



Pathfinder Economic Alert

## **Sri Lanka's Development Prospects: How to Overcome the Emerging Human Resource Bottleneck.**

### **Prospects of a Bright Future**

Sri Lanka has potentially extremely favourable medium-term prospects. In addition, macroeconomic conditions are likely to be more benign in the short-term, with 2014 being better than last year, provided the US Federal Reserve's tapering program does not cause severe turbulence in emerging and frontier markets. However, there are challenges that need to be addressed if Sri Lanka is to realize its full potential. It is arguable that the lack of the necessary human resources will be the most significant binding constraint that holds back the country's development. At present, the human resources necessary to support the government's five-hubs + tourism strategy are not available within the country.

### **No More "Drags" i.e. Protectionism, War.**

Sri Lanka enjoys the most propitious set of circumstances since the 1950s. Over the last 50 years there have been a number of major "drags" that have undermined the development prospects of the country. These include a sharp secular decline in the terms of trade for 25 years, commencing in the late 1950s; a demographic surge "60s and 70s"; dirigiste inward looking policies boosted by economic nationalism (60s and 70s), which proved to be extremely inappropriate for a small, open, resource scarce economy (resulted in economic stagnation: low investment, low growth, high unemployment and queues to obtain even basic essentials); and a 30-year civil conflict. Today, there are no such major "drags" on the economic prospects of the country.

### **Favourable Geography and FTAs.**

In addition, economic geography is more favourable than it has been for several centuries. Sri Lanka is located in Asia, the most dynamic region in the global economy. Furthermore, it enjoys extremely close bilateral relations with China and geographical proximity to India, the two Asian giants which are rising global powers.

With the likely completion of the FTA with China, and the existing Indo-Lanka FTA, Sri Lanka will have preferential access to a market of 2.5 billion people. This, combined with the proposed commercial hub legislation, is a potential game changer. This provides a framework for

achieving the FDI/exports (rather than remittances/foreign commercial borrowing) led growth that has proved so elusive for Sri Lanka, unlike the successful economies of East and South East Asia. Sri Lanka's lack of success in this respect is an important factor in explaining why a country which was ahead of even South Korea and Singapore, as late as early 1960's has fallen so far behind today.

### **Government and Private Sector Looking for Excuses**

While successive governments did not act emphatically in creating an easy to do business climate, a substantial section of the private sector has been in their protected comfort zone or engaged in rent-seeking activities. Sri Lanka's, governments and businesses have been good at finding excuses for our poor export performance. However, the bottom-line is that we are uncompetitive and do not produce enough goods and services that the rest of the world wants to buy from us (lack of competitive supplies). The government's target of sustained growth of 8% is not possible without a very significant improvement in export performance.

### **Correct Handling of Key Challenges**

As the Pathfinder Foundation (PF) has pointed out time and again, the first step for building a more competitive economy is to achieve more sustainable fiscal outcomes. The budget has been the main source of instability in the system for the last 35 years. It has consistently pumped excess demand into the economy. As a result of wrong fiscal policies, Sri Lanka has been a high inflation, high interest rate and overvalued exchange rate economy – diametrically the opposite to the successful economies in East and South East Asia. In this respect, it is commendable that the authorities have attached high priority to fiscal consolidation. It is still a work-in-progress with concerns regarding arrears and contingency liabilities. It is important that the government's stated trajectory of fiscal consolidation is achieved in order to boost the underlying competitiveness of the economy. Energy costs are another important determinant of an economy's competitiveness. High energy costs have undermined Sri Lanka's growth prospects. Here again, there are prospects of improvement. The completion of Norochcholai phases II and III and Sampur should reduce generation costs and contribute to making energy costs more competitive. The improvements in internal and external connectivity achieved through development of roads, ports and airports should also boost competitiveness by reducing transaction costs.

### **New Political Cycle: Opportunity for Reforms**

The commencement of a new political cycle, expected within the next year, also provides an opportunity to address a number of structural issues. The need for reforms in each of the factor

markets (land, labour and capital) as well as the SOE sector have been well known and well documented for many years. A package of structural reforms will not only increase productivity/competitiveness but also boost investor confidence, both domestic and foreign.

There seems to be evidence that a lack of confidence has been holding back investment. FDI flows have been disappointing. In addition, domestically banks are liquid but credit to the private sector is still lagging. In addition, corporate are cash rich but do not seem to be investing as much as they can. These trends seem to indicate an underlying lack of confidence and reinforce the case for a package of structural reforms to support the macroeconomic stabilization that is underway.

### **Goldilocks Scenario**

The “Goldilocks” (upside) scenario for Sri Lanka would be:

- Continued fiscal consolidation
- Package of structural reforms, leading to further liberalization.
- Structured interventions, such as FTA’s, the commercial hub legislation involving free ports and bonded areas, the port city and other mega projects in pursuit of the five-hubs + tourism strategy.

Even if a concerted effort is made to realize this “Goldilocks” scenario, there is a binding constraint that is looming up on the horizon: a lack of the necessary human resources.

### **Human Resources: Need for Breaking Out.**

The present scenario of increasing dependence on remittances and a tight domestic labour market is not consistent with the five-hubs + tourism development strategy. Already shortages have emerged in key sectors, such as apparel, tourism and ICT/BPO. The problem is compounded by an asymmetry between the current learning outcomes and the skills required to support the five hubs + tourism strategy. Short and medium/long-term measures are required to address this human resource bottleneck in order for the government’s strategy to gather momentum and place the economy on a sustained accelerated growth path. Priority should be attached to the following:

- ***In the short-run, regulations, including visas, should be relaxed to permit the import of labour to meet shortages in key sectors, at least to support the five hubs + tourism strategy. There is plenty of precedents for this that can be obtained by studying the experience of South Korea, Malaysia and Singapore. North America, Europe and Australia have also resorted to such policies.***

- *In the medium-term, education, training and skills development should be well aligned with the demand for labor (skills generated by the five hubs + tourism strategy). This challenge can only be met through a rigorously pragmatic approach to a combination of public, private and mix provision of education, training and skills development. Adherence to dated ideology will only serve to impair seriously the development prospects of Sri Lanka and its people.*
- *In the medium/long term the incentives should also be restructured to shift labour out of the two large wells of low productivity in the economy: subsistence agriculture and the public service. Agriculture accounts for 32% of the workforce and 11% of GDP i.e. productivity in this sector is 1/3 of the national average which is any way low when benchmarked with the successful economies of East and South East Asia. This serious misallocation of labour persists because of the highly distortionary incentives created by the fertilizer subsidy, guaranteed price scheme and free water. Over time these would need to be reduced to release labour from low productivity agriculture to meet the demand for labour generated by the five hubs + tourism strategy. This process can also be facilitated by the development of metro regions around the country that is underway as part of the government's urban development program.*

*Similarly, public service pension reform, which is inevitable in the context of an aging population, will change incentives related to employment in that sector. The public service has increased from 600,000 (2005) to 1.4 million (2013). Here again, there is scope to redeploy labour from low to higher productivity/value employment over time to meet the demand for labour generated by the five hubs + tourism strategy.*

### **Finding the People for the Five Hubs + Tourism Strategy**

It is clear that a lack of human resources will be a major bottleneck that will constrain the governments five hubs + tourism strategy. The highest priority should, therefore, be attached to addressing this problem in a pragmatic and non-ideological manner. It is important to recognize that economic nationalism is incompatible with a hubs based strategy which by definition has to be outward looking.

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