ECON 4311 – Economy of Latin America

Lecture 5B: Import Substitution Industrialization

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Outline

Introduction: Past Lectures

- **The Golden Age** (1870–1914).
  - High economic growth around the world, including LatAm.
  - High primary commodity prices → substantial export earnings LatAm.
- **Wars and Post-wars** (1914–1980).
  - World War I (1914–1918).
    - European countries decreased their imports from Latin America.
    - Low elasticity of supply → decreasing commodity prices.
    - Change in hegemony powers during the 1920s: UK → US.
  - Great Depression (1930s).
    - "Imported" crisis.
    - Further decline in commodity prices.

Introduction

- **Wars and Post-wars** (1914–1980).
  - Commodity prices fell much faster than manufactured good prices (very different elasticities of supply).

    $\Longrightarrow$ Negative effect on trade balance of Latin America.
  - Influential political figures (e.g., Raúl Prebisch) believed this relative decline in commodity prices was a long-run trend.

    $\Longrightarrow$ Latin America intensified **protectionism to develop domestic industry** (contrasting with what the rest of the world was doing)

    - Famous book: *The Economic Development of Latin America and Its Principal Problem* (1950).

- We'll try to understand why ISI was thought to be the solution to LatAm problems, how it was implemented in practice, and its results.

How ISI Came About

- **Context**:
  - Wars, Post-wars, and the Great Depression.
  - Slow economic growth.
  - Relative fall of commodity prices relative to manufactured goods.
- Natural to wonder whether relative decline in prices of commodities was persistent or temporary. Important welfare consequences:
  - *Temporary*: not much to worry about.
  - *Persistent/Permanent*: declining terms of trade raise potential concerns regarding the structure of the economy.
    - Need to develop the manufacturing industry.
    - This was the view adopted by Raúl Prebisch, director of the Economic Commission for Latin America (ECLA).

How ISI Came About

- **Structuralist economics**: the structure of an economy can have important effects on economic outcomes.
  - Closely related to industrial structure (previous lecture).
  - In the context of ISI, the belief was that a economic structure too tied to primary commodities was condemning LatAm countries to poverty.

- **Wrong (academic) conclusions**.
  1. LatAm structure: export commodities, import manufactures.
  2. Declining terms of trade.

  (1) + (2) $\Longrightarrow$ comparative advantage (in primary commodities) does not work for developing countries $\Longrightarrow$ government has to intervene.

How ISI Was Implemented

- **Import Substitution Industrialization (ISI)**. Set of economic policies aimed at developing domestic industries in order to reduce dependence on imports from other countries.
  - Forced and directed industrialization process.
  - Protection of domestic industries wrt foreign competition.
- **ISI policies**.
  - Trade policy.
  - Exchange-rate policy.
  - Targeted lending.
  - Establishment of SOEs.
  - Tax breaks and subsidies to domestic and/or MNCs.

Implementation of ISI

- **Trade policy** to limit competition from non-domestic producers.
  - **Most fundamental policy tool of ISI**.
  - Heavy tariffs and quotas on imports of industrialized goods.
    - Durable consumer goods (e.g., cars, refrigerators) were especially taxed.
  - Low tariffs on some capital goods that were key for industrialization.
  - Example of ISI policies in practice.
    - General Agreement on Tariffs and Trade (GATT) in 1947.
    - Most countries in LatAm did not join the GATT until decades later.

Implementation of ISI

- **Exchange-rate policy** to alter the terms of trade.
    - **Keep artificially-low exchange rates** to facilitate imports of capital.
        - Capital goods were essential for the development of industry.
        - LatAm countries did not produce them.
    - Maintaining low exchange rates becomes increasingly expensive.
        - Future lectures.

Implementation of ISI

- **Targeted lending** to provide start-up funding for new firms.
  - Private banks have no incentives to finance new firms in new industries if there is no assurance that money can be recovered (with profit).
  - Incentives not aligned with government.
  - Solution: set up state-owned or state-subsidized development banks.
    - Government raises money.
    - Allocates money to development banks.
    - Development banks loan to firms in targeted industries at low interest.

Implementation of ISI

Substantial lending in Brazil to finance developments in industry (state development bank BNDES + earmarked credit).

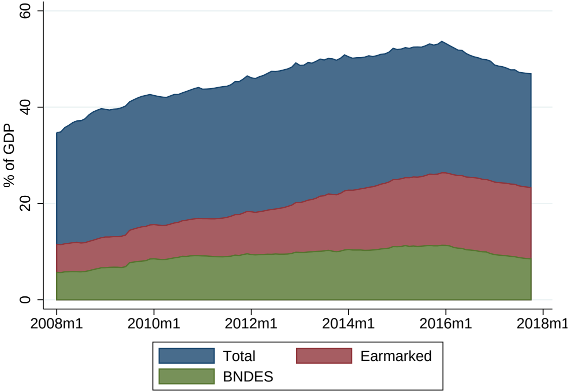

Figure: Targeted lending in Brazil, 2008–2018.

Implementation of ISI

Substantial differences in Brazil in interest rates between targeted and non-targeted lending.

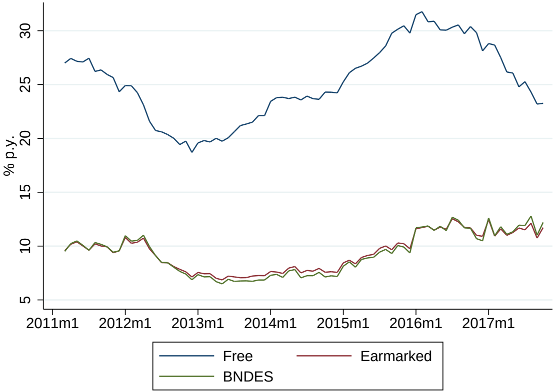

Figure: Interest rates of targeted lending in Brazil, 2011–2018.

Implementation of ISI

- **State-owned enterprises (SOEs)** can play a key role in establishing "heavy" industries (i.e., capital-intensive industries).
  - Placing SOEs in some industries may be warranted if the country has privileged access to primary commodity or the industry is "strategic".
    - Example: Steel industry.
    - Suppose country has access to minerals, but lacks the technology and the know-how to produce steel.
    - Steel is a key intermediate input to many industries.
    - Private firms may not be willing to take the risk.
  - Other examples: oil, computer and aerospace industries in Brazil, telecommunications. . .

Implementation of ISI

- **Multi-national corporations (MNCs)** can help to develop industries (especially when a country lacks both technology and know-how).
  - SOEs may be unfeasible.
    - Even if technology can be imported, need people who know how to operate the technology.
  - Leading MNCs in a given industry have the technology, the know-how, and experience operating abroad.
    - Experience in deploying resources in far-away geopgraphical locations.
  - How to attract MNCs to produce locally (FDI)?
    - High tariffs and quotas → exporting becomes difficult/less profitable → incentives to set up production where large domestic markets.
    - Offer special treatment (tax breaks, subsidies, etc.).

The Results of ISI

- **Impaired growth and misallocation of resources**.
  - LatAm countries displayed near zero TFP growth during 1960–2000.
- **Some specific consequences**.
  - Persistent regulation.
  - Neglected agricultural sector.
  - Expansion of informal sector.
  - Urbanization and pollution.
  - Inflation and debt accumulation.
  - . . . Lost Decade!

Some Thoughts

- Academic ideas can have effects in the real world.
    - Not always in a good way!
    - In the case of ISI, they led to misallocation of resources and substantial TFP losses.
- It seems like the initial implementation of ISI was an honest mistake.
- Can we say the same about the continued implementation of it when it was already clear that ISI was not working as expected?
- Were vested interests being protected?

Taking Stock

- **ISI**. Set of economic policies aimed at developing domestic industries in order to reduce dependence on imports from other countries.
  - Mix of trade, fiscal and industrial policies.
- **The implementation of ISI was favored by global circumstances** (wars, post-wars, and depressions) **that caused commodity prices to fall much faster than the price of manufactured goods.**
  - Elasticity of supply for commodities larger than for manufactures.
- The fall in relative commodity prices was seen by some influential economists as a long-run trend.
- This raised concerns about the economic structure of the region:
  - Exporter of primary commodities.
  - Importer of manufactures.

Taking Stock

- **Push for government intervention** to develop domestic industries.
- **Development of domestic industries was achieved with**:
  - Direct subsidies to certain domestic industries.
  - High tariffs and quotas on imports of industrialized goods.
  - Artificially-low exchange rates.
  - Favorable lending to firms operating in certain industries.
  - Establishment of SOEs.
  - Favorable treatment to MNCs (tax breaks, subsidies,...).
- **In the medium/long-run, ISI proved to be bad economic policy**: not sustainable, misallocation of resources and near zero TFP growth, neglected sectors, at the root of the Lost Decade...

Thank You!