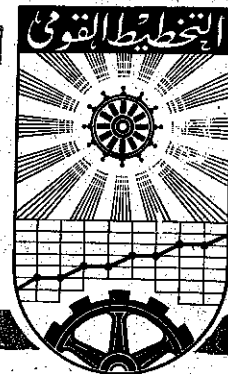


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ON THE IMPORT-SAVING MYTH
A STUDY IN ECONOMIC POLICY WITH SPE-
CIAL REFERENCE TO THE EXTERNAL SECTOR

BY

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Preface

The present study was originally meant as an introduction to a report on tourism and the role it can play in assisting to solve the foreign exchange problem. The idea was to establish the principle of considering a given policy recommendation within a general outlook for the economic condition and the integrated set of policies. It became apparent that such introductory remarks soon grew into an essay on policies related to the planning of the foreign sector. I have therefore decided to produce it separately, without claiming that it would turn into a thorough study of a subject that received the attention of economists for a long time, and still is.

Some of the ideas incorporated here had been treated at length in previous Memos. of the I.N.P. I have therefore chosen to follow the same path, and I feel happy that the present Memo. is produced shortly after my return to join the Institute's staff. It may be claimed that little is being added; but I do not think that it is not customary in economic literature that an adviser may find it necessary to stick to his previous set of ideas. Twenty years ago, Harrod in his "Policy against inflation" (p. vii) quoted Keynes remarking 'I seem to see the elder parrots sitting round and saying: "You can rely on us. Every day for 30 years, regardless of the weather, we have said 'what a lovely morning!' But this is a bad bird. He says one thing one day, and something else the next"'. It is not my intention to avoid the

accusation of being a bad bird by turning into a parrot. I would rather join Harrod (*ibid.*, p. 125) in saying "I have inveighed many times since 1949 against the devaluation of sterling in that year. So much so, that I have been charged in review with having a bee in my bonnet. But a proposition may be stale, yet true. For, whatever may be said in defence of the devaluation, it cannot be regarded as a policy against inflation; rather it was an act of policy for inflation."

It is a common knowledge from textbooks that while devaluation may work in a state of depression (what we shall call case of deficient demand) it is rather ineffective in a state of inflation (excessive demand). The point is relevant to tourism in so far as it was one of the major areas of starting the foreign exchange premium, later extended to an ever growing so-called "parallel market". On the other hand, a presumably foreign-exchange earning sector is to be judged within the framework of the foreign sector. But this leads to another fundamental issue, namely the export-oriented vs. the import-substituting approaches. The latter is considered as "import-saving", a claim which we regard as a myth, hence the title of the essay.

Thus, the arguments have a bearing on current issues; but they are not meant to be a square treatment handling data and actualities. At the same time, they are not formalized in a rigorous theoretical expression. They are meant to elaborate in a less formal manner some of those issues and relevant

policies. Needless to say, the ideas herein expressed are purely personal, and do not reflect any official view. It is hoped that they would provoke enough discussion to provide the decision-maker with sufficient insight in the implications of alternative policies.

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1. Introduction

- 1- Most developing countries suffer from persistent difficulties in the balance of payments, which hamper their efforts to realize reasonable rates of growth. The problem has been recently accentuated as a result of world stag-inflation, and due to adverse changes in terms of trade. It has become one of the most fundamental issues of current discussions on the New World (Socio-) Economic Order.
- 2- This paper does not claim to add to the studies related to the latter topic. Our objective is much more modest. We want to examine in some detail the arguments made in connection with the planning of the external sector. Some economists call for promotion of exporting industries. Others call for an import-saving strategy. Whenever foreign capital is invited, foreign investors seem to prefer participation in import-substituting activities. This is a common feature of the majority of proposals made to Egypt following the launching of the open-door policy. As is well-known, Egyptian plans during the past two decades have claimed to be import-saving. The outcome seems to be exactly the opposite. This raises the question as to where the error lies: Is it in the principle itself or in its application.

3. Quite often, and even in Egypt at present, policies are propagated which are simultaneously import-saving and export-oriented. This implicitly assumes giving lower priority (if any) to activities which are neither. If so, we should better start at the outset by classifying economic activities in an exhaustive list to determine what we would be talking about.
4. It is clear that two basic classes have to be differentiated at the outset. The criterion is not new, since it has been already used by J. Tinbergen in his Semi-Input-Output approach; namely the tradability of output:
 - a) Non-tradable sectors, which include most infra-structural and services activities, and some commodity sectors of a primitive nature or a purely local quality. Construction and domestic investment fall within this class.
 - b) Tradable sectors, whose products possess a recognizable world market, or can - under certain conditions - enter the export - import trade of the country.

In this latter group four sub-categories can be differentiated:

- i) Products which are currently export-oriented.
- ii) Products which, according to present conditions, are met through importation.

iii) Goods and services which are so far satisfied by means of domestic production that could still be expanded if demand were sufficiently stimulated.

iv) Goods and services which do not receive significant demand at present, but may be entered deliberately in the list of demand. (For example, by reducing the relative price of bottled gas, a market for gas ovens was created, thus justifying their production).

It is clear that these categories are not sharply mutually exclusive. However, different products may be classified under any one of them according to the relative importance of their major flows.

5. Thus a trade-oriented strategy (import-saving and/or export-promoting) means putting emphasis on categories (b-i) and/or (b-ii). It may be true that at times of acute foreign exchange shortage, it would be logical to subdue the other categories (b-iii) and (b-iv). In some cases, however, trade and price policies may help to move greater volumes of goods into them, calling for increased imports to the extent that they quickly move to category (b-ii). On the other hand, if the policies adopted do injustice to class (a), they may be eventually frustrated due to imbalances created through the bottlenecks interfering with the working of input-output relationships. This may lead to the creation of a state of affairs where the slackening of non-tradable sectors limits the effectiveness of the tradable ones. As this situation becomes more

critical, balance-of-payments difficulties call for further curtailment of investment in these sectors since they are not directly foreign exchange saving. They may be even considered as areas of inflationary expenditure, thus adding to those difficulties, at least in the short-run. This calls for a proper evaluation of trade-oriented strategies and determination of conditions necessary for their effectiveness.

6. While foreign-exchange shortages may be a common feature among several developing economies, their basic causes may differ widely. In general they may be considered as a manifestation of production - demand imbalances. But it does not necessarily follow that similar policy recommendations could be formulated without due regard to the origin of imbalances. Since the thirties economic thinking had been over-shadowed by the threats of deficiencies in effective demand. Developing countries, characterized by limited markets and low income levels, usually look for policy instruments that stimulate demand as a part of their developmental strategy. At the same time they try to expand their production capacities in order to support that demand by the incomes needed to make it effective, and to allow for a process of balanced growth. It is clear that a proper selection of policies requires a critical assessment of sources of imbalance. We shall differentiate between two cases: one of deficient demand and another of excessive demand, both in relation to existing production capacities. Having done that we can turn to an analysis of the implications of trade-oriented policies. Our findings will be brought to bearing on present conditions of the Egyptian economy.

II- The Case of Deficient Demand:

7. This case has received much attention since the Great Depression of the thirties. It arises as a result of the drop in (induced) effective demand below the level necessary to ensure full employment of all existing production capacities. This state is self-perpetuating if the prevailing demand conditions are projected in the future, since it frustrates new investments. This restricts present demand and diminishes the rate of growth of income, hence future demand. In spite of the existence of unutilized capacities, a foreign balance deficit may coincide. This may be due to a decline in the demand for exports, which directly affects the balance. But the differences between the structures of domestic demand (low as it is) and domestic production, may lead to increased imports while there exist idle capacities in production.
8. Such a state of affairs may arise as a result of a variety of reasons:
- a) A change in conditions governing one or more of types of domestic demand, especially in conditions that are not directly affected by the current level of income.
 - b) A contraction of foreign demand on the country's exports.
 - c) Changes in relative prices between domestic and foreign markets.
- This may be due to a general fall in world prices, or to a rise in domestic costs hence prices relative to world prices.

- d) Past erroneous investment decisions leading to production capacities in excess of what is warranted by actual determinants of demand at the prices reflecting the current cost structure.
 - e) Fall in induced demand following one of the previous causes due to the multiplier effect. This applies in particular to household consumption, which is mainly determined by income.
9. The logical solution out of such a situation is to deliberately manipulate demand. In fact, most policy recommendations emphasize demand adjustments up and down as the most powerful tool for achieving desired changes in the level of economic activity. Four conditions have to be fulfilled in order to ensure effectiveness:
- a) The initial impulse should be the least possible. This assumes choice of areas with maximum multiplier effects.
 - b) It has also to be financed out of resources which are not cut out of other uses, so as to avoid neutralizing effects. This is usually considered as a justification for "deficit financing" policies.
 - c) Further it should be directed towards products which are capable of being produced by means of existing under-utilized capacities. Otherwise it may lead to diversion of products from other utilizations, leading mainly to price increases for such products, and losing most of its stimulating effects.
 - d) For the initial and derived waves of demand, leakages should be the least. At the aggregate level this means watching for the foreign trade multiplier components. However, a more detailed analysis should

be carried out to make appropriate choices of the sequence of demands which minimize total import leakages.

10. The most obvious line of action is through public current expenditure.

Three types may be distinguished:

- a) Creation of a closed-circuit activity; i.e., of a class of production activities undertaken by the public administration to satisfy needs simultaneously created by it. Defence expenditures and some types of activities related to public works belong to this supply-demand group. The incomes thus created, and the ensuing demand for domestic inputs, hence further incomes would give the necessary impetus. The selection has to observe the above-mentioned conditions: inputs should come mainly out of those sectors which suffer from under-utilization of capacities; new incomes should go to recipients who direct them to domestic products rather than to imports; while finance of expenditures should not divert resources from other types of expenditure.
- b) Provision of certain types of services at nominal cost or free. Consumers would be left with the equivalent of values of such services, hence become able to increase their demand for other products. The affected income classes should possess a low propensity to consume imported goods, in order to avoid leakages. However, this method is less flexible, since demand for such services lies outside public administration, and it would be difficult to curtail such activities whenever conditions call for that. Originally, the most important types of such services (e.g., education and

health) should be treated on the basis of fundamental social considerations, rather than temporary economic events.

c) Adoption of a vigorous subsidization policy. Subsidies may go to consumers either in the form of direct transfers, tax exemptions, or subsidies to certain consumers' goods. This would help to add to disposable income directed for other types of goods. In the case of price subsidies, demand for subsidized goods is liable to increase by an amount determined by price elasticity. As a corrective measure, they should lead to increased demand on domestic goods whose present or expected consumption is diminishing. Increased imports should be avoided, unless strong social considerations call for subsidizing them. Subsidies should then be determined so as to keep their relative prices at a level which does not lead to unwarranted increases in their consumption. On the other hand if subsidies are meant to readjust cost structures, they may be directed to certain producers to stimulate falling demand on their products, making them available to other producers at reasonable prices.

11. As mentioned before, the choice of the most appropriate policy or combination of policies from the above list, should be coupled with an assessment of three conditions:

a) Securing sources of finance which do not lead to contraction of other types of expenditure. If deficit is incurred, it is understood that future expansion of economic activity would help to increase government revenues, thus helping it to cover its deficit.