Pathfinder Economic Flash

Revitalizing Lagging Exports: Is There an Option to Economic Openness?

Lessons from Failed Policies

It was reported in the media recently that there were concerns regarding the signing of Free Trade Agreements (FTAs) on the basis that such moves might endanger the import substitution industries, which produce internationally uncompetitive goods for the domestic consumers. This brings to our memory the 1960s and 70s policy prescriptions of infant and import substitution industries. These protectionist policy maneuvers brought disastrous consequences to the countries that blindly followed them, including Sri Lanka. Therefore, it may be opportune for us to refresh our memories regarding our past.

The inward-looking and protectionist policies, which were at their height in the 1970s, resulted in the dead-end of a low investment, low growth and high unemployment syndrome. Widespread scarcities forced families to be in queues for hours even for essential items, such as bread, sugar, milk foods and pharmaceuticals. There was a thriving black market where consumers, who could afford it, were confronted with high prices and poor quality. By the mid-1970s, Sri Lanka was among the most inward-oriented and regulated economies outside the Communist bloc.

Getting out of the Woods

Since liberalization, though partial, the economy has shown much more dynamism. Growth averaged 2.9% during 1971-77 when inward-looking policies were at their most intensive. The economy averaged 5% growth in the post-liberalization 1978 – 2009 period, despite the civil conflict impacting seriously on the country’s capacity to capture the benefits of liberalization.

There was also a structural transformation of the economy during the post-liberalization years. The share of the agricultural sector has declined from 30% of GDP in 1977 to 11% in 2012. The services sector has increased from 40% to 60% during the same period. While the share of the industrial sector remained broadly similar, there was a shift from inefficient production of import substitutes to globally competitive exports. This was reflected in the sharp increase in the share of manufacturing exports, particularly apparels. This was a major contributory factor in the increase in the trend growth rate from 2.9% to 5%. It also drove the increase in exports to a peak of 32% of GDP in 2000.

Learning from Chinese and Indian Experience

There is also evidence from all around the world that increased opening and greater integration with the world economy generate significant economic benefits. It is noteworthy that the Eastern coastal regions of China, which embarked upon a path of radical liberalization was able to achieve unparalleled economic growth and development for three successive decades. In contrast, the hinterland, which was much less integrated with the world economy, has lagged behind. China’s massive development and modernization process has resulted in the upliftment of over 400 million people from poverty. Similarly, only after economic liberalization, in 1991 was India able to transcend the “Hindu rate of growth” and record 8% - 9% expansion. The current stalling of the reform agenda has seen the economy lose its growth momentum.

Two Steps Forward One Step Back?

Since the end of the war, Sri Lanka has introduced landmark measures to open-up several sectors for foreign investment and Private Public Partnerships (PPPs). These include seaports building and operation, construction of highways and tourism related infrastructure development. With regard to imports and exports, the implementation of the FTA with Pakistan and the commencement of negotiations on similar agreements with China and Japan indicate the direction towards further trade liberalization.

Despite this, some economists have expressed concerns that the Sri Lankan trade regime has become more closed in recent years. The tariff regime has become somewhat more restrictive and there has been a significant increase in non-tariff barriers. These are some of the reasons why exports as a percentage of GDP have not kept pace with non-tradable sectors. Of course, long periods of overvalued real effective exchange rates have also been another important macroeconomic causal factor.

While Sri Lankan exports amount to only 18% of GDP, even India which is widely considered a relatively closed economy, has recorded exports of 25% of GDP. This has happened despite the fact that it is generally thought that Sri Lanka had advanced further in liberalizing its economy. This may be interpreted that liberalization alone will not result in an increase of exports. Certain other factors such as natural resource endowment, upgrading of infrastructure related to logistics, sea and air connectivity, ICT development and widespread availability of science and technology graduates are also necessary conditions.

Sri Lanka’s export performance is far behind compared with that of South Korea: 50% of GDP; Thailand: 67%; Malaysia: 78%, Vietnam: 78% and Singapore: 170% (includes a very large transshipment component). Sri Lanka has just emerged from 30 years of war and has embarked upon massive infrastructure development and therefore, there will be a lagged effect of getting the economy on the right track. This is more so with regard to export expansion and diversification. However, this potential cannot be realized without a far more conducive policy framework for exports. Furthermore, the need to earn foreign exchange to repay the debt incurred to finance infrastructure development places an even higher premium on increasing non-debt creating inflows through expanded exports. The current policy framework should be adjusted to incentivizing a flow of resources from the non-tradables to the tradables sector. The upshot is that growth cannot be revived to 8% on a sustained basis without reforms that reverse the decline in the openness of the economy.

Justification for Import Substitution: Food Security?

Food security is one of the areas where there could be a case for import substitution. A combination of an increasing global population; higher incomes leading to greater consumption of meat and dairy products in large emerging markets; and speculation in global commodity markets is likely to result in rising food prices in the medium to long term. In such a context, the government's efforts to promote import substitution in products, such as sugar and milk foods are justifiable, provided they are based on a careful assessment of the country's dynamic comparative advantage going forward. It is important that local consumers are not burdened with high prices and poor quality. Price competitiveness of essential food items have become even more important now that fiscal space for subsidies and transfers is shrinking with Sri Lanka's graduation to lower-middle-income country status and the consequent non-eligibility for highly concessional assistance.

Empowering People through Reducing Barriers.

In today's world, the prospects of trade liberalization on a multilateral basis are dim. This leaves three options: unilateral, bilateral and regional, trade liberalization.

1. Sri Lanka has the option of unilateral trade liberalization. This was pursued in 1977 and on occasions after that. As mentioned above, this pulled the Sri Lankan economy out of the doldrums following a period of misguided, inward-looking, import substitution policies.

2. Bilateral FTA's can be sub-optimal due to trade diversion. However, in the absence of multilateral arrangements many countries are pursuing bilateral trade agreements. Sri Lanka has two bilateral FTA's with India and Pakistan. There is a case for deepening these existing trade agreements on goods and to extend them to services and investment, provided they are based on the principles of non-reciprocity and special and differential treatment in order to address the asymmetry between these economies. The government has announced that it is also pursuing FTA's with China and Japan. This is a welcome development and the negotiations should be based on the same principles.

3. South Asia has two largely meaningless regional trade agreements (SAPTA and SAFTA). The state of Indo-Pakistan relations means that this situation seems unlikely to improve in the short-term.

Integrity of Policy Analysis

In conclusion, the PF wishes to stress the need for pursuing a non-ideological and pragmatic policy path. An increasingly closed economy cannot be a desirable option for any country in today's globalized economy, let alone for a small country of 21 million people with purchasing power driven by per capita income of only US$2,900. It is also important that our analysts are more objective and consistent in their public statements. They should not allow themselves to be swayed by vested or personal interests.

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