Pathfinder Economic Alert

Grasping Massive Opportunity: No Place for Complacency.

The Challenge: Macroeconomic Stability and Strategic Action

There has been an improvement in macroeconomic conditions since the introduction of the stabilization measures introduced in Feb/March 2012. Inflation has abated and the balance of payments has improved. However, though the growth momentum has picked up in 2H 2012, the balance of probability is that it has been well below the targeted 8%. More fundamentally, the current economic model, where consumption is very dependent on remittances and growth is disproportionately funded by borrowing, including increasing amounts of foreign commercial debt cannot be the basis for placing Sri Lanka on a higher path of sustained growth and development for a decade or more, particularly as international interest rates will rise in the future as the major global central banks unwind their extraordinary liquidity infusion. Despite this, the opportunity now exists to emulate the achievements of the successful countries of East and South East Asia which recorded rapid growth for 10 – 20 years. However, Sri Lanka cannot achieve such success without maintaining macroeconomic stability and taking some key strategic action.

Improved Macroeconomic Conditions: So-Far- So- Good

Fiscal Performance

The authorities have demonstrated significant resolve in pursuing fiscal consolidation, particularly in a context where revenue collection has been weak. It is noteworthy, that much of the adjustment has been borne by a reduction in recurrent expenditure. Considerable political courage has been shown in reducing public service emoluments, subsidies and transfers in real terms (this has been cushioned by the $6.5 billion which has gone directly into households in the form of inward remittances). However, the reduction, in real terms, of expenditure on health and education is a matter of concern in a country which faces the key challenges of strengthening education, training and skills development as well as coping with the financial burden associated with aging. A positive feature has been the protection of capital expenditure, which is important for development.

From the perspective of macroeconomic stabilization, it is commendable that the fiscal deficit has been reduced from 9.9% of GDP in 2009 to 5.8% in 2013. This is particularly welcome as

the size of the government budget deficit has been the main source of instability in the system since 1977. However, caution needs to be exercised regarding the buildup of arrears in payments due from the Consolidated Fund as well as contingent liabilities.

On a positive note, a great deal of credit must be given to the authorities for the courageous adjustments in electricity and fuel prices which have addressed the massive losses incurred by the CPC and CEB. This has both strengthened the balance sheets of the two state banks, thereby releasing more credit to the private sector; and removed a burden which would ultimately fall unto the government budget.

Monetary Accommodation

The IMF and some other commentators have expressed concern regarding the relaxation of monetary policy. In its latest move in the current cycle of monetary accommodation, which commenced end-2012, the Central Bank reduced the reverse-repo rate by 50 basis points to a record low of 8%, while keeping the repurchase rate unchanged at 6.5%. This serves to narrow the rate corridor to 150 basis points and is designed to narrow commercial bank's interest rates spreads. The relaxation of monetary policy has been justified on the grounds of muted inflation and an improving balance of payments. The tightening of fiscal policy has also provided more space for monetary policy activism. However, concern has been expressed, as mentioned above, that there has been excessive monetary accommodation, particularly as the official growth rate for 4Q 2013 was 7.8%. Furthermore, it has been argued that more caution should have been exercised as there is a lag before the effects of monetary policy adjustments are transmitted through the system.

However, the concern about the overheating of the economy is probably misplaced. This is due to the fact that growth has been sluggish resulting in an output gap. Proxies for growth, such as government revenue, imports, credit growth, corporate results, electricity sales and cement sales all seem to confirm this. If the economy did grow at 7.8% in 4Q 2013, then there would be cause for concern regarding overheating. In reality, the balance of probability is that growth was less. In this context, the CBSL was probably justified in relaxing policy on 2nd January 2014 on the basis of the persistence of an output gap. However, there is no doubt that the economy has begun to pick up momentum in 2H 2013 and considerable vigilance will now have to be exercised by the authorities going forward. In fact, it is possible that monetary policy may have to be tightened in 2H 2014. This raises the question as to how Sri Lanka gets out of this cycle of stop-go policies which have characterized the country's macroeconomic policies in the post-77 era. This cannot be done by demand management measures alone. Structural reforms, market based and/or discretionary, are necessary (see below).

Stronger Balance of Payments

The country's external position improved in 2013. However, it was driven by import compression rather than export growth. This would have had a negative impact on growth. There

was, however, a pick-up in exports in 4Q 2013 due to the recovery in the US and the bottoming out of recession in Europe. These external trends, combined with soft prices of oil and imported food items, are likely to create a more benign outlook for the balance of trade in 2014. The moderation of the trade deficit and buoyant remittance flows are likely to reduce the pressure on the current account of the balance of payments. Furthermore, it is important to note that gross reserves, boosted by the recent $1000 million bond issue have increased to $8.2 billion (over 5 months of import cover).

There has been satisfaction that exports reached $1 billion per month in the last months of 2013. On an annualized basis, this amounts to $12 billion – a mere 20% of GDP. The corresponding figures for Malaysia, Singapore, Thailand, and Vietnam exceed 60%. Even Sri Lanka recorded exports amounting to 32% of GDP in 2000. Today, that would be the equivalent of $20 billion (exports are estimated to amount to half that [$10 billion] in 2013). It is, therefore, not possible to escape the conclusion that export performance remains weak.

Though there are no balance of payments pressures anticipated on the horizon, there continues to be a structural weakness in the country's external position. The current mix of debt and non-debt creating flows utilized to finance the current account deficit is unsustainable. In practice, Sri Lanka is still too dependent on external commercial borrowing to finance the level of imports necessary to fund the targeted growth rate (8%). The country cannot get away from stop-go policies and achieve accelerated growth on a sustained basis without reducing the present over-dependence on remittances and external commercial borrowing. Sending more and more people, increasingly more skilled people, out of the country will become a greater binding constraint on the domestic economy, particularly in the context of an aging population. In addition, the headroom for more commercial borrowing is becoming constrained as the external debt service ratio has reached 20%, which is generally accepted as "amber" light territory. The solution is to attach the highest priority to FDI-driven exports. Increased exports would reduce the current account deficit and the need for external financing. FDI, in turn, would serve the dual purpose of boosting export-driven growth and reducing the dependence on debt creating flows.

Getting Ready for Major Reforms in the New Political Cycle

The challenge for the authorities is to achieve the twin objectives of macroeconomic stability and accelerated growth for 10 or more years simultaneously. These twin objectives cannot be achieved by demand management policies alone. Instead, one requires a combination of sound macroeconomic policies and measures to strengthen the growth framework of the economy. On the latter, there are two strategic options which are not mutually exclusive. The optimal outcome would be to pursue both side-by-side. First, it is important to implement a package of structural reforms which increases efficiency (productivity) and boosts confidence, particularly among domestic and foreign investors. (A menu of structural reforms was suggested in Pathfinder Foundation's Economic Alert 27 available at www.pathfinderfoundation.org). However, as PF has indicated before, it is unrealistic to expect the implementation of a package of structural

reforms at this point in the political cycle, with major elections anticipated within the next 15 months. This is due to the asymmetry in the timing of the political costs and economic benefits associated with such reforms. However, it is now the time to work on a package of reforms which can be introduced at the very beginning of the next political cycle.

Attracting Foreign Investment through Discretionary Measures: Specialized Zones.

The second option is to put in place a well thought out discretionary strategy including creation of dedicated economic zones to attract investors. Such measures will take advantage of Sri Lanka's two major strategic assets: excellent bilateral relations with China and proximity to India. Once the FTA with China is signed, Sri Lanka will be the only country with preferential access to the market of the two Asian giants. In practice, this would entail preferential access to a market of 2.5 billion people. A unique and unprecedented opportunity that is not available to any other nation in the world. The highest priority must, therefore, be attached to developing a strategic framework for taking advantage of this new set of circumstances. As mentioned above, FDI-driven exports are the path to 8%-10% growth for a decade or more.

In this connection, the following scenario seems to offer considerable promise. Chinese FDI can be attracted to create the capacity to export to India using the Indo-Lanka FTA and back to the Chinese market. The same applies to the Indian FDI which can be used to create capacity to take advantage of the preferential access to the Chinese market and to export back into India. The urgent challenge is to create the enabling environment for this. In this connection, the authorities should be commended for their commercial hub proposal (free ports and bonded areas). This is an excellent starting point. It can serve to create enclaves (Colombo Port City, Hambantota Free Zone, etc) which circumvent the negative factors that undermine the investment climate in the rest of the country. For this proposal to be effective, two conditions should be met:

- It is important to consult the relevant stakeholders in China and India regarding measures necessary to maximize investment and trade. As Sri Lanka needs these countries more than they need us, the negotiations should be made on a realistic perception of Sri Lanka's national interest – enlightened self-interest rather than swollen pride should drive the process with consideration being given to the establishment of industrial zones where they are deemed necessary to attract the required investment.

- All stakeholders within Sri Lanka (government, business and civil society) should work together to create the conditions to take advantage of the unprecedented new opportunities created by the FTA's with China and India. The country needs to operate as Sri Lanka Inc to maximize the benefits.

Conclusion: Realizing the Gains

Sri Lanka now has an excellent opportunity for extraordinary economic transformation. Continuation of the commitment to sound macroeconomic policies, supported by a combination

of orthodox market-oriented reforms to improve the efficiency of the economy and discretionary measures to leverage the excellent bilateral relations with China and proximity to India, constitutes the path to realize the enormous potential of the current historical conjecture.

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