Proceed with caution: Is Sri Lanka's Approach to Import Substitution Sensible?

A Pathfinder Perspective

In the immediate aftermath of the onset of the Covid19 pandemic and the unprecedented health and economic crises it unleashed, there was a widespread backlash in sentiment against globalization and open economic policies. The greatly increased human mobility associated with these phenomena were blamed for the rapid spread of the virus to all parts of the globe. The supply-side shocks, related even to basic goods, such as food and medicines, as well as demand pressures emanating from a rise in protectionism, were seen as being the result of the complex supply chains that underpinned the web of cross-border production networks that constitute a major part of the global economy on the one hand and the destruction of employment and incomes in an integrated world economy on the other.

However, as time passed, there has been a shift in sentiment. The focus has shifted to seeking ways and means of maintaining the substantial gains of globalization, while reducing the risks that were exposed and amplified by the pandemic. On the health front, the extraordinary achievement of scientists in developing highly efficacious vaccines, in record time, has created the very real prospect of opening up global mobility again. This has been supplemented by the exponential acceleration of remote working and living. On the economic front, the focus has been shifted from efficiency to resilience in maintaining global supply chains. There has been diversification as well as shortening of supply chains. On the demand side, the unprecedented policy actions of Treasuries and Central Banks around the world has propped up businesses and livelihoods to an extent where a relatively strong recovery, though multi-speed, is being seen in the world economy. These trends explain why there has been a shift in sentiment, as mentioned above.

While protectionist pressures are still present, the case for an open and rules-based international trading system is being reinforced, led by China. The Biden administration has also taken measures to revive the World Trade Organization, including through the appointment of a former Finance Minister of Nigeria, and Managing Director of the World Bank, as the first female head of the institution. The dispute resolution panel of the WTO is also being reconstituted. Protectionist sentiments and a shift to autarkic (national economic self-sufficiency) policies were also ascendant in Sri Lanka. The world seems to have realized that it is not advisable to "throw the baby out with the bath water." It is important that Sri Lanka absorbs this lesson as well.

It would be useful to trace the evolution of the thinking on import substitution and to examine briefly some of its sub-optimal practical outcomes. A paper by Douglas A Irwin, titled "The Rise and Fall of Import Substitution," (Working Paper, Peterson Institute for International Economics;

July 2020) traces the evolution of the thinking on import-substitution. Import substitution policies initially came to the fore in the early 1950s. It is probably no coincidence that they gained salience at a time when decolonization was gathering momentum. The ex-colonies sought to augment their political freedom with policies that reduced their dependence on the metropolitan centres. Many developing countries came to the conclusion that import substitution was the best trade strategy to promote industrialization and economic growth within a global economic system based on colonial structures that was geared very much against them through exploitative trading relations. Raoul Prebisch, based at the UN Economic Commission for Latin America, is widely recognized as the father of the import-substitution industrialization (ISI) strategy. However, he and other leading contemporary figures in development economics, in the 1950s, identified fairly quickly some of the weaknesses of import substitution policies in practice.

Import controls, particularly on manufactured goods, did not necessarily conserve foreign exchange as intended; rates of tariff protection were high, resulting in a misallocation of resources and higher priced and poor quality products for consumers; small and inefficient firms were created that served only domestic markets, and taken together, these policies became an obstacle to promoting exports. These shortcomings are relevant even today. Prebisch's own views changed by the 1970s. It can be argued that the intellectual demise of import substitution had taken place by the 1970s.

The Pathfinder Foundation believes that there is considerable evidence that openness to trade increases the growth, employment and incomes trajectories of economies. It is noteworthy that the unleashing of the potential of Asian economies (particularly in East and Southeast Asia) was greatly facilitated by two of the key pillars of globalization: liberalization of trade and capital flows. This enhanced the capacity of countries to take advantage of the opportunities created by rising external demand. The successful countries of Asia were able to attract FDI, with its capital, market access and know-how, to drive export expansion and take advantage of this increasing external demand brought about by globalization.

In practice, countries as large as China or as small as Singapore have been able to transform their economies through this combination of increased FDI and rising exports. In this context, it is noteworthy that the coastal regions of China, which were significantly more integrated with the world economy, have experienced far more dynamic growth and development than the hinterland, which is significantly less integrated, and more backward. The experience in China vividly illustrates within one country the tangible benefits of policies which are open to greater integration with the global economy.

It is also important to learn lessons from historical experience closer to home. The inward-looking policies adopted by Sri Lanka in the 1970s resulted in a low-investment, low growth and high unemployment syndrome. Long queues for even essential goods were emblematic of this period. The benefits of liberalizing the economy in 1977-78 have been curtailed by the three-decade-long civil conflict and the partial nature of reforms due to a lack of political consensus around policies that attract FDI and promote exports. Weak implementation has also amplified poor overall performance. The time has come to have a concerted and holistic approach to transforming the Sri Lankan economy.

In today's world of ever-increasing climate and other risks, there is a case for attaching high priority to food security. Well-targeted import substitution policies in agriculture can be justified on these grounds. However, the overarching focus should be on increasing productivity to avoid imposing high prices and poor quality on the consumers. The paddy sector reveals what should not be done. Sri Lanka has now reached self-sufficiency in rice production in most years. However, the outcome has been a long tale of low productivity, low income farmers whose subsistence has to be secured by inefficient and costly subsidies as well as guaranteed prices. Lessons need to be learned from past experience to avoid the same mistakes in the present and future.

In conclusion, the Pathfinder Foundation believes that it is encouraging that the most senior policy-makers have been stressing the need to develop "a production economy" driven by FDI and exports, along with a high-productivity agricultural sector. These goals should not be derailed by vested interests which focus on rent-seeking activity based on import restrictions. History, in Sri Lanka and elsewhere, teaches us that the outcomes will inevitably be bad.

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