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Road to prosperity: import substitution or raising export competitiveness?

The goal of any government in Sri Lanka (SL) should be to improve the overall well-being of the people mainly by increasing their real incomes (income adjusted for inflation to increase purchasing power).

This is needed to reduce poverty and improve the living standards of the people by raising the level of exports significantly, economic analyst Lloyd Yapa told Sunday Observer Business.

Lloyd Yapa

Excerpts of the interview

Official poverty statistics of SL in the latest Household Income and Expenditure Survey, 2012-13 of the Department of Census and Statistics (DCS) are confusing. The DCS figure below the official poverty line is 6.5 percent. But this figure is contradicted by the income distribution data of the different deciles.

If you calculate poverty using this data you will get a much higher figure. In fact, 36 percent of the people receive Samurdhi benefits, the government subsidy given to the poor (according to the Samurdhi Commissioner). The people are not happy either, the ranking of this country in the World Happiness Report (John Halliwell, Jeffrey Sachs and Richard Layard, 2013) is 137 out of 156 countries.

SL is surprisingly poor compared to the other small economies in Asia such as Singapore, Malaysia, Taiwan and South Korea when GDP per capita is compared. See table 1.

Poor performance

The picture is much worse if you look at the macroeconomic indicators. High budget deficits have been prevailing over a long period. Government revenue is less than its expenditure and it is even less than the amount needed for servicing the debts (103.3% of revenue in 2013) of the country.

The huge trade deficit is another issue. Our imports ($ 18 billion in 2013) are almost double that of exports ($10 billion in 2013). This is the reason why SL has to resort to external borrowing.

Export orientation

What is the strategy to overcome these problems? We have two ways to increase our economic growth. Boost domestic and foreign demand (export to the rest of the world). Since SL is a very small island nation with a population of a little over 20 million and a majority of them poor, our domestic demand is very low. Therefore, the only option is to increase exports.

However, our export revenue as a percentage of the GDP has been declining. It was 33 percent of the GDP in 2004 and in 2013 it had declined to 16.7 percent. Foreign exchange earnings still largely depend on the apparel and tea sectors and remittances from migrant workers.

It appears that these high remittances have made us complacent about expansion of exports. If you look at some other countries in the Asia region their economies grew mainly by following export orientated strategies. See table 2.

To boost exports we need investments to expand production capacity because we should produce goods and services for export. In the recent past governments signed Free Trade Agreements with India, Pakistan. But the reality is we don't have goods or services to export and this is the main reason for the failure of the trade pacts we have signed.

Savings

We have not increased our production capacity to produce goods and services for export because our investments have been very low. At present (2013) our total investment is 30 percent of the GDP and we need to increase it to 35 percent of GDP (some estimates indicate it should be about 40%). Since our national savings is 26 percent of the GDP (2013), there is an investment gap of at least 9-10 percent .

As there is no way to increase savings to fill the investment gap, the only option is to attract Foreign Direct Investments (FDI). Besides the capital, FDI brings in technology, management skills and global market access.

Sri Lanka has failed to attract sufficient FDI. For instance, from 2005-2013, Singapore attracted FDI worth US$365 billion, Malaysia US$ 125 billion, Taiwan US$ 98 billion compared to only US$ 6 billion by SL (World Development Reports and World Investment Reports).

In recent years there has been a slight increase in FDI inflows. They have been mainly for the real estate sector and may not help to boost exports.

To get back to the need to expand exports to boost economic growth and increase the real incomes of the people, besides investment especially in the form of FDI, we need to improve our global competitiveness (See table 2).

Competition

The latter boils down to improving productivity by increasing future output and returns from the present input or less of it to reduce unit costs of goods and services.

At the same time we have to innovate to raise the uniqueness of goods and services by way of quality and other value added features to satisfy the needs of different segments of the market while avoiding global competition. This is the way to obtain higher export earnings.

Today, we export commodities such as tea and rubber or near commodities such as apparel which fetch low prices in world markets and not large quantities of value-added goods and services.

Examples of SL firms exporting such unique products are Janet Cosmetics, Link Natural Products (beauty products and tooth paste), Hayleys Dipped Products (rubber hand gloves to meet various needs), CEAT tyres and Loadstar rubber products (pneumatic rubber tyres and solid rubber tyres). Hayleys and Loadstar are two of the world's largest manufacturers of tyres of this type.

We need many more of these, as in the case of Malaysia which gained Independence a couple of years after SL and is now a leading exporter of electronic equipment, motor vehicles, pharmaceuticals and light manufactures worth some $230 billion (2012, estimate).

The next major question is how do we significantly improve export competitiveness while increasing investments? The figures below attempt to give an answer.

Enabling environment

The enabling environment (EE) in SL during the past three or four decades was not conducive for investors. In the OECD Country Risk Index, 2014, SL's score was a negative 6 and Somalia's score was 7, (10 being the worst), while Singapore's score was an excellent 0 and other international indices.

Separation of powers among the executive, judiciary and the legislature is essential to improve EE including good governance. Therefore, the political slogans we hear these days such as reform of the Constitution to include freedom of expression, right to information, law and order, new election laws will help to create this enabling environment.

Law and order is essential for business growth because investors are concerned about the safety of persons, property, assets and profits.

Macroeconomic stability

Macroeconomic stability too is essential to create a conducive environment for businesses. Investors are keen on low inflation, low interest rates and stability of the exchange rate to maintain costs at a low level. Trade openness by bringing down import tariffs is another need.

Import tariffs and taxes

Another reason for import tariffs is to protect enterprises producing for the domestic market. Today, the real effective rate of protection is reported to be over 200 percent for some commodities such as maize due to various import tariffs and taxes (Rajapatirana).

But protectionist mechanisms contribute to price increases of domestic consumer items and hinder competition or rivalry among firms. Competition leads to pressure to improve productivity to lower the cost of production and innovation to improve the quality to meet the needs of customers and thereby get higher returns.

The solution is to lower import tariffs and taxes to a uniform level. Protection to a reasonable degree (which causes consumer prices to rise) can only be accepted in the food sector considering the food security of the country. But there too competition among such enterprises should be ensured to protect the consumer by maintaining tariffs at a uniform level .

Total Factor Productivity in SL has been negative and it was -8.5 in 2011 and -3.5 in 2012 compared to positive figures in other countries in the region, especially at the beginning of their journey towards prosperity. See table 3

Therefore, to boost export productivity and competitiveness we have to invest in the development of the factors of production such as land (agriculture and fisheries), labour, capital, physical infrastructure, health, human resources (technical and the soft skills such as creativity, working effectively in a team) to achieve targets and communication particularly in a foreign language such as English), technology and information (at present our investment in education is 1.8 percent of GDP while in Malaysia it is about 6 percent). The policy decision to increase it to 6 percent is a good move. Liberalisation of the labour market by simplifying the complexity of labour laws (about

Table 1. GDP Per Capita of Some Asian countries in 2013

	South Korea	Taiwan	Malaysia	Singapore	Sri Lanka
GDP per capita p.p.p., $, 2013 estimated.	**32,189**	**39,767**	**17,748**	**64,584**	**6,765**

Note: p.p.p – purchasing power parity – exchange rate adjusted to offset different rates of inflation among countries for better comparison. *Source: World Fact Book*

Table 2. Export Earnings of Some Asian Countries, 2012 , their Productivity and Competitiveness

	South Korea	Taiwan	Malaysia	Singapore	Sri Lanka
Exports, $ billion 2012, estimated	**548**	**288**	**239**	**431**	**11**
Global Competitiveness Index rank, 2014/15, out of 144 countries	**26**	**14**	**20**	**2**	**73**

Sources: World Fact Book, World Economic Forum

Table 3. Productivity in some Asian countries

	South Korea	Taiwan	Malaysia	Singapore	Sri Lanka
Labour productivity per worker, GDP per hour, $, (2005ppp.)2011,	**26,500**	**35,500**	**14,500**	**42,000**	**7,200**
Total Factor Productivity	**0.4**	**0.9**	**1.1**	**0.0**	**-3.9 (-8.5 in the previous year, 2011)**

45) in the country, upgrading of skills and the development of the financial and capital markets to reduce financial risks and costs are essential to improve not only productivity but also to attract investments particularly FDI .

Note: TFP - the relationship between output and all inputs like land, labour and capital. It can also be described as efficiency of production.
Sources: Asian Productivity Organisation and Conference Board Total Economy Database, 2012/13

Improving productivity, value chains or the supporting industries, is a responsibility of the State. Planting material production, extension services, cold rooms, warehouses, transport of produce and marketing especially in agriculture have to be developed and supported.

Another strategy is to improve the quality of goods and services to keep pace with international standards. To enhance productivity it is also important to improve the efficiency of all public institutions particularly simplification of the complex and cumbersome procedures and documentation.

It is ironic that setting up of manufacturing industries may support improvement of productivity in the public sector - by absorbing its surplus employment about 1.4 million when it can do with one-third the number) and in agriculture by giving well paid employment opportunities to the excess labour in the sector (about 31% of total employment). Else consolidation of agricultural holdings to improve productivity in the sector may throw out more than a million subsistence farmers who cannot obtain a farm surplus.

Institutional arrangements

Expansion of exports involves a number of public institutions dealing with planning, laws, policies and incentives connected with investment, production of goods and services, improvement of productivity, export competitiveness and promotion of exports in global markets.

It is thus clear that is not the sole responsibility of the EDB and the Department of Commerce which are at present engaged only in export promotion (difficult without sufficient goods and services).

Thus, the solution may be to bring the EDB, the Department of Commerce and the BOI under the supervision of the Ministry of Finance and Planning for greater co-ordination and effectiveness.

Achieving prosperity and alleviation of poverty is a matter of increasing investment especially FDI and improving productivity and competitiveness to differentiate goods and services to satisfy customers especially in global markets.

Import substitution should only be for special needs such as maintaining food security as SL is a small country with a small domestic market.

- **GW**