deteriorating terms of trade and poor economic performance. United Nations General Assembly designated its third decade as the Development Decade. The aim was to intensify the efforts of member countries to mobilize and sustain support for measures required on the part of both developing and developed countries. The objective was to accelerate economic growth and self-reliance in developing countries. A conference on trade and development was convened in 1964 by member countries and reports were prepared

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under the guidance of Dr. Prebisch, Secretary-General of UNCTAD reviewing the economic condition of developing countries. The report asserted that the slow growth of the developing countries was the result of a persistent trend towards external imbalances inherent in the developmental process and can be countered only with import substitution policies.

Therefore, in the fifties most of the developing countries accepted import substitution-led growth as their developmental strategy. But in the late sixties and in early seventies these countries again accepted export promotion policies which were restrictive in the 1950's and the first half of sixties were liberalised with the objective of bridging the domestic supplies gap and also to fulfil the import requirement for further industrialization and for the establishment of capital goods industries. Most of the developing countries adopted closed economies as their policy during the fifties and in the early sixties except Israel, Turkey, the Philippines and Chile. However, after liberalisation the economies of developing countries became more open. The increasing trade gap has led to a crisis in the developing countries. The burden of external debt on them has been increasing due to adverse term of loans and rigid procedures as well as increase in the interest rate of the international lending agencies. The developing countries were even unable to make interest payments. The debt servicing
power of developing country has been a matter of concern to
developed countries. Due to these reason, developing countries
face problem in getting external loans to finance their increasing
investment programmes. The only remedy before the developing
economies to overcome these problems is to organize their industrial structure, so as to utilize their existing production
capacity. In the present context of development, import substituting industrialization appears to be the best solution.

The present problem of developing countries has been summed up in the World Bank Annual Report of 1984. According to report, the developing nations are facing the prospects of the decline in their immediate growth. This is the cumulative impact of relatively low increase in exports volume and prices, high real rates of interest and constraints on the availability of external finances which forces the developing countries to pursue severely contractionary policies. The Report sound a note of caution for the developing countries, many of which are growing under the weight of increased debts. Observing that the current account deficit of South nations, rose from $ 69 billion in 1980 to $ 98 billion in 1982, the Bank recommends import substitution strategy oriented growth for a reduction in their external liabilities.
On the basis of the past as well as the present conditions prevailing in the economies of developing countries, it may be asserted that in order to achieve the economic goals, it is necessary to bring about structural change in their economies. These structural change can be achieved by pursuing efficient developmental strategies. Both export promotion and import substitution strategies should be followed in the developmental process by efficient allocation of resources in the economy. However, in present crisis due to economic problems facing the developing countries, high priority should be placed on import substituting industrialization.

II. INTRODUCTION TO CONCEPT OF IMPORT SUBSTITUTION:

International trade is an activity of strategic importance in the process of the growth of a developing economy. Foreign exchange resources provide crucial inputs and capital goods much needed in the early stages of development. In recent times, the developing economies are faced with structural problems in the realm of international trade. Severe foreign exchange crisis, adverse terms of trade and stagnation in their export earnings have resulted in a threat to their overall economic development. The widening trade gap on one hand and the limited capacity to save due to low per capita income in developing countries on the
other hand, have created problems of the availability of capital, much needed in the development plans of these countries. The developing countries have to depend largely on the inflow of foreign aid for their capital resources. In view of the difficulties in regard to the inflow of this foreign aid the strategies of import substitution and export promotion assumes a significant role for the conservation and earning of foreign exchange.

There are two broad strategies of development to choose from. There are inward oriented strategy and outward oriented strategy of development. Inward oriented strategy is the combination of protection and import substitution and outward oriented strategy of development combines free trade and export promotion.

Inward looking strategy refers to the policies which discourage reliance on foreign resources. Under this strategy in its extreme form, no foreign aid is permissible, no movement of factors of production to or from outside, no deals with multinational corporations and no freedom of international communication is permissible. Such a strategy was in operation in Russia during the post World War II period.

However, in the present economic conditions such as extreme form of inward orientation hardly exists in any country.
The opposite of this extreme form of inward orientation is the form of outward orientation, in which free movement of capital, labour, goods, technology, etc. are permittible. But it implies absence of competition which brings in many undesirable distortations leading to high cost pattern of production which is in general inefficient and wasteful.

As against these arguments the advocates of inward orientation plead that inward looking policies encourage indigenous efforts and talent, entrepreneurial skill, self-reliance, domestic technological development and suitable range of products.

The present study is concerned with the inward orientation strategy viz. import substitution policy. A number of economists have advocated industrialisation through import substitution for the developing countries. The collapse of world trade after 1929 pushed many countries towards exchange controls and protection measures and it is from this time that inward looking development policy can be dated.

The experiences of the Second World War also confirmed this. During the War, demand for exports from the less developed countries increased drastically, but imports were lacking. The less developed countries had no difficulty in selling their export products at good prices, but they could not import industrial goods, especially capital equipment. This hampered
the expansion of the industrial capacity of these countries. At the same time, the export boom led to a build-up of foreign exchange reserves, and demand was directed towards domestically produced goods. This brought with it a greater utilisation of domestic manufacturing capacity. Industrial output increased substantially in many less developed countries during the War years ranging from 9 to 20 per cent increase in India to an almost 50 per cent increase in Mexico.

There were rooted reasons for the view of the less developed countries that they were at the mercy of the major developed industrial nations. Not only did their incomes and export earnings fall relative to those of the developed countries but causes of the slump also emanated basically from the developed countries themselves. The bad experiences of the 1930s left deep smears in the memories of the less developed countries and made them opt for policies which would free them from the type of economic dependence to which they had earlier been subjected. Hence it is understandable that a large number of less developed countries opted for a policy of self-reliance based on import substitution.

**MEANING OF IMPORT SUBSTITUTION:**

The term import substitution has recently gained vital importance in development literature. Different economists have given different versions of this concept. However, it is not a
simple analytical concept. The concept of import substitution largely depends on its motivation. In general, the purpose of import substitution is the replacements of imports by domestic production. There are two alternative sources of supplies for satisfying the domestic consumption. The demand for commodities can be met either by imports or by domestic production. In the narrowest terms, import substitution refers simply to the takeover prohibiting imports in one way or another.

Chenery\textsuperscript{15} was in fact the first thinker to recognise import substitution as a crucial factor in growth strategy. He established his definition and the method of its measurement. His view of import substitution centres around a change in proportion of imports to total supply. He observes that when domestic production of a tradable commodity increases more than its imports, it indicates import substitution in this industry. He thus defined it as a differences between the growth of output with no change in import ratio and actual growth. Using it as a framework, Chenery makes a cross-sectional analysis of fifty-one countries. He rated import substitution as a very significant policy of economic growth based on his study.

Panchmukhi\textsuperscript{16} mentioned in his study that by import substitution is meant a shift in the source of supply from imports to domestic production. However, it may be noted that


Import substitution does not necessarily mean reduction in the total import bill or elimination of imports altogether. Nor is this the main aim of the policy. Reduction of imports is essentially a negative act, which can be achieved by means of import restrictions alone. Import substitution involves a more positive act of developing countries through replacing imports with domestic production. In fact, in the initial stages, owing to the need of imported capital equipment, technical know-how and raw materials, import substitution may itself become an import-intensive function. Import substitution is essentially a method of allocating the scarce resources of the country to maximise the rate of economic growth and it forms part of the overall economic policy of the country. But the extent of import substitution is largely determined by the tariff policy and the monetary and fiscal measures of the government.

A distinction may be made between the macro and micro aspects of import substitution. Mostly economists have dealt with import substitution at the macro level. Chenery has developed the macro economic concept of import substitution. The aggregative concept at the national level may be called macro concept of import substitution and the micro concept of import substitution relates to firm or industry level. However, the

Micro concept of import substitution has been paid little attention. A recent work in this area by Anne Kruenger is a notable departure. It examines the automobile industry in India and traces its progress in the area of import substitution within the context of government policy. Micro level concept of import substitution is a better instrument of policy for resource allocation, and it also leads to states the adoption of technological measures involving import substitution in a particular industry.

V. Bharat Ram defines import substitution in a micro context as the ratio of the foreign exchange value of items deleted from the initial list to the total foreign exchange value of a wholly imported product. The idea of deletion relates to the notion that import substitution takes place by stages.

The analysis of magnitude of import substitution depends on industrialization efforts and the changes in relative importance of expenditure in the national product or to some other cause. Import substitution resulting from industrialization alone is termed 'net substitution'. On the other hand, import substitution resulting from a change in the relative importance of exports is termed 'gross import substitution'. Gross import substitution can be listed either as a absolute magnitude or as a relative one.

A distinction is made between absolute and relative import substitution. In the absolute sense, the entire increase in home output may be considered import substitution, the argument is being that in the absence of such production, to import to that extent would have been necessary to maintain domestic availability. In the relative sense, import substitution is said to take place when there is greater proportionate increase in domestic output than the domestic consumption.

The absolute concept may be valid in a static and unchanging economy. When population and income remain static and demand pattern remains unchanged an increase in domestic production automatically lead to a decrease im imports. But in the dynamic economy, it is the relative concept which is more relevant. In the relative sense, import substitution is considered to exist in the case of a given commodity whenever its importation to that commodity constitutes a decreasing proportions of the total supply (domestic production and imports).


Import substitution in a relative rather than an absolute sense has a better operational significance for self-sustaining growth. The measuring rod for the decreasing import substitution in a relative sense is the ratio of import to total supplies. A downward trend in this ratio shows a positive import substitution, and an upward trend in the ratio shows a negative import substitution. In other words, a positive degree of import substitution occurs when the domestic industrialization programme results in a more proportionate increase in production than in consumption.

TYPES OF IMPORT SUBSTITUTION:

The phrase import substitution has assumed different meaning at different times. Import substitution of a commodity, in the usual sense, implies, the replacement of imports of a commodity by its domestic production. Thus, for example, the imports of copper may be replaced by the domestic production of copper. Such a substitution of product for product is termed direct substitution.

Import substitution may also refer to the replacement of import of a commodity by its domestic production of substitutes. Thus, for example, in the case of copper as mentioned above, import of copper may be replaced not only by its domestic substitutes production but also by aluminium and
plastics. Similarly Pyrites may be substituted for sulphur. Synthetic fibre may be used in place of cotton or wool and synthetic rubber can be used in place of natural rubber and plastic in place of metals. Such a type of import substitution, involves the adoption of alternative techniques of production. It refers to the substitution of one product by another of different kind but performing the same function. Import substitution in this context assumes not only an economic aspect but a technical one as well.

The success of functional import substitution depends to a large extent upon technological factors requiring great progress in research and development and in the application of new technology. It also calls for changes in the specifications, the end products in order to find suitable alternatives. This represents the most dynamic aspects of import substitution involving substitution not in terms of product for product but by entirely different products. Functional import substitution plays a very important role in the developing economies in view of the structural rigidities, the lagging primary sector and the advancing industrial sector. It also contributes greatly to the technological advancement of these economies.

In recent years, with the import of a variety of commodities which are predominantly manufactured indigenously, import substitution has come to mean merely expansion of production capacity to make up domestic shortages. This is a simple exercise in comparative cost advantage and is not import substitution as such.

FACTORS CONTRIBUTING TO IMPORT SUBSTITUTION INDUSTRIALIZATION:

Wars and depression have historically no doubt been most important in bringing industries to countries of the 'periphery' which up to then had firmly remained in the non-industrial category. The crucial role of the two world wars and the great depression in undermining acceptance of traditional idea about the international division of labour between advanced and backward countries is well known. But industrialisation has not only been the response to sudden deprivation of imports; it has also taken place in many non-industrial countries as a result of the gradual expansion of an economy that grows along the export-led path. Due to the increase in income and markets of these types, of economies, production becomes profitable and industries are established without an external shock or government intervention. 22 This type of industrialisation may be called 'demand linkage' as distinct from the continuation of

the process via backward and forward linkage effect. Gradual import substitution in response to the demand of domestic market has accounted for the wide spread establishment of industries which have substantial locational advantages.

Over the past two decades import substituting industrialisation has no longer been exclusively a matter of natural market forces reacting to either gradual growth of income or catalytic events, such as wars and depression. It has been undertaken in many countries as a matter of deliberate development policy, carried out no longer just by means of protective tariffs but through a wide array of credit and fiscal policy devices, through pressure on foreign importing firms to set up manufacturing operation, as well as through direct action. The establishment of state-owned industries or, increasingly, of development corporations or banks which are entrusted with promotion of specific ventures.

Hirschman has observed four distinct origins of ISI wars, balance of payment difficulties, growth of the domestic market (as a result of export growth) and official development policy.


Clearly, there is not just one ISI process. Industrialisation that takes place in the midst of and as a result of export growth is different from one that feeds on foreign exchange deprivation. In the later stages it is likely that inflationary development will accompany the industrialization process than in the former. The import substituting industrialisation brought by balance of payment constraints establishes the industries under the import control policies. These industries are mostly consumer goods especially of luxury goods.

Of the four forces ISI - balance of payments difficulties, gradual growth of income, and deliberate development policy - only the second leads to a bias in favour of non-essential industries. The last, deliberate development policy, is likely to produce exactly the opposite bias; and the remaining two causes are neutral with respect to the production of luxury goods by the industry.

**PROCESS OF IMPORT SUBSTITUTION**

The process of import substitution may bring about changes in the import dependence of an economy as a commodity \( M_i \) or in the import dependence of a sector on its input \( M_{i,j} \) or in the final demand component. The first type of changes may be indicated by a reduction in the market share of imports.

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in the total demand (intermediate plus final demand) for the commodity or alternatively by the reduction in $M_1$.

The second type of changes in the ratio $M_{ij}$ i.e. changes in the ratio of the $i^{th}$ imported input per unit of output of the $j^{th}$ sector. Changes in $M_{ij}$, over a period of time, indicate the changing import dependence of the $j^{th}$ sector on the various imported inputs that go into its production. The third type of changes may be indicated by changes in the share of imports in the final demand for a commodity. Considering the first two types of import substitution viz., changes in $M_1$ and changes in $M_{ij}$ one can distinguish between four important situations. In the first cases, the share of inputs in the market for the product of a sector, i.e. $\frac{M_1}{1 + M_1}$, may be falling while the import dependence of that sector itself may be rising. In other words, import of the finished product may be reduced while the imports of the inputs that go into the finished product itself may be increased. As a result, the import dependence of the economy on the commodity would be reduced. But in the domestic production of the commodity itself, relatively greater amounts of inputs would be imported. In the second situation, market share of imports may be increasing but the import dependence of the sector may be falling. This implies that the imports of the finished product are being encouraged, while the imports of the inputs that go into the finished are being restricted.
In the third, case, the import dependence of the economy and the sector may both be declining. Finally, in the fourth case, imports of the finished product and of the inputs employed in the finished product may both be rising.

In all the four cases, the policy under consideration has great impact on the growth of the sector under consideration, on the growth of other sector of the economy, and on the overall balance of payment position of the economy. In other words import substituting industrialisation starts predominantly with the manufacture of finished consumer goods that were previously imported and then moves on more or less rapidly and successfully to the 'higher stages' of manufacture, that is to intermediate goods and machinery through backward linkage effects. A sector's plan for import substitution in respect of its input requirements generates a particular pattern of import substitution in the economy as a whole.

SCOPE OF THE IMPORT SUBSTITUTION INDUSTRIALISATION:

Import substitution strategies are mostly linked with industrialization of the third world. The continuing debate in the past as well as in the present, context, regarding the underdevelopment and industrialisation has favoured the less developed countries to initiate economic development
independently of changes in the structure of their production and trade. The primary incentive to initiate programmes of import substitution is the prospects of industrialisation and the economic gains associated with it. It tries to correct the chronic long run structural disequilibrium in patterns of production and trade which was prevalent in economies of developing countries due to their mistakes in allocation of resources. In significant parts, structural changes through import substitution are also a response to changes in factor availabilities, factor use, demand and technology in the less developed world.26

However, the import substituting industrialization can be a right devise in bringing structural changes in trade and industry. Incidents of benefits from import substitution can be best estimated by reflection on structural change in the economy on the one hand and improving the balance of payment by removing the constraints of foreign exchange. These two stimulating forces of the import substituting industrialization would be the main area of research in the present study.

IMPORT SUBSTITUTION AND FOREIGN EXCHANGE CONSTRAINTS:

Early efforts towards import substitution were promoted by foreign exchange constraints of growth. It has been formalized in the two gap models of development and planning. These models of development postulates limited substitution possibilities between domestic savings and foreign exchange. Given this rigidly in production function, it is stated that a high potential saving is by no means a sufficient condition for growth of national income since the optimal use of domestic savings is prevented by a shortage of imported inputs. Similarly, a large capacity to import may fail to stimulate growth if the requisit domestic savings do not materialise.

The critical conclusion of the model is that a developing country be faced with the structural constraints of enormous significance, viz., (i) a minimum requirements of imports to sustain a given rate of growth of GNP and (ii) an actual or a potential ceiling on export earnings which insufficient to finance the required imports. The role of import substitution in the presence of a foreign exchange gap is fairly clear. It provides a feasible strategy for eliminating the import gap through domestic production of import replacements in sufficient volumes to allow a projected growth rate to be
met without excess demand for foreign exchange. Import substitution as a means of conserving foreign exchange, have been a general appeal to the planners.

**IMPORT SUBSTITUTION AND STRUCTURAL CHANGE:**

The developing economies are characterising by the traditional structure of trade and industry. In the twentieth century these characteristics of underdevelopment went against the developing country. The main aim of these countries was to achieve economic and social progress in short period of time. It required the structural changes in the economy. The structural changes can be brought from quantum changes in the pattern of demand, production, technology, and trade. The role of import substitution in structural changes in trade can be seen in the composition of foreign trade. Due to the policy measure, a traditional primary producing export sector turned to a manufacturing export sector. Likewise, a light industrial sector turned into a heavy industrial base. It does not alter only the structure of industry and trade but it also alters the structure of factor proportion, technology and income in the developing economy. Besides the two broad objectives and alternatively the achievements of import substituting
industrialization, there are also other factors affected by it. These factors are, employment, income, technology, demand pattern and standard of living. This policy was expected not only to promote economic growth but also to initiate a self sustaining growth mechanism through the cycle of "import-saving-reinvestment-increased productivity-higher profits etc".

In the pursuit of the ISI strategy, the developing countries were also encouraged by the experience of the developed countries. Almost all the developed countries at one time or the other, adopted the IS policy to achieve rapid industrialization. Developed countries, such as the USSR, the USA, Australia, Spain and Portugal, industrialised themselves behind high tariff walls. The history of industrialization of Australia, in fact, is very similar to that of the developing countries.

Thus, the policy of import substitution was expected to solve many of the problems faced by the developing countries. It brings structural change in the traditional economies and promote economic growth. It tries to transform developing economies and enable them to reach the level of development of the advanced countries.
CRITICAL APPRAISAL OF THE IMPORT SUBSTITUTION POLICY:

The import substituting industrialization policy as followed by the developing countries has been criticised on various grounds. These criticisms have arisen due to the great difficulties with a number of countries which based on their development plans on import substitution policy have experienced. Some of these difficulties and the corresponding criticism of the ISI policy are presented in this section.

A.O. Hirshman mentioned three principal accusations levelled against the industrialization process as it has appeared in Latin America.

1) Import substituting industrialization is opt to get 'stuck' after its first success due to the exhaustion of easy import substitution opportunities. It leaves the economy with a few relatively high-cost industrial establishments and with a far more vulnerable balance of payments since import consist now of semifinished materials, spare parts, and machinery indispensably required for maintaining and increasing production and employment.

ii) Import substitution industry is affected by seemingly congenital inability to move into export markets.

iii) The new industries are making an inadequate contribution to the solution of unemployment problem.

The first criticism is a matter of concern, because it indicate that import substitution results in economic stagnation. The possibility that the scope for import substitution has exhausted does not mean that the economies have to face economic stagnation. This according to Hirschman is a naive and a semi-naive view of economic development. Actually infinite scope exists for economic expansion where outputs like electricity, cement, plastic, glass, paper etc. can be used as inputs in a wide range of industries. In the case of specific inputs, the scale of production can be made viable by choosing interlinked investments. Some of the results on import substitution which tend to indicate the exhaustion of the potential of import substitution must not be taken too seriously in an economy of moderate size.

Harry Johnson\(^{28}\) has shown that when resources are allocated to import substitution industries by increasing

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protection, existing resources will also tend to be diverted to the production of import substitutes. Real income measured at world prices can therefore decline, even though real output would have increased at domestic prices, resulting in the phenomenon 'of immiserizing import substitution'.

The policies of protection adopted to promote import substitution also have a bias against exports. The effect of such policies is to over-value the exchange rate. As a result, the exporter has to pay more for the imported inputs or for the domestically produced import competing inputs, resulting in a high cost of production. On the other hand, the exporter receives less in domestic currency in compared to a situation of free trade. The exports of the developing countries are discouraged by high level of protection.

The defects of the policy of industrialization based on import substitution have been well summarized by Prebisch is as follows: 29

(a) The simple and relatively easy phase of import substitution has reached or is reaching its limit in the countries where industrialization has made

most progress. As this happens, the need arises for technically complex and difficult institutions activities, which usually required great capital intensity and very large markets if a reasonable degree of economic viability is to be attained. Thus there are limits to import substitution in the developing countries which can not be exceeded without a frequent and considerable waste of capital. Moreover, the extension of import substitution to a wider range of goods generates or increases demand for other imports, whether of raw materials and intermediate goods to manufacture products in respect of which such substitution is taking place or of new lines of capital goods or consumer goods that technology is constantly creating.

(b) The relative smallness of national markets in addition to other adverse factors, has often made the cost of industries excessive and necessitated recourse to very high protective tariffs, the latter in turn has had unfavourable effects on the industrial structure because it has encouraged the establishment of small uneconomical plants, weakened the incentive to introduce modern techniques and slowed down the rise in
productivity. Thus a real vicious circle has been created for exports of manufactured goods. These exports encounter great difficulties because of high internal cost and quality ground. Their export were not able to compete in international markets due to the above mentioned reasons created by import substitution policy.

(c) Usually industrialization has not been the result of a programme but has been dictated by adverse external circumstances which made it necessary to restrict or bar imports; these measures have been applied especially to non-essential imports that can be dispensed with or postponed. Thus production of these goods has been encouraged, absorbing scarce production resources, often regardless of cost. A more rational policy would have been given priority to import substitution in respect of goods which could be produced under more favourable conditions than others, not only consumer goods, as has generally been the case, but also raw materials and intermediate goods.

(d) Finally, excessive protectionism has generally insulted national markets from external competition, weakening and even destroying the incentive necessary for improving the quality of output and lowering costs under the
private enterprise system. It has been tended to stiffle the initiative of enterprise as regard to the internal market and exports.

Besides the above mentioned criticism levelled against the policy of import substitution, there are also other factors which blamed the import substitution policy. It is believed and experienced in developing countries that import substitution industries are mostly import intensive and capital intensive. Therefore, it is argued that such type of industrialisation leads to inflation in the country and labour unemployment of problem would be unsolved. It is also criticised that ISI policy leads to under utilization of existing capacity.

The various criticism differ from country to country and their existing economic structure, economic policies, social and political structure. These criticism are subject to change due to the aims and objectives of the various policy prescription.

It may be argued that even if these is loss in income through ISI policy, this may be so only in the short run. Rather, through a policy of import substitution the domestic base may get strengthened leading to an increase in productivity and profit. Increased profit would result in increased saving
which would be ploughed back leading to further increase in investment and income. Furthermore, import substitution helps in spreading investment in a large number of industries thereby encouraging the development of technology and improvement in the quality of factors of production. Import substitution in other words is a better instrument for capital formation in the developing countries. It attracts the multinational and foreign investment into the country thus furthering an increase in saving and investment.