The Pathfinder Economic Alert

Accelerating Growth: Catching the Wave or Missing the Bus

The Central Bank, in its latest Annual Report, has downgraded its growth forecast for 2012 from 8% to 7.2%. This is due to a combination of adverse global developments and the negative effects of domestic policy misalignments. The contractionary measures introduced to address the imbalance in the trade account (ie to encourage the country to live within its means) may well result in growth being less than the 7.2% forecast by the Central Bank. It is important, therefore, that reforms are introduced to accelerate recovery in order to achieve the government's own growth target of 8% or more. The Pathfinder Foundation (PF) is putting forward some suggestions to begin a discussion/debate on how this can be achieved.

Sri Lanka has had three major waves of reforms since 1977 and incremental reforms in the intervening periods. The reform process has not been a straight line, with a number of slippages along the way.

These reforms infused momentum into the growth process. However, progress was constrained by the persistence of the unsustainable fiscal deficits and the violent conflict. The end of the conflict has created a favorable set of circumstances for Sri Lanka. Despite this, the stabilization measures undertaken recently, while necessary, will have a negative impact on the short-term growth prospects for the country.

The policy-makers are faced with the challenge of stabilizing the economy in the short-run, while strengthening the medium-term growth framework.

The issues related to macroeconomic stabilization were addressed in previous Economic Alerts. The recent measures (exchange rate, interest rates, administered prices and tariffs) introduced by the government will result in a slowdown of the economy. However, the depth and duration of the slowdown are still not clear. It is important that the government initiates a new round of structural reforms to strengthen the growth framework, if it is to facilitate early recovery.

"The ADB in its Asian Development Outlook for 2012 states that despite the improved political and economic environment, growth in private investment in Sri Lanka is falling below planned levels". Daily FT 18th April 2012.

What should be done?

Path to Re-invigorating Economic Growth.

A new package of growth-oriented measures should include, inter alia, the following:

• Continued implementation of the recommendations of the Tax Reform Commission to simplify and rationalize the *tax system* and strengthening of *tax administration*

• Rigorous *public expenditure review*, including the size of the public service as well as subsidies and transfer payments. As a lower-middle-income country, which is ineligible for ODA, Sri Lanka can no longer afford its current level of subsidies and transfer payments; nor such a level of unproductive public sector employment. ***However, greater dynamism has to be infused into private sector growth to facilitate restructuring of the public sector.***

• Formulation of a consistent and coherent *SME development strategy*, focusing particularly on financing and access to technology. Past interventions have been fragmented and have had limited impact.

• Development of a transparent program for *public/private partnerships* (PPPs), particularly in infrastructure development and in improving the efficiency of public commercial enterprises. Fiscal constraints and more limited headroom for future public external commercial borrowing mean that there will have to be recourse to PPPs to meet the government's infrastructure development targets.

• *Capital market development*, particularly the development of a long-term debt market. Financing for industrial development has been a persistent problem since Independence. An aggressive promotion of the insurance sector will assist in this regard.

• *Labor market reform*. The level of protection afforded to workers in the formal sector is constraining business expansion and is also incentivizing the growth of the informal sector where labor standards are very much lower. It is also leading to a rise in unprotected part-time and casual employment. A recent survey conducted by the Employers Federation indicated that 91% of the respondents believed that labor laws and regulations were constraining employment creation. *In this regard the policy-makers should consider "buying-in" of certain labour rights by creating a safety-net for the unemployed and offering other benefits.*

• Strengthening the operations of the *land market* and creating a land bank of state-owned properties available for development. Currently government institutions, such as the Postal Department and the Railways, own considerable extents of land which are unutilized or underutilized. A concerted effort should be made to develop a program that creates an inventory of land available for commercial use.

- The removal of barriers to trade and investment on an unilateral basis has helped many East Asian countries to generate economic growth and development. In this regard, finalization of the *Comprehensive Economic Partnership Agreement* (CEPA) and similar arrangements with India and other countries in East and South East Asia could be considered a step in the right direction.

- Development of a *Science and Technology Policy* and strengthening the capabilities for technology management as well as the capacity of the national innovation system. Effective *technology management* (adoption and adaption), has been a critical determinant of the success of East and South East Asian countries.

- Strengthening the operational capacity and governance of *SOEs* (the previous Economic Alert dealt with this subject at some length). There is a strong case for selling a part of the equity of commercial SOEs in the stock market. In other countries the increased disclosure that ensues has triggered greater transparency and accountability; improved management; and strengthened financial discipline. It would also constitute a means of mobilizing much needed non debt-creating financing for the budget. Most importantly**,** free or subsidized allocations of a portion of the shares to the employees of such institutions will immensely benefit them and guarantee their commitment towards the success of the entities.

- Strengthening the *capacity of regulatory agencies*, particularly the Public Utilities Commission and the Securities and Exchange Commission

- Strengthening *Education, Training and Skills development*, particularly mathematics and science education; as well as increasing private provision of ~~tertiary~~ education. It is important to ensure that education and skills development are well aligned with the labour market and the country's opportunities for expanded economic opportunities (Dynamic Comparative Advantage)

- Mainstreaming *climate change* and other *environmental issues* into national policy-making. Climate change will impact on six areas: agriculture and irrigation; coastal areas; forests and natural eco-systems; human settlements and infrastructure; human health; and energy and industry.

In conclusion, there must be fiscal consolidation, flexible exchange rate management and prudent monetary policy to ensure strong macroeconomic fundamentals; as well as a more conducive investment climate based on improvements in the "ease of doing business" and competitiveness of the economy. In this connection, there is a real need to remove red tape (i.e reinvigorate the debureaucratisation agenda). Efforts to streamline processes for approvals, permits etc need to gain further momentum. Above all, there is a need for consistent and predictable policy–making.

Potential for Diversification & Growth

Accelerated growth in a country of 21 million people has to be driven by improved export performance. The potential exists to increase exports in all three sectors of the economy. The opportunities presented by economic geography, particularly Sri Lanka's location in the dynamic Asian region in close proximity to the fast growing Indian market, should be given priority.

There is considerable scope for growth in the *services sector*, particularly through exploiting opportunities for horizontal integration, particularly in the SAARC region.

- *Tourism:* Sri Lanka has considerable potential as a destination with a product that offers diverse attractions in a small geographic space. The challenge is to compensate for the likely reduction in arrivals from recession-affected Europe by increasing the quality & number of tourists from Asia (particularly India and China) and the former Soviet Union. Another challenge is to increase the daily spend of the visitors by moving up-market and establishing activity based tourism facilities.

- *Shipping:* Sri Lanka is attaching high priority to port development and acquiring hub status in the South Asian region. The country's strategic location, close to major shipping lanes, and the rapid expansion of Indian trade (transshipment from Sri Lanka) offer considerable growth potential.

- *IT/BPO*: The World Bank has indicated that this sub-sector has the potential to become a $1 billion industry for Sri Lanka. As costs in the region increase, Sri Lanka has the scope to expand this business. Continuing emphasis needs to be placed on strengthening the IT and English base of the human resources in the country.

- *Professional Services*: Sri Lanka has strong legal, and particularly accountancy professions. These can be exported as demand for such services grows in South Asia, the Middle East and East/Southern Africa. .

- *Medical/Education*: As incomes rise, the demand for these services will increase. There is a significant amount of unmet demand in the SAARC region.

- *Financial Services*: Sri Lanka has a strong and well developed financial services sector. The country can offer competitive services to the SAARC region.

Sri Lanka has the potential to be a niche player in the *manufacturing sector*. It has a world class apparel sector which has become very resilient and competitive through adjusting to the loss of the MFA and European GSP Plus status. The garments sector has been successful in moving up the value chain through tie-ups with reputed foreign brands. Domestic value-added has been increased, including through strengthening domestic design capacity. This sector has positioned itself successfully to penetrate mid-market niches. The next phase of development could be the continued growth of domestic brands for sale.

The successful industrial exports have included activated carbon, rubber products, ceramics, soft toys, leather and wood products, paper and luxury yachts. At present, Sri Lanka has a negligible presence in intra-company trade in Asia (supply chains) which is the most dynamic element of the international trading system. As mentioned in the previous Economic Reports, Sri Lanka needs to explore opportunities for vertical integration into the Asian supply chains, particularly Indian ones.

The rise of first Japan, and then China, transformed the prospects and performance of East and South East Asia. The potential exists for Sri Lanka to benefit in a similar way from the rise of India, particularly the dynamic Southern sub-region (Andhra-Pradesh, Karnateka, Kerala and Tamil Nadu). The challenge is to identify niches where Sri Lanka is competitive in the supply chains of both Indian companies and multinationals operating there e.g. the automobile industry in Chennai offers prospects for rubber- and choir- based products. However, the volume and quality of supplies are constraints that need to be addressed through strengthening production processes in Sri Lanka.

Another avenue that needs to be explored is attracting small- and medium-scale suppliers of India-based multinationals to locate in Sri Lanka. For instance, some of the giant Japanese companies like Nissan and Toshiba have very large plants in Chennai. Sri Lanka does not have the capacity to offer the scale required by such companies. However, some of their Japanese suppliers have also moved with them. Sri Lanka can make a concerted effort to attract some of these these suppliers to locate in the country.

Prospects for the *agricultural sector* have improved with the end of the conflict and the opening up of the North and East. Growth in agriculture can be fuelled by increased productivity from a low base. This would require changes in land ownership/use patterns and the product mix; reduction in post-harvest losses, including through investment in storage, refrigeration and transport; and improved cultivation practices and technology. The potential exists to increase the export of tropical fruit and vegetables to West-Asia. Priority should be attached to increasing production of high value crops and achieving greater value addition through promotion of agro-processing.

There is scope for expanding the *livestock and dairy sector*. Domestic demand is increasing with rising incomes and there is scope for import substitution. The expanding middle-class in India and changing food consumption patterns towards higher value products would also open up new opportunities. Here again, the challenge is to increase supplies and strengthen storage/processing capacity.

Fisheries and ocean-based resources also offer scope for expanded economic activity. At present, Sri Lanka makes limited use of its Special Economic Zone. In the modern world, the largest producers and processors of fisheries products utilize technology and capital intensive vessels and equipment. Therefore, Sri Lanka should offer incentives and negotiate with prospective investors to set up joint ventures for exploitation of our fisheries resources in the Exclusive Economic Zone.

Conclusion

A strong macroeconomic policy response to the recent deterioration in the country's balance of payments accompanied by a fourth wave of structural reforms can secure a prosperous future for the people of Sri Lanka, particularly as economic geography is so favourable. It is also important to shift from an ad-hoc deal-by-deal approach to a more strategic orientation. This applies both to the government and business.

This is the Twenty – Seventh in the series of Economic Alert articles published by the Pathfinder Foundation. Readers' comments are welcome at pm@pathfinderfoundation.org