Pathfinder Economic Flash

Export or Stagnate

The Pathfinder Foundation (PF) welcomes Dr Koshy Mathai's (IMF Country Director) call for increased exports to India and China. Dr. Mathai, in his keynote address at the Annual General Meeting of the Exporters' Association, stressed two interlinked themes that have been the subjects of several previous Economic Flashes and Economic Alerts: the decline in Sri Lanka's export performance needs to be arrested and reversed; and export markets need to be diversified.

Anti-Export Policy Bias

It is worth reiterating that exports as a percentage of GDP have declined from 33% in 2001 to 17% last year. Sri Lanka's share of global trade has also fallen. As pointed out on a number of occasions in previous PF articles, this reflects a loss in export competitiveness and an anti-export bias in the overall policy framework. In this regard, inter alia, an over-valued exchange rate, trade policy and high electricity tariffs have been cites as important explanatory factors. The sharp fall experienced in the share of tradable goods is another manifestation of a policy-mix that is not export-friendly and as such not consistent with a target of 8% sustained growth.

This Government's growth target can only be met through export expansion. A market of 20 million precludes a domestic demand driven growth strategy. Despite this, the overall policy-mix, particularly the exchange rate and a trade policy which has reduced the openness of the economy, has incentivized a flow of resources, both financial and human, into non-tradables. The sustainability of the growth process has been rendered even more questionable due to its heavy dependence on the expansion of "public administration". The twin problems of the structural fiscal deficit and high public debt, as well as low productivity, mean there is little or no leeway to rely on this sector as a source of sustained non-inflationary growth.

The macroeconomic reforms introduced by the authorities, including the shift to a more flexible exchange rate and fiscal consolidation, are steps in the right direction in terms of creating a more conducive environment for export growth. However, the jury is still out on whether enough has been done. The authorities need to exercise constant surveillance over the overall policy mix to ensure that the anti-export bias is eliminated. The exchange rate and trade policy are especially important in this respect.

Export Market Diversification

Market diversification has to be an integral part of any strategy to increase exports, particularly as the US and the Europe will experience sluggish growth in the foreseeable future. As PF has constantly pointed out, 60% of Sri Lanka's exports are directed to these markets. India accounts for 5% of total exports and China 1%. Sri Lanka's capacity to meet its growth targets will be determined, to a very significant extent, by its success in diversifying its export markets.

In this respect, PF would like to reiterate its constant refrain regarding the need to plug into Asian supply-chains: both vertical integration into manufacturing processes and horizontal integration to service sector activities**.** In this connection, the announcement that India would provide aid to establish a dedicated industrial zone to manufacture automotive and other engineering goods to service Indian supply chains is a welcome development**.** The proposed support for a pharmaceutical hub is also a welcome development. However, high priority should be attached to early implementation of these initiatives for the mutual benefit of the two countries. **India** offers the advantage of proximity and a well-functioning FTA that has taken on board the asymmetry between the two economies (see previous Economic Alerts and Economic Flashes). Indo-Lanka trade has grown eight-fold in the last ten years and India has become a major investor in Sri Lanka. There is considerable scope to build on this foundation. Encouragingly, it has been announced that Comprehensive Economic Agreement (CEPA) negotiations are being revived following the recent visit of the Indian Commerce Minister. If political compulsions and primordial fears make it difficult to sign the CEPA as a single-undertaking, then bite-sized steps should be embarked upon actively to deepen the agreement on goods and introduce a rules-based framework for expanding trade in services and promoting investment. If the term CEPA triggers irrational antipathy, then the process can be rebranded. In an increasingly multi-polar world, characterized by the rise of regionalism, Sri Lanka's economic and commercial relations with India will assume even greater importance in the future. It seems inevitable that this relationship will become the major determinant of Sri Lanka's long-term development prospects. In such a context, the extreme asymmetry between the two economies can best be handled by negotiating a favourable rules-based framework for handling Indo-Lanka commercial relations, as early as possible. India's recent very positive shift towards greater non-reciprocal unilateralism within SAARC offers a more propitious opportunity for achieving this objective.

There will be new opportunities in **China** as well, when the rebalancing to a more domestic demand driven growth model (domestic market of 1.2bn people) is accelerated, as anticipated, following the leadership change in October 2012. Sri Lanka's excellent bilateral economic relations with China, ranging from the Rubber/Rice Pact (1952) to the recent loans/investment for infrastructure development, again offer a promising foundation for a concerted effort to pursue new export and tourism markets as well as investment.

There are likely to be commercial opportunities in **other Asian countries** as well. Indonesia is another large economy that has shifted to a higher growth trajectory. As cost structures continue to rise in the other successful economies of East and Southeast Asia, new opportunities can emerge for Sri Lankan exporters. The **Middle-East** has surpluses generated by its oil revenue as well as young and rapidly growing populations. The "silent revolution" that has taken place in a number of **African countries** is also generating new and expanding potential markets.

At a time when the Doha Round of multilateral trade negotiations has stalled, Sri Lanka is one of the few countries that is not actively pursuing preferential trade agreements as a means of promoting two-way trade and investment. A focused investment promotion program targeting capital surplus countries in East and South East Asia as well as the Middle – East should also be a high priority.

Conclusion

The government's growth target cannot be met without good alignment between the overall policy-mix and the incentives for expanding exports. A more conducive policy environment is only part of the story. The private sector also has to be prepared to "put in the hard yards" necessary for successful export expansion. It is not easy and there are risks that have to be managed. However, the potential rewards are very considerable both for the country and businesses.

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