CHAPTER THREE

Import Substitution Industrialization

Looking Inward for the Source of Economic Growth

Many of the state-led investments under import substitution industrialization were in large-scale industries such as petrochemicals. (*Courtesy of the Inter-American Development Bank.*)
At the beginning of the twentieth century Argentina was one of the world’s wealthiest nations. Why did Buenos Aires’s elegant and luxurious buildings begin to seem locked in time as other nations modernized? Why did much of Latin America, despite its rich natural resources, experience slow growth? The export-led model discussed in chapter 2 did not deliver the anticipated growth. Distribution also had not improved. Why were the peasant campesinos stuck in a cycle of poverty? Emerging from the depression and the world wars, Latin America lagged behind its northern hemispheric neighbors. Once behind international competitors, how could Latin American nations ever hope to catch up?

Hoping to answer these questions, Latin American policymakers compared the performance of the region with that of North America and Europe; they also looked with interest at the takeoff of the Soviet Union. Two answers to the puzzle of slow growth emerged: first, an explanation for Latin America’s falling behind and, second, a prescription for what to do about it. Political economists such as Paul Baran and Andre Gundar Frank suggested that Latin America was not falling behind but was being pushed back by the exploitative development process in the powerful industrial countries. Raúl Prebisch and those at the Economic Commission for Latin America and the Caribbean (ECLAC) defined the development problem as the need to promote growth in the face of an international system controlled by the center countries. This chapter explores these tools of inward-looking development in the policy of import substitution industrialization (ISI). It treats the role of the state as a developmental actor and introduces the exchange rate and trade tools used to promote industrialization. It concludes by evaluating the performance of import substitution industrialization as an answer to the puzzle of how to promote development in Latin America. The following questions form the core of our investigation:

- How did theorists make sense of Latin America’s declining position in the world economy?
- How did the theory of import substitution industrialization propose to overcome the constraints on Latin American economic development?
- What were the key elements in the ISI toolbox?
- Was the approach successful in practice?

Understanding import substitution industrialization is an important step in unraveling the puzzle of Latin American development. It gives us a sense of the historical backdrop to contemporary policy and also locates one end of the policy spectrum with respect to the role of the state in development against which we can evaluate current practices.

**Dependency Theory: An Explanation for Backwardness**

For some analysts, answering the question of why some nations were growing and others were stagnating required looking not at countries in isolation, as individual plants in a garden, but rather at how countries interacted with each other in the
international system. Proponents of dependency theory postulated that a country did not thrive or falter simply because of its own national endowments. Rather, progress could be attributed to the power it had to set the rules of the international economic game. Center countries, or the industrialized countries, defined the rules; the periphery, or developing countries, were pawns in the international pursuit of profit. As dependency theorist Andre Gundar Frank postulated, underdeveloped countries were not developed countries in the making; rather, industrial countries

Box 3.1. Raúl Prebisch

The Argentine economist Raúl Prebisch was born in 1901 in the town of Tucumán. He was strongly influential in the development of Latin American economic policy, and his contributions to development economics broke with the neoclassical. Although later criticized, his views and ideas questioned the extent to which the free market and free trade could solve the problem of underdevelopment.

Prebisch was educated at the University of Buenos Aires, and during the 1920s he worked as a statistician for the Sociedad Rural, a stockbreeder’s association. Toward the beginning of his career, Prebisch believed in neoclassical economics, but the Great Depression and the writings of economist John Maynard Keynes shattered his faith in the free trade model. Prebisch began to formulate different theoretical views in the early 1940s. This shift was first manifested in The Economic Development of Latin America and Its Principal Problem, written in 1949. By this time Prebisch had served as director general of the Argentine Central Bank (1935–1943) and had witnessed the devastating effects of the depression on Argentina, which suffered from falling prices and debt payment difficulties. His 1949 manifesto reflected the effect of these external influences on economic development.

Prebisch divided the world in two, labeling one part the center and the other, the periphery. The center referred to advanced economies, producing primarily industrial goods; the periphery included developing countries, producers of primary products. Prebisch defined a skewed relationship between the two, with the center gaining at the expense of the periphery. For Prebisch, productivity gains in the North (the center) were translated into rising wages, not falling prices, due to the market power of business and unions. In the South (the periphery), surplus labor kept wages low, and slow productivity growth in agriculture and mining acted as a drag on the economy. The unequal distribution of economic gains was due primarily to declining terms of trade, as developing countries would have to export more and more to be able to import the same quantities as before. It is clear that by this point Prebisch rejected the idea that comparative advantage was the answer to growth for developing countries and opted for other policy prescriptions.

In 1948, the UN Economic Commission for Latin America was created; Prebisch became its influential chairman in 1949. Prebisch’s diagnosis for the causes of underdevelopment led him to advocate what is known as import substitution industrialization (ISI). From 1964 to 1969, Prebisch was the secretary-general of the UN Conference on Trade and Development (UNCTAD). During this time period, Prebisch put aside his theoretical thinking and formulated policies that were later ignored by both the developed and developing world. When Prebisch returned to his theoretical endeavors after the UNCTAD years, he suggested that a post-ISI policy was required, including removing protection from certain industries and encouraging nontraditional exports. He pointed to the need to develop internal savings to decrease reliance on external debt, suggested institutional changes in the labor market and financial sector, and advised budgetary reforms to consolidate change in Latin America.
had caused underdevelopment in other nations in the process of economic expansion. For Frank, underdevelopment was generated by the same historical process that produced economic development: the march of capitalism. Industrialized countries had access to cheap inputs for growth through the extraction of resources, the export of minerals, and the exploitation of cheap labor in the underdeveloped world. Rich countries became rich by making other countries poor.

The owners of the resources—the wealthy in the underdeveloped region—benefited from the international market. According to dependency theorist Paul Baran, local elites formed alliances with international capitalists, hindering long-term, dynamic growth in favor of short-term profits. Baran pointed to the feudal coherence of the latifundia system and the monopolistic market structure as impediments to vigorous long-run growth. A social glue bonding local and international elites cemented economic privilege for the upper class. Those with power had no interest in sharing it. Relatively concentrated markets weakened competitive pressures. For Baran and for Frank, while the periphery was tied to the center, there was no possibility of sustainable growth. As long as traditional elites remained in power, periphery countries would be shackled to center country interests. Revolution, therefore, was in order.

Other theorists, such as Fernando Henrique Cardoso and Enzo Faletto, disagreed with the revolutionary prescription. Although concurring with the assessment that the center countries controlled the dynamic of growth, Cardoso and Faletto argued that autonomous development was indeed possible within the periphery. It would, however, involve an active state policy to counterbalance the greedy hand of the international market. A powerful state acting in the national interest could counteract the strength of local and international economic elites to promote genuine development in the periphery.

From Dependency Theory to Development Policy: ECLA and the Structuralist School

The dependency theorists’ critique of the international economic system informed but did not completely define the position of the structuralists at the United Nations Economic Commission for Latin America (ECLA). Under the leadership of Raúl Prebisch, ECLA analysts looked at the disappointing economic performance of Latin America in the first half of the century, focusing on the volatility of primary product exports, and the progressive difficulty of paying for more technologically sophisticated (and expensive) products with the limited agricultural returns. Technological progress was controlled by the powerful center-industrialized countries and spread slowly into the periphery. ECLA researchers in the 1950s were also fascinated by a seeming correlation between the interruption of normal trade patterns with the industrialized countries during the war periods and accompanying robust internal growth in the Latin America region. Isolation from the international system apparently helped growth at home.

In part the disadvantaged position of periphery countries in the international system derived from the kind of goods they offered. Developing countries principally
traded primary products, such as raw materials and agricultural goods, for more technologically advanced products in the international arena. Within this unequal framework, they faced what was seen as declining terms of trade for their products. There are only so many bananas that people want to eat or so much coffee that they can drink. Given the low income elasticity for agricultural products, as the global economy grows, the relative demand for primary products declines. Instead, rewards tend to accrue to those engaged in technological entrepreneurship. Technological sophistication adds value to a good, increasing its market price well beyond the cost of basic inputs. Declining terms of trade for primary products reflected the argument that as the prices of sophisticated goods rose, developing countries would need to export more and more oranges or wheat to pay for the more expensive technological machinery. Without mastering technology, countries had little hope of advancement.

In addition to the position that all goods do not generate equal rewards, structuralists also offered a view contrary to that of traditional economists on how economies functioned. Challenging the tenets of neoclassical economic theory, which assumes that rational, self-interested profit maximizers operating in open and competitive international markets will produce the greatest good for all, structuralists argued that the economy was shaped by power and politics. For the structuralists, economic activity is conditioned by interest-group politics. Markets in Latin America are controlled by concentrated oligopolies in which firms are price makers and elites establish patterns of consumption. Powerful advertising conglomerates shape global tastes; elites tend to demand sophisticated goods produced by industrial economies. Importing these items would do little to spur local growth. The promises of trickle-down economics hold no magic for the masses of the poor in the developing world. In the structuralist’s eyes, the development process is not a movement toward equilibrium but rather is driven by imbalances and tension. Although the neoclassical model predicts benefits for poor countries from international trade, structuralists contend that international trade exacerbates inequality between and within nations because those countries and companies with control set the rules of the game in their favor. For the structuralist, the neoclassical model does not conform to the hard, cold facts of the international economy.

From Structuralism to Import Substitution Industrialization

The arguments of the dependency theorists and the structuralists shaped a policy package widely adopted in Latin America and known as import substitution industrialization. Perceiving the international game as stacked against them and with multiple external shocks repeatedly destabilizing the economy, Latin American policymakers turned inward to promote internal sources of

**Question for Thought**

Are the characteristics of Latin American economies as described by the dependency theorists and the structuralists consistent with the historical view of development portrayed in chapter 2? Are there pieces missing or overstated?
economic growth. Instead of relying on the international economy as the engine of growth, ISI policies sought to develop industries in a protected environment. The goal was to create industries capable of producing substitutes for expensive imports while simultaneously promoting industrial growth and the expansion of internal economies. The notion was that ISI would induce a process of learning driven by exposure to new ideas and processes that would dynamically spill over into the whole economy. Rául Prebisch and ECLA structuralists placed the role of technological change at the center of the development process and identified a strong role for the state in promoting national technological capabilities. Without mastering technological processes, developing countries had no chance to catch up. The only economic actor strong enough to counterbalance the weight of multinational corporations was the state.

The strategy of import substitution industrialization was informed by Albert Hirschman’s concepts of bottlenecks and linkages. For Hirschman, imbalances in the system, such as supply shocks and bottlenecks, were central to development as signals for investment. Hirschman characterized the development process as a bottle with a thin neck. Inputs—land, labor, capital—were constrained from freely flowing from the bottle by the constricting neck of scarce complementary factors such as technology, infrastructure, or entrepreneurial capital. If the state could break the bottlenecks in crucial industries, resources would flow back up the production chain, stimulating the demand for intermediate inputs, or they would flow forward from consumption patterns to create demand for new products. Therefore, by promoting a steel sector, for example, *backward linkages* such as those to the iron ore and smelters would stimulate the growth of these supplier industries while *forward linkages* would stimulate the auto or machine industries. If the state could target those industries with the largest backward and forward linkages, it could act as an engine of development.

A strong state was critical to the structuralist program. ISI theorists pointed to a simple fact: if the market could work on its own, why had it not been successful in promoting growth in Latin America? *Market failure* to produce sustainable growth provided the rationale for state intervention. Given the weak private sector and the large economies of scale attached to industrial endeavors, an active state was viewed as a necessary complement to the market economy. The ability of the state to deliver on public project investments contributed to the perceived need of governments to also meet the demand for social projects. This emanated from the highly unequal income distribution in Latin America.

The political demands of populism, of attending to the broad needs of the domestic population in the name of social peace, were consistent with the economic theory of import substitution industrialization. Populism drew on the charismatic power of leaders such as Juan Perón of Argentina or Getúlio Vargas of Brazil to mobilize support within labor and industrial elites in the service of a nationalist development strategy. Traditional populist strategies encouraged support for a developmentalist model to meet the changing needs of society without explosive class conflict. By co-opting key labor and industrial groups into the quest for change, support for interventionist policies could be maintained. *Economic populism*, a term applied to the developmental strategies of the 1950s,
1960s, and 1970s, emphasized growth and redistribution of income to the neglect of internal and external constraints. That is, as long as financing was available, the state kept attempting to buy off each group in the conflictual process of development. Labor, politically powerful, was given strong protection under the law. Industrialists were favored with development schemes. State-led strategies to reduce poverty and promote infrastructure were pursued to keep local political leaders happy. But constraints on development—inflation, fiscal deficits, external imbalances—were often ignored until it was too late and crisis erupted.18 Political demands to moderate the distributional tensions of development were consistent with the state-led ISI model.

The ISI Toolbox

Import substitution industrialization relied on a variety of economic tools to achieve its aim. The toolbox can be broken down into three categories: active industrial policy, protective international instruments, and accommodationist fiscal and monetary policy complemented by a careful program of transnational participation. It is important to note that although these tools were at the disposal of all policymakers in the region, they were applied in varying degrees in each country. We will discuss these three broad tools in turn.

Active Industrial Policy: The Role of SOEs

Industrial policy was anchored in the formation of state-owned enterprises (SOEs) throughout the region. Under the assumption that the state was the only able domestic actor with the resources to produce in relatively underdeveloped markets, state firms were formed in a wide range of heavy industries, including oil, petrochemicals, telecommunications, steel, and aircraft. In some cases these enterprises were wholly owned by the state, and in others they operated as mixed enterprises, incorporating state and private capital. State firms had access to public funds for investment, research, and development. Backed by sovereign guarantees, they also had easier access to international financial markets to borrow for large development projects. State ministries could assist in the negotiation of international technology transfer packages to jump-start production. Such firms had the resources to hire some of the brightest national scientists, engineers, and managers to run operations. Additionally, the pressures of producing initial annual profits were relieved as state firms were able to extend their time horizon for investment returns.

Although public enterprise status held many advantages, there were also restrictions. Hiring and pay scales were subject to national standards, sometimes placing a ceiling on the pay for skilled labor. State firms were subject to the whims of politicians and often became agencies for employing large numbers of constituents. Furthermore, the services of industries in basic infrastructure, such as the electrical or telecommunications sectors, were often underpriced to provide cheap inputs to stimulate the growth of the private sector. Cheap inputs allowed for a local manufacturing
boom; however, underpricing electricity or phone service led to losses that were absorbed by the SOEs. As resources became increasingly constrained, underpricing also resulted in underinvestment over time. Because firms were carrying losses, they couldn’t afford to expand to meet the demand.

Despite the difficulties that state-owned enterprises confronted, they proliferated rapidly from the 1950s to the 1970s in Latin America. In table 3.1 we see what types of industries were most subject to state ownership and ISI policies in the case of Brazil. We see that high rates of state ownership existed particularly in industries that required significant investment, such as public goods enjoyed by all citizens and critical industries, including national security enterprises.

### Table 3.1. State Enterprise Share in the Brazilian Economy, 1973

<table>
<thead>
<tr>
<th>Category</th>
<th>Proportion of Assets in State-Owned Firms</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>High Degree of State Participation (≥50%)</strong></td>
<td></td>
</tr>
<tr>
<td>Railways</td>
<td>100</td>
</tr>
<tr>
<td>Port services</td>
<td>100</td>
</tr>
<tr>
<td>Water, gas, and sewers</td>
<td>99</td>
</tr>
<tr>
<td>Telegraph and telephone</td>
<td>97</td>
</tr>
<tr>
<td>Electricity</td>
<td>79</td>
</tr>
<tr>
<td>Mining</td>
<td>63</td>
</tr>
<tr>
<td>Developmental services</td>
<td>51</td>
</tr>
<tr>
<td>Chemicals</td>
<td>50</td>
</tr>
<tr>
<td><strong>Medium Degree of State Participation (20–49%)</strong></td>
<td></td>
</tr>
<tr>
<td>Water transport</td>
<td>45</td>
</tr>
<tr>
<td>Banking and Finance</td>
<td>38</td>
</tr>
<tr>
<td>Metal fabrication</td>
<td>37</td>
</tr>
<tr>
<td>Services</td>
<td>36</td>
</tr>
<tr>
<td>Air transport</td>
<td>22</td>
</tr>
<tr>
<td><strong>Low Degree of State Participation (&lt;20%)</strong></td>
<td></td>
</tr>
<tr>
<td>Construction and engineering</td>
<td>8</td>
</tr>
<tr>
<td>Rubber</td>
<td>6</td>
</tr>
<tr>
<td>Road transport and passengers</td>
<td>6</td>
</tr>
<tr>
<td>Agriculture and forestry</td>
<td>4</td>
</tr>
<tr>
<td>Nonmetallic mineral</td>
<td>2</td>
</tr>
<tr>
<td>Transport equipment</td>
<td>2</td>
</tr>
<tr>
<td>Food and beverages</td>
<td>1</td>
</tr>
<tr>
<td>Machinery</td>
<td>0</td>
</tr>
<tr>
<td>Wood products and furniture</td>
<td>0</td>
</tr>
<tr>
<td>Textiles and leather products</td>
<td>0</td>
</tr>
<tr>
<td>Tobacco</td>
<td>0</td>
</tr>
<tr>
<td>Printing and publishing</td>
<td>0</td>
</tr>
<tr>
<td>Radio and television</td>
<td>0</td>
</tr>
<tr>
<td>Commerce</td>
<td>0</td>
</tr>
</tbody>
</table>

In an analysis of the cause for state intervention, Tom Trebat identifies six reasons for state enterprises: a weak private sector, economies of scale, public externalities, dynamic public managers, natural resource rents, and public historical factors. In steel, electrical energy, and telecommunications, state-owned firms were formed after private-sector failures. Particularly in Brazil, developmental nationalists believed state intervention was the pragmatic response to the failure of the free market. Economies of scale and the need for large investments to lower costs provided further grounds for state activity. In industries with clear public value, such as railroads, energy, and ports, it was argued that there were benefits to state provision of these services, especially when private providers had not emerged in the market. Because of public visibility and prestige, some state enterprises were able to attract the most dynamic managers. Finally, where industrialization was resource based, such as in oil and mining, it was argued that these resources belonged to the nation and should therefore be managed on the public’s behalf. Thus there was an economic rationale (although perhaps not always a compelling one) for state activity in the industrial sector.

The High Tariff Walls of ISI: Protectionism as a Tool of ISI

International economic tools facilitated the industrialization process. If your grasp of international economics is rusty, box 3.2 provides a quick review of terms. The growth of state and private enterprises was encouraged under the protection of high tariff and trade restrictions. These protective walls were designed to give less-competitive national industries, conceived of as infant industries, the chance to develop without the competition of large multinational firms. There was a perceived need for protection while an economy developed the necessary conditions to promote learning and innovation within the firm. The policy objective wasn’t to ignore exports; rather, the hope was that temporary protection would lead to the development of new products.

We can measure the degree of protectionism by looking at tariff rates. Average nominal protection over consumer and manufactured goods was 131 percent in Argentina, 168 percent in Brazil, 138 percent in Chile, 112 percent in Colombia, 61 percent in Mexico, and 21 percent in Uruguay in 1960. In the case of Mexico in 1970, the effective rate of protection—the nominal tariff rate adjusted for the protection also present in the purchase of intermediate goods used to produce the final good—was as high as 671 percent for fertilizer and insecticides, 226 percent for synthetic fertilizers, 206 percent for pharmaceuticals, 102 percent for automobiles, and 67 percent for electrical equipment. Across the board, for durable consumption and capital goods in Mexico in 1970, effective protection rates averaged 35 percent. High import tariffs often induced multinational firms to set up factories within the country. In 1970 in Mexico, 62 percent of the machinery sector, 49.1 percent of transport vehicles, and 79.3 percent of electric equipment were dominated by foreign enterprises. Although ownership was not national, labor learned new production techniques, and the technological level of production was raised.

Somewhat ironically, in the first stages of import substitution industrialization,
national imports usually rose. Steel, for example, could be produced only with huge furnaces, and they had to be bought somewhere. To promote the import of these critical inputs, states tended to maintain overvalued exchange rates, making imports relatively cheaper to purchase. Imports and access to this underpriced foreign exchange were often licensed to limit imported goods to those critical to the industrialization process. As reviewed in box 3.2, import licensing boards evaluated the quality and availability of national substitutes, their prices, and their importance in the production process before allocating cheap foreign exchange.\footnote{International trade and foreign exchange tools insulated the economy from rival foreign firms dominating the market. Box 3.3 contrasts the effects of various exchange rate regimes in development strategies.}

Box 3.2. A Review of the Tools of Protectionism

- **Export subsidy**: A fiscal incentive, sometimes in the form of a tax break, for reaching export targets. Export subsidies promote the development of export industries at home, arguably to unfair advantage compared to the international firms.

- **Foreign exchange controls**: To restrict the quantity of imports or to direct imports to certain sectors, the government may ration foreign exchange. This generally involves compelling exporters to sell foreign exchange to the government at a fixed price. Selective importers of key goods are offered preferential prices for foreign exchange, whereas importers of luxury items or those wanting to travel pay more local currency for their dollars, yen, or pounds. Foreign exchange controls are therefore linked to a system of multiple exchange rates. Not surprisingly, as there are therefore different prices for the same commodity—money—a black or a parallel market often develops. The black market price can sometimes be used as an indicator of how far the exchange rate has been taken off course by policy distortions.

- **Import licensing**: The legal requirement to obtain a license to import a certain kind of good. Import licensing boards evaluate national availability of goods to assess whether the import is critical or whether the need can be met by national production.

- **Industrial incentives**: Direct payments or tax breaks to a firm engaging in a particular line of production. These credits act as a protectionist device if an international competitor cannot meet the lower, subsidized price in the local market.

- **Quota**: A quota is a quantitative limit on imports. A quota presents a fixed limit on the quantity of goods that may be imported. Quotas may be assigned to suppliers or they may be auctioned, creating revenue for the central government.

- **Tariff**: A tariff, the most common type of protectionism, is a tax on imports. A tariff works best when the demand for the good in question is elastic or price sensitive. If buyers do not respond to the higher price, a tariff will not limit imports. With a tariff, the central government collects revenues. Nominal tariff protection is measured by looking at the tariff rate on the final manufactured good. Effective rates of protection adjust this rate for tariffs on intermediate inputs.

Additional Tools of Industrial Policy: Targeted Lending, Multinational Activity, and Passive Monetary Policy

Ownership was not the only tool of industrial policy in Latin America. Industrial policy was accommodated by monetary and fiscal measures. The state provided
subsidies to domestic firms, and it granted tax credits and soft credit to jump-start the national industrial motor. National development banks were formed, such as Chile’s Corporación de Fomento de la Producción (CORFO) and Brazil’s State National Development Bank (BNDE), to target investments in the economy. A national development bank has an advantage over commercial lenders in planning strategic investment projects. As a state bank, it has a longer return horizon and is able to be active in more risky sectors because bottom-line profits are not the objective. Key industries such as machinery, automobiles, shipbuilding, and telephones were targeted as central to industrial growth. In Mexico, the Law of New and Necessary Industries provided select tax exemptions to promote growth in a limited number of unrepresented but critical sectors in the economy.

Box 3.3. Exchange Rate Policy and Development

An exchange rate is simply the price of one currency in terms of another. Ideally, exchange rates should equate the value of one nation’s goods with those of another. There are three broad types of exchange rates: fixed, flexible, and crawling pegs. Under the gold standard (1870–1914) and the Bretton Woods systems (1945–1973), countries fixed their currencies to an anchor—gold or the U.S. dollar. A fixed exchange rate has the advantage of promoting stability. A critical economic price—the price of domestic goods in terms of international goods—is fixed. The rules of a fixed regime require that a country running a balance of payments deficit must clear its accounts by exporting gold or defend its rates by selling dollars or reserves. Because money supplies are anchored to dollars or gold, the decrease in money contracts the economy and few goods are imported. The economy should therefore expand only at the rate of its accumulation of real reserves—that is gold or dollars in circulation. The best way to understand this concept is to visualize the old trade rules: if France imported more from Great Britain, it had to send or “export” gold to pay for it, thus lowering the national money supply. In the next period France could buy less—and Britain more—balancing imports and exports.

Today many countries pursue a floating exchange regime. Under a floating system, if a country is running a balance of payments deficit, the price of foreign exchange adjusts or depreciates. Rather than a country exporting gold, the market changes the value of national money. The price of the currency is determined by the demand for a country’s goods. As imports surge, residents sell their own currency to buy the foreign currency needed to purchase the imported goods. As a result, imports become more expensive and exports appear cheaper in international markets. If consumers are responsive to price change, flows should begin to balance. A large stock of reserves is not needed to defend the rate. Nevertheless, whereas the fixed exchange rate promotes price stability, a floating exchange rate may exacerbate inflation. Depreciation makes crucial imports more expensive, exerting an upward pressure on domestic prices.

Finally, some countries attempt to have both the stability of a fixed anchor and the flexibility of floating rates with the use of a crawling peg. Under this exchange rate system the currency is set to a central value but is allowed to fluctuate around that target in the short run.

What is the “right” exchange rate in the long run? Essentially, the same good should sell for the same price in two different markets. If it does not, and transportation costs are minimal and trade is free, some enterprising person will buy goods in the cheaper market and sell them where they are dear. Not surprisingly, using the exchange rate as a tool of industrial promotion interferes with arriving at the “right rate.” Imbalances emerge that become difficult to sustain over time.
ISI contributed to the development of light manufacturing such as this Mexican knife producer. (Courtesy of the Inter-American Development Bank.)
In “strategic” sectors such as autos or steel, transnational corporations were welcomed as providers of needed technology and capital within the import substitution industrialization model. In table 3.2 we can see the significant role played by multinational corporations in manufacturing. In or about 1970, 24 percent of manufacturing in Argentina, 50 percent in Brazil, 30 percent in Chile, 43 percent in Colombia, 35 percent in Mexico, 44 percent in Peru, and 14 percent in Venezuela was under foreign control. Some of this participation predates the ISI period, but the strong involvement of transnationals, particularly in industrial production, was seen throughout the postwar ISI period.27

The entry of transnational corporations was somewhat paradoxical. ISI, after all, was attempting to reduce dependency on the international structure of production. However, there was also a degree of pragmatism at work. Transnationals provided critical financial capital and technology. The goal became to utilize these assets selectively, employing state bargaining power to transform the rules of the game. ISI policies set new rules: to produce and sell in the domestic market, transnational companies had to commit to technology transfer and the training of labor. Under the threat of market closure to the sale of their products, transnational firms agreed to joint ownership arrangements and the use of local inputs. In the automobile industry in Brazil, for example, GM do Brasil was a joint venture between Brazilian capital and General Motors (GM). Along with Ford, Volkswagen, and Fiat, it sparked the development of an industrial park. With high tariff rates, local production was the only viable way to sell cars nationally. Multinational firms defended market shares against the possibility of being shut out through local manufacture. If a MNC did not participate according to local rules, its international competitors would. Development of local parts suppliers was promoted by requiring 99 percent local content by weight for passenger cars produced locally.28 Mexico was able to prod concessions in creating national joint ventures in the electrical industry by playing one multinational against another.29 In addition to local content laws, contracts often stipulated the training of local managers to improve national managerial capacity, an assurance of technology transfer of technological processes (not simply sending the more sophisticated parts preassembled in the

| Table 3.2. Foreign Share of Selected Industries, circa 1970 (percentages) |
|----------------|----------|---------|--------|---------|--------|------|---------|
|                | Argentina| Brazil  | Chile  | Colombia| Mexico | Peru | Venezuela|
| Food           | 15.3     | 42.1    | 23.2   | 22.0    | 21.5   | 33.1 | 10.0    |
| Textiles       | 14.2     | 34.2    | 22.9   | 61.9    | 15.3   | 39.7 | 12.9    |
| Chemicals      | 34.9     | 49.0    | 61.9   | 66.9    | 50.7   | 66.7 | 16.5    |
| Transport      | 44.4     | 88.2    | 64.5   | 79.7    | 64.0   | 72.9 | 31.1    |
| Electrical     | 27.6     | 83.7    | 48.6   | 67.2    | 50.1   | 60.7 | 23.2    |
| machinery      | 25.7     | 22.3    | 7.9    | 79.3    | 32.9   | 64.8 | 20.1    |
| Paper          | 23.8     | 50.1    | 29.9   | 43.4    | 34.9   | 44.0 | 13.8    |
| All manufacturing | 23.8 | 50.1    | 29.9   | 43.4    | 34.9   | 44.0 | 13.8    |

Source: Rhys Jenkins, Transnational Corporations and Industrial Transformation in Latin America (New York: St. Martin’s, 1984), excerpted from table 2.4.
United States or Europe), and limits on the repatriation of profits to promote local reinvestment of revenues. Our case study of the auto industry in the appendix to this chapter further illustrates these concepts.

A large domestic market enhanced national bargaining power in establishing contract terms with the multinationals. Clearly Brazil and Mexico had greater bargaining power than Ecuador or Paraguay, as there were many more likely Brazilian or Mexican buyers of locally produced cars. Yet, even in the Mexican and Brazilian cases, exports of locally manufactured multinational products were necessary to take advantage of economies of scale. Despite technology and export earnings, multinationals were not welcomed in all sectors. Even where bargaining power was strong, nationalist sentiments reserved strategic industries, such as oil in Mexico, to wholly local ownership.

For the most part, a loose monetary policy greased the fiscal wheels of development. From the mid-1960s to the 1980s, the dominant political system in Latin America was an authoritarian government. Developmental nationalists saw it as their mission to promote development as a critical element of security. Rules were changed to decrease the autonomy of central banks, forcing them to accommodate fiscal spending programs. Nonetheless, in areas of monetary, fiscal, or international affairs, reliable data about developing nations were sorely lacking, and many macroeconomic decisions were made by guesswork and intuition.30

The Performance of Import Substitution Industrialization

How well did import substitution industrialization work? By the barometer of average annual growth rates of 5.5 percent over the period 1950–1980, one could call import substitution a successful strategy. Throughout the 1950s, Latin American economies were growing comparatively faster than the Western economies, and between 1950 and 1970 Latin American gross domestic product (GDP) tripled.

As illustrated in table 3.3, performance varied by country, with Brazil, Ecuador, and Mexico exhibiting the strongest growth rates over the ISI years of roughly 1950–1980. The production of basic consumption goods was widespread throughout the region, and some countries successfully initiated heavy-machine goods industries as well.31 Production outstripped population growth—making progress on this problem identified in chapter 2. While the population of the region roughly doubled over the period 1945–1980, gross domestic product in real terms quintupled.32

Import performance was variable. Most countries did not see a decline in imports as a ratio of GDP. Brazil was more successful. Comparing 1964 with 1949, imports in the Brazilian economy decreased substantially as a percentage of total national supply, ranging from 19.0 percent in 1949 to 4.2 percent in 1964. Predictably, during
Box 3.4. ISI Toolbox: A Summary

**INDUSTRIAL POLICY**
Form state-owned firms
Form mixed economic enterprises—part state, part private
Require government purchases from national firms
Require foreign firms to establish joint ventures
Pressure foreign firms to increase local content

**INTERNATIONAL INSTRUMENTS**
Tariffs on final goods
Quotas on imports
Exchange rate overvaluation
Exchange rationing
Import licences

**FISCAL AND MONETARY POLICY**
Subsidies for cheap inputs such as electricity
Subsidies for public transportation
Tax breaks in production
Preferential interest rates
Accommodating monetary policy

Table 3.3. Percentage Growth in GDP per Capita

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the first stages of ISI in Brazil, the import of capital producer goods doubled from 1949 (15.8 b Cr) to 1959 (29.2 b Cr) as machines were needed to produce other goods. However, by 1964, imports of capital producer goods had fallen to nearly half the rate of the 1949 levels. Over the same period domestic production of consumer and producer goods rose substantially, with national production of all manufactured products increasing 266 percent from 1949 through 1964.33

Less-tangible gains also accrued.34 Import substitution created forces for the development of an urban middle class, which demanded infrastructure entitlements in public utilities such as water and sewage systems. A national business class and a parallel labor union movement emerged, changing the agrarian balance of power. This coalition supporting the model, however, often intervened in policy making to thwart changes such as exchange rate valuations that might have prevented the accumulation of large fiscal imbalances.

The Crisis of Import Substitution Industrialization

Despite the apparent gains, import substitution industrialization was both unsustainable over time and produced high economic and social costs. In theory, ISI should have developed an internal momentum, expanding industrialization through interindustry linkages. Using his concept of linkages, Hirschman predicted that industrial growth should have occurred based on targeted investments. However, some contend that, given the limited size of the internal market in Latin America, ISI became “exhausted.” It was postulated that as one moves to ever more sophisticated production, especially heavy machinery, the minimum plant size increases. Successful substitution would therefore be limited to sectors in which the internal demand for the good exceeded plant size—or where exports could make up the difference. The export vent, however, was largely closed due to the unfavorable exchange rates and less competitive industries. One study suggested that with such a high degree of income inequality, a massive devaluation to make Latin American exports globally competitive would have been politically and socially explosive.35 Some programs were successful, such as the Brazilian BEFIEX (Special Fiscal Benefits for Exports) scheme, which provided incentives for exports. The benefits, however, were limited to countries and sectors with internationally competitive products. In many cases nationally manufactured goods did not meet international quality standards after growing up under protective tariffs, and firms were not forced by competition to become efficient. ECLA economists advocated economic integration within the region to expand the economies of scale, but the integration process was also stalled in its achievements. Economic performance was too varied across the region, and political differences made subregional integration difficult at times.

Others explained the crisis of import substitution industrialization in political and sociological terms. Because the industrial process was largely in the hands of elites, it failed to create a new entrepreneurial class that would have given the process greater dynamism. Given elite power, import substitution industrialization
may have provided more support to industrialists than to industry. Many of the tools used to manage ISI—import licenses, investment permits, and government contracts—created the possibility of profitable personal rents for those able to control them. Corruption became economically expedient under the ISI model. This led to the views of the new political economists, which will be discussed in chapter 5, suggesting a minimalist role for government.

ISI exacerbated inequality in the region. With more than a third of the region’s population living in poverty, internal demand was severely limited. Consumption patterns imitated those of the center elite instead of attending to the needs of the masses. Import substitution industrialization may also have been a more reactive and a less-coherently implemented strategy than is often supposed. That is, the policy-making process frequently may have been responding to balance of payments crises in erecting tariffs rather than proactive protection. Finally, instead of promoting risk-taking behavior, the comfort of state ownership and international protection coddled the business culture. ISI fostered the creation of inefficient economic institutions that have persisted into the contemporary period.

With resources focused on industrialization, agriculture was neglected. Necessary investments in agricultural infrastructure were not made as capital was directed to the industrial sector. Labor also gravitated toward urban industrial regions, pressuring cities. In some cases the decline in agricultural production meant an increase in the quantity of food imports, further pressuring the balance of payments. The neglect of agriculture weakened not only a source of profits but also the food security of nations. The urban, industrial bias was unsustainable. ISI was an imbalanced strategy.

Inefficiencies and inconsistencies abound under import substitution industrialization. Even Raúl Prebisch, founder of the ECLAC school, was not blind to the emerging challenges in the region in the late 1960s and early 1970s. Prebisch noted that overvalued exchange rates biased growth against the export sector. Where exports are a source of international or hard currency, this introduces a foreign exchange gap to finance development. Differences in domestic expenditures and revenue in state-owned firms led either to persistent deficits or to monetary expansion that results in inflation. We will consider these inflationary biases in chapter 5. Internal and external resource gaps were met through external borrowing, adding annually to debt obligations (chapter 4). As long as international financial markets were willing to extend financing, the model could be sustained; however, once the spigots of international finance were turned off, internally driven industrialization ground to a halt.

Lessons for Development: Was ISI Inherently Flawed?

Does the failure of import substitution industrialization in the 1980s mean that it was a misguided policy from the start? Some contend that the triumphant adoption of the neoliberal model throughout the region testifies to the inherent flaws of ISI. Others such as economist Werner Baer suggest that import substitution industrial-
ization was the appropriate policy for the period but that times changed. Indeed, it could be argued that the development of the industrial sector under import substitution industrialization made the dynamic private sector model possible in the 1990s. The international environment also changed substantially, with expanding globalization. After we look more closely at the neoliberal model in chapters 6–9, consider the counterfactual question for the case study of the automobile industry in Latin America that follows this chapter: Would the industry have been so successful without import substitution industrialization? Although we will come to no definitive conclusion, entertaining this question may foreshadow some of the future needs in Latin America with respect to the role of the state. Remember Gabriel García Márquez’s warning (chapter 2) about the repetitious cycles in Latin American history. Before we discard the goals and tools of import substitution industrialization forever, we might do well to consider that in the future; the past may reappear, with a stronger need for the state to address some of the problems of market failure.

But this is getting well ahead of our story. In the next two chapters we will look more carefully at some of the problems associated with the later ISI period: macroeconomic instability and the debt crisis. This will then position us for a careful look at the neoliberal model, with a strong role for the private as opposed to the public sector.

**APPENDIX: THE AUTOMOBILE INDUSTRY IN LATIN AMERICA—A CASE OF SUCCESSFUL IMPORT SUBSTITUTION INDUSTRIALIZATION?**

The automobile industry is one of the most important sectors in many Latin American economies. In Argentina, the industry and its linkages account for 22 percent of employment. After oil, automobiles and automobile components are the second most important export in Mexico. Brazil and Argentina combined are expected to surpass Germany in automobile sales by the first decade of the twenty-first century. You may be surprised to learn that the automobile industry in Latin America is not merely an assembly operation. Full-fledged production has been in place since the early 1950s; Brazil and Mexico have become centers of innovative production. As in the developed countries, the automobile industry occupies a central role in many Latin American economies, although it has not brought the same level of development. Unlike highly industrialized economies, the Latin American automobile industry is foreign-owned. Since its beginnings, like the region, it has experienced a tendency toward stagnation. Therefore, a look at the development of the automobile industry can enhance our understanding of Latin America’s economic development in the twentieth century.
The Automobile Industry and Its Role in Industrialization

As a leading sector in the development strategies of underdeveloped and developed countries, the automobile industry is credited with innovation in a number of production processes that have changed labor relations and international trade. Two such processes are Fordism and Toyotaism. Fordism—named after Ford Motor Company’s production strategy—introduced the assembly line, innovated the five-dollar workday, and separated geographically the managerial aspect of production—white-collar jobs—from industrial activities—blue-collar jobs. Toyotaism or “just in time” production (named after Toyota’s manufacturing strategy) has replaced Fordism’s concept of an assembly line with “flexible manufacturing,” using technology, robotics, and skilled labor to cut down inventory costs. Furthermore, Toyotaism integrates manufacturer and supplier to create more quality control and meet more varied consumer tastes. Both Fordism’s and Toyotaism’s innovations have been so successful that they quickly spilled over to other industries. It is therefore no wonder why developing countries would seek to establish an automobile industry.

Why Promote an Automobile Industry in Latin America?

The many forward and backward linkages of automobile manufacturing prompted Latin American governments to give it a central role in their development strategies. As Hirschman suggested, a large number of forward and backward linkages will stimulate development. The automobile industry creates backward linkages because it needs suppliers of steel, iron, glass, paint, rubber, and textiles. This stimulates the growth of steel mills, glass producers, rubber producers, and paint manufacturers. It creates forward linkages because automobiles need gas, oil, replacement parts, service shops, and better roads. This demand leads to private investment in oil refineries, gas stations, automobile parts, and construction companies. The result is an increase in economic growth, employment, and aggregate demand. In the mid-1950s a Brazilian admiral who was very closely involved with the promotion of the automobile industry stated, “As in the highly industrialized countries, the automotive industry will be without doubt the leading sector of the entire economy, by force of its magnitude, complexity, and dynamism.”

The Early Automobile Industry in Latin America

The growth potential of the automobile market led multinationals to the region. In 1916 Ford opened its first assembly plant in Argentina. In the following years operations by other automobile firms were established in Brazil, Mexico, and Chile. The market was too limited to support full production but was profitable for assembly operations. To promote expansion of locally based multinational corporations (MNCs), governments, at the request of the established foreign firms, set tariffs on fully assembled vehicles of nonresident producers to increase the profit margin of firms with local plants.
The importance of the Latin American market grew as a result of the expansion of road networks in the early 1920s. American manufacturers moved quickly at the opportunity to extend their U.S. production run of parts and components to these markets, since the European market was highly protected. By the late 1920s Argentina represented a market twice as large as Italy and a third the size of France and the United Kingdom.

The Role of the State in the Automobile Industry

A drop in commodity prices during the Great Depression debilitated the import capacity of Latin America. As available imports declined during World War II, a local parts-supply sector owned by private national capital developed to service the aging stock of vehicles. The strong demand for raw materials for war efforts boosted Latin American exports, creating huge reserves of foreign exchange.

The immediate postwar period witnessed a flood of automobile imports in response to the backlog in demand, but the availability of foreign exchange was short-lived. By 1947 vehicle imports to Argentina reached eighty thousand; in Brazil they peaked at 110,000 in 1951. This surge of imports led to a balance of payments deficit and endangered the existence of local parts producers. In response, the governments of Brazil, Mexico, and Argentina—the countries with the largest automobile operations—raised trade barriers to limit the number of finished automobile imports and protected local producers by setting local manufacturing content requirements for domestic assembly operations. These state actions were crucial for the transition to manufacturing operations and reflected the beginning of a government commitment to an ISI policy. In 1956 the Brazilian government banned all imports of cars, requiring any international producers wishing to sell in the Brazilian market to establish local operations. It also required that 90 percent of parts be procured from national producers within five years, stimulating the development of a supplier industry.

Foreign capital, as a source of technology and know-how, was crucial to this strategy. Since automobile corporations were among the largest and most technologically sophisticated in the world, governments had a particular interest in ensuring that they continued to invest locally. Therefore, import barriers and local content requirements were matched with high fiscal incentives. Between 1956 and 1969, the Brazilian government offered 89 cents worth of subsidies for every dollar in investment. Mexico offered 50–60 percent of the value of investment. In addition, to make the market even more attractive, governments created policies to control wages. Government subsidies were important in moving from assembly to manufacturing because the small elite market limited economies of scale. Therefore, fiscal incentives made the transition to manufacturing profitable for the foreign automobile firms. As a result, by 1962 Brazil

**Question for Thought**

Given your understanding of the automobile industry and economic policy, were appropriate strategies followed throughout the course of the development of the automobile industry?
produced 191,194 vehicles per year; Mexico produced 193,000 by 1970, whereas ten years before it assembled only fifty thousand with low domestic content.47

**Export Promotion and Debt-Led Growth**

State intervention was also critical in moving from production exclusively for the domestic market to exports. Balance of payments shocks driven by the oil crisis of the 1970s prompted export promotion to relieve current account pressures. Brazil developed the Special Fiscal Benefits for Exports (BEFIEX) program in the early 1970s. Manufacturers wishing to qualify for continued fiscal benefits and reduced tariffs had to meet a dollar-value export target. Otherwise, they were subject to exorbitant import taxes for capital goods, parts, components, and raw materials. In 1977 the Mexican government issued a decree mandating automobile firms eliminate their trade imbalances by 1982. Established firms complied to fend off increased competition by Japanese firms eager to enter the market. Instead of undertaking austerity measures, the government followed a debt-led growth strategy that provided subsidies and credits for those firms that would begin exporting automobiles with a high domestic content. Given the high production costs, it was very unlikely that the Latin American industry would have generated exports without government intervention.48

The majority of established firms complied with the export requirements. During the second half of the 1970s and the 1980s exports from Brazil and Mexico shot up. By 1981 the proportion of vehicles produced for export in Brazil had increased to 27.3 percent, up from 2.2 percent in 1972.49 The Mexican automobile industry by 1986 had reached a trade surplus of U.S.$1,117.7 million, over the 1977 industry deficit of U.S.$385.3 million.50 Argentina, the third major automobile producer in Latin America, had a short-lived boom in exports during the mid-1970s. However, the coup of 1976 brought a military government with liberalization policies that led to an increase in imports, dominating 25 percent of the domestic market. Although government fiscal policies in the 1970s led to the debt crisis, the automobile industry’s new capacity to export helped reduce losses from a contracted domestic market.

**The Debt Crisis and a Contracting Market**

During the “lost decade” of adjustment to the debt crisis, the domestic automobile market shrank. Increasing income inequality and erratic price changes made automobiles a luxury reserved for the rich. Governments eliminated many of the industry’s preferential subsidies and the depressed domestic market provided little incentive for firms to add capacity. Firms shifted their exports to the United States and Europe as their developing country export markets contracted. In Mexico, the market was so depressed that in 1986 the industry was producing 43 percent less than in 1981, most of which was for export.51 Firms with minimal
investments like Renault pulled out, but the largest firms—GM, Ford, Chrysler, Volkswagen, and Fiat—had invested too much to dismiss their Latin American operations as a loss.

**Austerity, Market Forces, and a Domestic Boom**

During the 1990s the automobile industry experienced a turnaround. Demand in Brazil and Argentina was so high that automobile firms needed to build more plants to accommodate the booming market. Plants in Brazil operated twenty-three hours a day and could not meet domestic demand. Mexico’s market, although it suffered a setback during the 1994–1995 peso crisis, grew by 33 percent in the first quarter of 1997.52 In Argentina, automobile sales ran at an annual rate of four hundred thousand units, while in Brazil the yearly rate was 2.2 million vehicles.53 Brazil and Mexico surpassed Italy, becoming the tenth and eleventh leading automobile producers in the world. In 1987, Ford and Volkswagen entered a partnership called AutoLatina to save their investments in the depressed market of the 1980s. In 1994 the partnership was dissolved because the market was once again big enough to handle the two competitors. The turn in market conditions was attributed to the sustained growth experienced by most Latin American countries. Price stability and available credit made automobile ownership a reality for many Latin American families. A study by Honda shows that more than 2.7 million households in Brazil have an annual income of $48,000 and an additional 8.6 million earn at least $24,000.54 Argentina, which has always boasted of the largest middle class in the region, has an antiquated automobile fleet, with an average age of fifteen years, that is rapidly being replaced.

Alongside growth and an expanding market have been neoliberal policies of maintaining price stability and a self-regulating market. In the 1990s these policies, instead of fiscal subsidies, enticed automobile manufacturers to invest in the region. From 1995 to 2000, automobile manufacturers poured approximately $23 billion into new automobile factories, more than half of which were in Brazil.55 Chrysler Corporation, which had not invested in developing countries since 1965, opened a plant in Argentina in 1997. The Japanese view Argentina and Brazil as the most lucrative markets in the world, and Toyota invested $200 million in a factory outside of São Paulo to serve Mercosur. Furthermore, technological spillover finally came to fruition. In the second half of the 1990s, Latin America became a locus of technological innovations in production and labor relations. Most plants are now using automation and robotics, requiring skilled labor. In 1996 Volkswagen opened a factory in Brazil that it claimed was the most advanced in the world. This factory bound VW and seven suppliers in the manufacturing and assembly process. VW supplied only two hundred workers, while the bulk of labor belonged to the suppliers. This reduced costs by 50 percent and increased worker productivity by 12 percent.56 GM is following suit by renovating the bulk of its plants from assembly-line operations to more flexible manufacturing.
Economic Integration Allows for Economies of Scale

Aside from economic growth, economic integration and liberalization in the 1990s was responsible for the heavy investment by the automobile firms. In the 1950s and the 1960s, automobile manufacturers were reluctant to begin manufacturing operations without government incentives because the markets were too small to reap the benefits from economies of scale. The markets of Mercosur, the North American Free Trade Agreement (NAFTA), and the Andean Pact made it possible for companies like VW, GM, and Ford to take advantage of economies of scale. Mercosur member countries lowered tariffs for producers within the customs union to 35 percent. This made it possible for companies to integrate their operations to serve the entire customs union. Mexico has for a long time produced GM engines for Detroit. During the peso crisis, automobile production in Mexico did not fall as much as it could have because NAFTA provided an escape valve through which producers could switch from production for the domestic market to U.S. and Canadian markets. Venezuela, with its very limited automobile industry, is now enjoying investment from the American “big three” automobile producers, who use it as an export platform to markets in Ecuador and Colombia.

Economies of scale allow for cost savings. GM do Brasil has launched new, technologically advanced and affordable automobiles for the Brazilian market. Another reason for falling prices and rising investment is the significant decrease in common external tariffs on imports from outside the integrated area. Imports have significantly increased, forcing the traditional producers in the Latin American economies to cut costs and prices. In Mercosur, external tariffs on automobiles were scheduled to drop to around 20 percent by the year 2000, although progress has been delayed by the Brazilian and Argentine crises until 2004.58 Competition appears to be working to spur improvements in productivity.

Reconsidering ISI and Neoliberalism

The contemporary success of the automobile industry is forcing some economists to reconsider their judgments on ISI. Many contend that the industry’s success today dates to the ISI policies of the 1950s and 1960s and the export policies of the 1970s. Producers were forced to consider the region as a profitable long-term production site. Once investments were made, they complied with government decrees to protect their privileged access into the region. In the 1980s firms had invested too much to pull out from the region. As a result, today GM, Ford, VW, and Fiat hold 99 percent of the South American market and are among the top investors.

However, the technological spillover that state officials foresaw did not bear fruit during the years of ISI. Instead, neoliberals contend that it wasn’t until governments began to focus on getting prices right, downsizing the state, and liberalizing the economy that Latin America became fertile ground for technological breakthroughs in automobile production. Furthermore, neoliberal policies have reinstated
growth, and market forces that have driven automobile MNCs to cut costs through technological innovations.

**Key Concepts**

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<th>Overvalued Exchange</th>
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**Chapter Summary**

**The Dependency and Structuralist School**

- The dependency theory states that the center—industrialized nations—expanded at the expense of the periphery—developing nations. Capitalism therefore created underdevelopment. Local elites forged alliances with international capital, blocking development.
- The structuralist school, as defined by the UN Commission for Latin America, had two main characteristics. First, declining terms of trade hindered economic development for Latin America. Second, concentrated oligopolies and elites determined prices and consumption patterns that proved incompatible with growth for the region.

**Import Substitution Industrialization (ISI)**

- In response to dependency theory and the structuralist school, Latin America pursued ISI. This inward-oriented approach sought to promote and protect domestic industries through an interventionist state that would attack bottlenecks and market failure.
- ISI relied on various tools to promote industrialization:
  - active industrial policy through the use of state-owned enterprises;
  - protective international instruments such as tariffs, quotas, import licenses, foreign exchange controls, industrial incentives, and export subsidies to protect infant industries;
  - targeted lending to industries such as machinery and automobiles;
  - subsidies and tax exemptions for particular industries, including transnational corporations that provided critical financial capital and technology;
  - strict investment rules such as local content laws and minority foreign ownership;
  - and passive monetary policy to finance projects under ISI.
Although data show that ISI had a positive effect on growth until the 1980s, there were also negative consequences. Nationally manufactured goods often failed to meet international quality standards, making them uncompetitive in the global market. ISI exacerbated inequality by preserving the power of the elite and failing to create an entrepreneurial class. In addition, the agricultural sector was neglected, which weakened a source of profit and food security. There was also a bias against export growth through overvalued exchange rates, leading to differences in domestic expenditures and revenue that contributed to persistent deficits and inflation.

Notes

12. The Spanish acronym for ECLA is CEPAL, the Comisión Económica Para América Latina. ECLA later became ECLAC, with the C reflecting the incorporation of the Caribbean.


26. This is based on the theory of purchasing power parity and the law of one price. Two sweaters should sell for the same price in two markets (adjusted for transportation costs). If they didn’t, some enterprising person would buy sweaters where they are cheap and sell them where they are dear.


34. This paragraph draws from Rosemary Thorp, *Progress, Poverty and Exclusion: An Economic History of Latin America in the 20th Century* (Baltimore: Johns Hopkins University Press for the IADB, 1998), 197.


42. This case was written by Erwin Godoy, Colby College graduating class of 1997.


54. Zuckerman, “In South America Car Makers See One Big Showroom.”


