Pathfinder Economic Flash

Export Promotion and Import Substitution: From Ideology and Prescriptions to Economic Reality and Pragmatism

In recent days, following the Budget Speech, there has been much discussion about the relative merits of import substitution. There has been pressure from some quarters for protection for specific goods. This tends to reflect the narrow interests of specific vested interests which do not take into account the broader interests of the economy, consumers or even other producers of goods and services for local or export markets. It is important to address the relative merits of exports and import substitution pragmatically, taking into account historical experience in Sri Lanka and abroad.

No Middle Path: Export or Stagnate

At the outset, it is important to recognize that an economy of 21 million people, based on purchasing power of $3,000 per capita income, can only achieve the targeted 8% growth for a decade or more through a vibrant export performance. There simply isn't sufficient domestic demand to drive the desired growth trajectory. While the successful countries of East and Southeast Asia have prospered through impressive export performance, Sri Lanka has been consistently poor since the 1950s on this front. In 2012, exports amounted to 17% of GDP. The corresponding figure for Thailand was 68%; and for Malaysia and Vietnam 75%. This serves to highlight vividly the backwardness of Sri Lanka's export performance. Even poorer neighbors, such as India and Bangladesh, now export a greater share of their GDP.

Learning from the Past: Debacle of District Development Councils.

In the past, many countries adopted import substitution based developmental strategies. It is an established fact that, with the exception of Brazil, their record was uniformly poor. Even Brazil eventually experienced stagnation and hyperinflation. Sri Lanka was no exception. The dirigiste inward-looking policies, which peaked in the 1970s, consigned this country to a low investment/low growth/high unemployment/high inflation (black market prices) syndrome. It was a period of shortages and queues even for basic goods. Consumers were confronted with costly and poor quality goods. In addition, financial and human resources were diverted into inefficient and uncompetitive economic activity thereby stifling the prospects for growth in output, incomes and employment. The genuine but misguided District Development Project programme of 1970-77 vividly demonstrated the folly of ***indiscriminate*** import substitution. This was an era where misguided beliefs led many policy-makers and politicians to imagine that Sri Lanka can produce anything and everything for the local requirements from Jossticks, mamoties, tractors to motor vehicles.

Partial Liberalization in 1977 but Failure in Export Expansion or Diversification

While the partial liberalization of the economy, in 1977/8, induced greater dynamism, export performance has never come anywhere near matching that of the successful countries of East and Southeast Asia. In fact, it is noteworthy that apparels have been the only new export sector to have emerged which has exceeded $1.5 billion in earnings (tourism is expected earn $1.2 billion in 2013). Even in the case of apparels, the initial growth was based on the quota system that underpinned the Multi-fiber Agreement. This means that there has not been a single export item that has emerged due to a combination of a conducive policy environment and dynamic local entrepreneurship. Having said that, it is important to acknowledge that the apparel sector has demonstrated considerable resilience and dynamism in overcoming the shocks from the end of the Multi-fiber Agreement; the loss of GSP+ into the EU market; and relatively high labour costs by moving further up the value chain. Sadly, the achievements of the garment sector have been very much the exception in terms of export performance. As a result, Sri Lanka badly trails a country like Thailand in terms of the complexity of its export structure (value addition and diversification). In 1980, the two countries had very similar export complexity. Today, Thailand has left Sri Lanka far behind. It is steadily increasing export complexity that enables countries to sustain an uninterrupted higher growth trajectory over a decade or more. Sri Lanka's poor export performance is due in no small measure to the "stop-go policies" that have characterized the post- 1977 era.

Moving in the Right Direction?

Large budget deficits have been the main causal factor for the persistence of stop-go policies. As the PF has constantly emphasized, the large fiscal deficit has pumped excess demand into the system making Sri Lanka a high inflation economy. This has, in turn, resulted in high interest rates and an overvalued exchange rate for much of the post-liberalization era. This has meant that the local exporters have faced a situation that is equivalent to running 120 meters while our competitors in countries like Malaysia, Thailand, Indonesia and Vietnam run only 100 meters – this is because these countries have robust fiscal outcomes resulting in low inflation which enables significantly lower interest rates as well as an undervalued and stable exchange rate.

It is important to point out that the need to accommodate high defense expenditures and the pressures for populist policies, which arise in a competitive and adversarial polity, have greatly complicated fiscal management in Sri Lanka over the last 35 years. Sri Lanka is now operating in a new paradigm which demands greater fiscal discipline.

The Budget Speech 2014: Grounds for Optimism

There are grounds for optimism regarding the direction of fiscal outcomes. The recent Budget Speech was consistent in its commitment to maintain a low and simplified tax environment. It is also encouraging that there has been a steady reduction in the budget deficit from 9.9% of GDP in 2009 to 6.4% in 2012. In addition the commitment to reduce the deficit further to 5.8% of GDP in 2013; 5.4 % in 2014 and 4.8 % in 2015 was reinforced in the Budget Speech. It must also be recognized that the courageous adjustment to electricity and fuel prices have addressed the massive losses of the CPC and CEB (Rs. 150 billion in 2012), with the latter running at a small profit this year and the former expected to break-even.

It is also important to extend the good work to manage contingent liabilities, arrears of payments due from the consolidated fund and the external debt dynamics.

Macro to Micro and Institutional Reforms

If the current trend of fiscal consolidation is maintained and the targets are met, Sri Lanka can move to a lower-inflation environment with reduced interest rates as well as a competitive and stable exchange rate. The competitiveness of the economy will be enhanced. If this materializes, Sri Lanka will for the first time have macroeconomic conditions that facilitate rather than constrain exports. Exporters will be able to run 100m rather than 120m in a 100m race. This can have a transformative impact on Sri Lanka's export performance. It is, however, important to emphasise that a more conducive macroeconomic environment is a necessary but not sufficient condition for better export performance. Other measures must also be taken to strengthen the doing business environment. Attention should also be focused upon Sri Lanka's performance on the Global Competitive Index, the Global Logistics Index and Transparency International's Corruption Index. Above all, there must be consistency and predictability in policies with clarity regarding the respective roles of the public and private sectors.

Sri Lankan Private Sector: From Complacency and comfort zones to "Animal Spirits"

The private sector which has recently been well rewarded through tax reforms, import tariff rationalization, and vastly improved inland and maritime infrastructure development needs to adjust to the new challenges and opportunities being created by the end of the conflict, political stability and massive infrastructure development. Furthermore, the combination of the FTA with India; the proposed FTA with China; and the anticipated entrepots and bonded area legislation is a potential game-changer in terms of transforming Sri Lanka's sub-par performance in relation to the twin objectives of promoting FDI and boosting exports. For the private sector, this is no time for complacency and remaining in their comfort zone. Risk appetites need to be recalibrated and what Lord Keynes termed "animal spirits" need to be activated. Sri Lanka Inc. needs to work together to forge ahead in the export sector.

It is often argued that the East Asian success stories were driven by protectionist policies. Two important points need to be made in this regard. First, protectionism was afforded within an extremely disciplined framework. It was granted to "infant industries' on the condition that they eventually grew into globally competitive exporters. When this condition was not met within a specified timeframe, the protection was eliminated. Secondly, some of the “industrial policies” adopted by East and Southeast Asian countries, in the past, are no longer permissible under the WTO rules prevailing today. One may conclude that the conditions that made time bound protection a successful policy tool in East Asia, in the past, are not replicable in Sri Lanka today.

Food Security: A Case for Import Substitution

The PF has previously made the case for import substitution for food security. The argument is based on the dynamic comparative advantage which would materialize as imported food prices rise in the future for the following reasons:

- Global population is increasing.
- Incomes are rising quickly in large emerging economies leading to greater consumption of meat and dairy products. Given the conversion rates from grains to meat and dairy, there will be upward pressure on food prices as a whole.
- The high liquidity level in the global economy fuels speculative activity in commodities.
- The agricultural subsidies (particularly in the EU and US) which distort/decrease global prices are likely to be reduced in the future. This is one of the key items in the Doha Round Multilateral Trade Negotiations. Reductions in subsidies will exert upward pressure on the price of agricultural products.
- Land has been transferred to the production of Ethanol as a substitute for fossil fuels. Reducing the acreage under cultivation for food products results in upward pressure on prices. The increases in Shale oil and gas are likely to mitigate this trend.

In such a context, there is justification for attaching priority to import substitution as a means of strengthening food security by providing some protection and incentives to selected agricultural and dairy products. In spite of ideologies and empirical evidence up until now almost all the countries in the world (US, Europe, Japan, Korea, etc) continue with their protection and subsidizing of selected agricultural and dairy products.

From Vested Interests to Forward March

The considerable potential of Sri Lanka’s current historical conjuncture cannot be realized without export expansion. Experience in other countries clearly demonstrates that FDI (markets, technology and managerial skills) plays an important role in boosting export performance. The twin objectives of improving exports and FDI are the most crucial challenges facing the country today. The outcomes on these fronts will be by far the most important determinants of the country’s economic future. Any distraction emanating from narrow vested interests seeking protection for their own particular products and services would be counter-productive and detrimental to the interests of both the country and the government.

This is the Fortieth Economic Flash published by the Pathfinder Foundation (PF). Readers' comments are welcome at www.pathfinderfoundation.lk

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