The Pathfinder Economic Alert

No Growth, Slow Growth or Great Leap Forward

Declining Trend

The Treasury has recently indicated that the country's economic growth this year will be around 6.5%. As the recorded growth rate of the first half of this year was 7.1%, this means that growth in 2H 2012 is being estimated at 6%. The growth momentum will inevitably slow down steadily during the course of this year, as the restrictive measures, particularly the 18% credit ceiling set for banks (23% where they have been able to borrow the incremental funds from abroad), take effect. The re-phasing of public expenditure, announced recently, will further dampen economic activity.

Taking these developments into consideration, it is highly likely that the rate of growth will settle in the 5% - 5.5% range in the last quarter of this year. This is around the average growth rate achieved during the course of the conflict period. Hence, 5%-6% growth in post-conflict Sri Lanka is tantamount to no growth at all. It is also unlikely that growth impulses will be significantly stronger next year, particularly as tight macroeconomic policies will have to be continued due to the persistence of inflationary and balance of payment pressures. Recovery in the global economy is also expected to be sluggish. It is, therefore, now apparent that the government's own medium-term growth target of 8% is unlikely to be a reality in 2012 and 2013. This is really an amber light (danger signal) that needs the urgent attention of the political leadership and policy-makers.

Although agricultural production will recover next year from a low base, provided there is normal rainfall, it is difficult to see positive growth prospects in other sectors. The services sector has contributed most to growth in recent years due in large part to a significant expansion of public administration. The fiscal consolidation essential for maintaining macroeconomic stability will mean that growth in public administration will have to be much more constrained. This will have an adverse impact on the overall growth prospects of the services sector. Growth in the manufacturing sector is also likely to be muted due to weakness in global economic activity, particularly the stagnation in Europe and the sluggish growth in the US. As a result of this, apparels as well as other industrial products will experience a slackening of export demand in key markets.

Economic growth will also be impacted negatively by demographic trends. The demographic dividend enjoyed by Sri Lanka in recent decades assisted the country to maintain an average 5% growth rate even during the conflict period. However, this source of dynamism in the economy is no longer available, with the ageing of the population.

Scope for Accelerating Growth Still Exists

It is now more obvious than ever that the growth momentum in Sri Lanka can only be sustained through implementation of a new cycle of reforms. Of course, any country can pump up growth artificially with imprudently expansive macroeconomic policies. However, it will be short-lived and the subsequent inevitable adjustment would be more painful than the current round. At this point of time, the country needs bold political leadership, willing to take prudent economic decisions. The need of the hour is smart demand management, structural reforms, and strengthening of the regulatory framework.

Some emerging economies, including China, India and Brazil, as well as low-income –countries such as Myanmar and a number of African countries, are implementing rigorous economic reforms to revitalize their respective economies by promoting local and foreign private investment. Such measures also open up opportunities for small and medium enterprises that create substantial employment. Obviously, the policy actions undertaken by the leadership of those countries should be an eye opener for the Sri Lankan policy-makers.

How to Accelerate Growth to Achieve 8% target?

Demand management measures introduced in Feb/March of this year need to be sustained, with a particular focus on fiscal consolidation, involving both the government budget and the off balance sheet deficits that are ultimately a call on the Consolidated Fund. While smart demand management is essential to create the macroeconomic environment for sustained growth, it is not sufficient on its own.

As emphasized by the Pathfinder Foundation in its previous analyses, several measures are necessary to maintain higher economic growth, particularly in the context of global economic uncertainties and domestic constraints. Nevertheless, leaders and senior policy-makers of the government should be pleased to note that there is still scope for reaching its 8% medium – term growth target through implementation of a set of economic policy measures. Structural reforms are necessary not only for their efficiency gains but, more importantly, to boost the confidence of private investors, domestic and foreign. In order to achieve and sustain the targeted growth rate, private investment needs to increase by 6% - 7% of GDP. As Pathfinder Foundation has reiterated, increasing the landscape for the private sector – small, medium & large scale – is a necessary condition for economic growth, regional development and social upliftment of the population.

In order to increase private sector participation in economic activities, the government should open up a few areas where it currently has monopoly control. This, combined with its domination of land– ownership, has created an unhealthy environment for attracting private investment. The government's sole ownership, management and operation of loss-making enterprises is arguably the most significant area of concern. Typical examples are: petroleum; electricity; aviation; and mass transport. Private sector participation in equity and management will not only reduce losses and generate profits but will also introduce new technologies that promote international competitiveness. Greater private participation in these sectors will release additional resources for social sectors such as health, primary & secondary education, as well as for building roads and highways, ports and airports. With improved operational efficiency, large enterprises can also create opportunities for small and medium size entrepreneurs in both urban and rural areas. For example: structural reforms introduced in the Telecom sector promoted large scale investment, technology transfer, modernization, hugely reduced rates to the consumers and most notably created thousands of small scale enterprises and opportunities which are now visible in every nook-and-corner of Sri Lanka.

There are considerable opportunities for expanding economic activities and generating employment in several sectors of the economy. These include agriculture, with changes in ownership/utilization patters and the product mix; livestock and dairy, which has significant scope for import substitution; tourism; shipping; professional services, particularly accounting and legal; IT/BPO; financial services; and manufacturing niches which take advantage of opportunities that offer favourable growth prospects.

Reform of factor markets should be another crucial plank of any reform program. The government's domination of the land market should be reduced by granting freehold titles to small private owners and long term leases to large scale private investors. The process of releasing the land to prospective investors should be speeded up with the minimum of bureaucratic delays. Continued priority also needs to be attached to the reduction of red tape, inter agency conflicts and corruption.

Learning from Successes

The political leadership and policy-makers can derive many lessons from economic reforms that are being implemented by China in the recent weeks. The Chinese have opened almost all State Owned Enterprises including, banks, and manufacturing, agriculture, education and health care services to private investment, both local and foreign, in order to reinvigorate the decline in growth. Similarly, the Indian government has continued with liberalizing civil aviation and even retail trade, in spite of stiff opposition in the parliament and outside

Unless or until the current reality is recognized and bold political decisions are taken, Sri Lanka is likely to be stuck at the 5% - 6% of pre-conflict growth trajectory. This is equivalent to no growth at all. The choice is No Growth, Slow Growth or Great Leap Forward to become a real Asian miracle.

This is the Thirty Eighth in the series of Economic Alert articles published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org

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