Chapter 4: Economic Development Strategies

Import Substitution Strategy

The import substitution strategy refers to a concept proposed by Prebisch, who observed that the demand elasticity for products from developing countries (primarily primary products) tends to decrease, while the demand elasticity for products from advanced countries or central manufacturing countries tends to increase. This works against the international terms of trade for developing countries or peripheral countries and in favor of advanced countries. Furthermore, it was also noted that technological advancements in advanced countries have contributed to raising real wages and creating a high standard of living. However, it has not contributed to reducing the prices of manufactured goods for developing countries. On the other hand, technological advancements in developing countries have not led to improvements in real wages but have led to price reductions, especially in the export prices in relation to the imported goods from advanced countries. This means that the gains from technological advancements are transferred to advanced countries.

To address this issue, the import substitution strategy is proposed, which primarily involves focusing on the domestic market to solve the problem of deteriorating international terms of trade. This is done through a protective policy. This strategy is considered one of the manufacturing strategies adopted by developing countries since the beginning of their political independence in order to achieve self-sufficiency and reduce their dependence on the international market. Import substitution means producing locally what was previously imported or producing locally what could have been imported if domestic production did not exist. The essence of this strategy is that developing countries establish certain transformative industries to meet the needs of the domestic market instead of relying on imported goods.

The strategy of import substitution aims to reduce or prevent the importation of certain manufactured products. To achieve this, customs tariffs or other restrictions such as quota systems, industrial standards, and other direct and indirect constraints are used. Restricting the importation of these goods and promoting their local production provides two important benefits:

1. The domestic product gains a competitive advantage over foreign products in terms of price competition. The price of the imported goods, after adding tariffs, becomes unable to compete with the local product.
2. The second benefit resulting from imposing restrictions on imports of these goods is the emergence of a local surplus in demand for these goods. This leads to price increases and consequently profitability in investing in their production locally. Domestic resources are then directed towards investing in establishing industries that produce these goods, which were previously imported.

Once these industries exhaust the opportunities for import substitution and achieve self-sufficiency, the door is open for them to engage in exports. At the same time, they expand their investments in intermediary and productive industries. These industries are characterized by:

- High capital utilization.
- Significant economies of scale.
- Large project size.
- Advanced technology used in production.
- The need for skilled labor.
- The need for highly skilled and experienced management and organizational personnel. Additionally, the profitability of these industries, especially intermediary ones, should be modest.

Implementing a development strategy through import substitution may lead to the following outcomes:

1. Relieving the burden on the balance of payments and saving scarce foreign exchange reserves. This results in a decrease in the import-to-total foreign trade ratio and a reduction in the importance of imports of consumer goods, while increasing imports of capital goods.
2. Restricting imports of consumer goods would free up foreign exchange resources previously used for their importation. These freed-up resources can be used for importing equipment, machinery, and other goods necessary for increasing investment (capital accumulation) in the industrial sector and the overall national economy.

3. Continuous expansion of industries that replace imports by creating favorable conditions for directing investments towards them. This can be achieved by increasing profitability of investments in these industries, leading to a continuous increase in the relative importance of the domestically generated national output in the industrial sector.

4. Expansion of industrial employment opportunities, thereby increasing the relative importance of industrial labor. However, this may come at the expense of non-industrial sectors, especially agriculture, which is protected.

Implementing this strategy, as described above, has resulted in the following outcomes:

- This strategy succeeded in stimulating domestic demand in developing countries, as they were unable to compete externally.
- It led to increased production costs, resource wastage, and underutilization of available production capacities.
- Domestic products faced challenges due to foreign competition, which motivated improvement in local products.
- Developing countries became more dependent on advanced countries due to their rising debt and the conditions and programs imposed by international institutions.
- Trade deficits and capital outflows in hard currency have become significant issues.

This strategy did not provide a proper solution for development or an escape from underdevelopment. It also failed to establish a balanced pattern of consumer manufacturing based on consumer demand, which contradicts the concept of balanced growth theory.