Evaluating ISI and EOI:

Circumstances for Success in Latin America and East Asia

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Abstract:

The last quarter of the 20th century exposed drastically different levels of economic growth between Latin American and East Asian states. Largely due to their different development models, both regions have since been analyzed to determine the efficacy of different strategies of industrialization. The literature largely describes the export-focused model of East Asia as being superior to the protectionist policies of Latin America. This literature review determines that domestic societal factors were great contributors to the success of East Asia, and that Latin America did not have the qualities for success with the same model, largely overlooked by the current research. This paper outlines the important circumstantial variables that contribute to the appropriateness for one model, and points to when export-oriented or import-substitution industrialization methods should be implemented, using Chile as a case study.

1.0 — Introduction

Examining the strategies used by developing states to grow their economies and what domestic factors play into the use of these strategies is essential for understanding the full scope of the efficacy of such development models. Development strategies, and their effects on the domestic markets, can be drastically different for some states than others. Two major developmental strategies utilized by states are Export-Oriented Industrialization (EOI) and Import-Substitution Industrialization (ISI). Pertinent examples of states under EOI strategies include several East Asian countries, commonly referred to as "the Four Asian Tigers," including Singapore, Hong Kong, Taiwan and South Korea, and the "Association of Southeast Asian Nations" (ASEAN), including Indonesia, Malaysia, Thailand and the Philippines. These eight countries have found great success in economic growth under the EOI model during the last quarter of the 20th century. This rapid growth experienced by these nations is often referred to as the "East Asian Economic Miracle." States that have pursued ISI strategies of development instead of EOI strategies include several countries in Latin America. During the 1980s, states pursuing the ISI model in Latin America experienced a debt crisis, commonly called the "lost decade," a strikingly different experience than the East Asian Miracle.

So why have these Latin American countries pursued ISI strategies of development? Under what set of circumstances does one strategy of development perform better than the other? This paper will examine the existing literature on the apparent contrast of Latin American development strategies and East and Southeast Asian development strategies. I will lay out the initial policy conditions in these respective regions, distinguishing differences and similarities that may have contributed to long-run success in accelerating growth. I will then examine the practices and consequences associated with both models, weighing heavily on examples from Latin America and East Asia. Although it is generally accepted that EOI models have experienced greater levels of efficacy, there are external pressures and internal shifts that may have had a greater influence on the rapid growth within the East Asian Miracle than much of the discourse in the literature takes into account. To demonstrate how the literature may be overlooking several important domestic factors that contribute to economic growth, regardless of development strategy, I will examine the history of economic growth and policy in Chile. Due to Chile's experience pursuing ISI strategies along with the rest of Latin America but early transition towards export-focused methods, it stands out as a unique example for examining both models in action. The case for Chile holds important implications for the economic future of other Latin American countries pursuing growth through market liberalization.

Through analysis of both EOI and ISI strategies in action, in particular within Chile, I determine that it is inappropriate to characterize the two models as a dichotomy, as is often seen within the literature. Instead, I point to the domestic qualities within Latin America that would have impeded growth, even with export-oriented policies such as the ones seen in East Asia. I also uncover criticism of both models that sheds doubt on the suitability of describing either model as a complete success story. This paper synthesizes the identified policies and situational circumstances coming from a post-World War II period that lead to the efficacy of the aforementioned models, laying out paths for further researchers and policymakers to consider when approaching strategies in given present-day circumstances.

2.0 — Export-Oriented Industrialization and East Asia

In the EOI model, countries aim to advance their exports within industries they hold a comparative advantage in. These countries will generally impose policies that favor these exporters, beginning with low-skilled and labor intensive industries before eventually moving to secondary-EOI, involving more technologically advanced goods. In the ISI model, countries often impose protectionist policies and trade barriers for foreign imports in an attempt to boost domestic production. The ISI model also includes a secondary stage in which state investment in building the skills of the labor force allows for protectionist policies to form around technologically advanced goods. In the early post-World War II period, many states focused on inward-oriented industrialization, imposing discriminatory trade restrictions to favor domestic producers. East Asian economies were no exception to this period of Import-Substitution Industrialization (Jaspersen, 1997). Only in the 1960s did East Asia turn to policies that favored exporters, with efforts to shift their economies from agrarian-based to manufacturing-based (Numazaki, 1998). The ensuing growth was driven not by domestic markets, but instead by the increase in foreign trade, in particular with the US and Japan. Several of the states to pull forward using these export favorable policies were the so-called "four Tigers," Taiwan, South Korea, Singapore and Hong Kong. After their shift to an increase in EOI strategies, these four economies experienced both a steady and high rate growth rate of their Gross National Product, almost full employment and an increase in a relatively egalitarian distribution of income. According to a 1998 study by Ichiro Numazaki, between 1965 and 1980 the four Tigers had annual growth rates of 8.6 - 10 percent. After this period, they were able to maintain steady and high levels despite the recession of developed nations. Between 1983 and 1993, Taiwan and South Korea were able to quadruple their Gross National Product per capita, while Hong Kong and Singapore tripled theirs. This rapid expansion can be seen as a direct correlation to the new export-based policies, as the ratio of exports to Gross National Product was over 50 percent (Numazaki, 1998).

This rise in exports came largely from industries such as clothing, textiles and other manufactures. Within the four Tigers, a range from 31.1 - 68.8 percent of their exports were manufactured goods. These goods were largely labor-intensive and didn't require high levels of skilled labor. By 1981, though, shifts in exports were made towards technologically advanced products, such as transportation equipment, electrical and non-electrical machinery. This shift follows an industrialization pattern termed "classic product-cycle industrialization pattern" by Bruce Cummings (Numazaki, 1998). In this pattern, states will begin with the lower-skilled primary products in which their state has a comparative advantage in producing, focusing their export pushes on these products. After this initial phase, states shift to higher-skilled labor, advancing from technological transfers through the increased international trade and engagement. This secondary-stage of industrialization would ultimately push states towards higher levels of technological advancement and production of products as such. Closely following the four Tigers along this product-cycle industrialization pattern were the original states of the Association of Southeast Asian Nations (ASEAN), including Indonesia, Malaysia, Thailand and the Philippines. These countries had similar high growth rates throughout the 1960s and the 1980s, with Thailand achieving an average annual growth rate of 9 percent in the 1990s.

2.1 — Japan as a Stepping Stone

The market for the exports coming from East and Southeast Asia was largely found in the US and in large US companies, which had been shifting more and more towards global sourcing, beginning with sourcing clothing from Japan. American department stores in particular began selling “cheap” clothing made in Japan in the 1960s (Numazaki, 1998). This trend of global sourcing included sub-contracting commercially for finished goods that could then be sold within the US under private labels. Other original equipment manufacturers (OEMs), or companies that sell manufactured goods to other companies to be resold under a brand name, would participate in ‘component supply subcontracting.’ This type of subcontracting consisted of high-tech parts being imported for the completion of final products that could then be sold under these private labels. East Asian manufacturers were attractive to these subcontractors because they were able to obtain high levels of industrial flexibility to adapt to quick shifts in demands. Pairing this with low labor costs within these states created ideal buyer-driven circumstances for large US retailers and transnational manufacturers.

These outsourcing practices began with the domination of Japan in clothing and footwear imports to the US, but other East Asian states were able to access the roots for this success to follow in Japan’s footsteps. After World War II, Japan experienced high labor costs and labor shortages, incentivizing Japanese companies to begin shifting production sites, direct investment, joint ventures and technology transfers towards the periphery, taking strong advantage of states in geopolitical proximity to Japan. In particular, South Korea and Taiwan became ideal locations for these shifts (Numazaki, 1998). By following the product-cycle industrialization pattern and having key access to these shifts by Japanese companies, the first of the four Tigers were able to import the necessary manufacturing tools and materials from Japan who had previously been able to develop them in their own process of industrialization. Not far behind the four Tigers followed the four ASEAN nations, and closely following these states was China. After dramatic political and economic changes experienced during the cultural revolution in China, an open-door policy was adopted in 1978 with market-oriented reforms, becoming increasingly linked to the world economy. While China is seen as following industrialization processes after the eight East and Southeast Asian states within their respective groups, their ability to import the tools and materials for focusing on export heavy industries within the Pacific Rim region has potentially allowed them to experience the dramatic levels of economic growth we have been witnessing after the turn of the century.

By the 1980s and early 1990s, Pacific Rim economies heavily permeated the US market in terms of capital and consumer goods. This presence in the US import market was achieved through outsourcing and "outprocessing" along the global commodity chain developed between Japan and the US closer to the mid-1900s. By 1994, 17.3 percent of all world exports had originated from these East and Southeast Asian countries. What often becomes overlooked when discussing EOI models is that subsequent Asian nations successfully implementing these export-driven strategies experienced a dramatic rise in their imports as well. Because of the need for these states to obtain tools and materials to redirect economies towards manufacturing-based, they relied heavily on importing from Japan and other leading developing states within the Pacific Rim. By 1993, the exports from the eight leading East and Southeast Asian nations to the US reached a total of $115.1 billion, but the imports from Japan to these eight countries was a staggering $121.6 billion (Numazaki, 1998). This created a dependency not only on the large US companies and transnational corporations for their subcontracting and outsourcing, but also a rather large dependency on Japan and the following Asian nations that had the necessary tools for industrialization.

2.2 — Importance of Domestic Investment for EOI

It is generally accepted in the literature that East Asia was able to secure their export-driven growth through through a combination of broad ranges of macroeconomic stability and high rates of accumulation of human and physical capital (Birdsall and Jaspersen, 1997). A 1997 study found that, depending on control for different parameter estimates, between 60 and 120 percent of the output growth in East Asia is derived from the successful accumulation of physical and human capital, resulting in an ensuing growth of the labor force (Page, 1997). Due to the largely homogeneous characteristic of East and Southeast Asian societies, there have historically been lower levels of income inequality and gaps in achievement than in other regions. For this reason, investments in schooling, health and nutrition by public policy has allowed for high rates of human capital accumulation in East Asia, ultimately contributing back to increases in labor market participation (Birdsall and Jaspersen, 1997). East Asian states have also had higher rates of domestic savings, contributing to their success in rapid growth (Suzuki, 2012). By implementing pro-growth policies, such as holding financeable limits on fiscal deficits, in response to the external shocks of the 1980s, East Asian states were able to maintain relative price stability which in turn sustained an environment focused on high rates of savings (Jaspersen, 1997). Demographic shifts during this time period that involved a larger amount of people either entering or staying in the labor market also factored into greater rates of private household savings (Page, 1997).

There have also been arguments that, in large, success in East Asia has been driven by effectively implementing institutions to assist in communications between the private and public sectors, along with the monitoring of performance at the industry or economy levels (Page, 1997). The strength of these public institutions and the credibility of the bureaucracy encourages private investment by economic agents, fostering sustainable growth. In this way, simultaneous investment in human capital, such as public and private investment in education and health, plays an essential role in terms of if the outcome of development policies. By already having a rather egalitarian and homogenous population, East and Southeast Asia was prepared for success through the EOI model.

3.0 — Import-Substitution Industrialization and Latin America

Latin American countries followed very similar paths to industrialization as East Asian countries in the immediate post-World War II period. In this period of time, the conditions and economic structures of growth in both regions actually reflected very similar policies. Both East Asia and Latin America had what were considered "mixed economies," in which they utilized a combination of both market forces and limited state interference in attempts to spur development (Birdsall and Jaspersen, 1997). During the period following the mid-1900s, Latin American states experienced particularly strong anti-export biases within their governments and trade regimes, which became reinforced by protectionist policies aiming to benefit domestic producers. Characteristic of these policies favorable to domestic producers was that they were indiscriminate to industries or sectors in which states may have had comparative advantages in, often critiqued as an inefficient use of resources (Baer, 1972).

The primary stage of ISI within Latin America achieved some levels of success after the mid-1900s. Growth rates were moderate in the early 1960s, with an average annual GDP growth rate of 7.4 percent across Latin America in 1964 (The World Bank, 2019). With the same pressure to de-link from the international economy after World War II as the rest of the world was facing, Latin America found a capacity for domestic production to replace foreign imports due to an abundance of domestic natural resources. While these natural resources allowed Latin American countries to focus solely on inward-oriented industrialization with growth in their economies, they also enabled the region to continue their isolation from heavy participation in the global market. The initial "easy-ISI" approach by Latin America involves placing an emphasis in replacing foreign imports with domestic production in the 'easy' manufacturing sector of mainly primary goods (Bruton, 2002). These goods were largely low-skilled and labor-intensive, similar to the primary stage of the product-cycle industrialization pattern of the EOI model. The shift to secondary-ISI incorporated a higher investment in domestic skills and labor force to adjust to higher-skilled and technologically advanced manufacturing. This secondary ISI approach involves a strong amount of government interference through investment in human and physical capital, often increasing levels of debt (Cypher, 1997). By implementing trade and financial liberalization policies in Latin America, prices were reduced and foreign borrowing became easier for financing domestic consumption. This inadvertently, though, led to a loss in domestic private savings (Birdsall and Jaspersen, 1997). The capacity for foreign borrowing created space for Latin America to attempt to finance their secondary-ISI through heavy external borrowing, thus making these countries susceptible to external shocks.

The pushes within Latin America for autarkic development, in which production was encouraged for intermediate and capital goods as well as final goods, has been argued to be non-conducive to growth as it impedes a focus on sectors that may be able to achieve the highest possible output due to their comparative and absolute advantages (Baer, 1972). The heavy emphasis on foreign borrowing and decline in private savings also created a space for the oil shocks of the 1970s and 1980s to have a great impact on Latin American economies. After this energy crisis, creditors' perceptions changed due to new interest rates and changes in the international terms of trade. The abrupt cut off of financing macroeconomic imbalances with external borrowing led directly into the Latin American debt crisis. Only at this point were the majority of Latin American countries finally shifting away from their severe protectionist policies and introducing structural economic reforms. The stagnation of growth in this period is commonly referred to as the "lost decade" of growth within Latin American countries, with inflation averaging 75 percent annually in the three decades leading up to 1990 (Jaspersen, 1997).

3.1 — Comparison of Latin America and East Asia

It is in these areas that the literature draws reference to the sensitivity of both models to external pressures. Latin American domestic markets were larger than East Asian domestic markets, and many industrial and labor interests within Latin America were vested in the protectionist approach. For this reason, Latin American countries felt internal pressures to remain on an inward-oriented process of industrialization, while East Asia did not have these internal influences. While the abundance of natural resources in Latin America encouraged continued ISI strategies, developing East Asian states did not have the resources to motivate this continuation. The ISI model also failed to create sufficient employment opportunities during mass migrations from rural areas to urban areas in Latin America (Baer, 1972). The pattern of growth within Latin America at the time can be characterized by increasingly restrictive trade policies with outbreaks of inflation and balance-of-payments crises. The secondary-ISI approach to expanding demand management gave way to little bursts of growth and stagnation in turn, termed as a "stop-go" pattern of growth in a 1997 study (Jaspersen, 1997).

When the energy crisis hit economies globally, East Asia responded with increasing exports and manufacturing. The high levels of private savings within East Asian states also were able to successfully curtail the brunt of the economic losses felt by countries in Latin America. Combining this with the fact that Latin America has had a much more heterogeneous population with larger gaps in equality, East Asia was predisposed for its human resources policies to overcome a potential deterrent for growth that Latin America faced (Birdsall and Jaspersen, 1997). During the last quarter of the 20th century, East Asian economies experienced high ranges of around 5 - 10 percent annual growth in comparison to the average 1.2 percent experienced by Latin American economies. As a whole, from the end of World War II to the end of the 20th century, the four Tigers and ASEAN nations experienced growth at a rate that was 3 times faster than that of Latin America and the Caribbean (Birsdall and Jaspersen, 1997).

3.2 — ISI in Western Countries

Protectionist strategies with the intent of expanding development have not only been employed by Latin American countries, but also by Western developed nations. While Latin

America was unable to foster sustainable growth through ISI policies, there has been a history of ISI being successfully used to protect specific industries. In the middle and end of the 19th century, both the US and Europe experienced a wave of protectionist policies (Baer, 1972). This inward focus was in part due to wars and isolation of states from an international system. Domestic production was stimulated by the need for substitutes to foreign imports, including technology (Landes, 1966). This process to protect infant-industries has therefore been proven to foster industry-specific growth, leading to countries that have achieved full-scale industrialization. Protectionism as a strategy to push towards self-reliance and independence from an international economy has largely been dependent on the political situation, though (Strange, 1985). While used by Western economies, ISI strategies tend to not be long-term models, and are rather dependent on the political tensions of the period, such as war or aggression hindering international trade (Baer, 1972).

4.0 — Chile's Case With ISI

Chile often stands out as one of the Latin American economies to establish higher growth rates through adopted structural reforms after a long period of ISI implemented strategies. These reforms follow economic policies similar to those in East Asia while still being tailored to the comparative advantages of Chile (Birdsall and Jaspersen, 1997). According to the International Monetary Fund (IMF), Chile's real GDP growth and its inflation rate have stabilized, particularly over the past 20 years. Chile has been championed as a success story following the IMF's structural adjustment programs. Between 1990 and the early 2000s, Chile experienced an economic boom with Gross National Product rates between 4 and 12 percent (Nef, 2003). Investment has been on the rise and there has been a decrease in overall national debt.

Chile had only undertaken these radical neoliberal reforms in the 1970s, yet this was much earlier than other Latin American states who retained secondary-ISI measures up to nearly the 1990s. Before this, Chile was a classic example of an economy incorporating inward-oriented development strategies. The introduction of the ISI model into Chile began in the 1930s and 1940s, after the Great Depression and associated collapse of the international economy led to a strong mistrust and bias against the lassez-faire system. Initially, this inward focus restored both political stability and social peace in Chile. According to a comparative review by Eduardo Silva on development strategies in Latin America, three strong features of the ISI model were consequently imposed in Chile. The first being the creation of an institution for development, called the Corporación de Fomento de la Producción (CORFO) developed in 1939. CORFO laid out the basics for the mixed-economy characteristic of many Latin American (and East Asian) states, and eventually became a model for other Latin American countries. The second being strong tariffs and industrial policies aimed to discriminate against traditional agricultural and mining sectors so as to effectively substitute foreign imports with domestic production. Finally, the third feature that indicated towards an ISI-based strategy was the formation of a social coalition that supported the general protectionist development policies. This social coalition also favored center-left political policies and advocated for Chilean democracy (Silva, 2007). CORFO was able to achieve success in growing the GDP of Chile as well as increasing the industrial share within the GDP in its beginnings, but eventually economic "bottlenecks" within the ISI model became present in the 1950s and 1960s. While investments from the World Bank, the US and bilateral aid may have been sufficient to spur growth within the stages of easy-ISI, the transition to secondary-ISI required greater levels of financing as laid out previously. Due to the inability to attain this type of investment, Chile began to experience inflation with periodic needs for IMF sponsored stabilization efforts. This contributed to the aforementioned stop-go characteric of development within Latin America.

During this transition to secondary-ISI, a nationalist sentiment within Chile strengthened with ensuing political pressures to keep profits from exports within the state. With the increase in economic bottlenecks restraining the in-place development strategies, political polarization and class divides deepened. Eventually a coalition of leftist and Marxist political parties arose to the forefront of the political sphere, called the “Unidad Popular.” This marked the end of the social coalition which had previously supported ISI policies. Continued political tensions led to the 1973 coup d’etat, collapsing Chilean democracy and introducing the military regime of Augusto Pinochet. Only under this harsh regime did Chile see shifts towards free-market policies. Although the break towards neoliberalism no doubt removed the previously restraining bottlenecks of ISI, countless human rights violations under the Pinochet regime did little to restore domestic political and economic stability. The constitution created under Pinochet also allowed for a discreditable bureaucracy, giving virtual immunity to both the police (“carabineros”) and the armed forces (Nef, 2003). After the regime ended in 1990, Chile has been marked by political instability in a transition back to democracy, though there has been economic achievement, albeit spread largely unevenly between sectors.

Chile is a unique case to examine because of its lessons for the rest of Latin America. Chile felt the economic restraints of ISI and its sensitivities to external pressures in the last quarter of the 20th century, but also was able to expand its economy through neoliberalizing efforts. While these economic advancements cannot be ignored, recent unrest over the history of human rights abuses has shaped the political sphere. These advancements, as well as favorable socioeconomic conditions conducive to growth, have also only been achieved through recent Chilean state investment in social programs and human capital (Davis-Hamel, 2012). Chile's current economic and political circumstances hold implications for if Latin American economies can follow the successes of East Asian economies.

5.0 — Discussion

So what accounts for the seemingly extreme divergence of the development paths of both Latin America and East Asia? Coming from similarly structured mixed-economies, the literature points to the domestic differences as to why external pressures persuaded the respective regions to pursue different development strategies. Latin America's history of rich natural resources and growth based on the exploitation of these mineral and agricultural commodities incentivized economies to maintain the inward and protectionist policies that were common after the international economic collapse of the Great Depression and the immediately following World War II. Special interests within Latin America had investments in the continuation of the easy-ISI strategies in place. East and Southeast Asia in comparison had little incentive to remain pursuing protectionist policies due to the minimal domestic market and lack of such natural resources. Instead, East Asian states followed Japan's pattern of market liberalization, utilizing the global commodity chain already in place between Japan and the US. When adverse external pressures connected to the 1973 oil crisis hit, East Asian states were able to export their way out while the practices of heavy foreign borrowing and investment cutting in Latin America to finance their secondary-ISI extremely stagnated economic growth. East Asian countries also were successful in gradually moving towards floating exchange rate regimes in the early 1980s that had not only the effect of offsetting the difficulties of trade liberalization felt by domestic producers, but also moving so far as to undervaluing the currency as to favor exports—exemplified in Taiwan and China.

Many scholars argue for the demographic of the populations within both Latin America and East Asia holding greater weight in their success towards industrialization. Through East Asia's homogeneous society, policies are more favorable towards equitable factor accumulation. Latin America's heterogeneous society with generally larger gaps in asset distribution and income does not facilitate the same success within strong public management. Bloated bureaucracies and reduced amounts of public investment, particularly in human resources policies, as consequences of the 1980s Latin American debt crisis only exacerbated a non-conducive environment to high rates of human capital accumulation. It is with examining the lack of investment in human resource policy in Latin America that observing Chile becomes increasingly important for determining the success of development strategies. Even with the introduction of neoliberalization by Pinochet, privatization lead to low wages, high unemployment, increased poverty and higher amounts of inequality (Davis-Hamel, 2012). The Chilean bureaucracy formed under Pinochet also lacked the transparency necessary to become reputable and encourage investment at the levels seen in many East and Southeast Asian countries.

6.0 — Conclusion

While the literature largely paints the ISI model as a failed strategy, in the past it has proven to be able to facilitate full-range industrialization. Nearly all Western developed nations have gone through easy-ISI in order to protect infant-industries in their process to development. The key to understanding the use of ISI strategies in these cases is that after initial industrialization, these protectionist policies cease to be used as mechanisms for development. It is also critical to express caution when viewing the general assumption that the EOI model is a success. The economies of the four Tigers and four ASEAN nations examined in this paper are characterized by steady GNP growth, relatively egalitarian income distributions, near full employment rates and heavy reliance on foreign trade. These factors encourage economic growth when used in coordination with export-heavy policies, but countries without homogenous egalitarian societies do not necessarily achieve the same amount of success through EOI.

The transition within Chile from the ISI model to neoliberalism holds importance for Latin American countries aiming to follow in the footsteps of the East Asian Miracle. In retrospect, it is clear that the heavy financing of development strategies through foreign borrowing came at an inopportune time and, in effect, made Latin American countries especially sensitive to further external shocks. While developed Western countries have proven the efficacy of using industry-specific protectionism, there are significant precautions that should be taken when relying on protectionism as a long-term mechanism for development. The literature indicates that ISI would be most effective when only used to protect specific infant-industries in which there is a comparative advantage. To follow with this, EOI has been shown to be effective only when accompanied with state investment into human capital. To decrease sensitivity to adverse external pressures that were felt by Latin America, the literature holds several policy prescriptions, including heavy focuses on good macroeconomic management, savings enhancement policies, human resources policies in pursuit of closing gender and equality gaps and an increase in international trade to allow for access to technology transfers. The apparent dichotomy in the literature can be a misrepresentation of the two models in this way, as they cannot address full-scale industrialization without considerable influence from subjective and circumstantial factors.

While there is a plethora of research into the success of EOI in East Asia, there is only scattered research into the circumstantial identifiers of when EOI would not be the best option. Further research should be conducted into the importance of societal homogeneity and state investment in human capital. The majority of the literature describes the EOI model as favorable to the ISI model, but closer examination infers that many of the perceived successes and failures were in response to demographic landscapes within populations as well as policies (or lack thereof) set to foster factor accumulation, even given adverse external economic shocks. Further examination should be taken into what political factors may have been important for understanding why Latin America and East Asia pursued these development models during this time.

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