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<https://www.dailymirror.lk/features/reducing-trade-deficit-is-the-government-jousting-with-toothpicks/185-33434>

Reducing trade deficit: Is the government jousting with toothpicks?

Sri Lanka has high trade deficits. And, instead of shrinking, they are increasing over the years. The current government policy, based on import substitution, will not be able to solve this serious problem.

A country has a trade deficit when it is buying more than it is selling. A household that buys more than it earns (by selling labour), will need to borrow to bridge the gap. It can't just keep borrowing because debtors come to collect and very soon it has to start selling something more. If family members are earning abroad, it can sponge off them. But if the debt problem is growing, sooner or later, the property and furniture will have to go too. It's the same for a country.

Today, Sri Lanka's trade deficits are not only increasing in absolute terms but also increasing as a percentage of the gross domestic product (GDP) (see Figure 1). In 2011, Sri Lanka had a higher trade deficit on record than the rest of the previous decade- 16.4 percent of the GDP. The government promptly announced several measures to reduce the deficit but these had little impact. In 2012, it was again a whopping 15.8 percent of the GDP. The trade deficit is clearly a problem but what is being done about it is not working and what will

work is not being done.

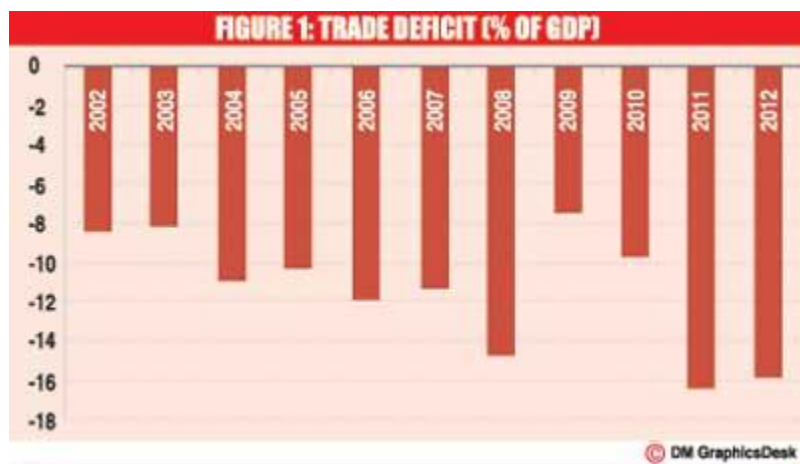
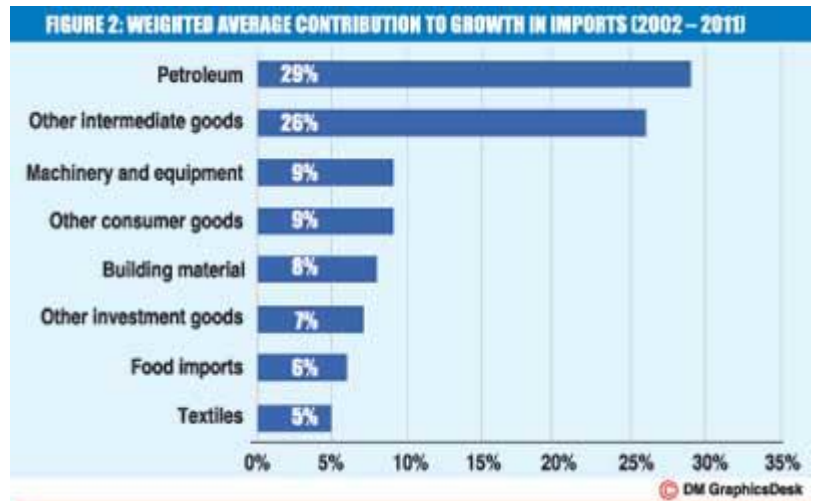
Import Substitution Strategy

The budget speeches and policies over the last few years suggest that a key strategy adopted by the government, to reduce the trade deficit, is to discourage imports and substitute with increased local production. In economics, this strategy is known as ‘Import Substitution’.

A key area picked for the Import Substitution Strategy has been food. For example, in the 2013 Budget the President said, “The promotion of dairy production in our country will save US \$ 350 million of foreign exchange. Therefore, I propose to maintain high taxes at the point of customs on imported milk powder.” He also said, “Imposition of a special commodity levy enabled us to encourage farmers to increase production of rice, maize, onion, potatoes and dairy products, to reduce imports,” (emphasis added).

Picking the wrong battle

Promoting local food production and reducing reliance on imported foods can have merit in terms of food security and supporting vulnerable farmers. However, as far as the trade deficit goes, it is the wrong battle to pick. The numbers tell the story (see Figure 2). Food was only 7 percent of the import bill in 2012



and its contribution to growth in imports was even less than that in the prior decade of 2002 to 2011. Import substitution on food is only going to prick the trade deficit; it will not even make a dent.

The unpicked battle

The big driver of import growth in the last decade was petroleum. Its share has grown from 12 percent of the GDP in 2000 to 26 percent in 2012. Another way of appreciating this leap is to calculate its contribution towards the growth of the import bill over 10 years. It's the biggest, at 29 percent (see Figure 2). Reducing the petroleum bill would involve promoting more fuel efficient means of energy and transport. On both, the progress is very sketchy. For example, consider transport: Steep tax concessions given to hybrid cars were reversed less than a year later; Sri Lanka's most populous train station in Colombo Fort is very poorly maintained and has seen little improvement since its inception in 1917; recent structured interviews by Verité Research in Colombo found poorer people quite resentful of bus transport conditions. This archaic supply-infrastructure of public transport creates a strong push towards private vehicles – demanding more petroleum.

Picking the wrong strategy

Actually, it's not just the battle within the Import Substitution Strategy that needs to be re-examined; it is the strategy itself. Here is the reason. Sri Lanka needs economic growth but its production supply chains (intermediate goods) are import dependent and without the large production scales that would be created by export orientation, it's not very profitable to invest in the supply chain inputs either.

This is not a new finding. An article in 'Dilemmas of Development' (1997) edited by Professor W.D. Lakshman says that the import substitution industries did not help save foreign exchange in Sri Lanka but merely diverted imports from final goods to intermediate goods (inputs into production activities). This has been the experience of many developing countries that pursued import substitution policies. The secret of the success of import substitution industries in East Asian countries was their ability to convert industries supported by

import substitution to become export oriented.

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The story is still relevant (see Figure 2). The second largest driver of the import bill in Sri Lanka, by 26 percent, is the category of Other Intermediate Goods, which includes fertiliser used in food production. There is a tie between 'Machinery and Equipment' and 'Other Consumer Goods' (the only exception) for the third place, with each contributing 9 percent and 'Building Materials' comes next, contributing 8 percent of the import bill growth.

The implication is clear. The battle with the trade deficit cannot be won with the toothpicks of 'home-grown' food and import substitution. It will require the double-edged sword of export promotion and supply-side infrastructure. Without such a strategy, taxing imports can burst the ballooning trade deficit only by also rupturing economic growth.

(Verité Research provides strategic analysis and advice for governments and the private sector in Asia)