Pathfinder Economic Flash

Does Sri Lanka's Growth Model Need Fundamental Correction?

The keynote address delivered by Dr. Kalpana Kochar, the World Bank's Chief Economist for South Asia, at the recently concluded CCC Economic Summit highlighted three fundamental flaws in Sri Lanka's growth model. It will not be possible to achieve sustained growth of 8% without addressing these effectively.

Lessons from the 1970s

The Pathfinder Foundation, and others, has emphasized the need to address these fundamental issues. It is to be hoped that policy makers and the leadership of the country will take urgent action to respond to emerging domestic and global developments. Sri Lanka is a small economy with a limited market and narrow resource endowment. The low investment/low growth/high unemployment, as well as rationing and lengthy queues, experienced in the 1970's demonstrated very clearly the severe limitations of inward looking "self reliant" policies. Dynamism can only be infused into an economy of Sri Lanka's size by growing the tradable sector, increasing exports and attracting non-debt creating foreign inflows. Dr. Kochar's presentation demonstrated that Sri Lanka's performance in each of these areas needs to be improved.

Poor Use of Scarce Resources

1. Trade, as a percentage of GDP, has declined from over 80% in 2000 to 44% in 2010. Even more worryingly, within the non-tradable sector, public administration has expanded very sharply. This means that a greater share of the country's resources, both financial and human, has been absorbed by a sector characterized by extremely low productivity. This was one of the reasons for the economy over-heating and dangerous external imbalances emerging last year, when an attempt was made to boost growth through expansionary monetary policy. A higher growth trajectory can only be achieved if a greater share of the resources is absorbed by higher productivity sectors, particularly exports. It is extremely difficult to sell in global markets if productivity is low.

Plummeting Export Performance

2. The size of the domestic market is such that export growth is essential for achieving a higher growth trajectory for the economy. Total exports have declined from 33% of GDP in 2000 to

17% in 2011. Sri Lanka's share of global exports has also declined. Taken together, these trends indicate that the Sri Lankan economy has been losing competitiveness. This may be attributed, inter alia, to an overvalued exchange rate (before the introduction of a more flexible policy in Feb 2012) and movement to a more closed economy through adjustments to the tariff structure.

Dr. Kochar was also able to show that while the structure of exports for Sri Lanka and Thailand was basically similar in 1980, today the depth and diversification of Thailand's export sector is significantly greater. In addition, Sri Lanka's exports continue to not to be linked to other similar higher capability products that would offer easy opportunities for greater value added diversification.

Where is the FDI?

3. Sri Lanka requires investment of 35% of GDP to achieve 8% growth. National savings amount to 25% of GDP which means that the savings/investment gap amounts to 10% of GDP. That is currently equivalent to $6 billion. This amount needs to be raised through a mix of debt and non-debt creating inward flows. As a lower-middle income country, Sri Lanka no longer has access to grants and concessional financing. The headroom for commercial borrowing is also being reduced. Hence, a major share of the financing of the gap of $6 billion needs to take the form of non-debt creating inflows, particularly FDI, which can also boost export performance.

It is noteworthy that Sri Lanka's total stock of FDI amounts to about $6 billion. Malaysia had an FDI stock of $73 billion in 2008 and attracted $8 billion in that year alone. The corresponding figures for Vietnam, which initiated market-oriented reforms much later than Sri Lanka, were $43 billion and $8 billion.

Conclusion

The hard data that Dr. Kochar presented must be seen as an eye opener. They make a persuasive case for an urgent package of economic reforms to strengthen the growth framework and boost exports. It is also a matter of concern that trends in tertiary education, particularly the decline of enrolments in science and engineering since 2002, indicate that it will be difficult to maintain the quality of Sri Lanka's ageing workforce.

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

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