Pathfinder Foundation Economic Alert

Should Sustaining Rapid Growth Remain Elusive?

No, Sri Lanka Can Make It

The promise of accelerated growth

The end of the conflict has raised expectations regarding the growth prospects of the country. However, a lesson to be drawn from the experience of 2010 and 2011 is that a sustained accelerated growth trajectory cannot be achieved by demand management policies alone ie adjustments to monetary, fiscal and exchange rate policies. The structural constraints that have persisted for several decades have invariably triggered an over-heating of the economy whenever growth accelerates. This experience was repeated again and resulted in the introduction of the stabilization measures of February/March 2012. Growth slowed down sharply since then.

A fundamental flaw in the Sri Lankan economy for over the past 35 years has been that growth has tended to be driven by the size of the budget deficit rather than the current account of the balance of payments. This means that incremental growth has been overly dependent on the excess demand generated by unsustainable budget deficits. This excess demand pushes up prices (inflation) and sucks in imports that exert pressure on the balance of payments. The fast-growing economies of East and Southeast Asia have had robust fiscal outcomes and their sustained high growth has been powered by strong outcomes in the current account of the balance of payments ie robust EXPORT performance. This raises the question as to how the growth framework of the Sri Lankan economy can be strengthened to support sustained growth of 8.00---the Government's target. How can one break the cycle of stop-go macroeconomic policies that have characterized the post-1977 era?

The ingredients for sustaining rapid growth

Anoop Singh, Director, Asia Department, IMF set out the following ingredients for sustaining rapid growth, in his Keynote Address at the Sri Lanka Economic Summit, organized by the Ceylon Chamber of Commerce: macroeconomic and financial stability; outward orientation; enhancing productivity growth; investment in physical capital; robust labor contributions; strong institutions and good governance; and inclusive economic growth. This was based on extensive research undertaken on the causes of growth, notably the work of the Growth Commission, Chaired by the Nobel Laureate, Professor Michael Spence (2008). Mr. Singh went on to assess the progress Sri Lanka has been making on each of these ingredients for sustaining rapid growth in comparison with countries which have succeeded in sustaining over 7% growth over at least two decades.

Macroeconomic and financial stability

Mr. Singh highlighted the importance of macroeconomic and financial stability for creating a strong growth framework. He recognized that Sri Lanka has made progress in reducing inflation during 2008-2012. However, it is still double the rate achieved by four ASEAN countries (Indonesia, Malaysia, Philippines and Thailand) cited by him.

He pointed out that Sri Lanka's performance has improved in relation to budget deficits and debt as a percentage of GDP, over the last five years. However, the ASEAN4 have recorded figures which are about half that of Sri Lanka over the same period. The budgetary outcome is the area where Sri Lanka lags the ASEAN 4 most markedly. It is also noteworthy that Sri Lanka's revenue performance has deteriorated recently.

On financial stability, Sri Lankan banks remain well capitalized (tier 1). NPL's have declined sharply between the periods 2000-2008 and 2009-2012. However, there has been some slippage this year, with the slowing down of the economy. On both capitalization and NPL's, Sri Lanka again trails the performance of the ASEAN 4, despite the improvements recorded.

Anoop Singh identified the following key priorities for lasting macroeconomic stability in Sri Lanka: stabilize inflation in mid-single digits; pursue growth-friendly fiscal consolidation (including greater revenue effort) for debt sustainability; strengthen the external sector; and continue safeguarding financial sector soundness.

One may conclude that Sri Lanka has made progress in terms of macroeconomic stabilization. However, the improvement in the debt/GDP ratio is tempered by the hardening of the composition of the public debt, with increasing external debt and higher shares of commercial and short-term liabilities. In addition, the budgetary consolidation needs to be placed in the context of SOE losses amounting to 2% of GDP which are on the balance sheets of state banks and increasing contingent liabilities arising from the foreign borrowings of banks and SOEs.

Outward orientation

The external sector continues to face challenges in terms of generating increased non-debt creating inflows in the form of exports of goods and services, FDI and portfolio flows into the stock market. Mr. Singh stressed that Sri Lanka needs to reverse the decline in the openness of the economy to support growth and productivity. He called on Sri Lanka to upgrade its exports (higher complexity and value) and take greater advantage of penetrating the fast-growing markets of its Asian neighbors. 50% of Sri Lanka's exports go to the EU and US, while India and China account for 7%. Sri Lanka accounts for a very negligible share of intra-Asian (regional) trade—the most dynamic component of the international trading system. China, on its own, accounts for 22%, while Indonesia, Malaysia and Thailand each accounts for 5%.

Enhancing productivity growth

Sri Lanka also trails the ASEAN 4 in terms of the diversity of its export structure and the complexity of its export products/services. Mr. Singh calls for greater support in this area through FDI, R&D and mathematics/science education. Japan, South Korea and Singapore have demonstrated the value of high and well-focused spending on R&D. Mr. Singh expressed concern regarding the declining trend in the proportion of students enrolling in science and engineering.

Investment in physical capital

Investment is key to sustaining growth as demonstrated most vividly by China, Vietnam, South Korea and India, since the dawn of the new Millennium, according to Mr. Singh. Sri Lanka has also achieved a significant increase in investment in infrastructure. The challenge for the country is to increase its investment ratio from 30 to 35% of GDP to support an 8% growth rate. Mr. Singh pointed out this requires an elimination of public dis-savings (deficits in the current account of the budget); higher private savings; and attraction of non-debt creating inflows, particularly FDI. It is noteworthy that none of the other eleven Asian countries cited in Mr. Singh's presentation recorded public dis-savings. While welcoming Sri Lanka's improved performance in the World Bank's Doing Business Index (DBI), he called for a concerted effect to improve the business climate.

Mr. Singh also drew attention to the increase in the dependency ratio that is expected as a consequence of the ageing of the population. He pointed out that this is going to pose a challenge for increasing savings in Sri Lanka. Mr. Singh also called for financial deepening to boost savings and investment, particularly the development of the long term debt market.

Robust Labour Contribution

Mr. Singh stressed that a healthy and educated labor force boosts productivity. The current pressures on the education and health budget are, therefore, matters of concern. Mr. Singh also pointed out that female participation rates were low. He stressed that improvement on this front would become even more important as the demographics dynamic of an ageing population kicks in.

Strong institutions and governance

Anoop Singh emphasized that a sound business environment requires strong institutions and governance. He pointed out that there was room for improvement in a number of areas. While Sri Lanka has recorded improvement in the DBI, its performance in the World Governance Indicator (2012) is more mixed, particularly in the area of voice and accountability. Mr. Singh called for policy initiatives in the following areas: strong rule of law, restrained Government involvement, focused and concise regulatory environment, basic social protection and political and economic inclusiveness.

Inclusive Economic growth

Mr. Singh commended Sri Lanka's poverty reduction achievements. There has been a significant reduction in the poverty head-count and the growth elasticity of poverty reduction has also been impressive. This has meant that the country has achieved a relatively virtuous growth cycle which compares favorably with the performance of other Asian countries on the GINI Coefficient, measuring inequality.

Sri Lanka's Potential

The Head of the Asian Department of the IMF ended his presentation on an optimistic note. He concluded that sustained rapid growth over a prolonged period is achievable in Sri Lanka. In his view, it can narrow the gap that currently exists with its comparators in Southeast Asia, if it pursues the key ingredients for growth success identify by him. This would be challenging. However, it can be achieved, provided Government and Business work hand-in-hand.

Conclusions

Pathfinder Foundation (PF) will monitor Sri Lanka's performance on the indicators identified by Mr. Singh on a bi-annual (6 monthly) basis, where data is available. Comparisons will be made with the competitor countries catalogued in Mr. Singh's Presentation.

This is the Fiftieth Economic Alert published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org

Economic Alert, Economic Flash & Economic Blast articles can be viewed at www.pathfinderfoundation.org you can also find us on facebook and follow us on twitter.