Sri Lanka import substitution should be temporary: economist

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ECONOMYNEXT – Sri Lanka should not extend an import substitution strategy beyond the short term as changes are taking place in world which the island should not miss out on an economist said, as the island is battling a new cluster of Coronavirus.

Sri Lanka has placed the worst import controls since the collapse of the Bretton Woods system of soft-pegs in 1971, after the country's currency plunged in March and April amid liquidity injections.

Private credit has since weakened but the import controls are in place amid excess liquidity in money markets.

Sri Lanka has placed the controls despite battling Coronavirus better that most countries.

"Sri Lanka is not the only country that is re-thinking its trade policy," Dushni Weerakoon, the head of Institute of Policy Studies, a Colombo base think tank said responding questions at a webinar during the release of its annual State of the Economy report.

"It has been in the cards since the global financial crisis, we have seen a push-back against globalization and Covid 19 I think is accelerating that process."

"The priority for the countries is to provide employment; there is a sense that if we protect our industry, give and them a relief period in which to recover.

"This is an unprecedented economic shock. We have no idea as yet what is the scale of the crisis is on the Sri Lanka economy.

"We have not yet seen the second quarter GDP growth rates that would capture in absolute terms what has happened. So we are working in the dark.

"So to that extent is understandable that a certain degree certain degree temporary import protection is offered.

Anti-trade economist nationalists have raised their voices in the West as seen by Trumpism, after the Federal Reserve triggered a financial and asset bubble which collapse around 2008, leading to run on banks and job losses, triggering massive state interventions in its wake.

Similar trade controls were seen after the Federal Reserve fired the 'roaring 20s' bubble and triggered the Great Depression. In the US, 1930 the Smoot-Hawley Tariff Act came was passed.

In Latin America where commodity exports suffered, import substitution became popular.

State led industrialization in particular was popularized by Raul Prebisch, the creator of Argentina's activist pegged central bank, which was expected to sterilize the balance of payments.

The central bank model which was adopted by the Fed's Latin America department and replicated in many other Latin American nations and also in Sri Lanka, triggering repeated currency crises and leading to sovereign default in many cases, analysts have said.

As the non-credible pegs collapsed countries turned to import substitution to 'save foreign exchange' instead of fixing monetary policy.

Most East Asian nations (and Gulf nations) on the other had adopted an opposite strategy backed by monetary stability (currency boards or highly credible pegs), and grew economies with foreign investment and created global value chains as well as domestic consumption.

East Asian nations which actively wooed foreign firms also over turned a Prebisch linked 'dependency theory'.

Free trade allowed living standards to soar, most recently seen in Vietnam, which embraced free trade early and had no domestic business class to oppose it as large companies were all state owned. Japanese branded goods are cheaper in Ho Chi Minh City than in Tokyo.

Ironically the push back against free trade in the West by nationalists and mercantilists during the Great Recession had come against East Asian industrial goods, while Latin America which pushed for import substation is still having currency troubles and sovereign defaults.

Meanwhile Weerakoon said there were new global developments that were taking place which Sri Lanka should not ignore.

"The sensible option is to view these as emergency measures, that once the economy starts to recover we have to re-think, because there are other developments that are taking place in the global economy," she explained.

"Value chains have been disrupted but they are re-structuring and re-organizing and coming back in more compact forms.

"China will be at the forefront of some of these value chain networks in the Asian region.

"And Sri Lanka cannot afford to miss-out by holding onto unwieldy tariff regimes and other protectionist measures in key sectors that we want to ensure that we break into international markets.

"If you want to join the global production structures you need a seamless tariff regime for raw materials and intermediate goods."

Weerakoon said Sri Lanka should also be cautious about state spending for 'stimulus' as there was a 'debt overhang' and the country had to repay foreign debt. Therefore some kind of credible fiscal policy was needed.

Sri Lanka's sovereign bonds are trading at steep discounts which is making it difficult to roll-over them at the moment and forcing the government to make bullet repayments.

Sri Lanka however has controlled the spread of Coronavirus allowing people to actually go out and work, which is a real not financial 'stimulus' analysts say. Colombo/Oct19/2020)

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