RELEVANCE OF EXPORT EXPANSION AND IMPORT SUBSTITUTION STRATEGIES FOR INDUSTRIALIZATION IN BANGLADESH

BY
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A THESIS SUBMITTED TO THE UNIVERSITY OF DHAKA FOR FULFILLMENT OF M.PHIL PROGRAMME

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CERTIFICATE

This is to certify that the materials embodied in this thesis, titled "Relevance of Export Expansion and Import Substitution Strategies for Industrialization in Bangladesh" submitted by Mohammed Parvez Imdad are original and have not been submitted in part or full for any other diploma or degree of any University. The thesis is worthy of consideration for the award of the degree of Master of Philosophy.

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ABSTRACT

In modern development strategies, industrialization is obviously a critical element. It has long been debated as to which of the two major strategies would be appropriate and relevant for industrialization--export-expansion or import-substitution. The study thus adequately identifies problems and prospects pertaining to application of these two strategies. The study which is a policy oriented one, analyses the importance of both these strategies. It also evaluates and examines the trends of emphasis in terms of policy application and shift with regard to both these strategies, both in the short-run and long-run and in the context of our trade and industrialization policies and priorities. In this aspect, experiences of selected countries/ regions with regard to both the export-expansion and import-substitution strategies have also been presented. In this regard, the imperatives, dimensions and perspectives of both these strategies in contributing to development in general and growth in particular, have also been highlighted. The dissertation also ventures to present a comparative presentation of the response of these two strategies with regard to variations in tariff, trade and manufacturing structure.

Each of the two strategies can significantly contribute to development at different stages/ points of time. Though export-expansion is the generally accepted area of emphasis conducive to industrialization, yet none of the two strategies can be viewed as evidentially and substantially superior to the other. In this regard, the most preferred option would be a policy-mix of both these strategies.

ACKNOWLEDGEMENT

Industrialization is an essential aspect in development. For most developing countries strategies for attaining the desired level of development are oriented towards pursuing appropriate trade and industrial policies. In this context the question of emphasis on outward or inward-looking strategies of industrialization has been a point of fundamental importance.

It is in the backdrop of an interest in this important economic policy option that I was encouraged to choose the topic entitled "Relevance of Export Expansion and Import Substitution Strategies for Industrialization in Bangladesh" as the object of my study for M.Phil programme at the Department of Economics, University of Dhaka. In this regard my sincere thanks and gratitude are to my supervisor, Professor Dr. M. Ayubur Rahman Bhuyan, Professor of Economics at Dhaka University. In fact, his academic guidance, supervision and encouragement inspired and enabled me to complete the thesis even after a prolonged interval due to hectic professional pre-occupation and stay abroad on official assignment. I am also grateful to Professor A.T.M Zahurul Huq and Professor Wahiduddin Mahmud of the Department of Economics of Dhaka University not only for their affectionate support and encouragement but also for providing me with useful texts and academic papers in this regard. I also like to put on record my thanks to the University authorities and the Department of Economics, Dhaka University for enabling me to submit the thesis by giving the necessary time extension.

I shall be failing in my duty if I do not mention the support and encouragement provided to me in this regard by my mother and by my wife. I also acknowledge specially the untiring efforts of Mr. Abdus Salim in the process of proof reading after finalisation of the thesis for eventual submission. Thanks also due to Mr. Ram Proshad Ghosh and Mr. Abdul Karim who helped in computer composing of the manuscripts.

Mohammed Parvez Imdad

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ABBREVIATIONS

ASEAN	:	Association for South East Asian Nations
BBS	:	Bangladesh Bureau of Statistics
BMR	:	Balancing, Modernizing and Replacement
C&F	:	Cost and Freight
DRC	:	Domestic Resource Cost
EER	:	Effective Exchange Rate
ERP	:	Effective Rate of Protection
EPB	:	Export Promotion Bureau
EO	:	Export Oriented
FOB	:	Free On Board
GDP	:	Gross Domestic Products
GNP	:	Gross National Products
IBRD	:	International Bank for Reconstruction and Development
IS	:	Import Substitution
LDC	:	Least Developed Countries
MRT	:	Marginal Rate of Transformation
MDC	:	More Developed Countries
NIC	:	Newly Industrialized Countries
NRP	:	Normal Rate of Protection
OECD	:	Organisation for Economic Cooperation & Development
RIP	:	Revised Industrial Policy
SMI	:	Small Medium-scale Industries
SSI	:	Survey of Small Industries
SCI	:	Survey of Cottage Industries
TIP	:	Trade and Industrial Policies
USSR	:	Union of Soviet Socialist Republic
USAID	:	United States for Assistance for International Development
WB	:	World Bank
WES	:	Wage Earner Scheme
XPL	:	Export Performance Licence

Chapter-I

INTRODUCTION

The question as to which is an appropriate and relevant strategy of industrialization for developing countries has long been debated. This necessarily follows from the fact that the developing countries are mainly concerned with finding ways and means for achieving economic self-reliance as well as to quicken the pace of economic growth. With this objective in view, priorities are emphasized and restructured on emphasis of growth of various sectors of the economy. Since most of the developing countries are still at a premature level of industrialization, and performance of the large traditional agrarian sector also remains poor, the need for planned industrialization strategies continues to gain momentum. The two major strategies in this regard are either the export-led (outward-looking) strategy or the import-substituting (inward-looking) strategy. Therefore, it is obvious that management of the industrial sector may involve consideration of rational choice among multiple and conflicting objectives of import substitution and export expansion.

The preference for the outward looking strategy is the natural reflection of the traditional Western view which, based on classical economic theory and the experience of major industrial nations, emphasizes the positive growth-transmitting effects of trade. In fact, export oriented strategy is continued to be viewed as a major determinant of economic growth not only for its effects on GDP growth and per capita income level, but

also in terms of income and employment generation and with regard to the indicators of social development. In fact, the export-led growth strategy continues to gain momentum as an effective tool. Experiences of the Newly Industrialized countries go a long way in validating this analysis. Reliance on the inward-looking strategy, on the other hand, is based on the school of thought which, while not contradicting the classical position, points out the possible negative effects of trade on growth. This school led by Myrdal[1], maintains that trade gains are unlikely to be significant for the less developed countries, because they lack the responsiveness to the market opportunities found in the developed market economies. The policy conclusion that emerges from this pessimistic view is that development of poorer countries could be best furthered by a strategy which increased the economic self-reliance of individual LDCs (or groups of LDCs) and reduced their trade gaps with developed countries.

According to this view, the choice is for an inward-oriented strategy of import substitution by which is meant a diversification of the country's production structure wherein formerly imported goods and raw materials are replaced by domestically produced substitutes. Foreign trade would then be used only to acquire goods and services absolutely unavailable at home and to dispose of domestic surpluses or to make up for unforeseen short-term gaps which were not planned.

While the theoretical arguments for or against inward or outward looking strategies have never been conclusively resolved, there is strong empirical support for the success of both these strategies. On the one hand, reliance on traditional primary exports, the orthodox strategy for development, has produced rapid rates of GNP growth in a fairly large number of poor countries during the decades of the fifties and the sixties. On the other hand, the policy of rapid import substitution has also been viewed

1) **G.M.Meier : Leading Issues in Economic Development (London: Oxford University Press, 1984)**

as a key factor determining the rate of industrial growth, a theory to which Chenery produced empirical support[2].

It is, however, not possible to rigidly classify countries according to whether they are 'outward' or 'inward looking' in their development strategies. A large number of developing countries in Latin America and Asia (Viz. Brazil, Argentina, Mexico, India and Pakistan) relied in the first phase of industrialization on import substitution. There are others viz., Singapore, Hong Kong, South Korea and Taiwan which chose the export-oriented route on the basis of their respective resource endownments[3]. Of late, it has been seen that many countries that previously adopted policies of significant import substitution switched over to export diversification (Argentina, Brazil, Colombia, Mexico, the Philippines, India and Pakistan). There are thus import-substituting economies that have sizeable export sectors (sometimes as a result of conscious policies), and also examples of export-specializing economies which have experienced the replacement of imports by domestic production.

The trend of industrial growth in Bangladesh was far from being satisfactory. The share of industry in GDP has stagnated around 10% for over a decade and gradually decreased to 3.1% (1996). This pattern and trend of performance of the manufacturing sector indicates a serious lack of dynamism in this sector. There is therefore reason to conclude that among the various factors that may have contributed to industrial stagnation in this country, the trade regimes in operation, as reflected in import tariffs, import policy and export policy have been important.

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2) **H.B Chenery, "Patterns of Industrial Growth", Americal Economic Review, 1960.**

3) **Bela Belassa : The Structure of Protectionism in Developing Countries, Baltimore, Md.John Hopkin 1971**

In fact, Bangladesh's experience with industrialization in the two and half decades since her independence in 1971 may be termed as semi-stagnant. During this period the country pursued a policy of economic development in a planned framework under successive five year plans including an interim two-year plan. Before independence the country had also gone through a process of planned development with less share of manufacturing output. However, judged by the rate of growth of GDP and per capita income, changes in the structure of GDP, growth of manufacturing value added, and growth of employment in manufacturing by which economic performance is usually measured, Bangladesh's experience with growth and industrialization has been but frustrating. While the deceleration of these traditional and familiar indices can be variously attributed to historical and structural factors, it is often contended that faulty planning and inappropriate mix of economic policies such as in trade and industry are the most important causes behind the poor performance of the economy as a whole and of the industries sector in particular.

Bangladesh is categorized as a "least developed country" (LDC), and with per capita income of only US$ 240 (as of 1995), it ranks thirteenth from the bottom in the list of these countries. The average annual growth rate of GDP in Bangladesh over the past two and a half decades has been hovering around 4 percent.

Bangladesh suffers from an acute resource constraint. The domestic savings-GDP ratio is low and has declined overtime. During 1980-1995, gross domestic savings ranged from 1.9 to 8.0 percent of GDP. Exports are only about 14 percent of GDP and

can pay for only 60 percent of the country's import requirements. As a consequence, the country suffers from a chronic negative resource balance. Because of this structural imbalance, the country has become increasingly dependent on external economic assistance. Its outstanding external debt as of June 1996 was US$ 16.4 billion which is about 60 percent of the country's GDP. The debt service ratio has of course been declining in the recent years, but it is still quite high, (13.3 percent in 1995[4]). The foreign exchange reserves in March 1997 were only US$1.9 billion.

It is now increasingly believed that a solution to these problems may be found in a successful process of industrialization which, by promoting exports and enabling efficient import substitution on a selective basis, might increase employment, generate income, increase foreign exchange earnings, and thus raise the availability of domestic and external resources necessary for development.

This study attempts a comparative analysis of the suitability of both these strategies. On the one hand it needs to be ensured that shortage of technical know-how and foreign exchange does not militate against rapid economic growth. This concern inevitably makes the expansion and promotion of the export sector an imperative one. On the other hand, strengthening of the nation's self - reliance and necessity of saving scarce foreign exchange through sustained reduction in import dependence, call for putting priority on an efficient import-substitution strategy. Due to the "competing" claims of these outward looking and inward looking strategies on incentive schemes and resources it implies that the two are mutually exclusive as one may impede growth of the other. But this has not been the case in terms of practical evaluation. Detailed analysis and evaluation of both the strategies, their impact and relevance, from the perspective of Bangladesh's development needs, are therefore of paramount importance.

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4) ***Govt. of Bangladesh : Aid Memorandum for Consortium Meeting 1991***

The objective of the study is primarily to examine the relative merits and demerits of both the export-expansion and import substitution strategies for Bangladesh. With this objective in view, we have outlined the following chapters as the focal points of the study. Chapter-I provides a general introduction to the study and its purposes and objectives. Chapter-II provides a review and comparative analysis of the relative merits/demerits of export oriented and import substitution strategies of industrialization. Experiences of selected countries with regard to export promotion and import substitution are presented in Chapter-III. Chapter-IV reviews Bangladesh's trade and industrial policies and strategies in the Pre-Liberation and Post-Liberation period and provides a short resume of industry and trade policies in Bangladesh. Chapter V, which is the core of this study, incorporates the following:

(a) An analysis of export promotion and import substitution pattern and trends in Bangladesh.

(b) An evaluation of export promotion and import substitution as practised in Bangladesh, indicating effects of both these strategies on growth.

(c) An analysis of the extent of industrial protection enjoyed by selected manufacturing industries in Bangladesh.

(d) Comparative analysis of export expansion vis-a-vis import substitution as effective strategies of industrialization in Bangladesh.

Finally Chapter-VI presents the summary and major findings of the study. A major conclusion of this study is that a restrictive trade regime has spawned the growth of a primarily import substituting industrial sector which has generally made inefficient use of domestic resources. In most cases the small size of the domestic market has led to high cost of production resulting from low levels of capacity utilization. At the same time, export expansion incentives have been weak and hence exports have generally received less effective assistance. Although export expansion should continue to be an important strategy of our industrialization, the study carefully examines both the option and confirms the off-repeated claim that these two strategies are not mutually exclusive but complementary. Just as excessive import substitution can create structural distortion in the economy so also excessive export promotion can hinder possibilities of trade adjustment. Therefore, extreme strategy positions indicating excessive emphasis on one to the complete neglect of the other can create structures, detrimental to economic development in the long run. We have sought to establish that a developing country should pursue strategies which lie somewhere between these two extremes. Such a strategy may diminish the controversy over the efficacy of either of these two strategies.

Economic development means growth plus structural change and hence the relevant question is whether import-substitution or export-diversification or a mixture of the two will achieve this objective. The position obtained in this study is that an appropriate policy bias of both the strategies would be conducive to the needs of long-term economic growth of the country. In this context, one must also carefully take into account the trends towards globalisation of trade, the expansion of frontiers of trade on the basis of regional and/ or sub-regional cooperation and of course, with regard to priorities for attaining higher levels of growth in domestic economic scenario.

Chapter-II

RELATIVE MERITS/DEMERITS OF EXPORT-EXPANSION AND IMPORT- SUBSTITUTION STRATEGIES

Industrialization is now-a-days considered as the most important source of economic growth. But opinions have differed since long about the appropriate policy for industrialization that would be conducive to economic growth. Export-oriented strategies of industrialization are, however, often preferred for a number of reasons, the most important of which is that these involve fewer and smaller departures from free trade and markets than do import substitution strategies. The superior performance of countries under export-oriented growth is spurred by a more efficient allocation of resources from participation in world trade. Traditional international trade theory explains this as being the result of specialization in accordance with comparative advantage. Optimal resource allocation (in static sense) under competitive conditions is achieved when the marginal rate of transformation (MRT) for domestic production equals that for international production. When the domestic and international MRTs of x:y are equal, no additional national product can be had by shifting resources out of product x in order to produce more of y. Empirical evidence generally supports this notion and strongly links trade and efficiency as well as trade and growth.[5]

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5. **Bela Belassa: Op.cit**

On the other hand, exponents of Import-substitution strategy contend that the tendency to replace imports by domestic production could be the preferred option.

Major Benefits of Export Expansion Policies:

The dynamic benefits of export-oriented policies are crucial: exploitation of economies of scale in the wider export market, fuller utilization of capacities, exposure to more competition, better quality controls, and enlarged technological and social capabilities. Economies of scale from higher potential export volume encourage new industries to start up much earlier than if they were confined to the domestic market. Exports also enlarge technological capability by facilitating technical transfers and by stimulating technical effort.[6]

The success stories of Taiwan and South Korea indicate that the most important induced effects of trade and foreign investment are likely to be in the acceleration of the economy's learning rate when the outward-looking policies are combined with reliance on the market system. Relaxation of the foreign exchange constraint through exports improved the credit-worthiness of these countries. Export earnings facilitated the importation of capital and intermediate goods necessary to sustain the capacity for high growth. The expansion of exports even increased demand for intermediate inputs from other industries, and the rising incomes from exports increased consumer demand. Because exports tended to be labour intensive, they increased employment and labour earnings.

6. **Meir: Op.cit**

The difficulties associated with import substitution policies, as will be seen in greater detail later, have led in recent years to a revival of interest in the export-oriented development strategy. Exports are now looked upon as a way to break the foreign exchange bottleneck by making possible the increased use of existing capacity, the application of large scale production methods, and resource allocation according to comparative advantage. In fact, domestic manufacturing production can now hardly be called the 'sole' dynamic force behind economic development, since the Green Revolution has shown that agriculture can contribute as much as manufacturing industry in this regard. Moreover, the argument that primary exports can no longer act as an 'engine' of growth' because of declining world demand loses much strength when these very exports were found to be the main driving force of economic development in much of Southeast Asia during the post-war years. It is true that external demand constraints have been a great deterrent to developing countries' exports, and some countries failed to expand their exports as much as others, but given the similarity of demand conditions and the apparent scope for increasing their currently small share of world markets, the variation in individual developing countries' export performance can be attributed to internal supply condition, and domestic economic policies rather than to external demand for their exports.[7]

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7) **Belassa: Op.Cit.**

There is ample empirical evidence to demonstrate that the superior export performance of individual developing countries has been due to adoption of appropriate domestic policies favourable to exports. In fact, the external constraints to exports being in a large measure beyond the control of exporting countries, the domestic policy measures should be regarded as most crucial in the formulation of a country's export strategy.

Strategies for Success in Export Promotion:

The first consideration in designing a country's export programme should be that of identification of export products. Obviously, the first step taken by a developing country should be in the direction of exporting labour-intensive manufactures like textiles and other light, consumer goods. These are, however, the very industries in which the present-day new comers are likely to face though competition from the already established exporting countries such as Hong Kong, Korea, Singapore, Taiwan, India and Pakistan[8] Nevertheless, the presence of abundant unskilled labour and low wages may enable these countries to enter into the export market if they can increase productivity and specialize in the particular lines of production where they will be able to make the best use of the specific skills and aptitude of their labour force.[9]

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[8] **Bela Belassa: "Export Incentives and Export Performance in developing Countries: A Comparative Analysis World Bank Staff Working Paper No.248, 1977, Washington, D.C.**

Secondly, in promoting exports emphasis should gradually be shifted to the production of those goods that show a long-run tendency to enjoy a growing world demand. This is not, however, to neglect the export of primary goods which for many countries happen to be the main source of foreign exchange. However, in the long run interest of export stability, the developing countries should adopt policies to avoid excessive reliance on a small number of primary products, and diversify exports so as to widen their export base. In this regard, developing countries may start by first concentrating on the further processing of raw materials thereby substituting the existing raw material exports by the exports of processed and semi-processed materials.[10] Depending on the range and volume of primary exports there should be considerable opportunity in each country for increasing the degree of processing done locally in a wide variety of products. This task will be greatly facilitated by the relative abundance of unskilled labour and hence low wage costs in the developing countries. The opportunities for developing processing activities may, however, be limited by the low productivity of labour relative to prevailing wages, and by the lack of adequate infrastructural facilities (transport, power supply etc.) which prevent the exploitation of locational advantages. Nevertheless, export substitution, by and large, appears to be the most promising way of promoting manufactured exports of the developing countries today.

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10) **Bela Belassa: "Export Incentives and Export Performance in developing Countries: A Comparative Analysis World Bank Staff Working Paper No.248, 1977, Washington, D.C.**

It is worth mentioning here that manufactured exports, whether of the labour intensive type or in the form of processed and semi processed materials, are subjected to various kinds of trade restriction imposed by the advanced industrial countries. However, despite the presence of these restrictive trade policies, export substitution in LDCs appears a better alternative than import substitution. The reason is clear. The process of import substitution pushed beyond the early phase will inevitably be hampered, firstly, by the smallness of the domestic market , and secondly. by the growing burden of foreign exchange costs that result from the rising imports of inputs and raw materials for the manufacturing sector. The policy of export exponsion, on the other hand, seeks to solve these two problems simultaneously. It will not only increase foreign exchange earning from the given line of export but will at the same time tend to increase the volume of local production of that material, large enough to attain the technical economies of scale in processing.[11] An essential pre-requisite in this regard is, however, to raise production and productivity in the primary sector, for exports, whether in raw or processed form, can be increased only if supply is more plentiful.

A promising line of manufactured exports of developing countries which has gained increasing importance in the recent two decades is in the so-called component industries. This opportunity has been created by the emergence of

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11) **H.G Johnson, "Comparative cost and commerical policy for A developing world Economy, Wickswell Lectures, Stockholm, 1968**

large multinational companies in which unskilled labour intensive processes midway in the production process are left to be performed by the developing countries. Because of the rising wages for certain types of easily trainable skilled labour in the advanced industrial countries these companies are interested in locating part of their productive processes (for instance, production of components of complex engineering and electronic equipments) in the low wage countries. These processes may consist of components manufactured from local materials, or in some cases may involve further processing of imported inputs for re-export. In any case, this "putting out" of processing activity offers an important opportunity to the developing countries' expansion of manufactured exports. Its success will, however, depend upon the availability of an appropriate infrastructure including land in conveniently located industrial estates and the availability of a suitable labour supply which can be readily trained in the required skills. More important will, however, be the tax treatment meted out to these exports by the advanced importing countries. Application of value-added tariffs rather than tariffs on the entire value of imports will greatly encourage the transfer of processes to the developing countries and boost their exports.

The argument concerning export processing leads to the question of the desirability of establishing export processing zones or industrial free trade areas and encouraging private foreign investment in export activities. In many Asian countries export processing zones were instrumental in boosting up their exports

and also achieving their employment and growth objectives. Foreign private investment also played an important part in the growth of manufactured exports of some countries in Southeast Asia and Latin America. It is claimed that foreign private investment provides the skill and technology required to produce for the export markets, provides some insurance against the protectionist pressure in developed countries, and eases the marketing problems of LDCs by providing their superior marketing talent and expertise.

These beneficial effects on exports notwithstanding, one should not, however, overlook some of the unfavourable side effects of foreign private investment. Thus, foreign firms are more likely to transfer inappropriate types of technology (e.g. labour saving production techniques) which are better suited to the advanced industrial countries. Moreover, these firms particularly export processing firms, have little beneficial spread effects, as the diffusion of skill and technology is very limited and they develop very few direct linkages with the rest of the economy.

It is often said that a phase of import substitution is necessary for the subsequent expansion of exports, for countries do not generally embark on the export of manufactures 'from scratch'. Normally, the export of manufactured goods is preceded by a phase in which the needs of the domestic market are first met. This was generally the case with Latin American countries[12] and is also supported by the experience in Pakistan.In such a case of transition from primarily a domestic

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[12] **Santiago Macarois: "Industrialization and Protection in the Latin American Countries, 1969**

oriented production to export the precondition is that the export product must have a suitable price and quality to make it competitive in the world market. It is never too early to concentrate on high quality and low costs, for there are instances that the virtually risk-free phase of easy import substitution behind high protective walls leads to inefficient methods of production, high costs and unused capacity. It is not enough to expand domestic production for exports; care must be taken to make production efficient. Unless appropriate measures are taken at the beginning it will become exceedingly difficult to overcome the vested interest and the attitude of producers and remove the damage done to exports. This leads us to the most important aspect of policies and incentives required for a successful export oriented development strategy.

Protectionist policies used by developing countries in the form of tariffs, quantitative controls and inappropriate exchange rates to stimulate domestic manufacturing result in a bias against exports of both primary and manufactured goods. Thwarting external competition by raising prices of manufactured imports develops an uncompetitive cost structure and causes excess capacity, since with high prices, production at low capacity is profitable. Also the structure of protection which is necessarily accompanied by an overvalued currency (and hence low exchange rates) and exchange controls enables cheaper import of capital goods thus favouring capital intensive rather than labour intensive industries. Maintaining exchange rates at an artificially low level makes exports unprofitable relative to

sales in the domestic market. Exchange control policies also indirectly militate against export performance. For example, the ability to expand production for meeting export orders requires access to import licence for raw materials, and capacity expansion requires import and industrial licenses; in each case red tape and uncertainty cloud the scene. In addition, certain other policy measures adopted in LDCs such as tax holidays to investors and minimum wage legislation tend to encourage development of uncompetitive manufacturing enterprises by artificially raising the cost of labour relative to capital.[13]

Removal of bias against exports:

The removal of these biases against exports and correction of the distortions in the allocation of resources created by import substitution call for a wide range of commercial monetary, fiscal, exchange rate, and pricing policies. Rather than discussing the whole range of policies, the measures of more direct relevance to the issue of export expansion are taken up for discussion in the following:

First, the bias against exports resulting from protectionist policies can be offset by reducing protectionism. Revenue and balance of payments considerations may not, however, justify wholesale removal of trade restrictions at a stroke. An attractive option may be a system of equalizing compensation whereby the discrimination against export inherent in the process of import substitution will be

13) **W.M. Corden, " The structure of a Tariff System and the Effective Protective Rate", Journal of Political Economy 74(3) 1966**

offset by equivalent export incentives. This conforms to what is known as the principle of social profitability. The considerations of social profitability call for giving equal incentives to exports and imports substitution. In theoretical terms, the norms to be established is to make the ratio of effective exchange rates for exports and imports closer to unity.

It is often suggested that the restrictions faced by governments of developing countries may not permit giving equal incentives to both exports and import substitution, and hence the average level of export subsidies may be kept somewhat lower than that of tariffs. However, fiscal restrictions do not make such exceptions necessary, for even if levying and collection of income taxes appears difficult, indirect taxes may be raised to pay out such subsidies. Nor is higher protection of luxury goods warranted on equity grounds. Taxing luxury items at higher rates may appear necessary for mobilising savings when direct taxes encounter difficulties, but it has the consequence of encouraging home production of these items. In such cases, comparable excise taxes on domestic production will be an appropriate measure. Higher tariff rates may be deemed appropriate in cases where consumers show an irrational preference for foreign goods even though they are available domestically at lower cost, but even so, such exceptions should be made only sparingly so as not to provide excessive protection to consumer goods that may lead to high cost, inefficient production.[14]

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14) **W.M Corden, "The Theory of Protection", Oxford: Clarendon Press, 1971)**

Similarly, just as higher tariffs may be applied to protect domestic industry on infant industry grounds, so also additional incentives may be considered desirable for infant export industries since the latter have to bear additional costs and risks for entering the foreign markets. But here also, as in the case of infant industry protection, additional incentives to new export activities should be given only on a temporary basis until new markets have been found. [15]

While the principle of setting equal rates of tariff and export subsidies is logically sound, there may be exceptions when differential treatment should be meted out to different activities within the export sector. Thus, for exports facing less than perfectly elastic foreign demand optimum tariffs may be applied. Again since the existence of externalities in manufacturing industries warrants preferential treatment of this sector, the variation in social benefits accruing from different industries also warrants differential treatment to particular manufacturing industries. Thus, greater export incentives may be given to exporting industries that show exceptional promise for technological improvements. Likewise, labour intensive export activities which have a greater potential for generating employment may be given greater incentives relative to those that use capital intensive techniques and hence are biased against labour.[16]

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15) **W.M Corden, "The Theory of Protection", Oxford: Clarendon Press, 1971)**

16) **H.G Johnson, "Op. Cit.**

Among the most important requirements for increasing and diversifying exports is the availability of a suitable export infrastructure. Most developing countries are at a disadvantage because of inadequate provisions for banking, credit and insurance facilities, and physical infrastructure such as well organized harbour facilities, and a well-developed transport and communication system. Government should provide these facilities which are specifically geared to meet the needs of export enterprises. In addition, government may promote the marketing capabilities of exporting units by providing market information, sales promotion assistance and export management training. Establishment of a commercial intelligence service for compilation and dissemination of information to guide exporters and foreign importers and building up export marketing advice and training facilities, possibly with the assistance to multilateral agencies, are called for in this regard.

Maintenance of price and quality competitiveness of export products is another essential prerequisite for successful export diversification. Inflation is a big threat to the existence of a viable export sector, as it raises the domestic cost of production and, given the exchange rate, reduces the competitiveness of export products in the world market. This problem has not, however, received as much attention as the other more direct measures for promoting exports. The maintenance of a reasonable internal price stability through controlling inflation

warrants the adoption of an appropriate monetary and fiscal policy. This will also render the government's task of coping with the short-run balance of payments pressure easier. As for the product quality, strict quality control measures should be introduced and their enforcement ensured by the requirement of compulsory preshipment inspection of exportable products.

The instrument of economic policy discussed above are some of the ways necessary to encourage exports, but of critical importance in the establishment of an appropriate incentive structure in foreign trade is the foreign exchange rate. In most developing countries exports are disadvantaged by the maintenance of an overvalued currency which reduces the domestic currency value of foreign exchange earnings below its scarcity value. Currency overvaluation also harms the import-competing industries as it permits the import of competing goods at a lower domestic currency cost. But whereas the import competing industries are protected by specific exchange controls and import barriers to offset the detrimental effect of the overvalued currency the export producers are not always similarly compensated for their losses. Encouragement to exports therefore demands the adoption of a rational exchange rate policy.[17]

Yet there is hardly any agreement among economists as to what should be the appropriate level of exchange rate favourable to exports. A straightforward devaluation is often suggested, but it might only bring a temporary improvement in export activity because structures based on tariffs and other restrictions could survive to counterbalance the effects of the devaluation, as was found to be the

17) **A,R Khan: "Import Substitution, Export Expansion and Consumption Liberalisation" Pakistan Development Review, Summer 1965**

case in India. Moreover, devaluation would be a questionable device, if the external demand were inelastic as in the case of raw materials, in which case the total export earnings might even be reduced. In addition, devaluation will raise the prices of all imports alike, and since import demand in LDCs tends to be inelastic, their balance of payments would probably be worsened unless additional measures were taken to reduce import demand.

Devaluation has also a tendency to worsen the country's terms of trade, but the principal reservation about the use of devaluation in developing countries lies in respect to its potentiality inflationary effects. Devaluation raises the price of all traded goods immediately. It also leads to a shift in domestic demand away from imports to domestic output. In the short run, however, the shift in demand may not be accompanied by an increase in domestic supply unless excess capacity exists. But even though considerable unemployment and underemployment exists in developing countries, an increase in demand is unlikely to bring about additional domestic output since unemployment in a typical developing country is due largely to structural factors and not the product of insufficient aggregate demand. Thus an increase in the demand for domestically produced goods coupled with the direct price raising consequences of devaluation will generate inflation, unless devaluation is accompanied by a cut in domestic demand (absorption). In that case, devaluation, in order to be effective, has to be accompanied by anti-inflationary monetary and fiscal policies.[18] It must be noted, however, that the income levels in LDCs being low, consumption demand cannot be easily reduced, and therefore cuts in spending can be achieved mainly by reducing investment thereby adversely affecting the development prospect of the country.

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18) **Bela Belassa: "The Structure of Protection In Developing Countries" Baltimore Md. John Hopkins, 1971**

Because of these disadvantages associated with devaluation a system of dual exchange rates is often recommended for developing countries. The system is akin to selective devaluation in that the official exchange rate is used for essential imports and traditional exports facing inelastic external demand, while the devalued rate is used for all other transactions. Dual exchange rates operate like a system of taxes and subsidies, and are an efficient means of offsetting some of the adverse effects of an outright devaluation. It is, however, considerably more difficult to operate than tax-subsidy measures, because like exchange controls, it requires a relatively efficient management system.

A pragmatic point of contention is that in the days of general international floating, decision-making by LDCs has indeed become a difficult task. The developing countries have to peg their currencies to one or the other of the major world currencies, or a basket of the major currencies, or to SDR whose value is itself determined by a basket of specified major currencies. But the constantly fluctuating values of the major currencies have increased the risk and uncertainty associated with the LDCs' external transaction and holdings of their international reserves. In fact, the decisions that the developing countries want to adopt must necessarily take into account new international floating regimes. Therefore with respect to the problems of uncertainty and making decisions on exchange rate policy the developing countries are clearly at a disadvantage as compared to the advanced industrial countries. Keeping this in view, some developing countries

such as Indonesia, the Philippines, South Korea and of late Bangladesh have, for sometime, followed a system of controlled floating, whereby their currency values are altered and parity re-fixed at short intervals. But, nonetheless more experience has to be gained before one can evaluate the adequacy of this exchange rate strategy.

IMPORT SUBSTITUTION:

Import substitution strategies rest on the assumption of external economies resulting from 'learning by doing', imperfect market for information and for capital, and with some qualification, the existence of factor-market distortions (e.g. prevailing wage is higher than the social opportunity cost of labour). Because of these conditions, it is argued that trade protection is necessary for infant industries until they can compete internationally. Some developing countries, prefer import substitution because it is believed that replacing previously imported goods with domestic production will ease the balance-of-payment situation and at the same time fulfill the countries' aspirations towards growth via industrialization.

i) **Strategic Importance of Import Substitution**:

The general feeling that automatically emerges is that the debate on inward-looking vis-a-vis outward-looking trade policies does not follow the same analogy of analysis for all developing countries.It may depend on prevailing trade, tariff and

industrial policies, stage of development,sectoral emphasis, etc. It could also be out of place to prescribe a mutually exclusive alternative as a panacea to the problems of growth need.

In fact, the critical international political and economic circumstances prevailing in the period following World Wars I and II, leading to disruption in the industry-trade link being acute and visible provides an explanation for the strategic shift of the Third World countries towards import substitution as a relevant strategy for industrialization. The quantum level and cost of imports become the focal points of economic policy matter to maintain a desirable industrial structure and also to face declining trade levels.

More vividly, after the end of World War-II, with the withering away of colonization the less pertinent issue arises as to whether industrialisation should be achieved at wider expansion of exports leading to increased income or whether manufacturing sector should be reoriented and restructured to hasten the replacement of imports by domestic production.[19]

Experience of countries depicts that import substitution in the first phase usually covers non-durable consumer goods industries. After the initial filling of market demand for these goods, industrial growth inevitably slows down the rate of expansion of domestic demand, unless the growth can be sustained by penetrating

19) **H.B. Chenery: Op. Cit**

foreign markets. Often the import substitution process must be pushed into a second phase, domestic production of consumer durables and intermediate and capital goods. This phase does not necessarily reflect a greater maturity of the economy or a changing factor endowment.

Import substitution involves a wide variety of government intervention with product and factor markets that artificially raise output prices and factor demand in the industries pormoted. It also allows a country to maintain a stronger domestic currency than would otherise be the case. Yet it discriminates against export-oriented industries and agricultural activities through higher factor costs (because of resource flows into protected industries), higher prices of other inputs and less competitive prices for exports.[20]

The difficulties associated with these policies have become apparent in recent years. In practice, as protected infant industries grow, their unit costs fail to decline. And even if they do decline, deliberate import substitution often leads to the entrenchment of business and labour groups more interested in retaining monopoly privileges than in raising productive efficiency.

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20) **H.G Johnson and Kenner P.B(ed) : Trade and development Geneva, 1965**

Import substitution strategies usually result in wide variations in Effective Protective Rates. Tariffs on capital and intermediate goods tend to be lower than tariffs on final products, frequently resulting in large positive subsidies on "final touch" production. Because exportables are usually not protected and inputs used in the production of exportables are often subject to duties (thus constituting a tax on exports), the Effective Protective Rate for exportable is often below average or even negative. The escalation of EPRs common in most counties that adopted inward-looking strategies indicate that protection schemes provide the least protection for capital goods and, in fact, subsidize the use of imported capital goods.

A number of policies associated with import substitution artificially encourage the use of scarce physical capital relative to abundant semi-skilled labour. Direct intervention by government in factor markets - minimum wage laws, interest rate controls, tariff concession or imported capital inputs and tax concession on investment in capital equipment has commonly been used. Tariff and non-tariff barriers usually provide greater protection to industrial activities intensive in the use of skilled labour and capital equipment.

The scenario in the seventies and the requirements aligned to development needs depict a marked departure from the structuralist view of development that had dominated the fifties and the sixties. With the recognition of the strategic

importance of the outward looking policies of growth (examples being South Korea, Taiwan, Hong Kong and Singapore), exponents of this view claim expanded growth in terms of employment expansion and income distribution, and taking into account the modus operandi of the growth of such industries, it is further claimed that the export-based strategy leads to increased factor utilisation and allocative efficiency.

Does this mean redundance of the import replacement strategy of manufacturing that had dominated the basic strategies of industrialization in the post War-II period and even later? Sharp critics of the outward looking policies not only doubt whether long term sustained growth is possible through export led industrialization strategy, but also question the viability of these strategies alone, specially when the question of a self-reliant development strategy is concerned. It is therefore important that factors influencing adoption of an appropriate strategy would depend on the priorities as well as requisite targets of development.

Poor developing countries can adopt strategies for self-reliance through an inward-oriented strategy of industrialization, i.e., import substitution, wherein formerly imported goods and raw materials are replaced by domestically produced substitutes. An added advantage in this case would be that instead of relying on external trade to foster domestic growth, foreign trade could only be enlisted to acquire goods and services absolutely unavailable at home and to ispose of domestic surpluses or to make up for unforeseen shortfall, gaps which were not planned.

Critics of the export led growth strategy, however, view with considerably logical suspicion that the "success stories" can be transplanted in other developing countries through the pursuance of outward oriented policies alone. They have reason to argue that economic growth is related to several other factors apart from the export emphasis alone, as it is obvious that in the case of very large countries, manufacturing exports alone can revolutionise the situation. There is also sufficient ground to doubt whether long-term sustained growth is possible through export-led industrialization strategy alone. [21]

Stages and Factors influencing Import Substitution:

The analytical steps then centred round the issue: what ought to be the stages of import substitution? Generally, policy makers insist that " import substitution" must begin with the process of production of essential consumer goods that are presently imported. Then there could be a gradual move towards heavy industry and capital goods.

But exceptions were there, like USSR that laid immediate emphasis upon heavy industries. Therefore, the strategy for chalking out steps for import substitution need not be uniformly identical for all countries. Conditions priorities the basis of objective situation for such transformation in the manufacturing sector and even the experiences with import substitution have been different among nations.

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21) ***B. Ward et al (eds.) :Targets for development : The Widening Gap-Development in the 70s.***

Import substitution has often been the result of conscious government efforts or often it was a natural outcome of growth efforts. Apart from this, other factors as different resource and technological basis have led to different results, so far as country experiences are concerned. For instance, import substitution experiences of Germany, Japan or the USSR were initiated under conditions of expanding income partially derived from exports. This is in sharp contrast to import substitution experience of developing countries where due to the saving - investment gap the import bill hinders ability to pay for development imports and to maintain a reasonable balance of investment. To what extent can import-substitution help in raising the level of income and investment in the industrialisation programme of a developing economy therefore depends not only on the pattern and structure of the economy but also on the inter-related historical, sociological and political transformation that tends to influence patterns of growth over time.

The export led industrialization of the traditionally identified export-led growth oriented countries of Taiwan, South Korea, Hong Kong and Singapore represents the fact that export of manufactures started growing and emerged as crucial factors in speeding up economic growth. This transition from import substitution to export oriented industrialization were also met with a favourable economic scenario linked with conducive domestic and external conditions. It was clear that apart from the creation of comparative advantage, the steady shift from import substitution to

export based growth was highly coincidental with a spectacular and phenomenal upward trend in international trade and investment.

It has been contended that the most serious impediment to the development prospects of the less developing countries was, apart from other factors, the inability to pay for a continually rising level of imports, related to a persisting savings investment gap, leading to a perpetual dependence on imported capital to finance domestic development programmes. Thus it is obvious that a higher degree of import dependence is a deterrent to attainment of the expected rate of growth. This is linked to the basic premise that self-sustained growth necessarily implies growth primarily based on effective use of sufficient domestic resources, and a declining level of imports.

The argument then leads one to expect that a planned substitution of imports is an essential condition for growth. This is believed to be quite pragmatic on the ground that the less developed countries, with a stagnant level of economic growth, have limited prospects of meeting investment requirements and for bridging the savings gap by increased earnings through export expansion. The pattern and level of available technology, narrow domestic market, requisite skill and expertise, the weak base of a manufacturing sector etc. all these factors limit the scope of accelerated earnings that would be needed to bridge the resource gap. The prospects of export led growth being bleak for countries like Bangladesh, it is

generally felt that higher level income for making domestic development expenditures is associated with emergent measures to reduce the volume and level of imports. Although the basis of the pursuit and practice of import substitution is primarily based on the objective of industrialization and meeting the deficits in balance of payments position, the policy has also been well rationalized by a number of protectionist arguments. It has also been asserted that much of the recent economic history of some rapidly developing under-developed countries can be written in terms of industrialization working its way backward from the 'final touches' stage in the domestic production of intermediate, and finally to that of basic industrial materials. [22]

The rationale behind this is to set up a base for effiency in the manufacturing sector such that the initial phase of high cost associated with inefficient scales of production is overcome. "Another special argument for industrialisation via import substitution rests on the contention that a peripheral country's demand for industrial imports increases more rapidly than does the foreign demand for its exports, so that the country must supply all these industrial products which cannot be imported in view of the relatively slow growth of its exports". Apart from that, even merely on the basis of the restrictive assumption that disparities in income elasticities of demand for imports vis-a-vis that of exports continue to persist a characteristic feature in the less developed countries), and in a scenario where

22) **A.O. Hirschman, The Strategy of Economic Development, New Haven, 1958 P.112; G.M.Meier, Leading Issues in Economic Development, Op. Cit.**

imports (both industrial and consumer goods) are of continuous necessity, the policy makers and planners have no alternative but to encourage domestic production of substitutes of goods that are presently being imported. [23]

But the questions that automatically follow are: (i) To what extent the prospect of growth is limited through export expansion ?(ii) Should a country resort to import substitution only when there are sufficient reasons to contend that export expansion would not be effective tools for industrialization ? (iii) Taking into account the economic costs of an import-substitution strategy, as experienced by many developing countries in favour of inefficient allocation of resources, and cost recurrings, what addition can industries based on replacement of imports provide to the gross domestic product vis-a-vis a growth strategy based on expanding and diversification of level and quantum of exports ?

In fact, what apparently seemed to be a notion of prospective growth via import-substitution has not fizzled out due to the dominant practice and emphasis on export expansion strategies in some of the developing countries. Bangladesh is still burdened with a huge import bill. This is inspite of the fact that the export sector has received priority emphasis over time, as part of Government efforts to rationalise trade and industrial policies. Therefore, the fact remains that even with an anticipated break-through in the level of export-earnings through newer and innovative non - traditional items, prspects that exports would cater to the needs of long term planned development remains a foregone conclusion.

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23) ***G.M Meier, Leading Issues Economic Development, Op. Cit.***

It is, therefore, imperative that the relevance and strategic importance of import-substitution became a focal point of analysis, to policy markers, planners and academicians.

Limitations and Problems of Import Substitution

Advocating unhindered growth of exports, Ragnar Nurkse argued "when industrialisation for the home market has taken root, it becomes easier to increase exports of manufactured goods to the more advanced economies."[24] Some other leading economic policy makers have also contended that it would not be wise to obstruct or divert the steady growth of exports. This is, however, an argument that falls slightly short of Nurkse's stand that "industrialization for domestic markets appear as a much more formidable task", wherein there is even continued emphasis on agriculture. There is, however, little disagreement on the contention that the developing countries have no alternative to a sustained and steady growth in the manufacturing sector. Industrialization, as a crucial factor of growth being undeniable, for the developing countries, the issue then is to what extent the policy of industrialization based on substitution of imports is feasible, in order to meet the chronic foreign exchange deficits, to bridge savings gap, and to ensure attainment of desired levels of growth.

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24) **Ragnar Nurkse; The Theory of Underdevelopment Op.Cit.**

The United Nations Economic Commission for Asia and the Far East[25] notes the problems of import substitution,which is generally characterised by excessive costs and breeds economic inefficiency.

"The adverse effect on productivity by indiscriminate use of the policy (of import substitution) may then defeat the very purpose of growth in productive capacity since domestic production is not really a substitute for imports in the economic sense. It is also too narrow a point of view to conceive of import substitution in the static framework of the existing market."[26]

The mere exclusion of foreign supplies is a negative approach, and inadequate. The aim should rather be to enlarge the domestic market through a coordinated growth in income and output expansion. This means that a proper growth policy must be based on something broader than mere import substitution. The dynamic effect of trade interference ultimately depends upon what happens in the domestic economy in matters of investment and productivity.

Another point of analysis is that with each successive phase of import substitution, from the basic to the intermediate and from the intermediate to capital goods, the capital intensity of import substituting projects rises, thereby resulting in a larger import content of total investment. On the demand side, the protected industrial units continue to require larger domestic markets in order to realize or even maintain a minimum efficient scale of production. Critical observations and country experiences depicting the problems and limitations of import substitution imply that :

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25) **UNESCAP : Policy Paper 1984**

26) **Nurkse, Ragnar : "The Theory of Underdevelopment"**

1) Due to unplanned practice of import substitution, the growth process is impeded due to inability of creation of capabilities for adequate rise in domestic saving, then having an adverse effect on the marginal saving rate as well as on social product.

2) Economic inefficiency has often appeared to be inevitable between misallocation of resources and recurrence of costs instead of cost minimization. Thus the breeding of economic inefficiency is obvious from indiscriminate protection, without taking into consideration market size and structure, the inevitable distortions in prices and production and the basis of such protection.

Regarding the possibilities of uneconomic operation of import substitution, a UN report observes, the excess cost of import substitution may be high, appreciably higher than is implied by the tariff rates or the excess of domestic over foreign prices. Progressive import-substitution could, therefore, easily absorb or more than absorb the potential increase in real income that would normally accrue from technical improvements and capital accumulation, and permit a country to accumulate capital at a substantial rate without achieving a significant increase in real income or real income per head ...."[27]

27) **UNESCAP: Commission Report 1984. Economic and Social Commission for Asia and the Pacific, Bangkok**

One of the inherent logic behind the import substitution strategy has been the emergent need to save foreign exchange through replacement of imports by domestic production. For this purpose, policies incorporated within scope of import substitution include trade and any such policy such as import duties, quotas, import or enlarged surcharges, and multiple exchange rates. While multiple exchange rates have operated as price protection devices, exemption and subsidies have been used to reduce costs in import competing industries. Adoption and use of these policies without taking into consideration long term effects, has not been able to attain the expected shortages, as have been the experiences of the Latin American countries, and even India and Pakistan, while they have practised import substitution in varying degrees and different intensities.

It has been contended that a developing economy having inherent structural limitation in expansion through exports is unlikely to attain desired growth targets on the same scale of manufacturing based on import substitution, since the inherently dependent factors and variables remain unaltered. Latin American experience shows that in cases of most of the import substituting industries, the protection oriented towards replacement of imports have not been effective enough in meeting foreign exchange shortfalls, because the "value of the items imported for the new industries tuned out to exceed that of goods replaced by domestic production".

One of the standing arguments put at a later stage, is that apart from creating distortions in the economies of the countries practising import substitution leading to inefficiency and high costs, a consistent emphasis on import substitution is likely to affect, and to a greater degree reduce the potentialities of an alternatively more viable strategy of export expansion. Viewed from a pragmatic perspective, the following problems with regard to import substitution may be seen:

a) It has often been pointed out that in the eventual process, import substitution may increase a country's dependence on foreign exchange instead of reducing such dependence. This emerges from the fact there may be increase in implied and indirect requirements of inputs, materials, and equipment in expanding domestic production of what was previously being imported. This may exceed the quantum of direct savings in foreign exchange as a consequence of import substitution within that scale.

b) In developing countries like Bangladesh, where the issue of income distribution is a relatively important factor, import substitution may lead to more uneven distribution of income in favour of the propertied urban class, whose level of income and expenditure corresponds to the growth of consumer goods industries having an import-substitution bias.

c) A key factor that logically follows is that export based industries may be seen to have more relevance to the tendency of 'rural industrialization' or toward

increase of real income and employment, because of the very pattern and nature of its structural and technology bias. On the contrary, the reverse impact holds true for import substitution industries. This is typically relevant in cases of attempts of industrialization in developing countries.

d) The arguments against import substitution that it leads to breeding and protection of inefficiency at high cost leading to possible saturation of the domestic market is well known. Such an industrial structure with inefficient and high import bias may be incompatible with the transition to a competitive export market. Raul Prebisch contends that the overvalued currency that goes hand in hand with exchange control and import substitution undertakes the prices of imports, and renders social cost to an abnormally low level that resembles a defeatist or surrendering tendency on the part of the developing countries so far as their ability to complete with the rest of the world is concerned.

e) Another anti-export bias of an import-substitution strategy would be that the high wage costs in the import substituting industries, possibly because of high profits based on highly protectionist measures, are also likely to spil over into the export industries, thus raising their cost of production and lowering their competitiveness. The experience of the Latin American countries, India and Pakistan aptly upholds the fact that a high degree of protection of the import-competing industries not only leads to breeding of high cost and inefficiency, but also creates distortion in the price system and tends to discourage the unprotected activities - mainly in the agricultural and export sectors.

STRATEGY OF IMPORT SUBSTITUTION

The above contentions do not necessarily rule out the practice of import-substitution as a viable means at all in the industrialization process. The following considerations may be treated importantly in this regard:

a) It has been asserted that the shortcomings in import-substitution are related to factors such as indiscriminate protection and with inadequate attention to the country's potential long run comparative advantages.

b) An essential pre-condition for successful import-substitution at an early stage of industrialization is that the country should not aim at producing everything in an indiscriminate fashion regardless of cost. It would be more realistic to concentrate on a few productive activities which will primarily use domestically available inputs in which the country has actual or potential comparative advantage.

c) Moreover, protection to competing industries should be accorded only if it can be ascertained that with the passage of time costs of production will be reduced and the protected industries will become efficient and competitive in all forms. Protective measures should remain in force only for as long as is necessary for the industries concerned to acquire the skill requisite to compete. There is therefore reason to contend that import-substituting industries should be allowed to produce in a competitive environment with attention on competitive quality and price so that the transition from domestic market to export market will be facilitated.

These considerations call for selectivity in industrial protection and also imply that protective measures should be purely temporary and the period for which the protection is to be accorded is fixed before hand.

d) The next element of an effective import substitution strategy relates to the structure of protection to the protected industries. Historically, all import substitution has begun with manufactured consumer goods for which there was already an obvious local market. Empirical evidence provided by the celebrated OECD, IBRD and NBER studies[28] on a number of developing countries indicates that the structure of protection in these countries was heavily biased in favour of consumer goods industries. The effective rate of protection as measured in these studies turned out to be much higher for consumer goods than for intermediate and capital goods. This imparted a clear bias against the development of local capital goods and intermediate goods industries and led to proliferation of industries producing luxury consumer goods. The lesson one may derive from the above is that the structure of domestic incentives in the LDCs has to be so designed as to provide a uniform rate of protection to consumer goods, capital goods and intermediate goods. It may seem reasonable in the early phase of industrialization to provide more protection to the consumer goods, but in a more mature stage, discriminating protection between different

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28) **J. Bhagwati : Foreign Trade Regimes and Economic Development: Antatomy and Consequences of Exchange Contol Regime (Cambridge University Press, 1978).**
A.O.Krueger: Foreign Trade Regimes and Economic Development Liberalisation Attempts and Consequents (Cambridge University Press, 1978)
B.Belassa et.al. Development Strategies in Semi-Industrial Economies (Baltimore; John Hopkins 1982)

sectors can lead to mis-allocation in the production structure, thus thwarting the growth of intermediate and capital goods industries. In order, therefore, to avoid the undesirable incentive effects, the selective import duties and other control upon consumer goods imports have to be accompanied by equivalent taxes (excise and sales taxes) on their domestic production.

In designing a strategy of import substitution, it is also important to remember that the system of protection accorded to industry necessarily discriminates against the agricultural sector. Protection raises the price of manufactured goods relative to agricultural products in the home market and is thus a 'tax' on the agriculture sector. Protection by supporting an overvalued domestic currency also reduces the domestic currency receipts per unit of agricultural exports. Whatever compensatory measures are taken by the government to reduce this bias (provision of subsidized inputs, cheap credit etc.), may go to benefit big landlords and farms thus aggravating the existing inequality of incomes. It is true that for rapid industrialization some bias against agriculture may appear necessary, but in many developing countries, this bias has been excessive, and the essential role of agriculture has been too long forgotten. In order to minimize the side effects of industrial incentives (e.g., bias against agriculture and exports), encouragement to import-substituting industries may be given not by use of labour, but by providing training facilities and other services, by improving the institutions through which savings are channelled to industry, and by rewarding industry directly for any external benefits which it may confer[29].

29) **G.K.Helleiner, International Trade and Economic Development (Penguin,1972)**

Once the eligibility of import-substituting industries for protection is determined on the basis of the above criteria, the policy makers in developing countries are confronted with the difficult question of choosing the form and intensity of protective measures. Three alternative methods of protection are available, viz, tariffs, quantitative restrictions (QRs) and subsidies. Tariffs are generally preferred by governments since, apart from granting protection, they are also a source of sizeable revenues. Economists, have, however, long argued against tariffs and other trade barriers as methods of protection because they are inefficient policy instruments relative to subsidies. QRs are also increasingly relied upon as a means of protecting domestic procedures, but these involve excessive government intervention, are highly complicated to administer and, therefore, lead to delays, create uncertainty, and tend to dampen initiative. The end effect is often mis allocation of resources, proliferation of inefficient firms and unused capacity.

For these reasons, it makes more sense to offer direct subsidy, since it can, apart from promoting specific branches of industry, do a great deal to correct maladjustments of the price mechanism,and avoid the distortion of consumption and the inappropriate apportionment of the 'tax' burden which a trade barrier carries with it. Subsidies may also be usefully employed to achieve certain important objectives.

For example, these may be offered on the basis of the number of jobs created, for the training of new skills, for experimenting with a new technology and

many more purposes. It is often contended that developing countries are usually handicapped by revenue constraints to finance subsidy schemes and hence they have to fall upon tariff and other control measures as alternative protective devices. This argument is, however, exaggerated. Protection can be granted to industries either by imposing lower or no taxes on domestic production relative to imports, or through QRs which raise no revenue. It will thus be very sensible if, as a first step, QRs are replaced by tariffs which would raise revenue. Protection can then be eliminated by levying taxes on domestic production to the same extent as the tariff. The resulting revenue may then be paid out by way of subsidies to industry which will receive the same encouragement but without the undesirable side effects, such as bias against export which causes protection.[30]

Finally, the most significant pre-condition for the success of import substitution is the use of an appropriate technology. Historically the import substituting industrialization based on protection has discriminated strongly against technological innovation in the LDCs. The distinct bias imparted by the structure of industrial protection towards the development of ligh consumer goods industries and against capital goods has resulted in the use of an inappropriate technology in the countries concerned. The protected consumer goods industries imported labour saving production techniques which were better suited to conditions prevailing in industrially advanced countries and paid no attention to developing

30) **W. M. Corden, "The Structure of a Tariff system and the effective Protective Rate", Journal of Political Economy 74(3), 1966.**

indigenous technologies, and labour-intensive production methods which were more suited to the conditions of LDCs. Even though the importance of developing indigenous technology that caters more specifically to the requirements of LDCs is well recognized, the protectionist policies followed by them have neither encouraged local producers to develop it nor induced foreign investors to import more suitable technical and scientific processes. The net effect has been to discourage technological innovation in LDCs and encourage capital-intensive industries which employ a relatively small labour force and accentuate income disparities. Moreover, the import-substituting industries that have been developed often show no sign of becoming competitive in the foreseeable future. Not only thus the policy of import substitution as practised in the LDCs has discriminated against exports and reduced their own ability to earn foreign exchange, but also it has increased their technological dependence on the developed countries.

The lesson derived from the foregoing analysis is that the import substitution policies should aim at providing incentives for the growth of the technological resources potential of the poor countries. It has to be realized that the problems of economic development of these countries - the problems of low productivity levels, inefficiency in production, high rates of unemployment and disparities in income - cannot be tackled adequately unless their technological backwardness and dependence on the risk is reduced and eventually eliminated.

Chapter-III

Experiences of Export Promotion and Import substitution in Selected Countries

Export Promotion Experiences of Newly Industrialized Economies :

Exports of manufactured goods provide advantages over import substitution in as much as they contribute to efficient resource allocation, comparative advantage, increased capacity utilization, exploitation of economies of scale and improvements in technology stimulated by competition in foreign markets. From a theoretical standpoint, to the extent that exports provide a more rapid increase in manufactured output than import, the indirect effect of export growth, too, will be larger in countries where resources are not fully utilized. A close correlation between exports and output growth will however depend on other factors such as investment activities and the political climate.

According to B. Balassa's study, there is existence of a positive correlation between exports and output growth in the manufacturing sector. Thus in 1960-66 period, Korea, Singapore, Taiwan and Yugoslavia had the largest export-output ratio as well as the highest growth rates in manufacturing while Argentina and Brazil were placed at the bottom with regard to both variables. The degree of positive correlation between exports and growth of the manufacturing sector is highly revealing in some country experiences. [31] With increased export orientation, the rate of growth of value added in manufacturing rose further in Korea, Singapore and Taiwan. In turn, with the slackening of export promotion efforts, Yugoslavia dropped out from the lead groups.

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31) **Bela Balassa et al, The Structure of Protection In Developing Countries Baltimore, Md. John Hopkins, 1971**

Yugoslavia as well as countries continuing with import substitution such as India and Chile, also experienced a decline in the growth of the manufacturing sector. In Brazil, with a pronounced shift to export promotion, the acceleration in the growth of the manufacturing sector was vivid and clear.

Export orientation in manufacturing also has favourable effects for the national economy by saving capital. An export-oriented strategy permits exploiting the comparative advantage of developing countries, which tends to link labour-intensive industries within the manufacturing sector. Moreover, increased capacity utilization through exports will lead to higher output without necessitating increases in the capital stock. Finally, exploiting economies of scale reduces capital costs per unit of output. [32]

Savings in capital resulting from the expansion of manufacturing exports are indicated in Westphal's study on Korea[33]. According to the estimates cited in this study, the average capacity utilisation rate in a manufacturing sector rose from 17.7% in 1962 to 31.8% in 1971. Westphal's study also finds that in the manufacturing sector labour-capital ratios are much higher for exports than for import substitution, with ratios for the direct use of labour and capital in the manufacturing process estimated at 3.55 for exports, 2.33 for imports and 2.64 for domestic manufacturing output in 1968. Similar conclusion has been reached with regard to Taiwan who compared the factor intensity of exports and that of intermediate products that were purchased abroad in exchange for exports.

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32) **Bela Balassa et al, The Structure of Protection In Developing Countries Baltimore, Md. John Hopkins, 1971**

33) **L.E.Westphal and K.S.Kim, "Industrial Policy and Development in Korea", World Bank Staff Working Paper No.263, August 1977**

There is also sufficient evidence to conclude that there will be further employment from the rapid growth of manufacturing output associated with export-expansion and from the relative labour-intensity of exports while it will be adversely affected to the extent that export orientation leads to more rapid increases in productivity that would otherwise have been the case. These influences have also been analyzed with regard to Taiwan and India by Banerjee and Ridel. [34] The results indicate that the favourable effects of output growth on employment were enhanced by structural change through the shift of production in a labour-intensive direction associated with export expansion in Taiwan while the shift towards capital intensive production had the effects of slow output growth in India.

The influences described with regard to the manufacturing sector operate on other aspects of the national economy level as well. To begin with, the direct effects of exports on output are observed in primary activities also. This is apparent from the high degree of co-relation between the growth of agricultural exports and that of value added in agriculture : for the eleven country group, the Spearman rank co-relation co-efficient between the two variables was 0.57 in 1960-66 and 0.71 in 1966-73. [35]

Furthermore, there are indirect effects operating in intersectoral relationships as manufacturing industries require primary inputs. Primary producers purchase manufactured inputs machinery, while higher incomes due to the expansion of exports, whether primary or manufactured, increase demand for the output of all sectors. Finally, export orientation leads to savings in capital and increases the availability of foreign exchange.

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34) **Banerjee S.K and Ridel, J: Country Experiences in Industrialization, Journal of Political Economy 1976**

35) **Bela Balassa, Export Incentives and Export Performance In Developing Countries: A Comparative Study, Op. Cit.**

Apart from increased capacity utilization, the exploitation of economies of scale, and the relative labour intensity of exports in the manufacturing sector, export orientation may lead to savings in capital by reducing the bias against primary exports. Savings in capital, in turn, permit increasing output through greater employment in countries with unemployment or under-employment of labour. Also, increased foreign exchange earnings can contribute to the growth of the national economy by easing the foreign exchange bottleneck that has often been an obstacle to economic growth in the developing countries in limiting the import of intermediate products and capital goods.

The impact of the increased availability of foreign exchange through higher exports is apparent in the continued rise of the share of imports in the gross national product in Korea, Singapore and Taiwan, and in the reversal of the decline in this share in Argentina, Brazil, Mexico and Yugoslavia. By contrast, import shares declined to a considerable extent between 1966 and 1973 in both Chile and India. For the sample group as a whole, the Spearman rank co-relation between incremental import GNP rates and the growth of GNP was 0.91 in 1966-73.[36]

These described influences are expected to lead to a positive relationship between export growth and the growth of GNP. As regards the results for the countries for the 1966 - 73 period, growth performance among the eleven

36) **Bela Balassa, ibid.**

developing countries was closely linked with export growth, except that the inflow of foreign private capital enabled Mexico to reach a higher rate of growth of GNP than expected on the basis of export figures. The relationship had been somewhat weaker during the 1960-66 period, when several of the countries concerned had started out with a low absolute export figure for the entire sample of co-relation, (the Spearman rank co-relation co-efficient between the growth of exports and that of the GNP was 0.87 for 1960-66 and 0.93 for the 1966-73 period). The estimated results are hardly affected if the rate of growth of exports is replaced by the incremental export - GNP ratio.[37]

It would thus appear that trade orientation has been an important factor contributing to the inter-country differences in the growth of GNP. At the same time, income increments have been achieved at a substantially low cost in terms of investment in countries that have followed a consistent policy of export orientation.

Thus taking the 1960-73 period as a whole, incremental capital output ratios were 1.7 in Singapore, 2.10 in Korea, and 2.44 in Taiwan. In the same period, incremental capital output ratios were between 3 and 5 in the countries in the second and third groups, with improvements shown overtime in their expected export orientation. While figures for the entire periods are subject to considerable error, it appears that the greatest improvement was experienced in Brazil following

37) **Bela Balassa, ibid.**

its pronounced policy change. Brazil's incremental capital output ratio declined from 3.84 in 1961-66 to 2.06 in 1966-73, when the low figure for the second period presumably also reflects increased capacity utilization to higher export level. [38]

Nowhere in the world has the growth of trade of the industrial sector played as critical a role as in newly industrialised economies of Asia such as Taiwan, Singapore, Korea etc. The economies of Taiwan and Korea in particular underwent fundamental structural changes in a remarkably short time. These countries are now so thoroughly identified as exporters of manufactured goods that it is hard to remember that only a couple of decades ago they were predominantly agricultural. In 1960, primary goods, mainly agricultural, accounted for 86 percent of Korea's exports and 73 percent of Taiwan's. At that time, exports were less than 10 percent of GNP in Taiwan and 5 percent in Korea. But industrial sector growth in the NICs was generally in excess of 10 percent per year and accounted for more than 40 percent of the total growth of GNP in the 1960s and 1970s. By 1970, manufactures accounted for over 70 percent of total exports. Manufactured exports led the high growth of the industrial sector in the NICs.[39]

The NICs's success is, of course, due to many factors, but there is no doubt that their outward-looking industrialization strategies are an essential component. Hong Kong was from the outset virtually a free trade economy and

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38/39) **Bela Balassa, ibid**

experienced exceptionally high export growth in the 1950's. Singapore, after it was forced out of the Federal states of Malaysia in 1965, had a brief import substitution phase but shifted to export orientation in 1967. In the 1950's Korea and Taiwan entered the first phase of import substitution; however, a major policy change in the late 1950's and early 1960 reduced tariffs substantially and provided more equal incentives for expansion of all economic activities. The biases against exports resulting from import barriers were offset by subsidy schemes (mainly tax and credit preferences), and export preferences compensated for a slight overvaluation of home-country currencies so that exporting remained as profitable as domestic sales. Exporters were not handicapped vis-a-vis foreign competitors. This "balanced" incentive system facilitated the shift from production for domestic markets to production for export, and encouraged the use of semiskilled and unskilled labour in light consumer goods manufactures and other labour-intensive industries. With the lifting or reducing of tariffs and other trade restrictions, profit rates in export oriented, labour-intensive manufacturing rose sharply.[40]

Korea and Taiwan continued to provide protection for selected industries even as they moved toward an export-oriented growth path. They appear to have followed Japan's pattern of export - industrialization. Japan in the 1950s shielded several of its infant industries from foreign competition,and some of these industries have grown to become the world's most efficient producers of various manufactures.

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40) **Bela Balassa, ibid**

It seems that the degree and duration of protection afforded to an industry is a significant factor in its subsequent development. High rates of protection for prolonged periods usually result in inefficient, monopolistic industry. In Japan and the NICs, moderate protection for infant industries was coupled with export incentives to encourage them to become competitive. The overall structure of protection was relatively neutral.

Average nominal and effective tariff rates were lower and non-tariff barriers and quantitative restrictions were used less widely in the NICs than in most other developing countries. The effective rate of protection for all manufacturing averaged 13 percent in Korea in 1968, 4 percent for Singapore, and 14 percent for Taiwan.[41] The protection structure left little room for excess profits or inefficiencies in these countries. In Korea, high profits were generally reinvested by Korean entrepreneurs. The Korean Government encouraged investment particularly in export and import substitution industries through credit and tax incentives, control of foreign exchange, and informal pressure. In addition, taxation on undistributed profits invested in new technology was kept low.

The important feature of protection in the NICs, was that, for the most part, international competitiveness was greatly emphasized. This meant that domestic prices were not allowed to exceed international prices for prolonged periods. In fact,

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41) **Bela Balassa, ibid**

industries receiving protection were pushed rapidly to become internationally competitive; firms were expected to produce goods of comparable quality and price to imports, and to begin exporting within a few years. The requirement to produce at world market prices prevented proliferation of excessively capital-intensive activities.

The overall industrialization strategy of the NICs supported an output mix that conformed to domestic factor endowments. The resources available had a strong influence on the pattern of industrial development. Because of Singapore's proximity to the ASEAN-4 (Thailand, Malaysia, Indonesia, Vietnam) petroleum refining and other resource-processing industries along with labour-intensive manufactures contributed to its industrial growth. Its geographical position also enabled it to use its considerable marketing talents and advanced service sector to trade intensively with its ASEAN partners.

For the NICs, their comparative advantage lay in their abundant and well-educated labour force. Traditional labour-intensive products (clothing, textiles, resources-based manufactures, and miscellaneous manufactures) constituted about 50 percent of total exports in 1970. Labour policies were used to enhance this advantage : into the 1970s, government intervention in labour markets remained moderate, tending more toward wage ceilings than minimum wages in excess of equilibrium wage rates. Average wage rates for unskilled labour were low and

stable during the 1960s; they began to rise when surplus labour was largely absorbed and labour productivity increased in the late 1960s and early 1970s.

Because of their emphasis on labour-intensive manufactures and their highly elastic supply of low-cost semiskilled labour, two-thirds of the NICs' industrial expansion were generated through added industrial employment. In Korea and Taiwan, the industrial sector completely absorbed the annual rise in the labour force and also drew labor from other sectors. From the 1970s on, there has no longer been a labor surplus. The increase in industrial employment has allowed all workers to share the benefits of rapid economic growth, especially in Taiwan.

The increase in overall industrial employment corresponded with a decrease in employement shares of small and medium scale industrial firms, from about 50 percent in Taiwan and Korea in the 1960s to 37 percent and 26 percent respectively in the 1970s.[42]

The large employment share of small and medium-scale industry (SMI) in Taiwan is due in part to the fact that, unlike the Korean Government, Taiwan did not actively pursue policies aimed at deliberately encouraging large enterprises. The SMIs in Taiwan contributed to a more even income distribution and a wide regional distribution of manufacturing activities.

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42) **Bela Balassa, ibid**

Small and medium-scale industrial firms (establishments with 5-99 employees) represented more than 90 percent of manufacturing employment. The share of SMIs in manufacturing value-added ranged from 17 percent in Korea to more than 20 percent in Singapore and Taiwan.[43] In Singapore and Taiwan, where price distortions are minimal, SMIs are highly efficient, contributing strongly to exports and serving as subcontractors for large firms. In Korea, however, subcontracting and exporting is not prevalent among SMIs : a survey in 1975 found that less than 20 percent of SMI sales were contract sales to other firms[44].

The incentive system applied in the NICs were not entirely free of bias, however. Intermediate and engineering goods industries enjoyed heavily protected domestic markets. Yet traditional consumer goods industries suffered : they had to pay higher prices for protected inputs. Still, such biases were not strong enough to affect either the profitability or the international competitiveness of labor-intensive manufactures.

Beginning with the mid 1970s, the prospects for future NIC development became less favourable. At the same time that higher labor costs tended to reduce the international competitiveness of some traditional exports (even though productivity gains acted to offset this), rising balance-of- payments deficits, inflation, and unemployment led Europe and the United States to impose additional trade barriers, discriminating against the exports of NICs.

43/44) **Bela Balassa, ibid**

Before NICs were seriously affected by these changes, their governments instituted new policies aimed at diversifying industrial exports. These policies were based on the judgement that the efforts of the new protectionism in more developed countries (MDCs) and the loss of competitiveness because of rising domestic wages could best be countered by shifting industrial production towards technology intensive and heavy industrial activities. The NICs were also concerned about their own balance-of-payments position: if some imported raw materials and machinery could be produced domestically, foreign exchange would be saved. This strategy is clearly revealed in the changing composition of industrial output and exports in these countries : capital and technology - intensive goods increased while light manufactures decreased. In Korea and Taiwan, incremental output shifted to machinery, basic metal industries, and chemicals, though light consumer goods maintained same level of output.

In the NICs, the share of traditional labor-intensive manufactured exports in total exports declined, while remaining large enough to keep these products among the top individual export items. During the 1970s, the factor content of NICs exports increasingly shifted into human and physical capital intensive products and services. In Taiwan and Hong Kong, the shares of electrical machienry in total merchandise exports were larger than those of primary products by the 1980s.[45] Similarly, the shares of non-electrical machinery, precision instruments, and transportation equipment showed significant gains.

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45) **Bela Balassa, ibid**

These changes indicate the enhanced competitiveness of the Asian NICs in sophisticated manufacturing industries.

The industrial policies aimed at shifting the output mix toward more skill - and capital - intensive manufactures had varying degrees of success. Korea embarked on an industrialization program emphasizing heavy industry by providing credit for selected industries at artificially low interest rates, and introducing import controls plus selective tariff protection. Its exports of iron and steel increased from less than 2 percent of total exports to almost 10 percent in the 1970s. But Korea had only mixed success in its promotion of heavy industrial exports. Although its industrial strategies had encouraged private investment to reach an unprecedented level by 1979, there was a substantial downturn in 1980 owing to social and political unrest, a poor harvest,and rising prices of food, oil, and other necessities. Domestic inflation accelerated during a time when output growth slowed down and even turned negative. This crisis led the Korean government critically to review its heavy - industry strategy. Subsequent policy changes have de-emphasized on heavy industries and moved to develop exports that are smaller in scale but, less import intensive and that encourage development of technology.

Overall, slower real economic growth has accompanied the new industrial strategy of the NICs. Some of the policy changes had the effect of reducing economic efficiency even as the external economic environment became more hostile. The NICs' industrial development will continue to be export-oriented

because of the limited size of their domestic markets and their poor natural resource endowments which create a high dependency on imported raw materials and energy. But protectionism against their traditional labor-intensive and semi-skilled products, increasing wage rates as a result of full employment of the labour force, and emerging competition from more labor-abundant countries will probably check further export growth in products such as textiles and clothing.

Whether the NICs can sustain high rates of export growth in the face of growing protectionism (particularly in Europe, Japan,and the United States) and slower real growth of international trade depends on future expansion of world and regional markets, and on which products the NICs can gain a comparative advantage. Structural shifts in MDCs can open up new, less-protected markets for more sophisticated exports from the NICs. But such opportunities will be limited if economic recession and rising unemployment continue to slow down adjustment processes in MDCs. Nonetheless, to some degree the Asian NICs may be able to circumvent barriers to their exports by export diversification toward more skill-intensive products, as they have done in the past. The markets for these products are less distorted by trade barriers, and retaliatory measures are less likely than in traditional labour-intensive sectors. Thus, the export-promotion experiences of these countries that relied exhaustively on such strategies gained economic benefits in terms of expansion of income, output and employment with lesser degree

of market distortions. The increase in growth rates and the levels of per capital income were greatly influenced by the degree to which export base was expanded.

Regional/Country Experiences of Import Substitution

Import-substitution experiences of some countries with regard to the impact of this strategy on economic performance of those countries are now presented. In this aspect, it would be relevant to examine the experiences of some Latin American countries and for the South Asian region, the experiences of India and Pakistan.

i) Latin America :

Before analysing the experiences of Import Substitution of some of the Latin American countries, it may be expedient to give a brief account of the industrial structure of these countries. The countries of the region were beset with problems of economic underdevelopment, a low level of manufacturing activity, a negligible share of the manufacturing sector in the gross national output, inadequate resource base, a high degree of dependence on external economic assistance, not-so-effective control mechanisms etc. More importantly, the structure of protection was a major factor determining the economic performance of most of these countries.

The reasons underlying the pursuing of Import Substitution by the Latin American countries were mainly the following (i) to enhance domestic production of imports, with a view to lessening the cost of production and reducng the volume of imports, and (ii) to ensure protection of industries and thus expand the base of

manufacturing sector. There being little scope for expansion of exports, import substitution appeared to be a major economic alternative.

The effect of import substitution in the Latin American countries is of spectacular interest. The inherent reasons behind resorting to industrial policy based on import substitution by these countries are as follows: (a) a continuous trade deficit leading to a chronic shortage of foreign exchange; (b) import-Substitution was in fact the outcome of a search for an alternative to export promotion strategy, the scope and prospects for which was rather limited due to antiquated technology, a narrow domestic market; and (c) an extension of efforts at widespread industrialization, based on a traditional approach of inter-sectoral shift of emphasis from one sector to the other.

As in some other underdeveloped economies, import substitution experiences of the Latin American countries, inspite of being an added factor in the process of industrialization, were controversial regarding effects on growth as in most cases the substitution process was put into effect without due regard to its implicit costs in terms of alternative uses of resources, and that the resulting industrial structures were characterized by lack of efficiency and high cost.

It has been argued earlier that a policy of import substitution based on high protection may often lead to development of inefficient industries, at high costs and uneconomic scale of operation. The pattern of industrialization was therefore based

on a net increase in the value of gross output, and thus oriented towards a more exhaustive and efficient utilization of available resources, apart from the consideration that the expansion of industrialization must not be at the cost of decline in other sectors. The issue then persists, what ought to be the strategy to select the scale and range of industrialization,on the basis of determined objectives of efficiency and growth. "That the foregoing considerations have not been fully taken into account in the import substitution and industrialization policies followed by most of the Latin American Republics is evident by the excessive and indiscriminate protectionism which, as has been shown,the countries of the region commonly accorded to their industries. Or rather, this kind of protectionism would seen to suggest that the primary objective perused through industrialization in Latin America is the attainment of self-sufficiency, for there, and only then, can any import substitution industry be regarded as admissible, and economic considerations be relegated to a secondary plan".[46]

Therefore,the nature of protection in the Latin American industrial structure assumed the following nature:

(a) Protection, without consideration of economic efficiency, continued to breed inefficiency. It is therefore an obvious conclusion that "industrialization based on overemphasis on import substitution and excessive and indiscriminate protection

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46) **A.O Krueger: Foreign Trade Regimes and Economic Development; Liberalisation, Effects and Consequences (Cambridge: 1978).**

has caused severe distortions in the economies of many Latin American countries and has contributed to an industrial structure characterized by inefficiency and high costs. But it is not only with regard to the efficient utilization of resources that the effect of this industrialization has been largely negative rather than positive, far from having contributed to the effective solution of some of the chronic problems besetting the Latin America economy, it has resulted in their aggravation.[47]

(b) The Latin American countries based their import substitution strategy on a base toward protection and ignored efficiency aspects and it was their pattern of indiscriminate protection that rendered their import substitution strategy weak. Brazil was among the few that had just reached the stage of development of basic industries and even production of simple machinery. In Brazil the experience of import substitution had more or less reached a point of significance regardless of the fact that economic efficiency suffered at the cost of such expansion. Similarly in Argentina, Mexico and Chile the linking of import substitution as the basic strategy of industrialization with a continued degree of tariff protection, led to the existence of inefficient enterprises, the consequences of which have already been mentioned[48].

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47) **Santiago Macarios, "Industrialisation and Protection In Latin American Countries", 1969**

48) **Bela Balassa, ibid**

(c) The tariffs preventing the entry of manufactured goods from abroad had permitted import of machinery and equipment for industry without any criterion of selected goods related to the prevailing economic conditions in the country concerned in terms of the relative prices of capital and labour etc.

(d) The other notable feature was the exaggerated height of prices of substituted goods in the domestic market which was an adverse effect of unbalanced protectionist measures, inefficient and uneconomic utilization of industrial capital.

The answer to what Latin America could have done has to be sought elsewhere. Actually, whichever might have been the strategy of industrialization, the ideal move would have possibly been weighing out the comparative stimulus to growth on the basis of long term policy perspectives. Instead, the strategies of industrialization have been tailored to meet immediate unforeseen economic contingencies. For instance, the strategy was adopted to combat consistent stagnation in the level of export earnings, continued trade gaps based on persistently serious balance of payment deficits etc. As would have been in the case of any developing country in search of immediate solution to these impending economic issues, the Latin American countries resorted to a not sufficiently far-sighted long term policy, to keep import substitution within the limits of economic advantage and supplement it with the development of import based industries, but have confined themselves to acting under preserve of emergencies in case of serious balance of payment deficits

through the adoption of measures within their immediate reach, namely import restrictions,and the consequent encouragement of indiscriminate substitution of domestic production for imported goods. [49]

The implications of import substitution transcend anticipated effects of introducing distortions in the structure of prices and production and the breeding of inefficiency and even more to a degree affecting existing, feasible or potential export industries, by slicing off substantive proportion of resources and imports, from tangible and viable sectors of export promotion to import substitution needs of immediate urgency. The industries thus protected under the import substitution strategy have also not been found to have necessarily been economically viable enough to generate sufficient foreign exchange or to have bridged the saving-investment gap.

The structure and intensity of protection has to a certain extent influenced the industrial structure of some of the Latin American countries. But here the structure of protection was not the sole influencing factor the role of the commercial policies was no less important.

Argentina, Brazil, Colombia and Mexico continued with Import substitution beyond the first stage. However, import substitution became increasingly costly as it was extended to industries that were highly capital intensive, required sophisticated technology and could not produce at an efficient scale or use capacity because of the limited size of domestic markets.

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49) **J. Nugent, Economic Integration in Central America: Empirical Investigation (Baltimore, Johns Hopkins University, 1981)**

At the same time, given the need for imported raw materials, intermediate products and machinery,the extent of net import-substitution in these industries was rather small. Adverse effects of the policies on exports followed further aggravated the balance of payments position in this group. The resulting foreign exchange bottleneck limited the possibilities of economic growth and in some instances led to the application of 'stop and go' policies. Chile traditionally had the highest level of import protecton in Latin America. The high level of protection constituted considerable discrimination against exports and penalized the export industries.

ii) Pakistan :

Pakistan's strategy of emphasis on replacement of imported consumption goods was based on the following nature and was faced with the following economic problems:

a) First, such a strategy must meet Nurkse's balanced growth requirement which stipulates that there can be no specialization for the home market. This means encouraging investment in the production of a little bit of lot of things with all of its disadvantages that it implies. It means in some cases an uneconomically small scale of production, while in others it means too few firms for the kind of competition that enforces efficiency and progress.It implies doing many things poorly instead of fewer things well. This tendency of adoption of the import-substitution industrialization

strategy implies scattering thinly scarce capital, foreign exchange and technical and organisational talent in an insufficient manner.

b) Next, the aspect of failure of Pakistan's import-substitution strategy was due to the fact that the early momentum of industrial development of Pakistan could not be maintained because of a failure to develop a self-generating mechanism for industrial growth. Thus the cycle of investment-profit-saving reinvestment which is necessary part of a self-generating mechanism could not be met.

c) Pakistan's lack of success in pursuing her import substitution industrialization strategy is the danger associated with consumption liberalisation. It is theoretically established that replacement by domestic production of imported consumption goods contributes effectively to growth only to the extent that consumption is simultaneously constrained. But in this case, the strategy carried within it implies an automatic decontrol of consumption.

d) In case of Pakistan, as import-substitution took place, income was transferred from the government (customs duties) and from the profits of favoured importers to income receipients in the new industries. Because of the relative inefficiency of these industries, a substantial part of the

value added there became non-profit income, a much higher proportion of which is consumed.

e) Finally, there was a natural tendency for the emergence of pressures to minimize the constraints on consumption when the business community was overwhelmingly committed to the output of consumption goods. As domestic production rose, the constraints on consumption steadily took more the form of restriction on the licensing of materials, parts and equipment for the consumption-goods industries, and less the direct limitation of imports on finished goods. Therefore the phenomenon of excess capacity due to scarcities of imported supplies emerged. This was mainly the result of a misallocation of investment in which too much capacity was installed to produce finished consumption goods and too little to produce materials and equipment. To justify the full use of the existing capacity would have required a rise in consumption as to emasculate the saving plan; but all of the pressures were on the side of liberalising the licensing of supplies. Since excess capacity was available,the cheapest way to get an increase in production was to import supplies. On the contrary, Pakistan should have gone for a stiff increase in taxes on consumption to offset the steady erosion of control over consumption. But higher consumption taxes could not be imposed when there was excess capacity in the consumption goods industries.

in this aspect, we may refer to findings of A.R.Khan's study that reveals the following: (a) very substantial liberalisation of domestic consumption for the five types of commodities, e.g, cotton cloth, sugar, ciggarettes, paper and tea (b) We may distinguish several types of inter-relationship among production, imports and exports that can be associated with consumption liberalisation[50].

The fact is that actual consumption of each of these commodities rose faster than the stipulated normal rate due to certain factors. First, the high degree of protection that preceded the process of import-substitution really allowed an excessive concentration of investment in the protected industries. Moreover, an "automatic decontrol" of consumption took place as the process of import substitution went on. In an economy where the only effective control of consumption consisted of import-licensing, the replacement of imports by domestic production gradually rendered such consumption control to be ineffective. Thus, domestic absorption of the import substituting goods grew at a faster rate than for other goods.

In his book on Industrialization and trade Policies,[51] Lewis concludes that the major change in the overall structure of Pakistan's economy took place over time,

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50) **A.R.Khan, Import Substitution, Export Expansion and Consumption Liberalisation: A Preliminary Report, Pakistan Development Review, Vol.III, Summer 1963.**

51) **S.R.Lewis, Industrialisation and Trade Policies, London : Oxford University Press, 1970**

amidst which a wide disparity existed in the economic performance of the then East and West Pakistan. Durng the 50s per capita income in the then West Pakistan rose at rate of approximately 1% a year, while GNP in the then East Pakistan fell at the rate of 1% per year. During the early 1960s the overall growth rates of real GNP were similar in the two erstwhile provinces, and so were the rates of increase of real GNP per capita. Lewis concludes that though the rates of industrial growth were approximately the same in the former two provinces, the industrial base was much larger in the Western Wing of former Pakistan and it tended to grow at a slightly lower rate than manufacturing industry in the then East Bengal. The 'success' of Pakistan's economic policy and performance at that period was attributed mainly to her growth rate of new exports (at the rate of 20-25%).[52] It was argued that the "principal tool of economic Policy which affected the rate of growth of the manufacturing industry was the system of exchange control and import licensing,which transferred large amounts of resources from the agricultural sector and from urban consumers to the new industrialists who were given access to foreign exchange at prices well below its opportunity cost to the economy". This establishes the contention that privatization in the manufacturng sector was encouraged at a substantive cost. Moreover, these industrialists were to sell at highly protected markets and in that initial period the effect of both direct and indirect taxes on the rate of industrial growth appeared to have been small[53].

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52) **S.R.Lewis, Industrialisation and Trade Policies, London : Oxford University Press, 1970**

53) **S.R.Lewis, Ibid.**

Although the economic policies of the Government did not affect the differential rates of growth among manufacturing during the 1950s, during the 1960s the differential impact of economic policy became much more evident. The rate of subsidy to manufacturing exports was exceedingly high, particularly when measured as a percentage of value added in the industry,rather than as a nominal subsidy to the exported products. The constraint in Pakistan's manufacturing sector that was constrained by a lack of imports for both capital goods and raw materials was to a certain extent, overcome during the Second Five Year Plan period.[54]

Thus, it is inevitable that Pakistan's import-substitution experience did not move to any successful trend. Rather it involved larger economic costs in the industrialisation strategy of Pakistan. Besides, the export sector of Pakistan received less attention in terms of resources and policy emphasis. Besides the tariff structure was also contrary to the purpose. Hence, the objectives of attaining growth on the basis of import substitution appeared to be a factor.

iii) INDIA :

The two foremost points of analysis with regard to India's gradual shift to import-substitution emerge from the following factors:

a) Pessimism about the role of exports has been a crucial factor in the formulation of a development strategy for the Indian economy. In fact, such trade orientation was characteristic of many developing countries in the immediate Post War period. The leading exponent of this school being Raul Prebisch. Therefore, while some economies changed their course in the early 1960s towards outward-orientation, India, alongwith some Latin American countries continued on the path of import-substitution.

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54) **S.R.Lewis, Ibid.**

b) However, the principal argument in favour of an import-substitution oriented strategy for India was the traditional argument of protection of infant industries. This argument provides a rationale for accepting a degree of additional short-run cost in return for the future benefits of establishing a dynamic industrial sector, particularly in view of the large domestic market. Thus, domestic infant industries were protected from the competition of exports through setting up very high tariff rates or quota restrictions. Therefore, more the extent of protection and higher the intensity of import-substitution, the economy found itself with industries in which it had lesser comparative advantage.

Main features of India's Import Substitution Experience:

In India, according to studies by Bhagwati and Desai (1970)[55] and later Bhagwati and Srinivasan (1975)[56] the following major features and trends in Indian import-substitution experience are noticeable:

(a) Protection was granted to industries that set up indigenous capacity without any regard for the relative costs of domestic and foreign production, (i.e quality).

(b) As the process of import-substitution was carried deeper and deeper, industries were set up to cater to the domestic market in areas in which India had less and less comparative advantage vis-a-vis other trading partners. One of the problems that arose from this was that in many cases the size of the domestic market was not large enough to exploit the economies of scale. Besides, the process of import-substitution in heavy industries called for greater demands on sophisticated technology and equipment that could not be made readily available.

55) **J.N Bhagwati and P.Desai, India : Planning for Industrialization and Trade Policies (Oxford University Press, 1971).**

56) **J.N.Bhagwati and T.Srinivasan, Foreign Trade Regimes and Economic Development: (India, NBER Columbia University Press, 1975)**

(c) The third factor is that the rationale of the infant industry argument would warrant that by the time the industries came of age, protection would be withdrawn and the industries would be exposed to foreign competition. Thus the industries in which India had competitive advantage could have easy access in the world markets. But this factor being not adequately looked into, the result was the development of a high cost industrial structure which could not operate except in a sheltered domestic market.

(d) Fourthly, in this context, the position taken by the Alexander Committee (Government of India) 1979 on the functioning of trade policies and possible reforms, may be relevant[57]. The report of the Committee heralds a substantial liberalisation of import policy, but it is interesting to note that the position taken by the Committee on the question of whether protection leads to high costs of production was quite different from that associated with the usual proponents of trade liberalisation. While recognising clearly the problems of continuing protection indefinitely, the committee stopped short of recommending opening up the economy to foreign competition. However, the Committee asserted that "There is merit in exposing the industry to an environment of effective and fair international competition so that it would learn the skills of efficiency of production and management, for cost reduction and quality production."

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57) **Commmittee on Trade and Tariff Reforms: V.A Alexander, Govt. of India, 1979**

The effect of import-substitution oriented policies discriminating against exports has been analysed at length. A number of studies have computed the domestic resource cost for different types of exports and have pointed to their high level and wide dispersion which reflects inefficiency in the allocation of resources stemming from the industrial strategy followed in the economy. The effective exchange rate for imports is found to be consistently higher than that for exports. The Alexander Committee also notes that a trade regime in which there is significant reliance upon tariffs and licensing affords substantive effective protection to domestic produces in import-competing lines while exports receive no comparable protection.

Inspite of the success trend in India's import substitution strategy, it has been examined that import-substitution slowed down after the mid 1960s and its contribution to industrial growth also declined. In manufacturing the slowdown in import substitution covered industries accounting for almost 80% of the total value added. The most significant exceptions in this respect were the machinery industries - electrical as well as non electrical which experienced continuing import - substitution. Except for capital goods and consumer durables, the slowdown in import-substitution was accross the board.

It has been recognised though after a successful phase, the trend towards inefficiency in import - substitution in India was a contributory element towards the evaluation of a high cost industrial structure in the economy.

Experience of India's import substitution strategy can be traced into two major categories:

a) Consumer goods

b) raw materials, intermediate and investment goods.

In the analysis of experience of import substitution within the above mentioned category, an important role is assigned to the intensification of the import control regime with the foreign exchange crisis of 1956-57 at the beginning of the second Five Year Plan of India. Except for a relatively small number of industries, the role of tariff protection declined in India since this crisis and quantitative restrictions became the chief instrument of de facto protection, often based on the principle that domestic production should necessarily be availed of by ruling out competitive imports. It is implied therefore that an explanation of the process of import-substitution, would lean heavily on the system of de facto protection and the incentives that it generated. The following dominant aspects are important[58]

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58) **Desai, Padma : Import-Substitution in India Journal of Political Economy 1987**

a) The imports of consumer goods have been considered non-essential but this definitional aspect of the principle of non-essentiality have not been extended to the domestic growth of import-competing industries.

b) Import of raw materials has generally been given the highest priority, though allocation within this group appears to have reflected dominant set of priorities except for the initiation around 1960 of the exchange retention schemes giving import entitlements of raw materials exporters.

c) The imports of machinery, when not directly financed from project aid, have been allowed against only deferred credit terms or private foreign investment (government approved).

Dealing on the categorization of import substitution, the following are important.

d) The first category included traditional Industries, mainly in relation to consumer goods and items where the import/availability is insignificant and where the process of import-substitution appears to have been completed prior to the period under review.

e) The second category consisted of industries where import/availability ratios appeared to have a declining trend. Concurrent with this phenomenon, resulting partly from significant cuts in import levels, there was generally a

significant increase in domestic production which also incorporate operation of newer avenues of productive activity.

f) The last category to be distinguished among consumer good industries included to industries where the import/availability ratio continue to be significant through the foreign exchange crisis, despite the non-essentiality of consumer goods, the imports of these items being kept close to pre-foreign exchange crisis levels and reduced only much later when domestic production stepped up to replace imports.

The resultant imposition frequently of a complete ban on import and other measures promoting domestic production in the case of consumption goods was the result of the foreign exchange crises[59]

Thus the experience of Import substitution in India was to some extent, a success story. A dominant feature of the process of import substitution in some categories was relieving tariff protection by the late 1940s or early 1950s. Apparently after the foreign exchange crisis in all cases except machine tools imports were found to fluctuate further than decline. At times, imports were adjusted to make up for shortfalls in domestic production.

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59) **Indian Planning Commission: Import-Export structure of India and Pattern of Trade, 1972**

Chapter-IV

TRADE AND INDUSTRIAL POLICIES IN BANGLADESH

The immediate Post-Liberation period witnessed a radical change in the country's industrial and trade policies. Almost all the major industries under the key sector of the economy were nationalised. Therefore, the public sector emerged with tremendous size, while the role of the private sector was reduced to a bare minimum.

The rationale for wide-scale nationalization was the following reasons :

a) It was within the election manifesto of the political leadership;

b) Nationalization was the effect of a post-revolutionary resurgence towards a thinking of a shift from private ownership and towards a socialist trend.

c) Nationalization was necessitated mainly due to the fact that the government had to take over abandoned industrial units and enterprises, due to exodus of the non-Bangalees.

Possibly other justifications that seemed to be predominant in the minds of the then policy makers were that it would accelerate the rate of industrialization within the framework of a state owned mechanism, and that such nationalisation would create grounds favourable for the eventual establishment of a "socialist society".

The problems in the immediate post-Liberation scenario were enormous. Due to the fact that a huge portion of total assets in the manufacturing sector were owned by erstwhile Pakistan, within a range of protection and continued dependence on the then Pakistan market and partly due to the fact that the country just went through a Liberation War, manufacturing sector in the post-liberation period was confronted with high cost of production, loss of market, inefficiency of managerial know-how and technical expertise, low rate of capital utilization, immediate need for domestic and external economic resources for financing manufacturing activity, labour unrest and indiscipline etc.

In addition to the structural limitations, the inter-related aspect of presence of contradictions in philosophical and psychological content in terms of both policy and action among the policy-makers, pressure groups and the implementing personnel, resulted in inconsistencies and imbalances through differences of interests and hindered the operational efficiency of the private sector. It was imperative to identify areas for promotion of linkages between a growing but semi-stagnent agricultural sector and an apparently expanding manufacturing sector aimed at expanding the small base of non-traditional exports. One of the significant policy attempts at a closer evaluation and examination of trade and industrial policies in relevance to our requirements was the formulation of the trade and industrial policy (TIP) by the government. The TIP aimed at formulation of interim recommendations for policy and procedural reforms while carrying out a broader review of

implementation of industrial reforms. In addition to the TIP study, other measures were also adopted in line with the framework of the new industrial policy. These included simplification of industrial investment and approval procedures, the opening of doors to foreign investment as well as foreign participation in joint ventures etc. How far these measures have been able to create conditions and attain success in attracting investment yet remains to be seen.

The new industrial policy sought to improve the operational efficiency of the public sector, by adoption of measures aimed at enhancing operational efficiency gearing up management and improving productivity, and at the same time a renewed thrust of emphasis was placed on the growth of the private sector. The salient feature of emphasis on the growth and expansion of the private sector included among other measures, simplification of the industrial information system, simplification of sanctioning procedures, expansion of scope of private entreprenuereship, decentralisation of sanctioning powers, improvement in terms of debt servicing and, over and above, a sustained attempt for a restructured organisational framework for the growth and expansion of the private sector.

The implementation of the First Five Year Plan was adversely affected [60] by such factors as resource constraint, high rates of inflation, non-conducive labour-management relations, which completely upset the plan estimates of investment

60) **Planning Commission, Review of the First Five Year Plan, Govt. of Bangladesh, 1975**

cost and external aid flows. The Second Five Year Plan aimed at 'diversification of industrial base aimed not only at increasing the local capability for the manufacture of machinery but also to reduce the dependence on imports". Therefore, along with the programme of export promotion and diversification, the plan aimed at production of local manufactures. The emphasis continued through the Third Plan, which bid laid stress on the key segments of import-substitution such as in engineering, iron and steel, chemical, textiles, petro-chemical etc.

In the post-Liberation Bangladesh, the rate of industrial progress was slow because of inadequate infrastructural facilities, inadequate allocation especially in terms of acute shortage of foreign exchanges and the lack of cohesiveness and continuity in policy formulation and implementation and the traditionally inherent intricacies in development management.

Later, however, the thrust of industrial policy shifted towards the private sector although reliance on government intervention still continued. The new industrial policy of the Government seeks to attain efficiency on the basis of a competitive structure. The rationale was that even if the private sector was widened enough to account for the major part of the performance of the manufacturing sector, some amounts of state controls and regulatory mechanism was necessary to facilitate private sector expansion.

Protagonists of an extended privatization for Bangladesh with enlarged areas of privatisation contend that the need for more relaxation of controls on investments and imports would necessarily call for measures as continued maintenance of a uniform pattern of incentives and protection based on flexibility. In fact, the contradictions between public and private ownership of manufacturing enterprises in an economy like Bangladesh is more related to political economy. Apart from this is the question of multiple objectives based on distinct aspects of different policy formulation. At least theoretically, the exponents of the public sector to contend that the objective of public sector oriented industrialisation was not immediate profit, but growth from a social standpoint. On the other hand, privatisation of industries is believed to be more oriented towards building a profit base for private entreprenures rather than an industrial base, the gains of which would accrue to the society. Moreover, if is contended that in an economy like Bangladesh, where the number of investors with adequate investments for setting up independent manufacturing units is quite limited, the financial strength of private entreprenueres is based on public funds and investment. Apart from these, tax holidays, customs rebate, longer repayment period, differential interest rates are concrete examples to subsidize the private sector.

The question then persists, whether the public sector episode have been a story of no success. Apparently, the public sector's success depends on essential factors like (a) sound political commitment, (b) provision of efficient managerial and

technical expertise, (c) a sustained process of implementation, (d) accountability within a coordinated framework etc Rehman Sobhan and Muzaffar Ahmed argue that public enterprises in Bangladesh can only realise its full potential as a source of surplus generation to be used as an engine of growth when the contradictions obstructing its growth have been removed[61].

The objectives of the national industrial policy (NIP) of 1982 were as follows[62] :

(1) expand the manufacturing sector with increased participation of the private sector.

(2) limit the role of public sector to the establishment of basic, heavy and strategic industries

(3) encourage optimum utilisation of existing capacity including measures for balancing, modernisation and replacement (BMR).

(4) encourage investments to move away progressively from "assembly" to intermediate/ basic manufacture.

(5) protect and promote local industries by responsible tariff measures and banning imports where there is adequate domestic capacity.

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61) **Rehman Sobhan and Muzaffar Ahmed : Public Enterprise in an Intermediate Regime, Dhaka : University Press Ltd., 1984**

62) **Ministry of Industries, Govt. of Bangladesh, New Industrial Policy, 1982.**

(6) limit the growth of investment industries having monopoly character.

(7) improving the efficiency and profitability of public sector enterprises by cutting down overheads, reducing wastage and losses, increasing productivity of labour and capital and toning up management.

(8) promote export oriented industries.

(9) make extensive and effective use of local resources, skill and know-how and minimise indigenous manufacturing content as quickly as possible.

The increased role of private sector which was emphasised in the new industrial policy accentuated the need for a restructuring of the country's trade and industrial policy framework. The inherent objective was to replace the previous pervasive system of public control mechanism and create conditions that would encourage private investment and growth.

Policy changes later provided for a growing role of the private sector to attract foreign private investment. The Foreign private Investment (Promotion and Protection). Act of 1980 was drawn to enable increased collaboration with local investors. Besides, liberal terms and incentives were made to foreign investors in the Export Processing Zone.

The NIP was further relaxed in 1986, and the Revised Industrial Policy (RIP) made further relaxation and changes in which all industries except seven strategic industries of the reserve list were opened for private investment. The industrial

policy announcement made in July 1991 reiterates the objectives of the NIP and the RIP of achieving a rapid expansion of the private sector and for its transformation into a more competitive market economy. To solve the existing problems of the industrial sector, some additional institutional and policy changes were proposed in the 1991 policy. A major goal of the 1991 industrial policy is to increase efficiency and productivity in the industrial sector by transferring public sector industries to the private sector. The objective was to further strengthen the process of industrialization, and the sanctioning procedure was further simplified. No approval will now be necessary to set up industries and for BMRE with funds from private banks or private financial institutions. Investment incentives for export-oriented and export-linkage industries have been expanded and simplified. The major policy instruments for speedy and effective implementation incorporates :

(a) Control of Investment

(b) Investment sanctioning procedures.

(c) Import control

(d) Simplification of import procedures.

Now we shall try to present an evaluation of the structure, growth and performance of the manufacturing sector in Bangladesh since independence. An accurate assessment of the structure of Bangladesh's manufacturing sector and its changes in the recent years is very difficult because of the lack of reliable and

comprehensive industrial statistics. Four groups of industries,. viz.,large industries, small industries, cottage industries and; handloom industries can be mentioned. The limited data available relates mostly to large-scale industries covered by the annual Census of Manufacturing Industries (CMI), The source of information on small industries (which employ 10-20 persons per unit with power or more than 20 persons with power) is the Survey of Small Industries (SSI) which was conducted in 1978/79. Information on cottage industries (non-handloom) is based on the Survey of Cottage Industries (SCI) which was conducted for 1980/82. Finally, for the handloom industry, basic information is available from a 1978 census of such industries[63].

Using data from the aforementioned sources a rough estimate was made in a recent study to describe the structure of manufacturing for 1981[64]. It was seen that the modern manufacturing sector comprising large-scale units employ only 18 percent of manufacturing labour force but generates 58 percent of value-added. Eighty-two percent of manufacturing employment and 42 percent of value-added originate in small and cottage industries. The value-added per worker in cottage industries is only 40 percent of that in small-scale industries indicating that the majority of industrial labour force are employed in jobs with very low productivity. At the same time, it can be seen that the average size of large-scale establishments (in terms of employment) in the public sector is 26 times larger than that in the

63) **Apart from CMI, other survey data are published at long intervals.**

64) **BIDS Study: The Structure and Performance of the Manufacturing Sector, 1982.**

private sector, but value-added per worker in the former is only marginally (only by 21%) larger than the latter. This implies that the larger size of public sector enterprises has not led to economies of scale reflected in proportionately larger labour productivity.

The relative importance of various industries is shown in another studywhich shows that textiles (which covers cotton and jute) is the largest industry with 33.8% of manufacturing value-added, 27% of gross output, and 61% of manufacturing employment[65]. This is followed by chemicals (17.4% of value-added and 7.1% of employment), food (11% of value-added and 10% of employment) and tobacco (10% of value added). As can also be seen in that study, these are the very industries which were dominant in the pre-independence period as well, and have over the years continued to account for about three quarters of manufacturing value-added. The production of wearing apparel in the recent years has become an important employment generating activity but it contributes only less than 2 percent of total manufacturing value added[66]. This indicates that the two decades of industrialization efforts in Bangladesh has not brought about any significant structural change in its manufacturing sector. Moreover, the aforementioned study also shows that the industry's relative share in all major sectors, viz., food, textiles, tobacco and basic metals exhibit wide fluctuations from year to year. No sector

65) **A.R.Bhuyan and M.A.Rashid, Trade Regime and Industrial Growth; A case study of Bangladesh (Dhaka: Bureau of Economic Research, 1993), Table 4.2.**

66) **Ibid.**

appears to have grown consistently except chemicals the share of which in value added rose from 12 percent in 1973/74 to 17 percent 1987/88. In terms of the relative size of other major sectors the structure of large scale manufacturing production has thus changed only marginally in recent years.[67]

That there has not been any significant change in the structural composition of manufacturing value-added in Bangladesh despite two decades of industrialization efforts becomes evident if the changes in the share of various industries are assessed on the basis of the end use of their products. Data presented in the study just mentioned shows that the share of capital goods in manufacturing value-added declined from 7 percent in the pre-independence period to as low as 2 percent in the middle of the eighties. The share of intermediate goods has registered only a slight upward change indicating a clear dominance of consumer goods (Table 4.1). This is indicative of a negligible progress achieved in import substitution and a slow overall progress towards the path of self-sustained growth.

STRUCTURE OF FOREIGN TRADE

IMPORTS:

Growth of the manufacturing sector usually brings about important changes in the structure of a country's foreign trade, present efforts at industrialisation in Bangladesh have also brought about some structural changes in the country's exports and imports but such changes cannot in any way be called remarkable.

67) **Ibid, Table 4.3.**

The study by Bhuiyan and Rashid shows that while the composition of Bangladesh's imports underwent a significant change in the immediate post-independence years, there has been little change in the structure of imports thereafter, although year to year variations have occurred in some categories of imports[68].

Thus, both capital goods and intermediate goods import remained at around a quarter of total imports during the whole of the eighties. Imports of foodgrains fluctuated widely, depending upon the local availability of foodgrain and performance of the crop sector in domestic production. Although for two decades now the government's declared policy has been one of attaining self-sufficiency in foodgrains, the target remains elusive, and it is unlikely that the country's import dependence will decline to any significant extent in the near future. The import of capital goods which include machinery and transport equipment has depicted a rising trend in the second half of the eighties. Domestic capacity in these lines of production being extremely limited, requirements of capital goods necessitated by planned development efforts must be met with external supplies, and hence a continuous increase in such imports is inevitable[69].

The share of imports of intermediate goods in total import has decreased in the recent years indicating some amount of import substitution in some items in which domestic production exists, such as petroleum products, fertilizer and yarn.

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68) **Ibid, Table 4.5.**

69) **Ibid**

Petroleum is, however, non-competitive with domestic production, and the declining trend in petroleum imports merely reflects a fall in oil prices as well as the country's increasing use of domestic natural gas resources. In the long run, however, a decline in the share of petroleum in total import is unlikely[70].

The residual category of imports that covers other consumer and intermediate goods has shown a rising trend in both absolute and relative terms. Bulk of the imports under this category is in the form of raw materials and current inputs the demand for which will increase as development proceeds. Some import substitution is likely in some of the manufactured consumption goods under this category, but since such substitution will be partly offset by increased imports of intermediate goods, overall imports under this residual category will continue to increase.[71]

EXPORTS[72]

In contrast with imports, a significant structural change has occurred in Bangladesh's exports in the past two decades.

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70) **Ibid**

71) **Ibid**

72) **Based on the test and data presented In A.R.Bhuyan and M.A.Rashid Op.Cit.**

Table: 4.1

STRUCTURE OF VALUE ADDED IN MANUFACTURING INDUSTRIES BY END-USE OF PRODUCTS (%)

Industry Type	Share in Manufacturing Value-added			
	1969/70	1979/80	1985/86	1989-90
Consumer Goods	56	59	59	62
Intermediate Goods	37	35	39	34
Capital Goods	7	6	2	4
Toal	100	100	100	100
Source: A.R.Bhuyan and M.A.Rashid of et al, Table 4.4				

Immediately after independence (i.e., in 1972/73), jute in raw and manufactured form comprised over 90 percent of Bangladesh's total exports. The remaining 10 percent was covered by leather, tea, shrimps and newsprint. In 1989/90, the share of jute and jute goods fell to under 30 percent. The dramatic reduction in the share of jute in total exports was due to the increase in two items, viz. ready-made garments, and shrimps and fish. The share of ready-made garments increased from virtually nothing in 1972/73 to 40 percent in 1989/90, while that of shrimps and fish rose from 1.3 percent to 9.5 percent during the same period. The remainder of the reduction in the share of jute was made up by some increase in the exports of leather and leather products, fertilizer, naptha, bitumen and some other minor exports.

The growth of exports of shrimps and fish products has no doubt been rapid since independence, but that of ready-made garments has indeed been

remarkable. As will be seen later, the expansion of the exports garments and other non-traditional items including leather and leather products has been made possible by a favourable exchange rate policy and a number of other policy incentives to promote exports. Traditional exports, such as jute and tea, on the other hand, performed poorly because of adverse price movements and unfavourable international market conditions. Because of these disparate trends, the share of non-traditional exports in total export earnings rose from 12 percent in 1979/80 to 56 percent in 1989/90, while the share of traditional items (jute, jute goods, tea, and leather goods) fell from about 88 percent to 44 percent over the same period[73].

It is worth mentioning, however, that although the garments industry has visibly become the largest source of foreign exchange earnings, it has also been very greatly dependent upon foreign sources for supply of capital, technology and current inputs. A recent study shows that the material cost per unit of output in the garments industry is about 70 percent, indicating a very low value-added[74]. Since the materials used in production are almost entirely imported, the net foreign exchange earning per unit of export is thus necessarily low. Nevertheless, the garment industry has been of great significance to the economy of its ability to provide employment to a great number of semi-skilled and unskilled labour, especially the women workers.

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73) **Ibid, Table 4-6**

74) **A.R.Bhuyan et al. Bangladesh's Cotton Textiles Industry : Constraints and Policy Options, Dhaka University, 1987**

The change in the composition of exports as illustrated in the foregoing analysis does not,however, indicate any diversification of the country's exports base. Exports are still heavily concentrated on a few items, the emphasis now having shifted from raw and manufactured jute to ready-made garments, leather, and frozen food products. Moreover, the changing structure of exports in the recent years is characterised by a steady increase and dominance of consumer goods. **Table-4.2** classifies exports by type of product categories shows that the share of consumer goods in total exports has steadily increased : from 21% in 1979/80 to 67% in 1989/90. The share of intermediate goods during the same period fell from 79 percent to 32 percent, the fall having been solely due to the decline in the share of jute and jute products. The share of capital goods in total exports has remained insignificant, rising from 0.1 percent in 1972/73 to a mere 1.3 percent in 1989/90. The structure of the country's foreign trade thus reflects the structure and level of its industrialization which, as has been seen earlier, is still at a very early stage of development.

Table - 4.2

CLASSIFICATION OF EXPORTS BY TYPE OF COMMODITIES (%)

	1969/70	1977/78	1979/80	1984/85	1989/90
Consumer Goods	8.7	25.0	21.1	37.6	66.6
Intermediate Goods	91.2	74.8	78.7	61.4	32.1
Capital Goods	0.1	02.	0.2	1.0	1.3

Table-4.3

Relation of Production to Imports of Major Manufacturing Industries

Industry	Percent of Production in total Supply			
	1976/77	1980/81	1987/88	1988/89
1. **Food and Tobacco**				
Sugar	77.5	45.9	64.5	41.6
Soyabean oil	15.9	36.1	6.6	10.0
Cigarettes	92.9	99.8	99.7	99.9
2. **Textiles:**				
Cotton Yarn	63.3	83.7	85.9	83.8
Cotton Cloth	83.8	62.9	51.3	34.0
3. Paper and Paper Products	90.1	85.1	81.1	69.5
4. **Fertilizer**				
Urea	95.9	72.9	99.7	98.1
TSP	66.8	20.0	33.9	31.7
5. Cement	54.3	44.2	17.9	17.2
6. Diesel Engine	6.9	16.9	24.2	n.a
7. Pumps	42.2	31.6	24.2	n.a
8. Television Sets	69.8	51.1	19.9	60.5
9. Radio Receivers	97.3	83.2	68.3	72.6
10. Motor Cycles, Scooters etc.	57.2	78.5	39.0	32.9
11. Commercial and Heavy Vehicles	27.1	31.8	23.6	9.0

Source: Reproduced from A.R.Bhuyan and M.A. Rashid of op. Cit. Table 4.8

TRADE AND GROWTH IN MANUFACTURING

The simplest way of evaluating the performance and the changing structure of a country's industrial sector is by relating domestic production to total supply (domestic production plus imports) as well as to exports. An increase in the ratio of domestic production in an industry to total availability (supply) provides a measures of import substitution in that industry, and an increase in the ratio of exports to total production can be taken as an indication of either successful export promotion or a favourable movement in foreign demand. Insufficiency of data on the volume of production and trade of all manufacturing industries does not enable us to calculate these measures across industries. By using the limited data available, an attempt has been made to estimate these ratios for some specific industries which are presented in Tables-4.3 and 4.4.

Table-4.4

RELATION OF PRODUCTION TO EXPORTS OF MAJOR MANUFACTURING INDUSTRIES

Industry	Percent of Production Exported			
	1976/77	1980/81	1987/88	1988/89
Jute Goods	94.0	87.4	88.2	85.0
Urea	--	11.8	15.0	32.1
Tea	86.4	73.0	68.3	36.3
Molasses	17.5	24.5	22.0	52.3
Newsprint	49.3	54.3	28.5	17.5
Paper	8.6	5.2	14.3	9.0
Raw Yarm	21.8	12.8	10.1	10.4
Naphtha	75.1	115.7	86.9	89.8
Furnace oil	25.2	23.9	12.8	13.0
Source: As per Table 4.3				

It can be seen that significant import substitution has been achieved only in a few consumer goods and intermediate goods industries. These are cigarettes, cotton yarn, urea fertilizer, paper, and radio and television sets. For most other products, the achievement is negligible - consumer goods like food items and cloth,

intermediate goods such as cement and TSP fertilizer, and capital goods in general. Some of the items showed rapid import substitution in the earlier years of restricted import regime but in subsequent years the ratio of domestic production to total supply declined due to a more liberal import policy and easier accessibility to foreign exchange in the secondary exchange market and possibly also increased flow of assistance.

Regarding exports, it can be seen from the above table 4.4 that the ratios of exports to the output of some traditional industries such as jute and tea are high. So is the export of naphtha. Urea exports have registered a steady increase, and with the planned expansion of the industry, its exports may continue to increase. The export intensity of newsprint and paper has fallen because of poor competitiveness in respect of both quality and price. The decline in the growth of tea export has been due to inelastic foreign demand as well as its low quality. For most other products world demand is sufficiently high, but the ratio of exports to production is low because of constraints on the side of supply.

Appropriate incentives to expand local production and policy measures for removing the anti-export bias should help achieve a considerable expansion of the country's manufactured exports.

INDUSTRIAL PERFORMANCE

Table-4.5 presents some selected indicators of industrial activity based on the limited historical information available on the past performance of the

manufacturing sector. It shows that in the past one and a half decade output growth in various sectors has followed a dissimilar pattern. Some sectors grew at very high rates, some only mildly, and some sectors exhibited negative growth rates. In food manufacturing, shrimps and edible oil have had the highest growth rate. In beverages, foreign liquor and soft drinks grew at some respectable rates but other products have witnessed a decline. The textiles, the largest sector, stagnated and in fact cotton cloth manufacturing has seen a negative growth rate. Intermediate goods industries like urea, TSP, paints and varnishes had some goods measure of growth. Among capital goods, certain non-electrical machinery (pumps) and electrical goods have shown fairly high growth rates but basic metals stagnated. By and large, data indicates that industries that have shown high growth rates have relatively low weights in total manufacturing output.

Table - 4.5

Growth Rates[a] of Selected Industrial Products 1974/75 to 1988/89

Broad Insutry Product Category Category		Weights[b]	Average Annual Growth Rate 1974/75-1988/89
Food	Shrimp, froglegs	1.09	10.2
	Sugar	5.68	0.7
	Edible Oil	1.10	9.3
	Tea (black)	3.64	2.3
Beverage	Rectified spirit	---	-3.0
	Other spirit	0.37	-6.3
	Foreign liquor	---	11.4
	Country liquor	---	5.9
	Soft drink	0.28	13.6
Tobacco	Cigarettes	2.09	2.2
Textiles	Cotton yarn	6.75	1.2
	Cotton cloth	1.58	-1.3
	Jute hession	---	1.6
	Jute Sacking	30.19	3.9
	Carpet backing	---	3.9
Paper and Paper Products	Writing Paper	---	0.8
	Printing Paper	---	3.6
	Packing Paper	1.60	1.7
	Newsprint	---	2.9
	Partical Board	---	-.30
	hard Board	---	1.0
Rubber Products Chemicals	Cycle tyres & tubes	0.82	3.9
	Urea fertilizer	---	24.3
	Amonia	6.54	4.5
	TSP	---	11.0
	Paints & Varnishes	0.34	25.6
	Safety matches	1.82	5.5

Broad Industry Product		Weights[b]	Average

Category Category			Annual Growth Rate 1974/75-1988/89
Petroleum Products Non Metalic mineral products	Refinery	0.20	0.2
	Glass Sheet	0.11	4.9
	Cement	0.69	14.0
Basic Metals	Iron and Steel	9.56	1.5
Non Electrical	Diesel Engine	0.20	-9.0
Machinery	Pumps	0.20	16.8
Electrical Goods	Ceiling Fans	0.40	8.7
	Bulb	0.18	15.0
	Radios	0.11	7.4
	Television	0.13	26.3
	Electrical Motors	0.40	4.0
	Telephone sets	0.12	15.6
Transport equipment Other Manufacturing	Buses, trucks and cars	0.78	1.6
Industries	Jute Pressing	0.61	14.6

Source : As for Table 4.4

a) Output volume in physical terms has been used in calculating growth rates.
b) Weights of each industry in total manufacturing gross output as of 1981/82.

The total manufacturing output of these industries may also be due to the very low base from which they started production. On the other hand, industries carrying high weights in manufacturing production, such as, sugar, textiles, iron and steel, tea, and tobacco, grew only nominally or have exhibited negative growth rates. Overall,

the manufacturing sector can thus be said to have grown only marginally over the past few years.

The poor performance of the manufacturing sector is also confirmed by data on the growth of real gross output and value-added presented in the study by Bhuiyan and Rashid[75]. The growth rates of real gross output exhibit such wide fluctuations from year to year that the under-lying long-run trend growth rate is difficult to interpret. The average annual growth rate of gross output during the 1974/75-1987/88 period was found to be only 5.2 percent. The trend in real value-added was far less satisfactory, the overall growth being only about a third of the growth rate of gross output. One plausible explanation behind the relative decline in value-added could be the increases in intermediate input prices which could not be passed on to product prices due to competitive pressure as well as inappropriate pricing policies followed by the public sector corporations which owned bulk of the large-scale enterprises and thus had a pervasive influence over the manufacturing activity in Bangladesh.

Be that as it may, as a result of the decline in value-added (while substantial increases occurred in the use of capital and employment of labour in production), the real income received by the primary factors of production has also decreased.Table-4.6 shows that the decline income originating in the manufacturing

75) **A.R.Bhuyan and M.A.Rashid,Ibid, Table 4.1**

sector has been shared by both labour and capital. Historically, both real wage and the real rate of return on capital employed in manufacturing in Bangladesh have declined since independence. With substantial increases in capital together with its declining share in gross output,the real rate of return on captal must have declined in the subsequent years as well. Likewise, real wages of labour in manufacturing fell by about 11% between 1969/70 and 1987/88. Labour productivity also declined in most major industries as is indicated by data presented in the table. The table shows that in each of the industries, productivity of labour has steadily declined and very greatly so in the largest sector textiles.

Table-4.6

FACTOR SHARES IN GROSS OUTPUT

	1969/70	1973/74	1978/79	1983/84	1985/86	1987/88
Labour's Share	.1218	.1701	.1209	.0938	.1178	.1240
Capital's Share	.3480	.3298	.2575	.2780	.2739	.2410
Source: As far table 4.4						

Note: Labour's share in gross output equals labour-output ratio (inverse of labour productivity)multiplied by the real wage in terms of the product price. Similarly, capital's share in gross output ratio (inverse of capital productivity) multiplied by the real rate of return to capital in terms of the product price.

The inefficiency of the manufacturing sector is also indicated by the low rate of capacity utilization and the poor financial and economic performance of the public sector industrial enterprises (Table 4.7).

Table-4.7

Capacity Utilization in Major Industries (% of installed capacity)

Industry	1969/70	1976/77	1984/85	1988/89	1992/93
Jute Goods	74	68	49	48	
Cotton Yarn	79	67	66	70	
Sugar	55	82	45	57	
Cement	53	80	56	80	
Fertilizer (Urea)	91	62	48	68	
Steel (ingot)	22	40	40	35	
Paper & Newsprint	69	37	97	96	
Chemicals	10	54	68	75	

Source: BBS: Planning Commission, Fourth Five Year Plan 1990-95

In the 1950s Government policies encouraged the ereation of exess capacity. After independence, the West Pakistani market was lost and some industries faced the problem of even more excess capiacity. Increasing the rate of capacity utilization has always been a policy goal of the government but, as can be seen in table 4.7, the problem persists in most major industries.

Reasons for low capiacity utilization vary from industry to industry. Nevertheless, a number of common factors can be identified. Among the major causes are: (1) lack of effective demand for industrial products due to slow growth of agricuture, slow economic activities and hence lower income of the people;

(2) shortage of foreign exchange for importing raw materials and inputs for import intensive industries (like steel, cement, petroleum etc.); (3) low agricultural production that causes irregular and insufficient supply of raw materials to industries which use domestic raw materials (like jute, sugar, tea, frozen food, leather, etc); (4) inadequate domestic infrastructure (power, transport, etc.) which interrupts the efficient and proper operation of industrial units; (5) inadequate maintenance of plant and machinery due to financial constraints, lack of adequate skilled manpower and use of obsolete technology; and (6) strained labour-management relations that result in frequent work stoppages. In addition, the poor management of public sector enterprises which suffer from bureaucratic rigidities and inadequate training and experience and their inconsistent pricing policy amid rising cost of production result in under-utilization of production capacity.

In Bangladesh, the success of the manufacturing sector hinges very greatly on the performance of the public sector enterprises which together currently account for about 40 percent of total fixed industrial assets of the country. However, as is extensively quoted, public sector corporations have incurred heavy losses since independence. Instead of contributing to the growth of GDP and domestic resource mobilization the public sector enterprises have become a burden on the economy through poor performance. Furthermore, because of their inter sectoral linkages, the poor performance of the public enterprises also affect capacity utilization in other sectors as well.

The poor financial performance of the public sector enterprises can be ascribed to a number of factors, the most important of which is the pricing policy pursued by them. The current practice is to set output prices on cost-plus basis with the exception of certain products (such as newsprint and cotton yarn) where the government deliberately sets the prices below costs in order to subsidize consumers. Prices, therefore, lag behind costs resulting in inadequate cost recovery on the products and services they produce. Other factors causing poor performance of the PSEs are the legacy of large-scale capital-intensive industrial investments that generate marginal or even negative returns; inadequate efficiency of operation in many lines of production; and low productivity which in some cases is due to a deterioration of capital stock through lack of adequate maintenance and investment for replacement and in other cases, due to over-manning which leads to high labour costs.

To sum up, an analysis of the structure and performance of Bangladesh's manufacturing industries reveals that the manufacturing sector is relatively undiversified and characterized by structural dualism. The lion's share of the total manufacturing value-added originates in large-scale industries, although bulk of manufacturing employment is in small and cottage industries. Despite recent measures of denationalization and disinvestment, bulk of the large scale industrial enterprises is owned and controlled by the public sector. The manufacturing sector is characterized by dominance of consumer goods industries even though there has

been some upward trend in the share of intermediate goods industries. The capital goods industries account for a negligible share of total manufacturing value-added.

The growth rate of real gross output has been declining in the recent years. The growth rate in the eighties was significantly lower than in the 1970s. The decline in value-added has resulted in a fall in factor incomes. Both real wages and real rates of returns to capital fell considerably. Also the deceleration in the rate of growth of output while the rate of growth of capital and employment of labour in manufacturing accelerated implies a decline in factor productivity. The rate of capacity utilization is low, and the poor performance of the public sector enterprises imposes a heavy burden on the national budget thereby making little contribution to the growth of GDP and domestic resource mobilization.

The poor performance of the manufacturing sector can be attributed to a number of factors. First, the country at the time of independence inherited an industrial structure which was vastly devastated by the ravages of the liberation war. Secondly, external shocks such as the oil price increase, adverse movements in terms of trade, and other domestic factors such as fluctuation of agricultural output and limited availability of foreign exchange contributed significantly to the poor performance. However, a part of the poor performance can be attributed to the policies followed by the Government. The pervasive influence of the Government in the manufacturing sector of Bangladesh through its control on all facets of manufacturing activity especially over industrial investments and foreign trade must

have directly and indirectly contributed to the poor performance of the industrial sector.

Recent Trend in Trade Policies:

Trade has been an important part of the comprehensive stabilization and reform program that Bangladesh has been implementing since 1992. In contrast to the piecemeal reforms of the 1980s, significant steps have been taken during the 1990s to liberalize Bangladesh's trade regime. In the late 1980s, prohibitive tariffs and quantitative restrictions resulted in underinvoicing and smuggling. Most tariffs were not binding, and there was a high incedence of "water in the tariff" - tariff redundancy which results from smuggling and prohibitively high tariff rates. In some cases, "statutory" levels of protection were higher than the observed levels of protection, as measured by the difference between world and domestic prices (for most goods, domestic prices were lower than the tariff-adjusted world prices). And in many others, competing imports were of higher quality than their domestically manufactured substitutes since domestic producers often compromised on quality to keep their prices below that of competing imports.

A large part of the trade reform effort so far has resulted in reducing the "water in the tariff" and bringing statutory levels of protection closer to observed levels. It has also reduced the average tariff burden on imports. Average nominal protection, measured as the average of all import duties and protective taxes, has fallen from 89 percent in 1990/91 to 25 percent in 1995/96, as seen in the following

table 4.8. However, nominal protection, as measured by import-weighted average protection rates, has declined since 1990/91, but by much less (21 percentage points) than the decline in unweighted average protection rates (64 percentage points). The practice of granting tariff concessions and exemptions based on end-use has slowed the move toward simplification of the tariff schedule.

Table-4.8

Trends in Nominal Protection, 1990/91 to 1995/96 (percentage of assessed value)

	Agriculture	Mining	Manufacturing	All Tradables
Pre-reform, 1990/91				
Unweighted	90.5	54.1	89.0	88.6
Import-weighted	20.9	24.0	51.8	42.1
Dispersion (CV)	63.3	51.7	58.6	59.0
Post Reform, 1995/96				
Unweighted	26.0	13.6	24.6	24.6
Import-weighted	10.1	38.8	21.9	21.0
Dispersion (CV)	56.7	82.2	73.5	72.7

Source: Trade and Tariff Reforms in Bangladesh, World Bank, Dhaka

Other reforms have steadily dismantled a complicated structure of import controls, though a crucial industry, textiles, remains protected. A voluntary preshipment inspection scheme supplements the use of rigid tariff values for import valuation.

As a result of such reforms, effective protection has decreased for most industries since 1992. But because effective rates of protection for the steel and engineering and food and dairy industries increased significantly, aggregate effective protection fell only 15 percent between 1992 and 1995. Observed average effective protection rates indicate that trade policy reform has not shifted incentives firmly towards the production of exportables.

Where export production has succeeded, it has been because a special environment, insulated from the prevailing trade regime, has fostered rapid growth. This environment, created through the use of various export promotion schemes, has assisted in providing world-priced inputs to exporters in the absence of general trade policies that would do the same for all would-be exporters. Schemes such as the special bonded warehouses and exports processing zones (complemented by other factors, such as quotas under the Multi - Fibre Arrangement and an innovative financing scheme) have allowed Bangladesh to use its abundant labour resources to develop an efficient ready-made garments industry, which accounts for over 50 percent of gross exports from Bangladesh. This impressive success has yet to be replicated in other industries, however, and Bangadesh's export base remains narrow.

Trends in Industrial Policy Reforms:

Over the years, emphasis on the private sector continued to gain importance and momentum. Since the 1990s, privatization has been a major aspect of the

country's industrial policy. Enormous incentives were also put forward by the Government to attract both foreign and local investment,and in speeding up the privatization programme. In fact, the privatization programme has emerged as a critical element of the on-going economic reform agenda of the Government.

Chapter-V

COMPARATIVE ANALYSIS OF IMPORT-SUBSTITUTION AND EXPORT PROMOTION STRATEGIES

In this chapter,we have sought to analyse the following:-

A) An Evaluation of the need for Export Oriented Industrialization vis-a-vis Import Substitution in Bangladesh.

B) An analysis of the Extent of Industrial Protection enjoyed by selected manufacturing industries in Bangladesh.

C) Export expansion Vs. import-substitution as a Development Strategy - A Comprehensive Analysis.

A. An Evaluation of the need for Import-Substitution and Export-oriented vis-a-vis industrialization:

a) Evaluation of export-oriented industries:

It would perhaps be safe to say that not much import-substitution has actually taken place in Bangladesh. On the contrary, like many other developing countries Bangladesh has followed a policy of restrictive access to imports as a means of rationing scarce foreign exchange, allocating it to priority areas and also as a

means of protecting vulnerable local industries from import competition. It may be relevant to mention here of the foreign exchange allocation system and the Import Policy order. The existing policy framework was set up to cope with conditions of extreme shortages of foreign exchange which have existed for much of the period since independence. Following the significant steps which have been taken to set a realistic exchange rate and to manage the economy so as to build up reasonable foreign exchange reserves, some people have reason to believe that it should be desirable to relax, to some extent, the complex set of import and foreign exchange restrictions which currently represent serious obstacles to efficient growth of the manufacturing sector. Over the years, there has been some reforms of the import policy regime. The most significant innovation was the introduction of the option of financing imports through the secondary foreign exchange market where supply and demand determind the price of foreign exchange. A considerable proportion of imports however remained subject to administrative regulation and control. The Government took a number of further steps in the direction of import-liberalization in 1984 by expanding further the list of importables such as foodgrains, coal, fertilizer etc. All items which could be imported by industrial or commercial importers were also eligible for import under the WES and the XPL (Export Performance Licence) Schemes.

On the other hand a number of imports which competed with domestic production were banned by the Government with the express purpose of protecting domestic industries.

Incentive for export oriented activities has been strengthened primarily through modifications in the duty drawback system and in the Export Performance Licence which however does not exist now. Export financing facilities as well as provisions to provide institutional credit to export-oriented industries have also been provided. The Government's thrust on the export-expansion programme gained momentum over time. The export sector received priority attention, as part of the Government's efforts to rationalize trade and industrial policies. Inspite of the inherent and structural limitations in boosting economic growth only through emphasis on export-promotion measures, the overall performance of exports in relation to Bangladesh's long term perspectives of growth needs in earning enough foreign exchange remains fundamentally weak. The level of exports continued to lag considerably behind that of imports. Given the likely and expected external aid levels, exports are needed to permit increased imports of current and capital inputs essential in the very process of development. Over the longer run Bangladesh's development strategy will need to accommodate a gradual reduction in the current heavy dependence on external aid to prevent import shortages from deterring development efforts.

The trade regime generates industrial incentives which are highly product specific and depends largely on ad-hoc policies. The government can provide differential protection to import competing industries by varying the import-quotas and the commodity specific rates of duties. Domestic industries are also provided protection through the allocation of import licences which gives them access to imported inputs and machinery at the official exchange rate. Protection is also provided through differentials in the sales tax on imported vis-a-vis domestically produced goods. Studies reveal among other things, that many industries, particularly those consumer goods industries that are highly intensive in the use of imported inputs, are seen to have no comparative advantage[76]. To a large extent, this reflects the highly inefficient industrial base that Bangladesh inherited from Pakistan.

Another significant aspect is that while some of these inefficient industries continue to enjoy high rates of protection under the present tax structure, many sectors which seem to have long-run comparative advantage enjoy relatively low rates of protection (e.g. cotton textiles, footwear; bicycles. In its net effect, the present system has also a strong bias against export vis-a-vis import substitution.

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76) **W. M. Corden, "The Structure of a Tariff System and Effective Protective Rate", Journal of Political Economy, 1966**

As part of Government's efforts to synchronise between trade and industrial policies, the implicit bias in favour of the export sector is obvious. This is inspite of the fact that overall performance of exports in relation to Bangladesh's long term needs to earn sufficient foreign exchange to bridge savings-investment gap remains fundamentally weak.[77]

Apart from the emphasis on the export sector there is also reason to believe that the alternative basic development approach which Bangladesh has tenaciously pursued since independence is encouragement of growth along lines of import-substitution. Although this has been a commonly adopted approach in the early stages of industrialization, limitations of this approach to generate sufficient level of growth have widely been felt.

Government efforts to reduce the existing policy bias against exports could proceed through an increase of export incentive which will simultaneously bring a rationalization of the general level of effective rates of protection for import-substituting industries and thus TIP has put forward separate recommendations to rationalise the structure of assistance to almost all important import-sbustitution industries. Unless therefore a move is taken towards a rationalised structure of assistance for these industries, the heavily protected import-substituting industries will continue to use a disproportionate share of the ratio of scarce resources at the cost of the relatively more efficient sectors of the economy.

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77) **Govt. of Bangladesh, Ministry of Industries, New Industrial Policy, 1991**

It has therefore been stressed in the TIP study that imports should be allowed with adequate tariff protection to help increase efficiency in local production so that local products became more competitive, both in quality and price.

It has been observed that Government's protective trade and industrial policies can create distortions in factor markets. Such distortions may lead to the following undesirable effects:-

- by increasing the cost of imports or replacing imports with higher-cost domestic production, they increase the cost of domestic production and thereby retard economic growth ;
- by encouraging relatively less efficient (cost-effective) production activities, they result in less than potentially achievable growth with the same amount of available resources;
- by limiting competition, they provide no incentives for operational efficiency and technological change;
- by making available less foreign exchange resources than are usually associated with a more reformed structure of incentives, they limit the prospects for further growth to the extent foreign exchange serves as a constraint on growth; and

- if further growth leads to greater investment in the economy the distortions deprive the economy of such dynamic gains also.

The distortions are sometimes observed to have also other undesirable effects : less employment under a more capital-intensive structure of production and lesser equal distribution of income under import substitution-oriented strategy.

It has also been asserted that protection adversely affects the growth of an economy through its effects on savings (investment). The loss of potential income through the cost of protection results in reduced per capita incomes and may cause a further decline in income growth due to the fact that higher saving ratios are generally associated with higher per capita income levels.

In developing countries including Bangladesh where there is widespread unemployment, a more rapid growth of manufacturing output associated with export expansion along with a more labour-intensive character of such growth will lead to greater employment. This higher employment together with the fact that this often goes with higher real wages will also lead to desirable improvements in income distribution. In the countries studied by Balassa and associates, it was found that along with the decline in unemployment, real wages increased considerably in cases where exports expanded rapidly[78]. Furthermore, the lessened discrimination against agriculture under reformed trade and industrial policies also tend to reduce income inequalities.

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78) **Bela Balassa etal, Policy Reform in Developing Countries (New York: Oxford University Press, 1977)**

In addition to the benefits recounted above of a strategy that provides similar incentives to both import substitution and exports, one can say that such an industrialization policy aims at greater competition, provides incentives for technological change, product improvement and greater operational efficiency. Export industries are under pressure to introduce technical change to survive international competition. Likewise, subjecting import substitution industries to less protection and greater competition with imports will force them to become more efficient or to go out of business. Due to a low rate of technological change in countries that continue with import substitution behind high protection, total factor productivity is bound to be low.

Krueger points to the superiority of price over quantitative interventions and suggests that an outward-oriented strategy is generally accompanied by primary reliance upon pricing incentives as opposed to an inward-looking import substitution one which is, often characterized by a heavy reliance on quantitative controls. "The use of price measure limits the degree of variance (or dispersion) of the regime and makes the cost of policy interventions more apparent compared to the effects of official rates. There is, moreover, reason to believe that policies which provide incentives to individuals are considerably more effective than those which attempt to prevent them from undertaking profitable activities[79]."

Krueger further points out that policy mistakes are likely to be self perpetuating and the policy bias is likely to be intensified under an inward-looking strategy, the latter because more tenacious pursuit of import substitution requires embarking on more effective and costly activities, while an export-promotion strategy places pressures on policy makers that serve to limit the extent of bias[80].

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79) **A.O. Krueger, Op. Cit**

80) **Ibid**

The structure of tariff on imports and the control of imports through quantitative restrictions in Bangladesh have been historically based on considerations of the need to conserve foreign exchange curtailing excessive imports and imports where domestic production exists. There is also the need for maintaining a stable and principal source of government revenue. The existing tariff structure marks little basic departure from the one that was inherited from the Pakistan days.

The possible government revenue effects of inustrial assistance policy reform should be fully taken into account and the feasibility of devising possible revenue losses should be explored. Another relevant consideration to take into account is the possible impact of such policy reform on the balance of payments.

Traditional Measure

The recommended reformed structure of trade and industrial policies for Bangladesh as suggested in the Trade and Industrial Policy studies as outlined above embraces the following elements:

(1) Phasing out of bans and other QRs on imports and exports except in special cases;

(2) Chalk out a phased programme for instance over a period of three to five years, of reducing the high tariffs including those which replaced the QRs.

(3) There are a few products to which export prohibition is applied. Excise tax is more than 3.50 percent, we may stipulate its progressive reduction to these levels over this period by stipulating appropriate annual changes. Overall net

protective tariff over 50% is either counter-productive as it encourages smuggling or it leads to gross inefficiency in domestic production.

(4) Raise the tariffs which are now lower than 20-30% on many products, mainly primary products, to such levels over a period of time, say three to five years. This may raise problems for the government for products where it is presently providing subsidies and also for foodgrains where the government wants to keep the prices at low levels. But these problems can be overcome since government can still continue to subsidise explicitly with the higher revenue raised.

(5) Raise the export incentives to export products, to foreign sales of products which are also sold domestically and to sales of domestically produced materials used in export production to levels of 20%-30% of the FOB or equivalent value of exports. The scheme of reform of the export incentives as proposed by TIP can be implemented without difficulty. It hardly needs any time phasing. The study proposes that the government may proceed gradually if it likes but should move fast enough in this area since the export sector needs a lot more encouragement.

(6) Raise the government revenue increasingly depending on the domestic sources, especially raising the domestic excise taxes. Match always domestic excise taxes with equivalent revenue taxes on imports. This provides the opportunity to raise overall gross tariff on imports beyond the net protective levels suggested on relatively luxury goods.

(7) If it is feared that the reforms as proposed would lead to balance of payments difficulties, resort to an appropriate dose of devaluation to accompany the reforms. The kind of devaluation that will help trade and industry policy reform in Bangladesh, is called partially compensated devaluation, which is accompanied by a partial adjustment of tariffs.

The country is now following flexible exchange rate. The indications of existing distortions have prompted experts to suggest that Bangladesh should move towards 'a free trade' regime by devaluating its currency and reducing government intervention (fiscal or otherwise). But this may not be a feasible proposition from the following standpoints.

(a) There is definitely a strong case for reducing anti-export bias in respect of manufactured exports facing potentially elastic demand in the world market. But for most of the primary exports which suffer from supply inelasticities, a general export subsidy could only result in increasing taka prices and windfall profits to exporters.

(b) In some cases, it may lead to a misallocation of resources.

(c) A straight devaluation, with the existing rates of tariff would also have inflationary effects, raising the price of many wage goods.

(d) It would also be relevant to rectify the highly distorted structure of incentives (protection) provided to different types of import competing industries.

One of the suggested ways for an efficient tariff base is to relate protection to economic efficiency and not to eliminate protection. There will also be the need for renewing the specific subsidies from time to time to avoid excessive protection dealing with excessive profits. It is important to ensure that the tariff structure as at present has tended to become a mechanism by which the ex-post profitability of investment is ensured, rather than itself being an instrument for guiding investment decisions ex-ante.

The other important factor to be kept in mind is that in view of the extremely low rate of domestic savings in Bangladesh, a reform in the tariff structure has to be achieved without affecting the narrow revenue base of the Government. It would thus be necessary to evaluate:-

(a) the nature, extent and magnitude of import dependence,

(b) the nature and pattern of our emphasis on outward looking growth strategies - the performance of the export sector, the prospects and potentialities of growth through exports and import and the extent import dependence of exporting industries.

The nature, extent and magnitude of import-dependence of the Bangladesh economy primarily owes its origin to weak structural characteristics, the nature and state of the economy itself, its semi-stagnant production base and near-absence of adequate technology. The certain structural characteristics of the economy incorporating low levels of domestic savings, deficit in availability of foodgrains, undiversified manufacturing sector with inadequate capacity to produce import-substitutes and poor export capability have rendered the economy vulnerable to change in both the domestic and international sphere.

If we analyse the nature of this import-dependence, we find that this dependence is sustained, prolonged and considerable. For instance, as a proportion of GDP, imports have risen from 10% 1972-73 to 22% in 1980-81, to 39% in 1983-84, to 41% in 1984-85, 53% in 1986-87 etc. This depicts the critical nature of import-dependence. As regards foodgrains, imported foodgrains constitute on the average, 12-13% of the total

availability in the country while the public distribution system have fully relied on imports.[81]

The agriculture sector, which is predominant in its contribution to GDP is also heavily dependent on imports, even if relatively less dependent than the other sectors of the economy. Most of the important development programmes in this sector like the distribution of fertilizers, irrigation and pesticides depend on imports. Moreover, intensive rural works programme relating to infrastructure like embankments, canal excavation, roads and bridges, depend on imported food, under food for work programme.

The manufacturing sector depends on imports both for expansion of productive capacity and for utilisation of existing capacity. Thus it is evident that the stage and level of present and future industrial production is affected by availability of imports. The major manufacturing industries of the country, in terms of employment of industrial labour, is dependent on imports for full utilization of capacity for instance, the handloom industries rely wholly on imported cotton, yarn and dyes, jute mills depend on imports of spare parts while the entire chemical industry as well as the country's only steel mill depend on imports of raw materials and intermediate inputs. Even the expansion of productive capacity in manufacturing sector and increases in capacity of infrastructure, is also dependent on imports. Domestic substitutes of intermediate inputs or capital goods are virtually non-existent.

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81) **Bangladesh Bureau of Statistics; Statistical Yearbook of Bangladesh**

Taking into view the broader national perspective, the national budget is dependent on counterpart funds from commodity aid as well as revenue for imports. Thus the level of external assistance and imports is a critically important factor for the budget.

The ultimate analysis in this regard necessarily establishes the fact that Bangladesh suffers from a chronic structural imbalance in trade as a result of her perpetuated dependence on capital and other imports for development and economic growth. Her limited capacity for exports and low levels of savings renders her highly dependent on phased and programmed inflow of external resources to finance imports and investment. The deterioration in terms of trade has also been a major economic problem for Bangladesh [82]. Such deterioration has resulted mainly from rises in import prices in the face of constant and sometimes falling export prices.

Bangladesh is compelled to undertake variations in imports through exchange control and trade restrictions, for reasons of balance of payments. The use of exchange and trade control as instruments to vary imports does result in a direct relationship between import capacity and actual imports, though not necessarily one-to-one relationship. Since restrictions are used to control imports as an aspect of balance of payments policy, and domestically produced import-substitutes are unavailable, there has been a tendency for imports to determine output. Consequently, changes in import capacity affect the economy's growth potential adversely.

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82) **A.R.Khan, The Economy of Bangladesh, Oxford University Press, London, 1972**

In this context, it may be useful to assess whether drastic reduction in import capacity had differential impact on imports of different categories. Such variations normally depend on the extent of differential change in import prices and differential price elasticities. But in Bangladesh exchange control mechanism and lack of substitution possibilities (between domestic goods and imports) do not allow such a relationship. Instead, the discretionary decisions of exchange control authorities and changes in real value of disbursement of various types of 'aid' have come to determine the extent of variations among different categories of imports. The strategic importance of the various categories of imports, and the effect of the trend in the share of intermediate input in total imports, automatically leads one to conclude that such sustained import dependence have no doubt, a direct connection to debt-servicing.[83] Here a look into the structural composition of imports vis-a-vis the ratio of import-dependence will testify that the worst hit area is that of imported intermediate inputs. This is due to two reasons:

(a) firstly, all imported capital goods are a direct function of the extent of project assistance.

(b) secondly, most intermediate inputs (apart from raw cotton, cotton yarn, crude oil, fertilizers etc.) are financed by own export process. Consequently, the variability of Bangladesh's exports and the purchasing power of its receipts have a major impact on imports of intermediate inputs.

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83) **Government of Bangladesh : TIP Studies 1983-86**

For these reasons, when imports rise excessively, own export proceeds are used to finance a part of this import. Thus the reasons for continued and sustained import-dependence vis-a-vis the perpetuated debt-servicing obligations are obvious.

Since the early 1980s, Bangladesh has experienced a vibrant export growth. In the category of non-traditional exports, the economy averaged 20% growth per year during the 1980s. Although the considerable export potential of Bangladesh remains largely unfulfilled due to the lack of a more vigorous pro-export policy environment, it is equally true that economic reforms have attempted to address the fundamental shortcomings in export policy.

The relatively superior export performance in the 1990s than in the 1970s is mainly due to the rapid growth of non-traditional exports. Traditional exports did not grow at all in the 1970s and posted a sluggish growth of only 1.5% in the 1980s. This compares with a 24% average growth for non-traditional exports in the 1970s and 14% for the 1980s. Thus most of the average export growth of Bangladesh (14% in the 1970s, 19% in the 1990s and 16% in the 1990s) is accounted for by expansion of non-traditional exports.

It has been statistically established that virtually all export growth was accounted for by non-traditional exports and this contributed positively to the economy's growth performance.

An export expansion strategy for the future must therefore focus on consolidating the gains already attained in the non-traditional exports sector and must take effective steps to create new market opportunities globally and a supportive economic environment domestically.

Key ingredients of such a strategy may include:

a) Identification of activities with proven or potential comparative advantage.

b) Provision of a competitive cost structure to exporters by ensuring world-priced inputs (through an effective duty drawback scheme for dutiable imported inputs) and maintenance of real wages in line with productivity.

c) Elimination of any anti-export bias in the tariff and quota rationing regime by sealing down nominal and effective protection while removing quota ratio imposed for trade reasons.

d) Assurance of the profitability of export production through effective exchange rate management to yield a favourable real exchange rate to the exporter.

e) Streamlining of the regulatory and incentive framework while devising selective interventions for an export push.

As mentioned in the introductory part, until the recent past little attention was given to the growth and development of the export sector. The productive role of

exports in Bangladesh's future development was shrouded in a high degree of pessimism. The basis of the anti-export bias was (a) high concentration of the exports in few commodities; (b) structural rigidities in production causing low elasticity in the supply of major exports; and (c) low income elasticity of demand for Bangladesh's major exports and so on. In the absence of vigorous economic and diplomatic drives the export market remained narrow and historically a few traditional items dominated the composition of exports [84].

However, since 1978-79, there has been an increase in the share of non-traditional exports and all of these exports can legitimately be considered manufactures, the major share being accounted for by ready-made garments and processed food. For example, during 1977-78 to 1988-89 while total and traditional exports grew at annual average rates of 7.7% and 4.3% respectively, the growth in the same in the aftermath was a remarkable 25.1%. The growth of non-traditional exports, during the last few years, was astoundingly high at 33.3%.

A number of policies contributed to such a shift. The current incentive schemes are aimed at increasing, especially, the exports of non-traditional items. The schemes include, besides Export Performance Bonus Scheme, other important measures such as (a) access to tax-free imports of intermediate inputs used in export production by a variety of measures, (b) an easy access to imported inputs for some special products, (c) a more liberal and subsidised access to credit, (d) reduced taxes on machinery imports, and (e) special income tax concession. At the helm of all, a somewhat flexible exchange rate is followed.

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84) **M. Akhlaqur Rahman, Foreign Aid and Self-Reliant Growth - The Case of Bangladesh; Centre for Social Studies, Dhaka University, 1984**

However, the current policy prescriptions relating to the export sector are neither sufficient nor are immune from deficiencies. First, the overall effective assistance provided to the export-oriented industries is much lower than the import-substitution industries. The average effective assistance for export-oriented industries range drom 73% to 2% while that for import-substitution industries range from 200% to 400%.

An estimation of the Effective Exchange Rates suggests an anti-export bias of some 30% when all exports are considered against dutiable imports and one of over 30% when non-traditional exports are compared with dutiable imports. Even non-traditional exports do not seem to be specially favoured against traditional jute goods which are getting a larger level of assitance in terms of higher interest subsidy[85]. Second, these incentives confer sizeable benefits on only a few industrial activities such as readymade garments, finished leather and leather products, some specialized textiles etc. while most other activities and starved of such incentives. Third, export promotion policies may create bias against exporters using domestically produced tradeable inputs. Likewise, the access to bonded ware house facilities or to duty draw backs, are an incentive only to the extent that the exporter uses imported inputs. Thus an exporter who purchases domestically produced intermediate inputs which embody dutiable imports is discriminated against as compared to the exporter enjoying bonded wire house facility with no dutiable intermediate inputs.

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85) **Abdur Rab, Bangladesh Policies to promote Export, Paper prepared for the World Bank,1989**

The obvious conclusion that emerges is that the prevelent incentives are not adequate for exporting on the one hand and fail to encourage structural change and development of industrial linkage on the other. This calls for the creation of policy instruments that provide a positive incentive for export activities and for backward integration.

(b) An Evaluation of Import Substitution Industrialization in Bangladesh.

Early industrialization efforts in Bangladesh, as in many other developing countries, focused mainly on promoting import-substitution industries with little attention initially being paid to the expansion and diversification of the export sector. A low elasticity of foreign demand for the major exports, inter alia, provided a further justification to the bias toward import substitution. The problems of the export sector were unwisely over-emphasised and no sincere efforts were made to overcome them[86]. Excepting the last few years when export sector has been receiving some kind of a boost from the government, the universal trend of over-emphasizing import-substitution continued unabated in the post-independence era.

The experiences of countries which opted for an unduly emphasised inward looking strategy, however, establish that trade and industrial policies towards such strategy not only fail to build a dynamic industrial sector but also contribute little to bridging the balance of payments gap. It is now being argued that the strategy provides a spectacular growth at the beginning but later falls on its face and further expansion is contained by the built-in-bottlenecks.

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86) **A.Rab, Export Performance and Prospects and Government Policy of Promote Exports in Bangladesh", Bangladesh Journal of Political Economy, Vol.8, No.2, 1988**

Although generalization is difficult to make on the basis of the experiences of other countries, it may nevertheless, be useful to consider the relevance for Bangladesh of some of the reasons as to why heavy reliance on an inward looking trade and industry policy may result in limited success. The enquiry into the industrial policies of Bangladesh and the subsequent industrial structure so created, is expected to shed some light on whether the strategy of industrialization in Bangladesh should be inward and outward looking.

The extent of Import-Substitution (IS) in Bangladesh:

The measurement of the extent of import-substitution (IS) after independence requires a lot of quantitative exercise. However, a crude measure of the magnitude of IS might be obtained by looking at the percentage of the total supply (domestic plus import) met from domestic production, over different time periods[87]. Thus measured, it can be observed that, over seventies, the country has become more self-sufficient in the production of cotton textiles, fertilizer, cement, and drugs and pharmaceuticals. But for the supply of cotton yarn, transport equipment and other goods, the country now depends more on imports for meeting domestic demand.

The Structure of IS Industries by Economic Use

The long history of industrialization of countries now recognized as industrialized market economies bears evidence of a transition of industrial structure sequentially through three stages dominated successively by consumer goods, intermediate goods and capital goods industries[88]. Exception to this, however, has been observed in planned economies where ideology came to dominate history.

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87) **Atiq Rahman, Development Strategies and Productivity in Bangladesh, BIDS, 1985**

88) **W.G.Hoffman, The Growth of Industrial Economics, London, 1956**

The experience of Bangladesh with industrial development seems to be consistent with the pattern of such transition. Two phases of industrial development are discernible. First, prior to independence the share of consumer goods sector had been rising as this was the early phase of industrialization. As against this, the share of intermediate goods sector steadily declined. In the post independence period, the change in the industrial structure conformed to the universal pattern showing a shift away from consumer goods to intermediate goods, and also slightly to capital goods. Notwithstanding this movement, as of now, more than half of the fixed assets and more than four-fifths of the value added are accounted for by the consumer goods sector.

Reasons for rapid growth of consumer goods sector

Historically, a policy of IS favoured the rapid growth of consumer goods industries for various reasons. First, the markets in developing countries like Bangladesh are mainly of consumer goods where entrepreneurs need not have to undertake the trouble of looking for the outlets for domestically produced goods. Second, since foreign exchange is scarce, government usually controls the flow of consumer goods (essential and non-essential) into the country through imposition of high import duties. This insulates the domestic producers from the world market and provides protection to grow into adulthood. Profitability created by such protection obviously attracts private investments into consumer goods. Third, the revenue aspect of the government also contributes to the option for restricted trade and ultimately speed up the growth of these industries.

Consumer goods Sector and Economic Development

There are however, dangers associated with over emphasising consumer goods while adopting Import-Substitution[89]. First, this leads to consumption "liberalization". With protection, consumption of goods increases whereas in the absence of such protection, shortage of foreign exchange would act as a constraint to increased consumption. A.R.Khan 1963 observed substantial consumption liberalization in the early phases of import-substitution in Pakistan[90]. Preliminary findings for studies in Bangladesh show that consumption liberalization has taken place, to a greater extent, in case of textiles, sugar, cosmetics, cigarettes and soft drinks. While more work is needed to arrive at a sound judgement, it can be hypothesized a priori that protection to domestic industries producing consumer goods leads to consumption liberalization. This only exacerbates the problems created by the prevalance of a dismally low private savings.

Second, a high degree of protection that is associated with the process of import-substitutions usually allows (and probably induces) excessive concentration of investment in protected consumer goods industries. Once the capacity is created (export possibility being non-existent or un-explored) the optimal way is to utilize the production capacity by inducing domestic consumption through sales promotion as well as putting pressures to keep taxes and other constraints lower on the consumption of these goods.

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89) **J.H.Power, "Industrialization in Pakistan - Case of Frustrated Take-off," Pakistan Development Review, Summer, 1963.**

90) **A.R.Khan, "Import-substitution, Export Expansion & Consumption Liberalization", A preliminary report", Pakistan Development Review, Summer, 1963.**

Import-substitution and Capital Goods Sector

Bangladesh has comparative advantage in the production of capital goods e.g, engineering and metal. The sector already accounts for 9% of total manufacturing employment in the country and each one million taka of gross output in this sector generates 23.6 jobs compared to only 18 in manufacturing as a whole. But government policies designed to foster industrial development as well as agricultural development through imported machinery have resulted in negative protection for most of the goods which are or can be produced in Bangladesh. On many occasions, in the name of quality differential, machineries have been or are imported which can be produced in Bangladesh.

Since such industries constitute the base on which is raised the edifice of modern industrialization, it can be deduced that the aim of economic policies in Bangladesh was not so much industrialization with lasting effects as to get quick results in the form of increased value of output irrespective of the social cost involved.

Import-Substitution and Domestic Resource Cost

The mis-allocation of resources is another dimension of the existing protection. Johnson H.G argued that import-substitution as far as it departs from the principle of comparative advantage may saddle a country with high cost industries which can only breath behind a tariff wall[91]. In fact these industries may turn out to

91) **H.G.Johnson, "Tariffs and Economic Development", Journal of Development Studies, October, 1964.**

be so inefficient that the amount of protection that has to be provided to them is greater than their contribution in terms of value-added. High protective import tariffs, the import licening schemes not only brings into existence industries which, on grounds of comparative cost, would never have been started (inefficient use of resources) but also may obscur the priorities within the industrial sector.

Import substitution and Consumption levels:

Among the consumer goods, effective protection accorded to "non-essentials" was higher than essentials. It may be mentioned here that the income elasticity of demand for these goods is greater than one and hence can be treated as "luxuries". The strategy of import-substitution thus appears to have promoted "elitist" consumption. Since these commodities are generally consumed by the richer section of the society, for the system to continue,the present style of development requires that income and expenditure are concentrated in the wealthiest strata. Liberalization for an open trading regime is not a solution to the problems mentioned above. To develop a significant manufacturing base, a rational tariff structure has to continue with more emphasis on import-substitution in capital goods and expansion and diversification of the export sector. A sudden liberalization of domestic or external market could result in consequences contrary to economic interests.

B. An Analysis of Industrial Protection and Assistance Enjoyed by selected manufacturing Industries in Bangladesh:

This Section attempts an analysis of the extent of industrial protection enjoyed by selected manufacturing industries in Bangladesh as to available in the emperical literature. Some of the important policy conclusions that emerge from the

analysis of industrial assistance policies made in a most recent study are summed up in the following[92].

Tariffs, quantitative restrictions (QRs), and fixation of Tariff Values have been used to protect domestic import-substituting activities in Bangladesh. The importance of QRs as a protective instrument has declined; this is reflected in the fact that a large number of commodities the import of which was previously banned or restricted can now be freely imported. At the same time,tariff rates in general have been brought down. These indicate a liberalisation of the trade regime in recent years. In contrast to this relaxation of the two traditional instruments of industrial protection, viz. tariffs and QRs, increasing use has been made of fixing Tariff Values. While the professed objective of fixing Tariff Values is to prevent the practice of under-invoicing by importers, fixation of Tariff Values above the actual C&F prices does confer additional protection to domestic production of import-substitutes. The analysis reveals that import-substituting activities in Bangladesh enjoy fairly high levels of protection even after trade liberalisation has got well under way.

According to the study, the Nominal Rate of Protection (NRP) on product is high for most activities. Observed NRPs, are however negative for several activities even though import taxes, and in some cases QRs, are quite high. Negative NRPs

92) **See A.R.Bhuyan and M.A.Rashid, Op.Cit for greater details.**

are attributable either to smuggling in of superior quality foreign goods, as is the case of cigarettes, or to the price control policy of Government which has sought to keep prices of certain essential goods low for users, as in the case of newsprint, paper, paper board and chemical fertilizers. In many cases, import-competing products are provided with more protection than they can absorb. In such cases, a portion of tariff protection has become redundant, and changes in tariff of varying degrees are observed.

Up untill the early 1980s, a wide variation was observed in the rates of import tariff. Since the mid-1980s, tariff rates have been rationalised, a consequence of which has been to reduce the wide divergence between import duty rates. Doubtlessly, there is need for further reform, particularly in the direction of lowering the general level of import duties as well as narrowing down their spread. The principle that import of goods deemed as 'luxury items' ought to be discouraged through imposition of bans or prohibitively high tariffs has been treated as an article of faith in designing import policy. This is exemplified by, for example, the cosmetics industry, procelain China tableware industry etc., from among the industries considered in that study. The danger inherent in following such a policy is that inefficient domestic production of these luxury goods is encouraged, and this has in fact been confirmed by the experience in Bangladesh.

It is difficult to see the logic of heavily protecting exportable commodities when sold in the domestic market, since these supposedly enjoy comparative cost advantages; frozen fish, readymade garments and leather provide good examples in

this regard. It is interesting to note that commodities produced by public sector enterprises have received high levels of protection, as for example, sugar, diesel engine,bicycle, etc. Maximizing Government revenue appears to have been a very important factor in fixing tariff rates, and in this process the objective of providing rational industrial assistance through policy seems to have been overlooked. Inputs have often been taxed heavily, thereby saddling user industries with high costs of production.

The proportion of value-added in the value of output in the assisted situation has been remarkably low (i.e. 10% or less) for activities like frozen food, soybean oil, packet tea, newsprint, billet,etc.This is sometimes attributable to low labour-output ratio, as in the case of frozen food, and sometimes to inefficient production, as in the case of billet. Value-added in the assisted situation is negative for commodities like diesel engine and ceiling fan. In such cases, the cost of material inputs has exceeded the value of output. Value-added at border prices has been negative for commodities like soybean oil cotton fabric billet etc. This indicates that import-substituting production of these commodities results in a net loss of foreign exchange.As is to be expected, the proportion of value-added in the value of output in the unassisted situation is smaller than that in the assisted situation for commodities which receive positive Effective Rates of Protection (ERP). This is however reversed for activities which receive negative (and less than 100%) effective protection.

Import substitutes have received high levels of effective protection. It is important to note here that in many cases it was not possible to incorporate the effect of quality difference between imports and their domestic substitutes in the calculation of ERP. Since local products are generally inferior in quality compared to imported ones, incorporation of quality differences would have yielded still higher ERP's. Positive ERPs have resulted from protection to product exceeding protection to inputs, as in the case of frozen food, sugar, rayon and ready-made garments. Negative ERPs greater than 100%, including high levels of effective protection, are observed for commodities like soybean oil, cotton fabric etc.; in such cases, protection to product has again exceeded protection to inputs. However, protection provided to inputs has more than offset protection given to output for such commodities. Some specific examples are packet tea, cotton yarn and newsprint in which cases ERPs are negative but less than 100%. This exemplifies an irrational aspect of industrial assistance policy in Bangladesh.

Assistance received for sale in the domestic market has been higher than for export, as exemplified by frozen food, ready-made garments etc. This clearly reflects the policy bias, deliberate or otherwise, in favour of sale in the sheltered domestic market and against export. Policy discrimination against export must be removed if export growth is to be accelerated.

Short-run Domestic Resource Cost (DRC) ratios are found to be generally high., DRC ratios have tended to be higher for import-substitutes than for exports. This reflects the obvious fact that domestic resources are more efficiently utilized in producing exports than import-substitutes [93].

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93) Ibid

THE CURRENT TRADE REGIME AND ITS IMPACT

By the late 1980s, despite some efforts at reform, Bangladesh's trade policies had resulted in a trade regime with prohibitively high tariffs and quantitative restrictions that fostered smuggling, particularly along the long, porous border with India. An important reason is that in some cases "statutory" protection, calculated from the tariff regime was higher than the observed protection measured by the difference in world and domestic prices. In the case of many other products competing imports were of higher quality than their domestically manufactured counterparts since domestic producers often compromised on quality to keep their prices below that of competing imports.

In contrast to the piecemeal and partial reforms of the 1980s, significant steps have been taken since 1992 to liberalize Bangladesh's trade regime. The reforms have reduced the "water in the tariffs" bringing statutory levels of protection closer to observed levels.[94] The import-discriminating, multiple rate sales tax was replaced by a 15 percent value added tax levied on both imports and domestically produced goods, Regulatory duties and surcharges on imports were replaced by a supplementary excise duty, a trade-neutral consumption tax. Tariffs were reduced in each successive budget, and some exemptions based on end-use were eliminated, resulting in some compression of the tariff structure.

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94) **World Bank,"The Structure and Performance of Bangladesh Manufacturing, USAID, Dhaka, 1992**

According to estimates made by NBR, average nominal protection, including all import duties and protective taxes, fell from 89 percent in 1990/91 to 25 percent in 1995/96, a drop of 64 percentage points (**Table-5.1**). The import-weighted average protection rate fell by 21 percentage points. The import-weighted average protection rate for the manufacturing sector fell even more than the overall average-about 30 percentage points-the rate rose for mining-- by 15 percentage points-mainly because tariffs on petroleum, oil, and lubricants were changed from specific rates to ad valorem rates in 1993/94.

Table- 5.1

Trends in Nominal Protection, 1990/91 to 1995/96 (percentage of assessed value)

	Agriculture	Mining	Manufacturers	All Tradables
Pre-reform, 1990/91				
Unweighted	90.5	54.1	89.0	88.6
Import-weighted/[a]	20.9	24.0	51.8	42.1
Dispersion (CV)/[b]	63.3	51.7	58.6	59.0
Post-Reform, 1995/96				
Unweighted	26.0	13.6	24.6	24.6
Import-Weighted/ [a]	10.1	38.8	21.9	21.0
Dispersion (CV)/ [b]	56.7	82.2	73.5	72.7

a) **import-weighted nominal protection rates for 1990/91 are weighted by import data for the corresponding year; for 1995/96 they are weighted by 1994/95 imports.**

b) **CV is the coefficient of variation for the unweighted average.**

Source: NBR, staff estimates.

Though tariff reforms have been extensive, little attention has been paid to simplifying the tariff schedule by reducing the number of tariff rates applied to a particular product. The proportion of tariff lines with multiple rate at the four-digit harmonized system (HS-4) level fell from 54 percent in 1991/92 to 44 percent in 1995.[95] The number of HS-4 headings with five or more rates first fell from 79 to 21 between 1991/92 and 1994/95, but then increased to 53 in 1995/96.

One reason for the slowdown in the move towards simplification of the tariff schedule is the continuing proliferation of end-user concessions. The number of concessionary categories had been reduced from 20 in 1991/92 to 11 by 1993/94. Currently, seven concessionary categories exist, including one for 100 percent export-oriented manufacturers who are exempted from paying duties on capital equipment. Though a useful concession, this has raised the complexity of the tariff schedule and increased the number of duty-free items from 300-350 during 1989-95 to 1,295 in 1995/96. The tariff dispersion has also remained high.

Progress has also been made in reducing quantitative restrictions. A complicated structure of import controls has been steadily dismantled, although a crucial subsector, textiles, remains protected and reductions have occurred unevenly across commodity groups and sectors. In general, restrictions on domestically produced goods have been removed more slowly than those on other goods, and restrictions on manufacturing goods have been lifted more slowly than those on agricultural goods. In manufacturing, controls on consumer goods

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95) **The harmonized system (HS) is an internationally accepted system of classification of imports; the greater the number of digits, the greater the level of detail in the description of the commodity. HS-4 denotes a fairly broad level of disaggregation.**

have been more stringent than those on intermediate and capital goods. Currently, the textiles sector enjoys the heaviest protection from quantitative restrictions; almost 25 percent of all eight-digit harmonized system lines in textiles are under quantitative restrictions. By comparison, barely two percent of tariff lines overall are now subject to trade-related quantitative restrictions. Import bans are in place on all woven fabrics, and gray cloth imports are restricted to the ready-made garment industry. This protection has reduced the competitiveness of the local textile industry and has encouraged smuggling of foreign textiles and domestic leakages of textiles and garments from bonded warehouses, whose stocks are restricted to be used for ready-made garment exports.

The Government has set tariff values that are to be used in place of the invoice price declared by the importer in assessing the import value of some imports. In many cases, the tariff values are set higher than world prices, thus increasing the protection provided by tariffs. A review of import transaction data in 1993/94 reveals that tariff values can increase protection by as much as four to seven percent (for basic metal products and textiles)[96]. In certain cases, the tariff value has inadvertently been set below the CIF invoice price. The recently completed Textiles Sector Study reveals that the tariff value on a certain quality of polyester yarn was below its CIF price, therefore actually undercutting the intended protection[97].

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96) **Bangladesh Tariff Commission.**

97) **A.R.Bhuyan, Report on the Textiles Spinning Sub-sector (Bangladesh Tariff Commission, 1996).**

To improve the import valuation system, the Government introducted a voluntary pre-shipment inspection scheme in its 1993/94 budget. In 1994/95 the system was amended to allow pre-shipment inspection values to override fixed tariff values. The improvemet increased the usage of the pre-shipment inspection scheme. In 1995/96 it covered approximately 25 percent of all imports. Other improvements in import clearance include publication of the tariff schedule, and installation of a computerized customs appraisal system at Dhaka and Chittagong.

C. Export Expansion Vs. Import Substitution as Strategy of Development.

In order to determine what ought to be the ideal strategy within the framework of a viable industrialization policy for Bangladesh, export-expansion or import substitution, the determining factors that deserve prior attention are: (a) what could be the extent and magnitude of the role of the industrialized sector in an agrarian economy like Bangladesh? (b) To what extent can our economy accommodate a wider range of manufacturing activity vis-a-vis expansion of trade leading to increased economic growth? (c) Assuming that a steady rate of industrialization based on export expansion continues to persist, the issue remains whether this is sufficient for the attainment of growth objectives through industrialization.

In an economic scenario like that in Bangladesh, where the manufacturing sector contributes to only around 12% of the Gross Domestic Product, where the limited scope of industrialization is primarily based on a high degree of industrial

imports, prospects of expanded industrialization based on import substitution may not be substantially effective. Moreover, there is the apprehension of the possibilities of breeding inefficiency in the protected industrial units. If however the manufacturing sector is intended to play an increasingly bigger role in the years ahead at least to supply agricultural inputs and some essential consumer goods, the issue then becomes as to what extent can industrialization fulfill these objectives. In other words, an essential condition for a successful programme for rapid industrialization would be a balanced and consistent industrial policy.

If industrialization is to play the key role in the country's economic transformation, it will be necessary to determine a uniformly consistent pattern of industrial policy that would continue for a reasonably longer period. Next, a decision is to be taken as to wheather the manufacturing sector should be oriented more towards increasing the volume of our exports or geared towards substitution of items that are presently imported.

The rationale of increasing the quantum and volume of our exports is obviously to increase foreign exchange earnings that would help in bridging our trade gap. This is the common industrial philosophy for countries that seeks to cover their trade deficit through the export-led growth strategy. On the other hand, excessive dependence on imports is a characteristic phenomenon of perpetual economic dependence, and this has also obviously led many developing countries

to opt for import substitution rather than expanding industrialization just to enhance the level of earning through diversification and expansion of exports. The choice between these two alternatives should be very carefully examined.

A characteristic feature of industrialization strategies of all developing countries is that of increasing the level of earning and bridging the resource gaps through export expansion and export diversification programmes. The developing countries have, however reason to contend that had more reasonably fair and stable prices been ensured for their exports, growth rates based on export target and outward looking manufacturing production could have been substantially higher. To be more specific of our own strategies in this regard, the value of our total volume of exports has increased over the years. Although the items of our exports have remained limited to items as jute, manufactures, tea, hides and skins etc., it has been observed that attempts to shift from traditional to non-traditional items have led to steady increase in earnings from exports. This can be seen in the growing share of non-traditional items in our total export volume, for instance, 26.11% in 1980-81 to 35.80% in 1984-85 to 45.25% in 1990-91 and 87% in 1994-95.[98]

98) **Export Promotion Bureau, Bangladesh Exports Statistics, 1991-92**

The question that now arises is whether the export promotion strategy alone can attain the desired levels of growth for the manufacturing sector in particular and for the economy in general ?

In fact, the emergence and rapid growth of non-traditional exports has proved to be a leap forward for the Bangladesh economy, which, if sustained through appropriate incentives and liberalisation strategies, has the potential to produce the breakthrough needed to reduce dependence on external economic assistance and to embark on the path of sustained growth.

It is however, sobering to note that despite many favourable trends in the export sector, Bangladesh's growth performance at an average rate of around (till 1996) 4% remains below its potential and well behind growth rates of other Asian economies as Malaysia, Thailand and Indonesia, China and other east Asian NICs. Apart from certain institutional weakness, the most dynamic component of exports, viz., RMG, is characterized by low domestic value added and negligible backward linkages which makes little impact on the country's growth performance. While potential exists both for diversification of exports and expansion of backward linkages, considerable improvement is warranted in the regulatory and policy environment before the export sector performance in terms of output, employment and investments can match those of competing nation in South and East Asia. The immediate step would be to assess the extent of increase through diversification and expansion of export base. Here factors of relevance include those such as state of our technological base, the factor endowment, the managerial, technical and labour skills available, and the pattern of external demand.

Given the weakness of these strategically important factors that are the pre-requisites for a successful export-led growth, a total neglect of the domestic import substitution industries would be undesirable. Instead, selective import substitution of items like (a) agricultural inputs, (b) locally produced machinery and spare parts, and (c) essential consumer goods may be encouraged.

Again, this approach will raise the question whether it would breed economic inefficiency or high cost of protection that have retarded the prospects and possibilities of growth in some of the developing countries. A cautious approach may present such an eventuality. Caution should be taken not to go for import substitution on a wide scale. This will call for : (a) fixation of annual targets of production, and (b) identification and selection of appropriate items of import that can be domestically produced at a cost that does not exceed the total cost of import. Lessons drawn from the experiences of Pakistan or the Latin American countries could be used such that import substitution does not become costly and inefficient and hurt the export sector.

The course of our contribution is that both export-orientation and import substitution should constitute a corelations of our trade and industrial policy. We have to focus on export expansion as the major strategy of our industrialization programme but it should not negate the role of import substitution altogether. Substitutions of selected items of import may be allowed in specific items of manufacturing specially relating to essential consumer goods. True import substitution for a time may be costly but export-markets may also be difficult to

penetrate because of external barriers. To follow the middle course in this regard is the ideal answer.

In fact, extreme strategy positions such as only import substitution or only export expansion to the complete neglect of the other can create structures detrimental to a country's long term development.

Chapter-VI

SUMMARY AND CONCLUDING REMARKS

The study has sought to evaluate and examine the economic feasibility of import-substitution vis-a-vis export expansion as appropriate industrialization strategy for Bangladesh. From the preceding analysis, it may be asserted that these two strategies are two sides of the same coin, having identically broad purposes and objectives as bridging foreign exchange gap, overcoming chronic balance of payments deficits, promotion of industrialization, employment and growth.

In the Post-war era, where a new economic resurgence and industrial build-up emerged side by side, import substitution received considerable emphasis. This was obvious on grounds of:

(a) Achieving greater self-sufficiency and economic dependence.

(b) Reduction of dependence on the developed countries amidst an emerging economic nationalism, which was the consequence of a reawakened political nationalism in various parts of the world.

(c) There were risks and uncertainties involved in export-based strategy primarily because of finding markets, and hence it remained to be a limited and selective form of industrialization.

(d) Export subsidization involved politically difficult budget decision whereas it was easier to apply tariffs, quotas and exchange control measures as instruments of protection.

Over time, the emphasis on austerity gave way to a growing enthusiasm for export-led growth strategy. Import substitution policies resulted in inefficiency and high cost and even indiscriminate protection, which served to retard rather than accelerate the growth process. Though the fault was more due to absence of wiser and more effective application of import-substitution policies, the popularity of choice tended more towards export promotion. The exponents of the outward looking strategy speaks of not only high rates of industrial growth, through growth of manufactured exports, but also of the expansion of employment and a better income distribution, apart from increased factor utilization and allocative efficiency which the export promotion strategy generates. There is strong emperical evidence to show the attainment of better economic growth through export oriented strategies than through policies oriented towards import substitution.

For purpose of this study, the relative merits and demerits of these two strategies have been assessed both on theoretical grounds and historical factors. Experiences of the Latin American countries, India and Pakistan provide appropriate lessons. Turning to the aspects of appropriate industrialization strategy for Bangladesh, it was inevitable to examine in greater detail and depth, trade and

industrial policies of pre and post independence periods. Here the trade and tariff structure, the shifts and trends in policy perspectives and their effects on the economy and growth pattern have been taken into consideration.

An in-depth analysis of the scenario in Bangladesh indicates the necessity of export-oriented strategy as an effective vehicle of industrialization. The rationale behind export-orientation need not, however, de-emphasize the role of import substitution which too, can be a vehicle of growth if it can be pursued without creation of high cost, inefficient industries through giving indiscriminate protection. In fact, excessive and total reliance on export promotion to the complete neglect of domestic production structure can be contrary to economic efficiency. It is thus apparent that the two strategies are not mutually exclusive but complementary to each other. In fact, import-substitution success stories may incorporate impressive export sectors, just as there may be export-oriented economies which also undertake various import replacement activities. We may look at export-oriented success in Hong Kong, South Korea, Malaysia, Singapore and Thailand, while again, the transition from a primarily domestic market-oriented economy to one with increasing emphasis on export-expansion has taken place in the case of Brazil, Columbia, The Philippines, Pakistan and India.[99]

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99) **Bela Balassa " Export Incentives and Export Performance in Developing Countries; A comprehensive Analysis, Op.Cit.**

Though most of the developing countries have turned towards export promotion, one should take sight of an efficient domestic sector. In fact, excessive reliance on export promotion to the complete neglect of domestic production may fail to diversify the domestic production structure. Just as excessive import-substitution can create structural distortion in the economy, excessive export promotion can hinder the prospects of growth of the non-exporting sectors. There is, therefore, sufficient reason to contend that extreme strategy stands, such as only import substitution or only export diversification to the complete neglect of the other can deter prospects for economic growth and thus create structures detrimental to long term development.

Therefore, in trying to analyze and evaluate the requisite pattern and structure of Bangladesh's strategy for industrialization it is necessary to take into account the level of manufacturing activity, the structure, size and limitations of the domestic market, the question of access to international markets, resource endownment, the socio-economic infrastructure, the implementation capability of planning, the linkages between the central and local agencies of the administration, the level of education and the learning capacity of the population in acquisition of general, technical and skilled education.

Taking into account the economic scenario of Bangladesh, it is essential to look at import-substitution, at least as a strategy limited in content to saving foreign exchange apart from reducing step-wise dependence on imports. This may not

restrict the present level of emphasis on export-promotion as the most significant vehicle of economic growth. There are undoubtedly many positive lessons to be learnt for Bangladesh from the experiences of countries like South Korea and Taiwan that have been successful in achieving export-led growth. At the same time, it may be economically feasible and expedient to avoid costly and inefficient import-substitution and take full advantage of whatever possibilities that exist for expanding manufactured exports. In the immediate future as well as in the long-run, it is apparent that Bangladesh can attain a greater level of income mainly through industrialization and expansion of trade in manufactures. But this does not imply that it will forego attempts at efficient import-substitution. It is imperative that the development of manufacturing level and skill widens prospects for both export promotion and import-substitution. Thus, as a country advances towards better results of export promotion, the capabilities for import substitution may also be developed and widened. This study recommends such a strategy for Bangladesh.

An analysis of the growth and performance of the manufacturing sector in Bangladesh and the impact of the industrial and trade policy regime on this sector can be discerned in Chapter V. Our analysis shows that, in Bangladesh a restrictive trade regime has spawned the growth of a primarily import substituting (IS) industrial sector which has generally made inefficient use of domestic resources. In most cases, the small size of the domestic market has led to high costs of production resulting from low levels of capacity utilization. The higher price and

often inferior quality of import substitutes have not only seriously affected their international competitiveness but also have reduced consumer welfare. There has thus occurred a redistribution of income from the poor to the rich import substituting industrialists.

Export incentives have been weak, and hence exports have generally received considerably less effective assistance compared to import-substitutes. This discrimination against exports has undoubtedly discouraged exports and encouraged import-substituting activities. If, as is generally believed, export-led industrialization is to form the basis of rapid economic growth of Bangladesh, then the trade regime has worked contrary to this goal. In recent years, significant progress has been made in trade policy for moving towards a more favourable environment for industrial growth, but further reform in this area is urgently called for, if the pace of industrial growth in Bangladesh is to be accelerated.

At the present stage of our development priorities and industrialization needs, we cannot go for import substitution alone, in view of the numerous reasons of economic, social and political reasons. Nor can we advocate only export-expansion strategy, at least in the purview of long term perspectives of growth. While the emphasis on export promotion will continue the following mechanisms should be considered in order to achieve a balanced expansion of the domestic and export sectors.

An "ideal" scheme of export incentives should aim at assuring that the expansion of exports, and resource allocation in general, conforms to the requirements of social profitability. It should further aim at minimizing the chances of retaliation on the part of the importing countries. Finally, the export promotion scheme should have an across-the-board character and should provide certainty and stability to exports.

Social profitability consideration calls for providing equal incentives to exports and to import substitution. For one thing, from the point of view of the national economy, a dollar earned in exporting is equivalent to a dollar saved through import substitution. For another, as noted above, equal incentives to production for domestic and export markets are necessary for exploiting economies of scale and for contributing to technical progress.

The application of tariffs and higher rates may be warranted in cases when consumers have an irrational preference for foreign goods that involves a cost to the national economy as consumer goods are imported at a higher cost than they can be produced domestically. Such exceptions should be made sparingly, however, so as to avoid excessive protection of consumer goods industries leading to high cost, inefficient production.

It is also suggested that higher tariffs are applied to protect infant industries. But infant industry protection should apply to exports as well. In fact, it may be desirable to grant additional incentives to new export activities. For one thing, there are additional costs of entering foreign markets, including the cost of the collection of information and marketing; for another, the risk to individual exporters tends to be greater than to the national economy that has a diversified export structure. However, just like infant industry protection, additional incentives aimed at new exports should be given on a temporary basis until new markets have been established.

Setting tariffs and export subsidies at equal rates on all products would be equivalent to free trade. This would not be the appropriate policy in developing countries, however. For one thing, in the case of exports facing less than infinitely elastic foreign demand one should apply optimum tariffs that equate the marginal revenue derived from the exportation of the commodity in question to marginal costs. For another, the existence of externalities in the manufacturing sector warrants the preferential treatment of this sector in developing countries.

At the same time, to the extent possible, exceptions should be made and considerations other than economic efficiency introduced, in the form of direct measures rather than higher rates of protection. Thus, in industries which show

exceptional promise for technological improvements, the direct subsidization of research and development is preferable to additional protection that may lead to the establishment of high-cost firms. Also, measures taken to reduce the cost of labour will be a more appropriate way to encourage private investment than the protection of labour intensive industries that promotes the use of both labour and capital in these industries.

Both import substitution and export promotion have common objectives. Both policies seek to overcome balance of payments difficulties. Both of these seek to promote industrialization, employment and growth objectives. Import substitution enjoyed great popularity among countries at the early stages of their industrialization. The strategy was defended on grounds of achieving self-sufficiency and thus greater economic independence from the developed countries. Export orientation was considered only a limited and selective form of industrialization. It was also considered risky because of the uncertainity involved in finding export markets. Financing import substitution was also politically easier than export promotion, for export subsidization involved politically difficult budget decisions whereas tariffs, quotas and exchange control measures as instruments of protection could be employed to tax the population in a hidden manner.

Experience, however, reveals that all too often import substitution policies were carried too far, resulting in expensive production processes and inefficient methods which served to retard rather than accelerate growth. These policies were also accompanied by a neglect of agriculture and aggravated employment and income distribution problems. The current popularity with export promotion is no doubt the result of the sobering experience that many developing countries have had with import substitution. Empirical studies also demonstrate that export-oriented economies have shown much better economic growth than those oriented towards import substitution. It is not that the export-oriented strategy was so successful because it was technically more progressive or that it was administered better than import substitution strategies. Some of the successful exporting countries also continued with import substitution policies, but their export successes lay on the emphasis they put on cost and quality considerations and on creating conditions favourable for efficient production and growth of export.

The rationale behind export orientation need not, however, de-emphasize the role of import substitution which can also be a useful strategy if it can be pursued without creating over-protected, high cost and inefficient industries. In fact, excessive reliance on export promotion to the complete neglect of domestic production may fail to diversify the domestic production structure. The two strategies are thus not mutually exclusive but complementary. Just as excessive

import substitution can create structural distortion in the economy, so also excessive export diversification to the complete neglect of the other can thus create structures detrimental to long-range economic development. The solution lies in an appropriate strategy-mix which will be determined by such factors as the size of the country's domestic market, resource endowment, infrastructure, the quality of administration, the level of education and the learning capacity of the population. All this may constitute important lessons for policy makers in Bangladesh, as in many other resource poor developing countries.

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