Pathfinder *Economic Flash*

From IMF potential Growth Rate (6.7%) to the Target Rate (8%)
IMF Projected "Potential" Growth and Limits to Growth

A recent IMF study used a number of statistical and modeling based methodologies to conclude that Sri Lanka's current potential economic growth rate is 6.7%.This implies that the economy is likely to over-heat if the growth rate exceeds 6.7% on a sustained basis, i.e inflation would rise above the mid-single digit target and the balance of payments/reserves would come under pressure. The government growth target is 8%.The challenge, therefore, is to explore ways and means of raising the potential growth rate (6.7%) to reach the target rate(8%), assuming that the IMF estimation of the potential growth rate is credible.

In a number of its previous articles, the Pathfinder Foundation (PF) has stressed that the target 8% growth rate could not be attained on a sustained basis without strengthening the growth framework of the economy. The desired growth target cannot be achieved through demand management measures alone. i.e. one cannot rely only on increasing aggregated demand through adjustments to interest and exchange rates as well as fiscal policies. Sound demand management needs to be supported by structural reforms that increase the productivity/competitiveness of the economy. The position taken by PF seems to be corroborated by the IMF's calculation of the potential, growth rate.

Going Beyond Prudent Demand Management Policies

The IMF has recommended that Sri Lanka should settle for a period of below potential growth to squeeze excess demand out of the system. During the post-1977 period, the budget has consistently pumped excess demand into the system through unsustainable deficits. The current account of the budget has been in deficit in every year since 1987. This means that successive governments have had to borrow to fund some recurrent expenditure as well as the whole of capital expenditure. Furthermore, the impact of the budget deficit on aggregate demand tended not to be captured fully by the headline deficit figure, as part of the deficit (eg. subsidies on fuel and energy) was kept off the government balance sheet and parked in the books of the state banks. The excessive aggregate demand generated through the budget deficits over the previous decades may be attributed to the combined effects of the pressures that exist in a competitive polity and the need to finance a protracted conflict. However, there has been a qualitative change in parameters with Sri Lanka's graduation to lower-middle-income country status: loss of eligibility to foreign aid and exposure to rating agencies and international capital markets. This places a much higher premium on sound demand management policies.

There are currently some positive trends which seem to indicate that the authorities are making progress in aligning aggregate demand with the compulsions of a stable macroeconomic framework: mid-single digit inflation and a sustainable deficit in the current account of the balance of payments (i.e. an external deficit that can be financed without incurring unsustainable foreign debt). The authorities have made significant advances in terms of fiscal consolidation. The deficit has been reduced from 9.9% of GDP in 2009 to 5.8% in 2013. There is a firm commitment to contain it below 5% eventually. Progress has also been made in reducing significantly the losses of the CEB and CPC and in settling arrears in payments due from the Consolidated Fund. The progress made, so far, should be built upon and continued priority needs to be attached to achieving the fiscal consolidation targets. This would serve to squeeze excess demand out of the system, provided prudent monetary policies are also pursued. This would enable attainment of the potential growth rate (6.7%) without macroeconomic instability i.e. rising inflation and balance of payment pressure; and lay the foundations for creating the enabling conditions for reaching the target growth rate (8%) on a sustained basis. Sri Lanka can move from a high budget deficit, high inflation, and high interest rates and over-valued exchange rate economy to one which has a competitive macroeconomic base.

Proxies for growth (eg. imports, government revenue, credit growth, corporate profits as well as electricity and cement sales) seem to indicate that the balance of probability is that growth has been below the potential growth rate since February-March 2012 when stabilization measures were introduced to squeeze excess demand out of the system. It is important, however, to monitor closely the current trends in inflation and the current account of the balance of payments, following the relaxation of monetary policy in recent months. This is necessary in order to consolidate the stabilization achieved so far, in a context where the growth momentum has picked up since 4Q -2013.

Sustained Growth Of 8%= Reforms, More Reform and More Reforms

The next step should be to supplement the success achieved, so far, in containing excess demand with structural reforms which create the conditions for sustained growth of 8%. The Sri Lankan economy grew at 5%-6% during the 25-year conflict when large tracts of the country were affected and a high war-risk premium severely constrained the investment climate. Five years after the end of the conflict, the time is now ripe to move decisively to increase the potential growth rate of the economy to the target of 8% by introducing a package of structural reforms. These could cover factor markets (land, labour and capital); SOEs (including stock market listing of 10%-20% of commercial enterprises); and further efficiency enhancing deregulation. A more detailed treatment of options for structural reform is available at PF Economic Alert 27. As there is an asymmetry in timing between the pain and gains from such reforms, it is politically unrealistic to expect such reforms at this stage. High priority should, therefore, be attached at the commencement of next political cycle (after the major elections) to the introduction of a package of reforms to raise the growth potential of the economy to 8% or more. A small import-dependent economy, like Sri Lanka, cannot achieve such a growth trajectory without productivity/efficiency enhancing reforms which are necessary to generate FDI-driven transformation of the current highly lackluster export performance. It is not possible for Sri Lanka to avoid the middle-income country trap without a significant improvement in exports. In the past, growth has been overly dependent on the excess demand generated by the size of the budget deficit. In the future, it must be driven more by the strength of the current account of the balance of payments to avoid the repeating cycles of stop-go policies that have characterized the post-1977era. Without this the potential growth rate cannot be raised to match the targeted 8%.

The upside scenario for achieving the 8% growth target

As set out in PF's Economic Alert 56, the upside scenario for Sri Lanka depends on the following: attaining the fiscal consolidation targets: introducing a package of structural reforms to enhance productivity/competitiveness; taking advantage of Sri Lanka's excellent bilateral relations with China (the proposed FTA and the shift from lending to investment/equity) and proximity to the growing Indian sub-continent market (especially taking greater advantage of the Indo-Lanka FTA, including through plugging into Indian supply chains). High priority should also be attached to strengthening education, training and skills development, as well as, in the short-term, to reviewing current immigration policies, to ensure that human resources do not become a binding constraint.

Another Game Changer-Natural Gas Discoveries

Prudent exploitation of the natural gas discoveries in the Mannar Basin constitute another a major opportunity to transform the economic prospects of Sri Lanka. In order to maximize the gains from these discoveries expeditious negotiations with the exploring firms and other stake holders, entering into marketing/gas purchase agreements and building necessary infrastructure are necessary conditions. If the government initiates action today (without delaying years as in the case of the coal power plant) natural gas discoveries in the Mannar Basin will be another potential game-changer in 4-6 years.

This is the Forty Fourth Economic Flash published by the Pathfinder Foundation (PF). Readers' comments are welcome at www.pathfinderfoundation.lk

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