From Import Substitution to Export Promotion: Finding the Right Formula

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Introduction

Many believe that Philippine industries suffered a bad fate because the import substitution strategy that led to the birth of our industries wasted much resources and spawned a lot of corruption. While admitting that the first part of the accusation is true, nevertheless import substitution was undertaken for valid reasons when we were still an infant economy devastated by war. It did result to an industrial base that gave opportunities for global competition. Amid failed industries, we can find companies that became globally competitive. Rather than casting them away, we must nurture them. Equally important, we now also have a base of industrial entrepreneurs and managers.

In this paper, I will touch more on the import substitution strategy of industrialization which we pursued from 1950 to 1985, and less on the export promotion strategy which followed and continues to the present. I will also draw on the experiences and opinions of some players in the iron and steel, textile, and appliance industries.

Background of the import substitution strategy

Let us recall the beginnings of the import substitution strategy because some of the problems which surfaced then still plague us to this day.

Imports were cheap because of a fixed and overvalued exchange rate of P2 to U.S.$1. We could not change the exchange rate without the permission of the U.S. President under the Bell Act. This restriction was removed in 1955 but in its place was put the parity provision of the Laurel-Langley Agreement, giving extended national treatment to U.S. investments in the country.

Thus, rather than let market forces correct for (sic) a surplus of imports over exports by letting the peso depreciate, we defended the fixed rate of P2 to U.S.$1, which in effect overvalued the peso and encouraged more imports. In order to ration out the limited supply of foreign exchange (we were reeling from the devastation of war and

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our exports of primary products which supplied us with the dollars took time to recover and even then such exports were low valued, i.e. the terms of trade were in favour of manufactured exports) we resorted to foreign exchange and import controls.

In the allocation of foreign exchange, priorities were established. Hence, essential goods were given first preference, then semi-essential, and lastly non-essential. This system of forex and import control gave stimulus to import substitution.

In 1962, the peso was devalued to P3.20 and a multiple exchange rate system was set in place with lower rates for imports of essentials and semi-essential goods.

The Iron and Steel Industry

The iron and steel industry was based on a derived demand for its products, i.e. from the demand of the steel using industries such as construction, infrastructure, automotive/transport, furniture, appliances, food/beverage containers, industrial containers and metal fabrication. The steel industry itself can be divided into upstream, midstream and downstream industries as shown in Figure 1.

Figure 1 helps illustrate the results of import substitution. All the steel-using industries were the product of deliberate policies of import substitution, except for the construction/infrastructure sectors, which were characterized as producing "non-tradeables". These in turn would stimulate demand for flat and long steel, which would create a demand for the midstream industries which in turn would stimulate the iron-making/steel-making industry. This is referred to as the process of backward integration and aptly illustrates what import substitution hoped to achieve.

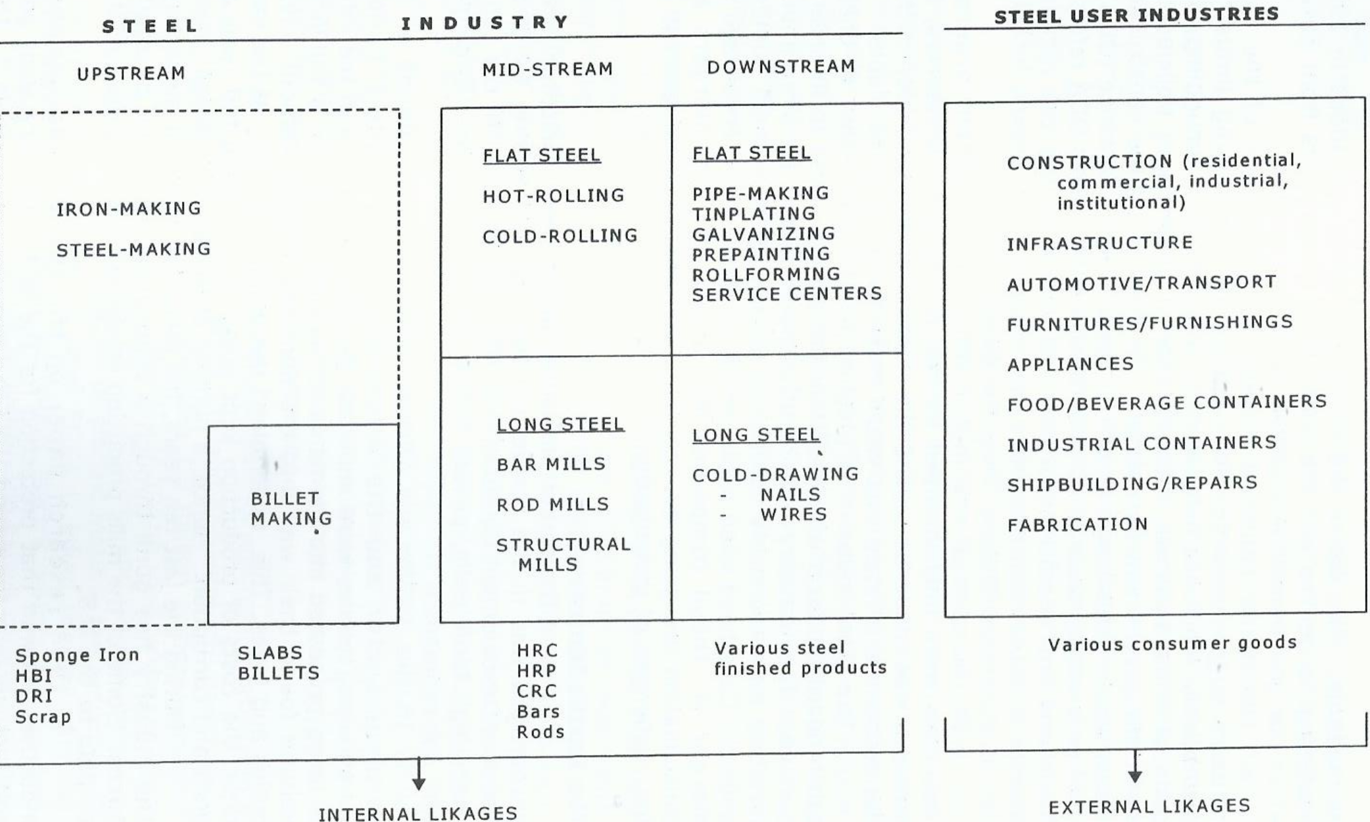
An integrated steel mill would encompass all three industries. Because of the large amounts of capital needed for an integrated steel mill, the steel industry developed with companies starting up in either the midstream or downstream segment.

The National Steel Corporation (NSC), formed in 1974, was based on the Iligan Integrated Steel Mill, which began in the 1950s. It started in midstream, as a hot and cold rolling mill, later integrating backward into billet making and forward into tinplating. The Philippines established these industries ahead of South Korea and other Asian countries.

Before its privatization in 1995, NSC was profitable, exporting steel to a number of other countries. From 1994 to 1995, it exported 3,000 mt of tin plates per month to China. In 1995, it also exported 5,000 mt of cold rolled coils monthly to the US and 4,000 mt of tin mill black plates to Indonesia every two months. For at least two years, the company geared itself for exports.

Its troubles started after it was privatized in 1996. It is alleged that the new owners milked NSC, so that it was unable to pay

Figure 1



its creditors. This led to the suspension of its operations in 1999. Hastening its demise was the dumping of cheap billets from Russia, which our government was unable to redress in time.

The major cause of the underdevelopment of the steel industry is the underdevelopment of the steel using industries themselves, which are hampered by small markets, smuggling, high costs of doing business, inconsistency of government policies and inefficient government bureaucracy. In the case of the construction/ infrastructure industries, tied official development assistance (ODA) is cited as a major cause of its underdevelopment. Tied ODA refers to the terms and conditions of such aid which require the recipient country to source the machinery and equipment necessary, including the consultants/engineers, from the donor country.

In the case of the motor vehicle development program, incentives were only intended for two or three manufacturers, but pressure was made to expand the number of entrants, jeopardizing the economies of scale that would make these ventures viable.

The steel industry is plagued by the production of cheap, substandard products which some of the players resort to in order to survive. The industry is currently characterized by overcapacity resulting from too many companies producing for a small domestic market. Calls have been made for the government to encourage the merger of these companies into a few. In fact, mergers and consolidation are going on internationally, as companies gear up for the challenges of globalization.

The Textile Industry

One of the earliest industries where import substitution was encouraged was in the textile industry with the setting up of the National Development Corporation's (NDC) textile mills. In the 1960s, under high tariff walls, private textile mills were set up. Smuggling was not rampant.

In the 1970s and 1980s, with the development of the garment sector and the establishment of customs bonded warehouses, textiles were imported, tax and duty free with the intent of being processed into garments for exports. However, a significant volume found their way into the domestic market without paying duties and taxes. This undermined the textile industry. At the same time, the costs of production kept going up, including red tape and graft and corruption. Hence, a number of textile mills closed down.

During the last ten years, the mills that survived modernized. The industry has gone through a rationalization driven by market forces. Some of the mills producing woven fabric export most of their outputs to the U.S.

A 1994 research paper on the textiles and garments industries showed that protection for the textile industry went down substantially over the period 1983 to 1988. Please see Table 2. Thus,

effective protection rates (EPR) for primary textiles went down from 90.5 percent in 1983 to 29.1 percent while net effective protection rates (NEPR) dropped from 52.5 percent to 2.4 percent.

These data can be better understood if it is recalled that a tariff on a product is usually ad valorem and is expressed in percentage terms. Thus, a tariff on a product of 10 percent represents the nominal protection rate. But the protection does not extend to the product alone. For example, without competition from imports, workers can receive higher wages than if there were cheap imports. Thus, the effective rate of protection can be greater than the nominal rate if the sum of wages, interest, profits and depreciation allowances paid by domestic firms, i.e. its value added, can exceed what these would be if there were no tariff protection.

However, the overvaluation of the currency can offset the protection of tariffs. The NEPR factors in the relative overvaluation or undervaluation of the currency. The EPR goes down when the currency is overvalued, i.e., because imports of the product are cheaper if the dollar costs P20 rather than P25. There is an incentive to import the product even if the nominal tariff rate is high. Thus, the low NEPRs for textiles in 1988 indicate that the peso was overvalued. The use of NEPRs underscores the fact that tariffs alone, are not the sole determinant of the level of protection.

The Appliance Industry

For the appliance industry, one expert observed that the country (and the industry) did not pursue a program of local value added "religiously" so as to fully exploit backward linkages to the metal and electrical machinery industries. The development of a local compressor illustrates this failure.

The compressor is the heart of a refrigerator as well as an air conditioning unit. The country had a foundry for precision casting required for the production of a compressor. It also produced the special type of magnetic wire required by the electric motor. While two or three companies were producing compressors (in the late 1960s and early 1970s), a consortium of several companies was proposed in order to attain economies of scale and to upgrade technology, which was offered by a U.S. firm that possessed it.

The plan failed because of disagreements among the prospective members. The U.S. firm moved to Thailand and went into partnership with a local firm, which now produces 1.8 million compressors and exports these to the U.S. No other plant in Southeast Asia manufactures compressors for air conditioners and refrigerators.

As for the local production of electric motors, the reduction of the tariff on magnetic wires after EDSA I, killed the industry, as imports were cheaper. Today, we import electric motors for the two million electric fans we produce annually. The expert commented that

there is basically a lack of appreciation of the importance of the electric motor industry as a prime mover of the economy, one that can stimulate the further development of our metals and engineering industries.

In the appliance industry, average tariffs steadily fell from a high 71 percent in 1978 to 11 percent in 2001 for the industry as a whole. For refrigerators/air conditioners, the corresponding figures are 100 percent and 12 percent.

Table 2 shows EPRs and NEPRs for the subsectors of the appliance industry and for radio and TV parts for the years 1983 and 1988. For the refrigerator/air conditioner subsector, both measures registered substantial declines. It should be noted that the NEPR for refs/aircons in 1988 was 44.96 percent, just slightly above the nominal tariff rate of 43 percent.

Table 2 EFFECTIVE PROTECTION RATES AND IMPLICIT TARIFF RATES

	1983		1988	
	EPR	NEPR	EPR	NEPR
Appliance Industry	70.15	36.12	41.69	13.36
Subsectors Audio-video appliances	128.82	83.05	38.49	10.79
Cooking-heating appliances	39.25	11.4	18.91	-4.87
Refs and aircons	182.48	125.98	81.19	44.96
Miscellaneous appliances	45.39	16.31	27.18	1.74
Parts Industry				
Radio and TV Parts	69.3	35.44	33.66	6.93

Source: Lapid, Dennis D. " Appliance Industry: Impact of Trade Policy Reforms on Performance, Competitiveness and Structure." Research Paper Series No. 94-05, Philippine Institute For Development Studies, 1994

Inward-Looking vs. Outward Looking Industrialization Strategies

I will touch briefly on the major features of the export promotion strategy that our government has adopted to replace import substitution and give some evaluation of the two.

The Tariff Reform Program (TRP) began in 1980 but was suspended soon after because of the economic and political crisis triggered by the assassination of Ninoy Aquino in 1983. It was resumed in 1986 and resulted in the steady reduction of tariffs across-the-board. As of 2001, average tariffs were at 7.72 percent, while in 1990, it was 27.84 percent. These are all slated to go down to a

uniform 5 percent in 2004. However, the Federation of Philippine Industries have petitioned the government to maintain tariffs of 355 products at their 2001 levels, ranging from 7 percent to 20 percent while the other reforms in the economy, which would bring down the costs of doing business, are still being put in place.

We could say that the period of export promotion formally started with the passage of the Export Development Act on December 21, 1994, granting incentives to exporters. But even before then, E.O. 226, issued by then President Corazon Aquino in 1986, granting fiscal incentives to both inward and outward looking firms, promoted exports, followed by the Foreign Investments Act of 1991 and its amendment to further liberalize foreign investments in 1996. The idea in liberalizing the conditions for the entry of foreign investors was that, with globalization and the reduction of tariffs, we needed the capital and technology with which to build up our export base.

We formally joined the WTO in 1995. For manufactured goods, we committed to reduce tariffs on 47 lines and bind the rates of other products at 10 percent above 1995 rates. This means we would not increase tariffs beyond these levels. For agriculture, we agreed to remove quantitative restrictions and to replace these with tariffs, but at high levels such as 100 percent, going down over time. However, we would allow a certain amount to be imported at a lower tariff rate, the so-called minimum access volumes (MAVs).

What can be said about the import substitution strategy? I believe we can say that it did stimulate industrialization but that we wavered in pushing it consistently. This was probably due to several factors. First, it encouraged complacency among those who received protection as the incentive to be efficient was blunted by lack of competition. Worse, the system of forex and import controls spawned rampant corruption in both public and private sectors. Second, we failed to exploit opportunities to integrate backward such as in the large-scale production of compressors. Thirdly, government policies were not consistent, as in the case of the motor vehicle development program.

There were successes. We did set up industries which exist to this day and which can still be made competitive if we get our act together. We have a chemical industry, a steel industry, a pulp and paper industry, a wood products industry, etc. While individual firms in these industries have closed shop, others remain who are competitive. The mindset of these firms is no longer one of protection. They are doing everything they can to be efficient. More and more of them are being certified by the International Standards Organization (ISO) as conforming to world standards of management, product quality and environmental compliance. What is needed is for our government to complete the necessary reforms in other sectors which affect these industries such as power, finance, transportation, infrastructure, its own bureaucracy.

As shown in the case of NSC, it had attained such a high level of efficiency that it was able to export and to maintain this. Aside from semiconductor firms, garment firms, refined sugar and coconut oil, there are other manufacturing firms that are already exporting: chemicals, boilers, cast iron pipes and manhole covers, small arms and ammunition, automotive batteries, etc. These can be further developed with a combination of the right policies and the enforcement of the law to, e.g., eradicate smuggling in all its forms, prevent the sale of substandard products.

Hence, the import substitution strategy, with all its defects in implementation, created an industrial base on which we can build and which can be part of the export promotion drive. Government should not write them off. What it should do is to reduce interest rates, power, and shipping rates to the same rates as available in competitor countries. And to improve its own bureaucracy to the same level of efficiency as in competitor countries.

Is an export promotion strategy inherently superior to an import substitution one? Michael Todaro, in his book Economic Development [1997] sums up the findings of various economists. It is a rather lengthy quote but well worth reading:

"We can evaluate the debate on two levels, the empirical and the philosophical. In his study of the experiences of developing countries over the past three decades, Rostam M. Kavoussi argues that the empirical evidence demonstrates quite clearly that neither the trade optimists nor the trade pessimists are correct at all times. It all depends on fluctuations in the world economy. Thus, when the world economy was expanding rapidly during the period 1960 to 1973, the more open-economy LDCs clearly outperformed (in terms of aggregate export and economic growth) the more closed-economy nations. The trade optimists' arguments appear validated during this period of rapid world growth. But when the world economy slowed down between 1973 and 1977, the more open-economies (with the notable exception of the four Asian NICs) had a more difficult time and the trade pessimists fared better. A follow up 1988 study by Hans W. Singer and Patricia Gray, which extended Kavoussi's empirical analysis for the period 1977 to 1983, when world economic conditions were even more unfavorable , supports the finding that high growth rates of export earnings occur only when external demand is strong . Changes in trade policy appear to have little or no effect. Furthermore, low income countries were found to fare worse across all time periods. Singer and Gray argue that contrary to the position of the World Bank and other trade optimists, an outward-oriented policy is not necessarily valid for all LDCs.

Conclusion

To conclude, therefore, that either export promotion or import substitution is always an unambiguously better strategy - even for promoting economic growth narrowly conceived, let alone our broader

definition of development - is to miss a key conceptual and empirical insight that a growing number of development economists are beginning to recognize.

"In the final analysis, it is not a developing country's inward or outward-looking stance vis-à-vis the rest of the world that will determine whether or not it develops.... Inward-looking, protectionist policies such as tariffs, quotas, and exchange-rate adjustments do not necessarily guarantee more jobs, higher incomes that are more equitably distributed, adequate nutrition and health, clean water, or relevant education any more than outward-looking, non-interventionist policies do. Even though policies of export promotion appear to have contributed more to GNP growth than import substitution did during the 1960s and 1970s, similar results were not forthcoming in the period 1979 to 1991.

"In short, the current consensus leans toward an eclectic view that attempts to fit the relevant arguments of both the free trade and protectionist models to the specific economic, institutional and political realities of diverse Third World nations at different stages of development. What works for one may not work for another. For example, the East Asian success stories may have little relevance for other developing nations beyond the important conclusion reached by Colin I. Bradford:

> 'What seems to distinguish the East Asian development exercises is not the dominance of market forces, free enterprise, and internal liberalization, but effective, highly interactive relationships between the public and private sectors, characterized by shared goals and commitments embodied in the development strategy and economic policy of the government. The dichotomy between market forces and government intervention is not only overdrawn: it misconceives the fundamental dynamic at work. It is the degree of consistency between the two sectors-rather than the extent of implicit or explicit conflict that has been important in the successful development cases. A coherent development strategy was not only formulated but followed by both the government and the private sector in providing an unusual degree of common direction of national energies in these cases.'

We can see that today, the globalized trading system promoted by the WTO has been brought into question because of global recession which has triggered protectionist responses from the world's biggest economies.

A final comment on the conclusion that a development strategy is successful if there is an "unusual degree of common direction" of both government and the private sector. Is the government really listening to the private sector as it pleads for a slowing down of its drive for trade liberalization until other economic reforms are in place? For participating in the formulation of its negotiating stance in international economic agreements? The pendulum has swung from the one extreme of protectionism to the other extreme of free trade. The "common direction" as established by our own brand of democracy most likely lies in the middle.