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Import Substitution in Developing Countries

In the previous chapter we dealt with Swedish agricultural policy as an example of how the theory of distortions can be applied. We showed how the tariff-based policy has led to welfare losses in comparison to the free trade situation, and we discussed how the optimal intervention policy is conditioned by the different formulations of the emergency restriction in agriculture. In the present chapter we will go into a similar application of the theory of distortions, which is a case that deals with increasing domestic production at the expense of imports, namely the trade policy of developing countries. This policy has often been based on import substitution behind tariff walls.

The background

The background to the import-substitution policy of developing countries can be found in two historical events in the theory of economic development of the 1950s and in the industrialization policy employed by the socialist bloc in Eastern Europe. The two historical events are the Depression of the 1930s and the Second World War. When the Depression arrived the developing countries were strongly dependent on raw material production and exports. The majority of Asian and African developing economies were still colonies where production patterns to a large extent focused on production for the needs of the European ‘mother countries’. Latin America was also dependent on primary exports. Most of the manufactures consumed were imported.

Primary exports *per se* do not necessarily imply anything negative. On the contrary, it is quite possible for raw material exporting countries to obtain high growth rates in their economies with the aid of primary export. This, however, presupposes that the raw materials in question are *staples*, (i.e., goods in high and increasing demand in the world market). Primary exports have a direct effect on the national product and on the rate of growth. Even more important, however, is the fact that staple exports
may generate so-called linkage effects which stimulate growth indirectly. Forward linkage implies that the raw materials are used as inputs in the production of other sectors. Backward linkage consists of the spread of growth impulses from raw material production via the demand for other sectors’ products to be used as inputs. Consumption linkages are also conceivable. The incomes generated by raw material production are used for buying the products of other sectors. Finally, raw material production will generate tax revenue for the government, and this revenue may be spent on increasing the production capacity and the infrastructure of the economy.

Raw materials are, however, not necessarily staples. Rather, the possibilities of growing along the lines of the staples model to a large extent depend on what happens in the industrialized economies that are the prime buyers of raw materials. The covariation between the growth of world trade in primary products and the growth of the manufacturing output of industrialized countries is high. According to Arthur Lewis, the trade in raw materials grew 0.87 times as quickly as the output of manufactures over both 1873–1913 and 1953–73.

For the developing countries the high correlation also implied that when the Depression of the 1930s arrived the prices of raw materials fell drastically. Hereby both export revenues and growth rates were reduced as well. Between 1929 and 1932 the average dollar price of raw materials was halved and export revenues fell further yet. Acute balance of payments problems arose, and this was exacerbated by the fact that many countries were net capital importers that had to manage their debt service at new, considerably lower, export prices.

The Second World War created another type of problem. The recovery after the Depression had in most countries been a slow affair, but when the war broke out the demand for raw materials increased in the industrialized economies. Export revenues were high, although the blockade, especially of Europe, made it difficult to use the entire export potential. A more important problem, however, was that of imports which consisted both of consumer goods and of important capital goods and inputs, since the production capacity in Europe and North America was employed primarily for the production of war material.

Hence, both the Depression and the war provided impulses for domestic industrial production. When the war came to an end the developing countries could also look for inspiration to the conscious industrialization drive that took place in the new East European bloc. There, the development of industry was given priority, often ‘heavy’ capital goods production. Foreign trade with countries outside the bloc was avoided whenever this was possible. Instead a meaningful division of labour within it was attempted.

During the first postwar years the attitude of economists to import substitution behind tariff wars was often positive. Several arguments were put forward in favour of an industrialization policy that was aimed at the