Pathfinder Economic Alert

# Export Expansion: The Key to Sustain Accelerated Growth. No Short Cuts only Hard Choices.

## The Negative Narrative

Sri Lanka's exports have declined from 33% of GDP in 2000 to 16% in 2012. In addition, Sri Lanka's share of global exports have also declined (this reflects clearly a decline in competitiveness). Exports have declined in absolute terms in 1Q 2013.Furthermore, in 1980, export complexity in Sri Lanka and Thailand was similar. Today, Thailand's exports structure reflects a far more diverse and complex mix of goods and services. This disappointing performance is a function of both an anti-export bias in the policy framework that has tended to persist since 1980 and a lack of competitiveness/low-productivity. Challenges exist for both policymakers and business to affect a decisive turnaround. This is crucial as Sri Lanka with a very small domestic market cannot achieve an accelerated growth path on a sustained basis without significantly better export performance. It is a cause for concern that remittances are the only non-debt creating source of foreign exchange that is not underperforming in relation to government targets.

A key lesson that needs to be drawn from the experience gained in 2010 and 2011 is that it is not possible to put the economy on an accelerated growth trajectory by pumping excess demand into the system through loose/inappropriate macroeconomic policies. It should be recognized, however, that there was enormous pressure on the authorities to deliver a peace dividend in those years. They responded through an over-relaxation of monetary policies (interest rates were reduced 500/600 basis points); the Real Effective Exchange Rate (REER) became 25% overvalued; and the budget deficit (and the quasi deficit) were excessive. This mix of policies inevitably led to unsustainable credit expansion, a deterioration in the balance of payments, pressure on the Rupee and a sharp decline in external reserves. This led to the necessary austerity measures that were introduced in Feb/March 2012.

It is important to recall, therefore, that painful measures which were a burden on the people became necessary because the economy became overheated when there was a "dash-for-growth" following the end of the conflict. These policies delivered: 8% growth in 2010/2011; made it easier for the people to acquire consumer items (including all categories of motor vehicles) on the back of cheap credit and an overvalued exchange rate that reduced the Rupee costs of imports; and contained the burden on the budget (Rupee costs) of the intermediate and capital goods that were necessary for the government's accelerated infrastructure development program. However, these policies could not be sustained. The consequential austerity measures have meant that growth has probably been less than 5%, since 3Q 2012, when these measures triggered by overly expansionary policies began to take effect.

In addition, the current policy framework has been channeling resources (financial and human) into the non-tradable goods sector. In recent years, the main sources of growth have been non-tradables, such as construction, mining and quarrying, retail and wholesale trade and public administration. This is not a recipe for sustained accelerated growth, given a market of 20 million people with per capita incomes of $2,980.

**No Scope for Short Cuts**

The government's growth target of 7.5% - 8% cannot be met on a sustained basis merely by tinkering with macroeconomic policy instruments. At present, there is no scope for expansionary fiscal policy (i.e. tax cuts and/or increased public expenditure) as the budget is already in difficulty due to extremely low revenue collection and continuing expenditure pressures, including arrears rolled over from 2012. The low revenues are, in part, a consequence of low growth as 80% is collected from indirect taxes which tend to be linked to the level of economic activity. Above all, the deteriorating debt dynamics (increasing external debt and within that rising commercial debt, including over $4 billion worth of foreign holdings of Rupee denominated Treasury instruments) place a binding constraint on the scope for expansionary fiscal policies to revive growth. Sri Lanka's debt stock of 79.5% of GDP compares unfavourably with the median of 36% recorded by its peers with a BB- rating.

The space for an aggressive use of the exchange rate (depreciation) to boost growth through increased exports and more supplies of import competing goods is also limited at this time. The impact of any currency depreciation on the cost of living would be immediate, while the benefits in the form of higher growth will only emerge in the medium term (the J-curve effect). Furthermore, an active exchange rate policy in the context of weak fiscal discipline will result in an inflationary spiral. The politics of this, therefore, are very challenging when there is already pressure on prices consequent to the electricity price adjustment.

This leaves monetary policy as the easiest option for stimulating growth at this time. The CBSL has, accordingly, cut policy rates by 50BPs. However, the authorities need to exercise extreme caution to ensure that the loosening of monetary policy does not lead to the same type of macroeconomic instability (inflation and balance of payments pressures) that emerged in late - 2011/ early 2012. In this respect, it is important to recognize that the impact of the necessary increase in electricity prices are yet to feed through into inflation. There will be both direct and second-round effects that will filter through to the price level. An over relaxation of monetary policy will, therefore, pump excess demand into the system at a time when an upturn in inflation is already in the pipeline following the electricity price increase.

Relaxation of monetary policy can also have an adverse impact on the balance of payments. There has been an improvement in the country's external position in 1Q 2013, despite a worrying decline in exports. This is because imports have declined even faster. It is important to recognize that this reduction in imports is largely a function of a sharp slowdown in growth. The favourable impact of increased hydro-power generation on the oil bill is also a positive factor.

Pushing for higher growth through looser monetary policy is likely to result in a repeat of the cycle of an increase in credit followed by an unsustainable level of imports. It is particularly noteworthy that if imbalances emerge as they did last year, particularly on the balance of payment front, this time around both the external debt and net reserve positions are more vulnerable. The risks associated with this are compounded by the roll-over risks associated with a higher level of foreign holdings of Rupee denominated Treasury instruments.

**Hard Choices**

As argued in previous PF articles, the government's growth target cannot be met merely by tinkering with macroeconomic policy instruments. The anti-export bias in the policy framework needs to be addressed, including the overvalued REER and the tariff regime which has resulted in a more closed economy. A package of structural reforms that covers, inter alia, factor markets (land, labour and capital), SOEs, education, training and skills development and technology management are necessary to strengthen the growth framework of the economy.

Business also needs to take the lead in initiating an aggressive growth drive. The challenges include: diversifying export products and markets; increasing value added exports; innovation; and branding.

The path to export-driven acceleration of growth is not an easy one. It requires a strategic perspective and concerted action on the part of both government and business. Hard choices and hard work cannot be avoided. Pain in the short- term is inevitable, as rebalancing of the economy takes place, before benefits are generated.

In the meantime, it would be advisable to settle for lower-growth (5% -6%). It is better to drive the engine at 20/30 mph and avoid overheating rather than seeking to achieve 50/60 mph and blowing a gasket.

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