The Pathfinder Economic Alert

Let's Face the Challenges

Introduction

After thirty years of conflict, the people of Sri Lanka deserve better than continuing with the boom and bust cycle which has capped the country's growth rate at 5-6% over the last three decades. There is ample historical evidence from both Sri Lanka and from around the world that inward-looking autarkic strategies do not result in accelerated growth and development on a sustained basis. This is particularly so for a relatively small economy like Sri Lanka. Export growth has, therefore, to play a major role in taking the economy to a higher growth trajectory. In a context of globalised markets for goods and services, this places a very high premium on the competitiveness of the economy.

A comprehensive strategy for increasing competitiveness is challenging but the rewards would be considerable. Such a strategy should be based on the following:

- sound macroeconomic policies which promote savings/investment and maintain key prices, such as interest and exchange rates, at competitive levels;
- increased efficiency in factor (land, labour and capital) markets
- increased productivity in agriculture, manufacturing and services (particularly exports and import competing sectors)

Sound Macroeconomic Policies

As mentioned in a previous Pathfinder Economic Alert, moving the economy to a higher growth trajectory to meet the government's targets requires investment to increase from 25% of GDP to about 35%. Attention needs to be paid not only to the quantity of investment but also its quality. Increasing productivity through strengthening investment performance is at the core of sustained development. The overall macroeconomic policy framework should, therefore, incentivise all forms of savings and increase the efficiency of resource allocation.

Sri Lanka needs to get away from the stop-go policies that have characterised its post-independence history. One needs to increase productivity to the point where the economy does not overheat when it achieves 5-6% growth on a sustained basis. This requires a stable, predictable and transparent macroeconomic policy framework that creates the conditions for low inflation and balance of payments viability. The Budget

Speech 2011 has set out a process of fiscal consolidation that would contribute significantly towards achieving this objective, if it is implemented effectively.

A previous Pathfinder Economic Alert indicated that macro-economic stability cannot be achieved without fiscal consolidation. High budget deficits exert pressure on the interest and exchange rates, which are important determinants of savings and investment decisions. They result in higher interest rates which increase the cost of funds in the economy leading to lower growth, employment and incomes. In addition, unsustainable fiscal deficits exert pressure on the exchange rate by increasing the inflation differential between Sri Lanka and its major competitors and trading partners. An uncompetitive exchange rate subsidises imports and discourages savings and investment by reducing the competitiveness of the domestic economy. Exchange rate adjustment however, without fiscal consolidation would trigger an inflationary spiral.

The key message is that interest and exchange rates are key determinants of the competitiveness of the economy. Fiscal and monetary policy must be designed to ensure that these key prices are competitive while still maintaining macroeconomic stability (low inflation and sustainable balance of payments). The fast growing countries in East and Southeast Asia have been able to maintain competitive (undervalued) exchange rates and low interest rates due to strong fiscal performance that did not complicate demand management in their economies. The surpluses they have been able run in the current account of their budgets have also boosted their savings ratios. Their robust fiscal outcomes have been an important determinant of their successful economic transformation.

At the macro level, the taxation system also influences a country’s competitiveness. A simple and transparent tax structure with competitive marginal rates would boost the competitiveness of the economy. **Singapore and Hong Kong are examples of jurisdictions that have benefited greatly from a simple and low tax environment.** The recommendations of the Tax Reform Commission, introduced in the Budget Speech 2011, have sought to increase the efficiency and buoyancy of the tax system and improve tax administration, while reducing tax rates.

Increased Efficiency of Factor Markets

The **land** market in Sri Lanka is characterised by a number of rigidities that reduce productivity, and, therefore, competitiveness. The State continues to own large tracts of land that are not being used productively. There are strategic decisions to be made regarding land utilisation. Currently, productivity is very low in the agriculture sector. The paddy sector absorbs considerable resources (irrigation, fertiliser subsidy, extension services and the guaranteed price scheme), yet yields low returns. Crop diversification and the balance between small-holder and commercial agriculture are issues that require careful and balanced consideration. Increased adoption of technology and high yielding varieties, as well as improved extension services, also require attention. **Increased agricultural productivity was an important element of the "East Asian miracle".**

Land titling is another area that continues to provide scope for improvement. The work of de Soto has demonstrated the substantial returns that can be generated both in terms of increasing productivity and alleviating poverty.

A skilled **labour** force with high levels of productivity is an important element of a competitive economy. The education system, vocational training and overall skills development should be aligned to the demands of the labour market. These, in turn, should be linked to Sri Lanka's dynamic comparative advantage in a highly competitive global economy. Asian countries, which have been successful in achieving accelerated growth and development, have been able to align their human resource development with opportunities in the globalised economy. Singapore is a notable example of this. India too has been able to develop the skills (IT, engineering and English) needed to take advantage of massive opportunities in the world market. Historically, the Sri Lankan education system has been supply driven resulting in a mismatch between expectations and opportunities. Educated unemployment has been an important factor underlying the rise of separatism in the North and East as well as the two youth insurrections in the South. The authorities have sought to address the problem of the educated unemployed by creating unproductive employment in the public sector, thereby pulling down the overall productivity of the economy through inefficient allocation of financial and human resources. The Sri Lankan public service, with 1.2million persons, is one of the largest in the world on a per capita basis.

The controversial area of labour market reforms is another subject that requires pragmatic debate and effective action. The objective should be to achieve flexible labour markets that generate the right balance between the interests of investors and labour, within the competitiveness parameters set by global markets for goods and services. A mixture of skills development, innovation and design can increase productivity and create the conditions for higher wages, while maintaining competitiveness.

Employment generation is the best transmission mechanism for sharing the fruits of growth. Interest and exchange rate policies as well as the tax system must be geared to support productive investment and inclusive growth. Rural/urban imbalances are less pronounced in Sri Lanka than in many other countries. However, as mentioned above, the performance of the rural sector is adversely affected by the low productivity of the agricultural sector. This constrains increases in incomes.

High cost of funds and under-developed **capital** markets undermine the competitiveness of the economy. As mentioned above high fiscal deficits have resulted in uncompetitive interest rates in Sri Lanka. Successful implementation of the fiscal consolidation envisaged in the Budget Speech 2011 would serve to reduce interest rates. However, high spreads also contribute to the uncompetitive cost of funds in the economy. The recent action taken by the Central Bank to reduce spreads is good for business. The financial sector needs to continue to take concerted action to reduce the costs of intermediation in the economy. As the financial system is the lifeblood of any economy, it is important to ensure that it is fit for purpose in the coming decades of the 21st century.

In this respect, there are structural issues that result in a lack of medium and long-term credit. Commercial banks face a maturity mismatch which renders them reluctant to provide such financing. They mobilise funds on a one or two year term basis. It is, therefore, unlikely that they will provide the development financing required to stimulate business activities. The budget speech 2011 has sought to address the twin problems of high spreads and the need for long-term finance by foregoing some taxation on the banking sector to provide what is effectively subsidised credit through the Central Bank. This constitutes an innovative means for reducing the cost of funds and extending maturities. It is important, however, to learn lessons from refinancing schemes run by the Central Bank in previous years which became politicised and resulted in a misallocation of scarce resources. This creative initiative needs to be complemented by a holistic approach that fosters development of venture capital and private equity institutions to meet the increasing demand for risk capital.

Increased Efficiency of Product Markets

Increasing the competitiveness of Sri Lankan export and import competing goods and services requires: improving the investment climate; strengthening physical infrastructure to reduce overheads and transaction costs (using PPPs where appropriate); developing the capacity to adopt and adapt technology; and promoting innovation and dynamic management at the enterprise level. These have been essential ingredients of the East Asian miracle. As a first step, the various business associations should benchmark the performance of Sri Lanka's export and import competing sectors against that of competitors. This should be supported by a detailed analysis of respective cost structures to prioritise the areas which require remedial action/policies.

Conclusion

A stable macroeconomic framework, supported by structural reforms, which improve the economy's efficiency are necessary to boost its competitiveness. A comprehensive and consistent package of policies need to be developed to increase the efficiency of factor and product markets. This will result in both a shift of resources (human, physical and financial) from low to high productivity sectors as well as more efficient utilisation of resources within sectors. There is a debate to be had on the pace and sequencing of these necessary but politically sensitive reforms. In considering this, there is a strong case for arguing that "pain in the short-run will ultimately yield gains in terms of more growth, employment and incomes in the longer term". The short-term pain can be reduced by well designed compensation and retraining schemes to mitigate adjustment costs. An efficient social safety-net needs to be an important element of any ambitious reform programme to improve Sri Lanka's competitiveness. It is also inevitable that the future growth trajectory of the economy would have to be less carbon intensive.

Sri Lanka is currently faced with a unique opportunity for transformative change. There are risks to be managed but the public and private sectors should work together to look forward to the future with confidence and boldness to secure a much more prosperous future for all Sri Lankans.

This is the Fourth in the series of Economic Alerts issued by the Pathfinder Foundation.

Readers' comments via email to pm@pathfinderfoundation.org are welcome.