

How Import Substitution is Related to Economic Competitiveness: Russia's Case

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Abstract— This paper argues that the concepts of import substitution and competitiveness do not contradict each other. Import substitution can manifest itself as a result of domestic businesses successfully competing against their foreign counterparts. We herein suggest it is only logical to view the interrelation of import substitution policies and economic competitiveness in the context of an institutional approach. It is argued that import substitutions in Russia's agricultural sector are imperative as they are part of the country's food security strategy.

Keywords— *import substitution, competitiveness, industrial strategy, economic sanctions, world's economic relations, international division of labor*

I. INTRODUCTION

In Western economic theories, mostly those of the Neo-Keynesians (H. Chenery, M. Bruno, A. Straug, N. Carter, P. Lindert, etc.), import substitution, viewed in the 20th century as a priority of economic development, is interpreted as a model for the accelerated development of the internal market, targeted at integrating the country into the world's economic relations.

However, implementation of this concept (and the concept of self-reliance) has never brought the desired results. In Argentina, the birthplace of R. Prebisch who was behind the concept of import substitution, the experiment consisting of switching the national economy to import substitution and *dirigisme* was a failure. The economic crisis worsened considerably by the 70s and rendered the country bankrupt by the late 80s, which is why the very term "import substitution" that Russian mass media are so eager to use in the most blatant manner is seen as an expletive in Argentina.

Of course, Russia is not Argentina, and drawing any kind of analogy would be improper, as would be choosing by specific development strategy from English economist J. Dunning's classification or its variations [1, 2]. "The public policy must not be tied to any specific theory: instead, it must be based on common sense. The market mechanisms alone cannot produce an economic structure capable of bringing

prosperity to Russia: they are more likely to further the country's dependence on raw materials." [3]

The main implications of economic sanctions against Russia are rooted in the sphere of imports. The greatest difficulties are associated with the country's continuous dependence on the import of high technology, mechanical engineering products, medicines, etc.; another aspect consists in negative trends with respect to foreign investments. Russia's credit ratings, an indicator that stands for the country's investment attractiveness, are in decline. In this regard, Russia's import substitution policy and analysis of its methods and effects seem to be an extremely important scientific problem.

The contribution of Russian scientists into import substitution research is generally unimpressive compared to their research in competitiveness problems [4,5,6,7,8]; import substitution studies mainly focus on the effects of macro-economic processes, the competitiveness of import-substituting products, the principles of organizing import substitution as a business process on a regional scale, the mechanisms for the furtherance of import substitutions in specific commodity categories, etc.

The following questions are, unfortunately, not paid due attention to: what must be an industry's import substitution strategy under economic sanctions? Are there any manufacturing industries (except the MIC), where discussing the scope import substitution makes no sense at all? How does import substitution relate to the competitiveness of Russian products in foreign and domestic markets when compared against their non-Russian counterparts? Does the concept of import substitution answer the question how to make Russian products competitive in a climate, where virtually any manufacturing effort (even in mechanical engineering) costs more than "fighting the harsh nature", etc.

II. STATEMENT OF PROBLEM

The thesis that the main reasons for the observed stagflation of the Russian economy lie not in the sanctions imposed by the US and its allies, but in the exhaustion of the

former sources of economic growth, today no longer needs proof. In turn, the exhaustion of sources is a natural result of the financial and economic policy of recent decades, when the excess profits from high prices for hydrocarbon raw materials and other "gifts" of nature were not effectively used to boost the national economy (and, moreover, were invested in the economies of the countries applying sanctions today).

"Contagion" of the Russian economy, the so-called "Dutch disease", the meaning of which is the deindustrialization of the state due to reliance on the export of raw materials (which, in parallel with the improvement of the trade balance, usually leads to a decrease in the competitiveness of manufacturing industries), is costly to the state. The situation is complicated by the fact that the theory of comparative advantages gives only a "diagnosis" of this "disease", but does not give specific recommendations – how to get out of the current state. Under these circumstances, to overcome the "market imperfection" the duty of the state through the development of specific policies of re-industrialization by creating effective incentives for the private sector, to intensify participation in research and development, etc. One of the possible ways of overcoming the stagflation of the society was the proposed policy of import substitution, which was declared by the government in 2014.

The goal of this research consists in evaluating the industrial strategy for import substitution and its effect on the country's economic competitiveness, achieving which was dubbed "a national idea" by Vladimir Putin. In this respect, we are trying to find the answer whether all import-dependent manufacturing industries must be covered, or support for import substitution is only legitimate in those sectors where Russian manufacturers must as soon as possible become compliant with Western standards, being able to make *competitive* products. The question wouldn't be so difficult on equal terms (without sanctions) with respect to the international division of labor, whereby cheap quality products would bring more profit when imported abroad, and import substitution wouldn't be an end in itself. However, today the West is grossly violating the rules of world trade.

III. RESULTS

A. *Import substitution vs competitiveness in Russian economy*

In his 2008-published *Competitiveness at the Crossroads: Choosing the Future Direction of the Russian Economy* [9], Harvard Business School's M. Porter, renowned specialist in economic competitiveness, and his team described the cons of Russia's economy as of 2006–2007; ordered by the Moscow Center for Strategic Research (CSR), this paper presented multiple economic drawbacks which haven't been really dealt with ever since. Besides, now the list of cons actually includes nearly everything that used to be a "pro", e.g. dynamic economic development, stable financial position, growing influx of foreign investments, stronger positions in the world exports market, etc.

One may of course complain about the attempts to actually define that is competitiveness; begun as far back as in the times of A. Smith and D. Riccardo, such attempts have been

made by E. Heckscher, B. Oilin, P. Samuelson, even M. Porter himself; or even complain about the discrepancy in the opinions on Russia's economic competitiveness. That won't do anything though. Losing in science, technology, and innovative development, Russia, a country where political and bureaucratic conservatism prevails economic common sense, finds it ever more difficult to generate new competitive advantages, or even to retain the existing ones.

In this regard, the high-tech sectors of economy, listed in the Concept of Long-Term Socio-Economic Development of the Russian Federation for Until 2020 (aviation and space-rocket industry, shipbuilding, radio electronics, nuclear power complex, power engineering, information and communication technology) will be facing difficulties if their products do not become more competitive. We should specifically note the need to stimulate *corporate industrial science*, as it must be a more important factors in gaining new competitive advantages compared to universities and academia, while the latter must supply qualified researchers.

The "*incompatibility of import substitution and competitiveness*", quite common a wording today, kind of implies that the world's top economies have long rejected the idea of import substitution, as it, they say, is unhealthy for national economies. That's too simplified a point of view. First of all, truly competitive Western countries have long passed their import-substitution stage and yet continue to pursue it in some specific industries; protectionism does not necessarily result in any increase of state ownership or in any de-incentivization of entrepreneurial risks. Good examples are the military-industrial complex, the agriculture, etc. It is not only about customs duties or sundry import constraints (import licensing, quotas, etc.); it is also about subsidizing the vital industries. Second, import substitution can manifest itself as a result of domestic businesses successfully competing against their foreign counterparts. Russian weapons are globally renowned for their high quality—doesn't it prove the concepts of import substitutions and competitiveness are more than just compatible?

B. *Import substitution as a prerequisite for the country's economic and food security*

Russia's use of import substitution concepts shall not be viewed in isolation from the destructive trends emerging at the new stage of globalization and internationalization of the world's economic relations. As Western WTO members grossly violate the rules of economic competition by regular use of antidumping measures and providing tax incentives to their exporters, the traditional import policies have to be adjusted, especially where imports critically affect national security.

Many industrially developed countries had to undergo the import-substitution "stage" before their products became competitive. The USSR also made efforts in import substitutions and was successful in strengthening its economic infrastructures yet lagged behind in terms of *competitiveness* (except military tech) and labor productivity. With this in

mind, we conclude that import substitution can only be efficient in two situations: a situation where a country has to nationalize its market, subsequently aiming at better competitiveness (including technological advancement) and economic growth; or a situation where a country is subjected to economic blockade and sanctions.

The authors convincingly argue that uncompetitive industries are better than no industry at all. Special attention is paid to the *agricultural sector*, where Russia will find competition against the West extremely harsh for the years to come. This is not only about a considerable lag in labor production; more than that, it is *Russia's specific climate* that inflates the cost of agricultural products. Does that mean that agricultural import substitutions are not feasible due to the country's inability to become competitive in the production of most agricultural products?

This opinion is not only untenable, being contradictory to the basic principles of the country's *food security strategy*. Russian citizens must have domestic grains, meat, milk, and some other foods *even if the respective industries are to survive on subsidies*. This is *imperative* in the current situation, where sanctions and economic barriers result in a cynical violation of international trade rules.

At the same time, the real difficulties associated with increasing the competitiveness of domestic agricultural products are not fatal. In Russia, there are many regions where achieving comparable with Western countries indicators of agricultural efficiency is not only possible, but also necessary. We are talking primarily about the Krasnodar and Stavropol territories, Rostov region, some republics of the North Caucasus, etc.

Neglect of the country's food security issues in previous decades has led to the fact that it has actually acquired not only a shameful, but also a dangerous status of "freeloader", which has become a reality due to the current sharp deterioration of its trade relations with the EU and the US.

Data suggests that Russia's forced food embargo against Western countries and their allies did reduce the value of food imports from those countries. This has not become a booster for Russia's agriculture; but in some categories, domestic manufacturers have managed to rapidly increase their production capacities. This applies to cheese and cheese products, canned vegetables and mushrooms, less so to meat and poultry. Being competitive in the world market is certainly important; however, food security is far more important.

In other words, the efficiency of domestic agricultural production should be increased regardless of the growth rate of gross domestic product and the volume of the Reserve Fund and the national Welfare Fund. In the view of A.Maslow (the author of the famous pyramid of needs), the ideal happy society is, first of all, a society of "well-fed people" who have no reason for fear or anxiety. Relying on the import of almost half of the food consumed is a direct threat to the security of the country.

Speaking of competitiveness improvements, special emphasis is made on the ever greater role of innovations and

the use of agricultural high-tech (in particular, greenhouse farming in cold climates), something that is still paid unduly little attention to [10]. At the same time, innovative agriculture is not only about technology, it is also about biology (use of more productive breeds and varieties) and human factors (professional development in the industry), etc. A thorn in the side of Russian agricultural businesses is the exaggerated role of *middle-men*, forcing foodmakers to whole-sale their products at unacceptably low prices, meaning that farmers have literally no access to the market.

There are expert estimates, indicating that the size of the trade margin in Russia is about 40%, while in the world it ranges from 8% to 12%. It is clear that as long as mediation remains a priority, the efficiency of the agricultural economy will not increase significantly, as profits will be concentrated not on producers but on intermediaries.

Of course, reducing the role of mediation in the agricultural sector will not automatically lead to a tangible increase in the competitiveness of the industry. The above-mentioned factors of competitiveness growth, including also radical credit policy reforms, improvement of the secondary market of agricultural machinery, regulation of access to mineral and organic fertilizers, expansion of the use of resource-saving and environmentally friendly technologies, etc., need to be put in place. We also note the negative decrease in protectionist opportunities associated with tariff and non-tariff protection of agricultural producers after Russia's accession to the World Trade Organization.

IV. CONCLUSIONS

Going back to the main idea of this paper, i.e. the relations between import substitution and competitiveness, we have to underline that the dialectic of such relations is different from that in other economic sectors; it is more reminiscent of the relations between such processes in the country's military industry. The idea of better competitiveness in military and agricultural industries (especially in agriculture) will always be relevant; however, import substitution policies in both industries are self-contained, as they are crucial for the national security.

No sober-minded Russian economist sees import substitution in its traditional interpretation as a historical chance for the country, as harsh international competition and the loss of the Soviet Union's scientific and technological advantages mean that large-scale production of some high-tech commodities will not be a thing in the country in the foreseeable future. This mainly happened due to the liberal reforms of the 1990s, when a considerable portion of industrial R&D assets have been privatized and then disappeared, while the Stabilization Fund was spent to finance the economy of enemy countries (the sanctioning ones) and as such wasn't available to Russia's own economy.

In general, regardless of the trends in the development of the world market and the practice of economic sanctions, the implementation of specific measures to change the structure of the national economy and give it an innovative quality is long

overdue, and they are somehow associated with import substitution. As an example, it is enough to cite mechanical engineering—the technological basis of the industry, which in Russia was actually "defeated" in the years of reforms, when the entire industries and, above all, the machine tool industry disappeared from the national register of economic classification. And if for small countries of Western Europe, skillfully "built" in world economic relations, this situation does not pose a threat to national security, for Russia, traditionally one of the leading countries in the world - is tantamount to tragedy.

In conclusion, a few considerations about the effectiveness of import substitution policy in Russia. In this regard, official sources cite the successes of the agricultural sector, where the total export of products to the world market in 2017 reached 20 billion dollars (while the share of imported food products in retail trade has significantly decreased). However, the factors of the Russian Federation's successful exit from the economic recession are connected not only with the sphere of agriculture and raw materials production. Economic growth in modern Russia is also due to industrial production, including high-tech products, which "recaptures" both Russian and foreign markets.

Of course, the production of such products is primarily associated with the military-industrial complex. In 2017, Russia has sold arms worth \$ 14 billion on foreign markets. (The main sensation in this market was contracts with Turkey and Saudi Arabia, traditional allies of the United States, worth about \$ 6 billion). However, the "effect of import substitution" was clearly manifested in the IT sector. The production of Russian computers and components has increased significantly. Domestic production of computer programs is growing. The domestic market was enriched by programs of transition to domestic applications in state institutions, as well as increasing the volume of exports of program services.

Tangible progress in such a problematic area as pharmaceuticals. Formally, more than 80% of the vital medicines sold in Russia are already produced in the country. However, the expression "in the territory of the country" is not yet evidence of the actual localization of production, the level of which is slightly more than 50%. At the same time, successful domestic start-UPS are already emerging in Russia (for example, the production of phosphorus-32 preparations, opened in Tomsk by specialists of the local Polytechnic University).

It is no secret that the process of import substitution in a number of areas (in the machine tool industry, in the production of oil production equipment, in certain areas of electronics, etc.) is extremely slow. The reasons for this lag are due, inter alia, to the fact that the relevant production facilities are being re-established from scratch, with a shortage of production lines, trained personnel and too much import pressure.

Thus, the program of import substitution in Russia in some sectors of the economy is successfully implemented. Significantly increased the production of food products, machinery, vehicles, computer programs, electronics,

pharmaceuticals, etc. While less successful policy of import substitution is correlated with the growth of competitiveness of the national economy. Although initially the locomotives of the process were large state-owned companies, thanks to the investments of which the old ones were modernized and new production facilities were created, much will depend on private investors (including foreign ones).

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