THE PATHFINDER ECONOMIC ALERT

Achieving Double Digit Growth: *Plugging into Asian Supply Chains*

Unprecedented Opportunity

The current historical conjuncture offers Sri Lanka the prospects of achieving unprecedented prosperity and long-term peace and stability. However, a strategic approach is required, supported by decisive action on difficult issues, if hope is to be translated into optimism and potential into progress.

The end of the 30-year conflict; a government with a large majority; favourable economic geography, with Sri Lanka being located in the fast-growing Asian region and in close proximity to India; and the absence of major "drags" on the country's economic prospects, such as the terms of trade decline and demographic pressure that characterized the 1960's and 1970's, all combine to provide Sri Lanka with an unprecedented opportunity to shift to a higher trajectory of growth and development. The country enjoys the most propitious set of circumstances for over 50 years.

Private Sector: To Play a Transformative Role

The government has a target of doubling per capita GDP by 2015. This requires double digit growth and an increase in investment to about 40 percent of GDP. In 2005-09, these indicators averaged 6 percent and 27 percent respectively. This means the investment ratio would have to increase by about 13 per cent of GDP, if the government's aspiration of doubling per capita GDP by 2015 is to be fulfilled. The twin problems of fiscal deficits and high public debt levels mean that the anticipated increase in the investment ratio would need to take place within a contractionary fiscal framework. The government has recognized that public investment should not exceed the current level of 6-7 percent of GDP for the desired trajectory of fiscal consolidation to be achieved. This means that the incremental investment to meet the government's growth targets would need to originate from the private sector, domestic and foreign.

The private sector clearly has to play the major role in transforming Sri Lanka into the "Wonder of Asia." The government has a target of increasing Foreign Direct Investment (FDI) from 1 percent of GDP to 4-5 percent, which at current prices would amount to about $2 billion. (Vietnam and Thailand attracted FDI of $8 billion in 2008.) This means that private domestic investment would have to increase by about 10 percent of GDP to achieve the incremental investment required to achieve double digit growth. This is challenging and places a high premium on building confidence in the long-term stability of policies.

Though challenging, double digit growth is attainable. However, it would only be possible if the enabling environment is created for the private sector to play a transformative role. Above all, there needs to be a clear understanding of the respective roles of the government and business. This relationship varies from country to country. Sri Lanka needs to work out a predictable and transparent framework on how the public and private sectors would work to achieve the country's goals. Success, in this respect, requires a harmonious and supportive relationship between government and business based on trust rather than mutual suspicion.

During the conflict, when risks were elevated, it was inevitable that the private sector would focus on projects with short pay-back periods and/or where a significant share of the risks could be transferred to the government. A new approach needs to be developed which is focused on longer –term investment horizons in the private sector and less dependence on a fiscally constrained government. In the past, growth, investment and employment have been driven by public expenditure. Historical evidence suggests that this inevitably led to unsustainable fiscal deficits and worrisome debt levels. The public expenditure driven model is inherently unstable and cannot be the basis for achieving sustainable double digit growth. The viability of this model has been undermined even further by Sri Lanka's reduced access to concessional finance (foreign aid) now that the country has achieved lower middle-income country status. Sri Lanka needs to move to an exports/current account of the balance of payments driven growth and employment strategy.

Improving the Investment Climate.

A new approach based on a stable relationship between government and the private sector as well as a predictable policy – framework is necessary to support the quest for double digit growth. Fiscal sustainability, a stable and competitive exchange rate and low interest rates are essential components of a conducive investment climate. Fiscal discipline facilitates achieving the other macro-economic objectives. Fiscal consolidation is important not only for macro-economic stabilisation but also for increasing the competitiveness of the economy and improving investor confidence.

While fiscal consolidation is vital for improving the investment climate by reducing macro-economic risks related to inflation and the balance of payments, there are, of course, other measures that need to be implemented to boost investment, both domestic and foreign. International surveys, such as the World Economic Forum's "Global Competitiveness Report" and the World Bank's "Doing Business Report" have set out some markers on what needs to be done to strengthen the investment climate.

Macro-economic stabilization, as well as infrastructure and human resource development, are necessary conditions for creating an environment that is conducive for achieving the incremental private investment needed to achieve double digit growth. However, they are not sufficient. To achieve the target of doubling per capita GDP by 2015, Sri Lanka also needs to adopt a strategic approach to take advantage of the rapid changes in the global economic landscape.

Plugging into Asian Supply Chains.

For attaining sustained 8-10 per cent growth, Sri Lanka has to improve its export performance significantly. The size of the local economy precludes a domestic demand driven strategy for achieving the government's growth targets.

In this connection, full cognisance should be taken of the shift in the global economic centre of gravity to the East. At present, almost 60 percent of Sri Lanka's exports are directed to the sluggish markets in Europe and North America. Little is exported to the fast – growing markets of South, South East and East Asia. Sri Lanka's exports to China and India amount to only 1 per cent and 4 per cent of total exports respectively. Increasing exports to the Asian region should be integral to any growth strategy for the country. Exporting finished products into Asian markets is likely to prove challenging. Instead, there should be a focus on plugging into the dynamic supply chains in Asia, particularly India. At present, intra-firm trade in Asia, is the most dynamic element of the international trading system. The nature of modern production processes are such that they are often located in more than one country. This suggests that there should be considerable scope for Sri Lankan companies to identify niches where they are competitive in the dynamic Asian supply chains.

Located a mere 20 miles away, Sri Lanka has an unparalleled opportunity to hook into the fast-growing supply chains in India, particularly Southern India. The rise of first Japan and then China transformed the prospects and performance of East and Southeast Asian countries. Increased supply chain based intra-firm trading was a major part of their success story. The potential exists for Sri Lanka to benefit in a similar way from accelerated growth in India. In this connection, it must be noted that for India to record its current 8-9 percent growth, the four Southern states (Andhra Pradesh, Karnataka, Kerala and Tamil Nadu) must be achieving double-digit growth to offset lower growth rates in the "lagging" states. This means there is a rapid growth in the middle class and disposable incomes in the four Southern states, which constitute a market of over 250 million people, located just across the Palk Strait.

The challenge for Sri Lankan companies is to explore the potential for plugging into the supply chains of companies operating in India, and beyond in the rest of Asia. In India, particularly the Southern sub-region, they need to identify competitive niches in the supply chains of both Indian companies as well as multinationals operating there. For instance, there are 300 Japanese companies operating in Chennai alone. Nissan, on its own, has a plant that exceeds the size of the Katunayake Free Trade Zone. Of particular interest is the fact that the smaller Japanese suppliers to large companies, like Nissan and Toshiba, have also located in Chennai. The challenge is to become competitive enough to break into these supply chains, tapping into foreign investment, including joint ventures, where necessary.

Conclusion.

Sri Lanka needs to undertake a national competitiveness study to identify areas where it has the potential to break into Asian, particularly Indian, supply chains. The Asian Development Bank (ADB) is already undertaking a study for Bangladesh and Nepal on how they can benefit from the rise of India. Sri Lanka should not fall behind. It must become flexible and adaptable enough to grasp the opportunities arising from the rapidly changing global economic landscape.

In conclusion, the potential clearly exists for placing Sri Lanka on a double-digit growth trajectory, provided there is fiscal consolidation; an enabling environment that incentivizes both domestic and foreign investment; and, above all, a concerted effort to take advantage of favourable economic geography.

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

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