

Please answer the following question.

In recent years, international trade has re-emerged as a major topic of discussion. With reference to developing countries, explain the possibilities, advantages, and disadvantages of adopting the following two policy approaches:

- a) Inward-looking (Import substitution) development policies, and
- b) Outward-looking (Export promotion) development policies.

Learning Objective:

International trade has often played a central role in the historical experience of the developing world. There is a great deal of diversity in developing countries' experiences with trade. While there is a spectacular export success of East Asia, some other regions are lagging behind. The objective of learning the ISI and EOI policy approaches is to answer the following two questions: 1. Can a developing country by its own actions determine how much it trades or which products and services it sells? 2. What are the possibilities and limitations of building domestic industrial capacity by protecting local industries and how to integrate into the global economy by producing goods for international markets?

Model Answer

a) Inward-looking (Import substitution) development policies

Definition and possibility: Inward-looking policies in developing countries stress economic self-reliance on the part of developing countries, including domestic development of technology, the imposition of barriers to imports, and the discouragement of private foreign investment. Import substitution is a deliberate effort to replace consumer imports by promoting the emergence and expansion of domestic industries.

Import substitution industrialization (ISI) believe that a developing economy should initially substitute domestic production of previously imported simple consumer goods (first-stage IS) and then substitute through domestic production for a wider range of more sophisticated manufactured items (second-stage IS)—all behind the protection of high tariffs and quotas

on these imports. In the long run, IS advocates cite the benefits of greater domestic industrial diversification ("balanced growth") and the ultimate ability to export some previously protected manufactured goods as economies of scale, low labor costs, and the positive externalities of learning by doing cause domestic prices to become more competitive with world prices.

(10 marks)

Advantages

1. Shielding young industries from global competition allows them time to mature and become competitive. Developing countries can use ISI to build local industries by protecting them from foreign competition through tariffs and quotas.
2. ISI helps shift economies away from dependence on primary commodities (like agriculture or raw materials) toward industrial goods. ISI can serve as a stepping stone toward more advanced industrialization and eventual export-led growth.
3. Promotes domestic innovation and reduces vulnerability to external shocks. Countries may lessen reliance on developed nations for manufactured goods, strengthening economic sovereignty.
4. Expanding manufacturing sectors builds a skilled workforce and supports urbanization. By fostering domestic manufacturing, ISI can generate jobs and reduce unemployment.

(20 marks)

Disadvantages

1. Protected industries often fail to innovate, leading to poor-quality goods and high production costs. Secure behind protective tariff walls and immune from competitive pressures, many IS industries (both publicly and privately owned) remain inefficient and costly to operate.
2. Most import substitutions have been made possible by the heavy and often government-subsidized importation of capital goods and intermediate products by foreign and domestic companies. To encourage local manufacturing through the importation of cheap capital and intermediate goods, official exchange rates have often been artificially overvalued. This has had the effect of raising the price of exports and lowering the price of imports in terms of the local currency. Developing countries still rely on imports of machinery and technology, which can worsen trade deficits.
3. Domestic markets in many developing countries are too small to sustain large-scale industrialization without exports. Many infant industries never grow up, content to

hide behind protective tariffs and governments loath to force them to be more competitive by lowering tariffs. In fact, governments themselves often operate protected industries as state-owned enterprises.

4. Protectionist policies can foster monopolies and political favoritism, reducing efficiency.
5. The main beneficiaries of the import substitution process have been the foreign firms that were able to locate behind tariff walls and take advantage of liberal tax and investment incentives.

(20 marks)

b) Outward-looking (Export promotion) development policies.

Definition and possibility: Outward-looking policies in developing countries that encourage exports, often through the free movement of capital, workers, enterprises, and students; a welcome to multinational corporations; and open communications. In export promotion, government efforts to expand the volume of a country's exports through increasing export incentives, decreasing disincentives, and other means in order to generate more foreign exchange and improve the current account of its balance of payments or achieve other objectives.

Export Oriented Industrialization (EOI) advocates primary and manufactured goods cite the efficiency and growth benefits of free trade and competition, the importance of substituting large world markets for narrow domestic markets, the distorting price and cost effects of protection, and the tremendous successes of such export-oriented economies as South Korea, Taiwan, Singapore, Hong Kong, China, and others in Asia. They stress that firms in these economies have learned a great deal from the firms in the United States, Japan, and other developed-country economies that have been their long-term customers.

(10 marks)

Advantages

1. Exposure to international competition and foreign investment accelerates adoption of advanced technologies.
2. Developing countries can expand their markets beyond domestic demand, tapping into international consumers. Access to larger global markets allows firms to produce more efficiently and reduce costs.
3. Expanding export industries creates jobs, especially in manufacturing and services.
4. Competition forces firms to innovate, improve quality, and reduce inefficiencies.

Export promotion encourages industries to meet global standards, fostering innovation and competitiveness.

5. Export earnings strengthen reserves and reduce reliance on external borrowing. Exporting generates hard currency, which can finance imports of technology, capital goods, and infrastructure.
6. Countries like South Korea and Taiwan transformed from agrarian economies into industrial powerhouses through export-led growth. Many "Asian Tigers" (South Korea, Taiwan, Hong Kong, Singapore) used export-led strategies to achieve sustained high growth.

(20 marks)

Disadvantages

1. Supply side structural rigidity of many rural production systems in developing countries—such as limited resources, poor climate, bad soils, antiquated rural institutional, social, and economic structures, and nonproductive patterns of land tenure. Developing countries may struggle to meet international standards, requiring significant investment in infrastructure, education, and governance.
2. Heavy reliance on exports makes economies susceptible to global recessions, trade wars, or falling demand. Tariffs, quotas, and, increasingly, nontariff barriers such as sometimes arbitrary sanitary laws regulating food and fibre imports, or cryptic rules of origin limit exports,
3. If exports are concentrated in primary goods, price volatility can destabilize economies. The income elasticities of demand for agricultural foodstuffs and raw materials are relatively low compared with those for fuels, certain minerals, and manufactures
4. Export industries may cluster in urban areas, leaving rural regions behind.
5. Pressure to stay competitive can lead to low wages, poor labor conditions, and environmental degradation.
6. Over-reliance on developed countries' markets can limit autonomy in policy-making.

(20 marks)