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Industrial policy: it's all about competitiveness

There is a growing consensus that we need an industrial policy. Advisor Commerce and Industry has promised we will have one by May. Fortuitously, the movers and shakers of our policies have stayed put in Washington D.C., keeping the Advisor out of harm's way.

Despite glaring market and coordination failures we have been faithful followers of Washington consensus: market forces, not government, should shape industrial policy. Only occasionallyhave we beenresponsive to industry'sneeds – often articulated through advertisements carrying pictures of dispensers of favours.

Some nine years ago the World Bank relented a bit and agreed to fund a study only if it was styled as spatial (regional) industrial development. To their credit, the authors cheated a bit and produced the contours of an industrial policy. For reasons unknown, it was shelved.

We believe this very policy is now being dusted for the Advisor, by the same consultants. The final product will no doubt get a brushing-up from the several unofficial advisers, 'successful' businessmen all, who surround the Advisor.

Webadly need an industrial policy to give new vigour to our manufacturing that is caving in under growing imports and declining exports. Its share in both global and domestic markets has shrunk. The slide is likely to continue, putting more manufacturers out of business.

Advisor isaiming to bring down two birds – import substitution and export growth -with one stone. He risksmissing both. It is not the inherent inconsistency of the two objectives – indeed one could strengthen the other – but should both be pursued simultaneously, or would it be more prudent to nurture one in a way that has a virtuous effect on the other?

Import substitution does not reduce the import bill if you do not have a 'producer goods'base (machines to produce machines). You pay more dollars for imported inputs than you save on end product. Put another way, there is minimal (sometimes negative) value addition.

To test that, it will be worthwhile to do a study on foreign exchange savings by our mollycoddled auto industry. Have the assemblers and parts manufacturersreduced the import bill – or the high import content has added to it?

The situation is exacerbated by size compulsions. Domestic market is not big enough to provide economies of scale.Limitations of size also render unviable R&D investments that are essential to innovation, technology adoption, and value addition.

The typical response strategy – protect local industry through high import duties – has two structural downsides: it militates against efficiency and hurts exports. Also, the smuggling margin goes up, as does space for spurious products, exposing the formal sector to unfaircompetition.

All these – FX savings, value addition, scale, tariff rationalization, labor intensity – will be important elements of a responsive industrial policy. But the ultimate goal has to be improved competitiveness, withoutwhich we can neither secure our own market nor thrive in world markets.

You get competitive, a function of innovation and productivity, only through greater competition. In our case competition, to put it mildly, is quite subdued. For the domestic market cartelization is the norm. For export marketpriceis the driver.

The two birds that the Advisor has in sight – import substitution and exports – cannot fly together until you strengthen competition by inducing greater domestic rivalry. Productivity - the efficiency with which societies combine their people, resources, and tools – is a natural corollary of competition.

Our weak performance, domestically and globally, is because of low productivity levels, lending credence to Paul Krugman's quip "Productivity isn't everything, but in the long run, it is almost everything".

Industrial policy has its task set out: address low competition and productivity.

Our fear is import substitution, seeking to check the ingress of foreign suppliers, will translate into less competition. Also, on the pretext of scale, we could end up with a few large firms, that will further weaken competition and dampen productivity.

Our other fear is import substitution will come on the wings of protection. This will disincentivise productivity and efficiency gains. It will also have a negative impact on exports.

The debate is about a protected domestic market ultimately leading to export growth (size accumulation and marginal costing argument) versus an export-led growth which then flows into the domestic market.

The case for the former isone of leveraging the strength gained from the domestic market to make an export impact. A protected domestic market, the argument goes, provides you the opportunity to become more productive and better equipped to assail the highly competitive export market.

Even if this line of reasoning is not without theoretical merit there is scant evidence from around the world to support it. While it is true that more competitive firms export more, you get competitiveness from more intense domestic competition, not less (Hiep and Nishijima 2009).

There is also evidence that domestic markets with several equally sized firms, rather than a few large ones, tend to show better export performance.

A deliberate import substitution policy tends to lower domestic competition and increase the 'concentration effect', especially where competition law is weak or poorly enforced, as is the case with us.

In contrast, exports create significantly greater competition and have lower entry barriers, both contributing to greater productivity.Exports also benefit more from 'knowledge spillovers'.

The argument against prioritizing export-led over import substituting growth is one of weak export capacity. We produce low-end export products that have a shrinking demand and the buyer is the Pied Piper.Can we start producinghigh value-add products, become part of the global value chains, quickly enough?

The answer is no. But shouldn't we make a beginning, even if the rewards are somewhat distant - as indeed is the case with import substitution?And it is not a question of either this or that. Both share the common goal of a stronger manufacturing base. It is a questionof resource allocation: which one should one invest more in.

That will be the real challenge of industrial policy: to make sure one doesn't become the enemy of the other; which it will if 'import substitution' bumps up the anti-export bias – making the domestic market more rewarding than exporting.

Either way, it is all about competitiveness. Research suggests export-led pays greater competitiveness dividends.

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