Pathfinder Economic Flash

The Growth Deficit: The Competitiveness/Productivity Challenge Beyond a Remittance Dependent Economy

Stalling Growth

The growth momentum in the Sri Lankan economy has slowed down significantly. It is important to examine its performance subsequent to the necessary stabilization measures introduced in Feb/March 2012 to address the overheating of the economy. This was reflected in the severe balance of payments/reserves and inflationary pressures at that time. Trends in indicators that are often used as proxies for growth, such as electricity consumption, shipments (total cargo handled minus transhipment) and cement consumption (domestic production plus imports) seem to point to growth of less than 5% in 2H 2012 i.e. the period when the stabilization measures would have taken effect.

The government has set a growth target of 7.5% for 2013. However, there are a number of factors that will make this challenging.

- The electricity price hike, though necessary, will have a negative impact on growth in a number of ways. Exporters will not be able to pass on the increase in their electricity costs and the resulting loss in competitiveness could well lead to some loss in market share. Producers for the domestic market can pass on the cost rise to their customers. However, this is likely to dampen demand thereby constraining growth.
- Overall consumption, particularly of fast-moving consumer goods, is likely to decline, with negative implications for growth.
- Investment is likely to be deterred by the higher cost structures associated with the increased prices of electricity and fuel.
- The combination of the increase in electricity prices and an over-valued real effective exchange rate will erode the competitiveness of the economy. This will dampen growth prospects for both exports and import competing sectors. The current poor export performance, where exports have halved from 33% of GDP to 16% over the last decade, will be exacerbated.

On the positive side, the improvement in the state bank balance sheets brought about by the recent electricity and fuel price adjustments will create space for some easing of interest rates. In addition, the prospects of lower interest rates are likely to boost the stock exchange. The wealth effects of this are likely to provide some support to both domestic consumption and investment. This will serve to boost growth prospects in the economy.

Limited Scope for Expansionary Macroeconomic Policy

It is unlikely that the positive phenomena mentioned above will be sufficient to offset the combined effects of an overvalued real effective exchange rate and higher energy and fuel prices. In the present context, it is also important to recognize that too aggressive an easing of macroeconomic policies, particularly interest rates, will result in a repeat of the balance of payments/reserves and inflation problems experienced in late 2011/early 2012. There is also limited scope to loosen fiscal policy at this time given the constraints being faced on the revenue front and the worrying trends in debt servicing. Total debt repayments were greater than total revenue in 2012. The increasing exposure to external debt and within that short-term commercial debt further circumscribes the room to maneuver in terms of loosening fiscal policy.

The positive impact on domestic consumption of the wealth effects associated with gains on the stock market are unlikely to offset the reduction in consumption triggered by the electricity price increase, particularly as the marginal propensity to consume is relatively low among the wealthy who invest in the stock market.

Strengthening the Growth Framework through Improved Productivity / Competitiveness

In a context where imports are double exports, the Sri Lankan economy has become overly dependent on remittances and borrowed capital inflows (by the Government, banks and corporates). The headroom for such borrowing could run out relatively quickly, particularly if the creditworthiness of the country is not enhanced through a boost in export performance. At present, remittances are the only bright spot in the country's external account. This is a very precarious situation. Furthermore, the growth record, since April 2012, demonstrates that even with buoyant remittances the economy does not have the import capacity to grow faster than 5-6% without overheating. It would be disappointing if post-conflict Sri Lanka had to settle for a growth rate which is not very different from that achieved during the 25 years of conflict. The root cause of the problem is low productivity and a lack of competitiveness that has undermined export performance.

Sustained growth of 7.5% - 8% (without repeated boom/bust cycles eventually leading to a major crisis) can only be achieved through a package of measures to strengthen the growth framework of the economy based on increased productivity/competitiveness. Given the size of the domestic market, the Sri Lankan economy cannot achieve a higher growth path on a sustained basis without a significant turnaround in export performance. This requires an elimination of the anti-export bias in the macroeconomic policy framework. Addressing the over-valued real effective exchange rate (which reflects the movement in the cost structures between Sri Lanka and her major competitors/trading partners) and trade policy (tariff structure) should be a central part of any reform package. This needs to be supplemented by structural reforms that increase the competitiveness of the economy, including measures to restructure the electricity and fuel sectors to contain costs. Another major challenge is to address the low productivity in the agricultural sector and the public service which absorb large amounts of financial and human resources and yield a very low return to the economy. The Pathfinder Foundation (PF) has set out a menu of structural reforms in the Economic Alert no: 27 (19. 04.2012). The highest priority should be attached to improving the investment climate as a higher growth path is not attainable without increased domestic and foreign investment. Attracting non-debt creating flows, particularly long-term investment in the form of FDI, is central for sustained growth and development of the country. Furthermore, the momentum of the government's infrastructure development program cannot be maintained without increased private sector involvement.

Conclusions

There seems to be clear evidence that growth is stalling. The scope for expansionary macroeconomic policies is limited. The space for lower interest rates brought about by the electricity price increase is unlikely to offset the

negative impact on growth generated by the combined effects of the increased cost of power, the over-valued real effective exchange rate and low-productivity/competitiveness. Repeated boom and bust cycles (including the possibility of a major crisis in the future) cannot be avoided without a package of reforms that strengthen the growth framework of the economy through improved productivity/competitiveness to boost exports

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