THE MAGIC EIGHT PERCENT

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Background

When the three decade long civil war came to an end in 2009 there were broad based expectations that the Sri Lankan economy was destined to enter an above trend growth path. The consensus view was that GDP growth would be at 8% or above in the medium term. In the first two post war years this expectation did indeed materialize, with the country achieving growth above 8% in two consecutive years for the first time in its history.

This of course had important implications for the banking and finance sector as well, since the rate of economic growth is a crucial determinant for enhancing demand for advances and magnitude of deposits. Furthermore, the pace of economic development will determine the pace at which financial markets in Sri Lanka will mature and become increasingly sophisticated (though to an extent in this case the direction of causation runs both ways). Therefore, the future of the banking and finance sector in Sri Lanka is very much contingent on the evolution of the economy in the coming years. In this context we need to ask the question as to whether the growth experienced in the last two years is sustainable – can we continue to surpass the magic 8 percent?

Sri Lanka's Economic Growth in 2010-11

Considering the fact that the country was coming out of a pro-longed conflict it was natural that a significant short term peace dividend would materialize. There was a great deal of expectation and confidence that created a substantial increase in consumption (particularly imported consumption, helped by a stronger Sri Lankan Rupee and also a number of tax reductions). At the same time the government led post war reconstruction efforts provided an immediate boost to the construction and transport sectors. The growth in the transport sector did not see a substantive contribution from the ports and aviation sub-sector, which experienced very meager growth during this period.

The newly available land in the North and East that was brought into agricultural production also provided a boost to growth in 2010. "Animal spirits" also helped drive a stock market boom in the country. It is interesting to note that the bulk of growth occurred in the non-tradable sectors of the economy.The manufacturing sector accounted for just 16% of the increase in GDP in 2010 and 16.6% in 2011.

Table 1: Contribution to the Increase in GDP (%)

Sector	2010	2011
Trading	21.7	29
Transport*	15.8	15.6
Construction	7.7	11.6
Finance	8.4	8.4
Government Services	5.3	1.2
Total	58.9	65.8

**Excludes ports and aviation related services which contributed 0.6% in 2011 and 1.4% in 2010*

Sector	2010	2011
Agriculture	8.7	-0.1
Fishing	1.8	2.3
Manufacturing	16	16.6
Total	26.5	18.8

Source: Central Bank of Sri Lanka Annual Reports 2010 and 2011

Examining the sectors that accounted for the major share of GDP expansion during this period draws notable similarities with growth experienced during the 1977-1983 period – another period that the economy received a boost (through fiscal stimulus of the Mahaweli development programme – the last major infrastructure thrust) following a period of slackness. Quoting Premachandra Athukorala, "*Growth occurred mostly in non-tradable sectors – construction, transport, utilities and other services. The average combined share of these sectors in GDP during 1977-1983 was 70% compared to 55% in 1977.*[1]"

It is clear that the major growth drivers in 2010 and 2011 were influenced by factors that may not have self sustaining properties over the long term. The trading sector was probably influenced by high import growth (including motor vehicles and investment goods) and cheap credit (in 2011 in particular), the construction sector would have been influenced by post-war reconstruction whilst transport and finance are influenced by both the above.

Being a relatively small domestic market with a population of 20 million and a GDP of US$ 60 billion, one cannot expect the non-tradable sector to continue to drive growth over 8%. Sustaining such levels of growth would require tapping into far more substantive global markets through the export channel.

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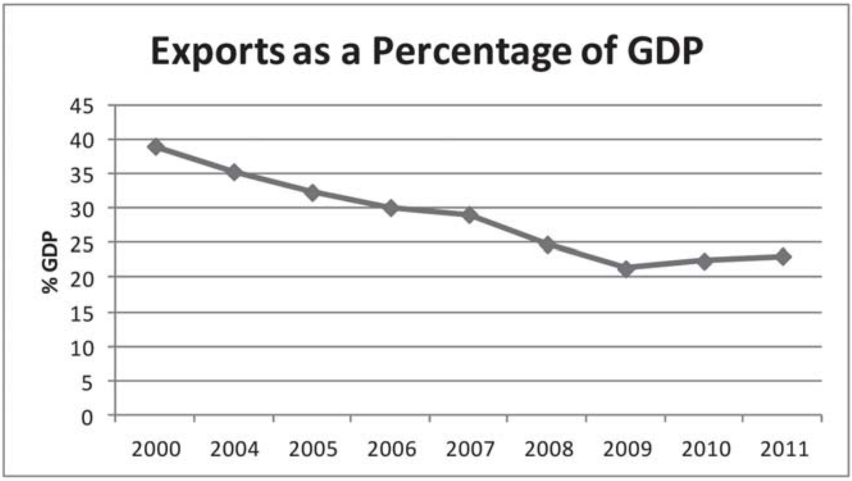
[1]Athukorala, P "Macroeconomic Policy and the Trade Liberalisation Outcome: Lessons from the Sri Lankan Experience" in "Essays in Honour of ADV de S Indraratne" Ed. Jayawardena, A.S et al (1993), pp 22

Unfortunately in recent years the role of exports in the economy has diminished. As indicated in Figure 1, exports as a percentage of GDP has declined rapidly in the last decade. Sri Lanka's overall share of the global export market has also diminished during this period of time.

Therefore in order to reap the full opportunities of global markets to help drive domestic growth, it becomes necessary to re-orient Sri Lanka's entire economic structure towards the export sector. Accordingly, Sri Lanka needs to understand what needs to be done to encourage further investment in the export sector. There are a number of factors that have an influential role in this – and in this article I will look at a few of these in more detail.

Figure 1: Sri Lanka's Exports as a Percentage of GDP



Source: CBSL Data

Encouraging Investment

It has been repeatedly stated in policy circles that in order to generate sustainable GDP growth of 8%, it is necessary for investment to reach close to 35% of GDP on an annual basis. In the last decade or so Sri Lanka's annual investment has averaged between 26% and 28% of GDP, indicating a requirement of scaling this up further. In 2011 investment reached 29.9% of GDP which is a commendable improvement. Foreign Direct Investment also reached a record US$ 1 billion in 2011. However much of this investment was concentrated in a few sectors such as tourism. In order to ensure sustainable growth in the longer term it is necessary for this investment to become more broad based and to contribute to exportable goods and services in a more substantive manner. What then are the major factors that could help encourage precisely such form of investment? I will go through a few of them here – though this list is far from exhaustive.

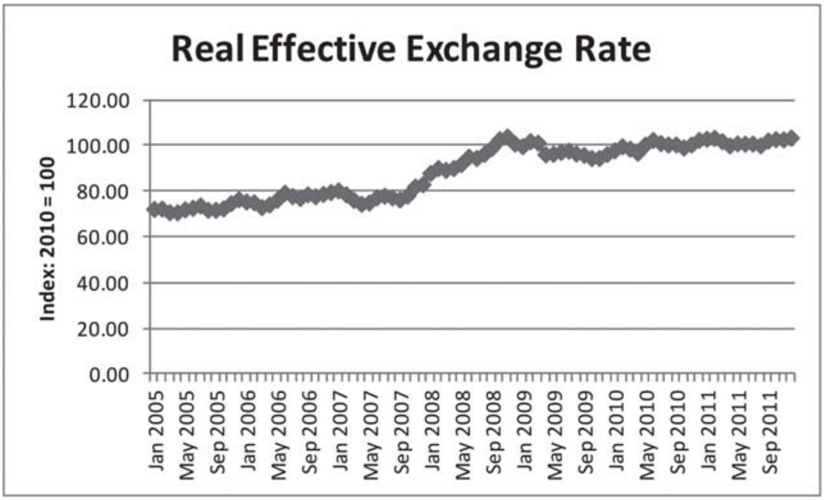
i) Security of Property – For investors intent on committing to significant capital outlays, the security of this capital is essential. The civil war was one reason that Sri Lanka has failed to consistently attract high quality capital intensive investment – since the security of such investments could not be guaranteed. As a result Sri Lanka was able to attract more labour intensive investment such as investments in the apparel sector. In the post war context what becomes more prominent in the mind of an investor is security in terms of property rights. To secure this, strong institutions are required in areas of governance, rule of law and dispute resolution (efficiency and independence of judiciary). If there are perceptions that private property can be seized in an arbitrary manner it would naturally deter serious investors. Perceptions in this context are crucial and even one off instances of arbitrary property alienation can have very damaging longer term impacts. For technology intensive investments, security of intellectual property is crucial.The independence and credibility of the institutions related to overall governance and rule of law are very important.

ii) Policy Stability – Sri Lanka's investment promotion in the last couple of years has been built around the fact that Sri Lanka now has political stability after many years of instability and uncertainty. However, what is more important than stability of political structures is the stability and predictability of key policies. Constant reversal of major policies is a negative signal for investors. A good recent example of this is the Indian experience post 2010. A number of key policy reversals, including the retroactive imposition of taxes on certain big ticket international investments and the reversal of the decision to allow over 50% foreign equity in multi-brand retail, led to a significant erosion of investor confidence in India. The macroeconomic implications of this have been material. With the loss of investor confidence, capital flight has occurred resulting in a depreciation of the Indian Rupee, which in turn has kept imported inflation high, preventing the Reserve Bank of India from reducing interest rates to support a weakening economy. One thing that could prevent this or at least reduce the likelihood of such reversals, would be institutionalizing a more inclusive decision making structure. By taking into account the perspectives of a broader group of stakeholders, policies can be designed in a manner that would not be met by popular opposition, leading to a reversal of the original policy.

iii) Macroeconomic Policy –The stability of key macroeconomic variables is also important for long term investors since this is an important determinant of security of profits and the ability to plan and have control over revenue streams. However it is important to distinguish between the stability and predictability of variables themselves, and the predictability of the overall policy structure. To illustrate this, what is important to an investor is not whether the Rupee will be at a certain value on a certain date, but an understanding that the exchange rate policy is either for it to be floating or fixed. Or with regard to interest rates, whether the overall policy is to enable a flexible interest rate regime or to maintain rates within a certain range to promote growth. A clear articulation of the policy direction is therefore much more important than having an idea of absolute numbers. This way firms are able to make their own assumptions of the market and make decisions accordingly. Sri Lanka's own recent experience indicates the futility of attempting to control and fix exchange rates. The mispricing of the exchange rate in mid 2011 contributed to a widening current account deficit as imports surged, forcing the authorities to run down foreign exchange reserves until it was compelled to allow the Rupee to float, triggering a sharp depreciation of the Rupee that would not have been easy for firms to predict. Whereas if a floating rate was adopted from the outset, the Rupee value would have adjusted in a gradual and predictable manner.

iv) Export Support – When looking at export oriented investment in particular, it is important that the macroeconomic policy environment is favourable for exports. The recent deterioration of Sri Lanka's export share of GDP could be attributed in part to an unsupportive macroeconomic environment. In the last 5 years the country has seen the nominal exchange rate failing to adjust to higher domestic price levels, thus resulting in an appreciation of the real exchange rate. When domestic prices increase it raises the cost structures of exporters, who are the uncompetitive compared to lower inflation countries. Unless the nominal value of the currency declines[2] exports will continue to decline and imports will increase. Over time, this results in resources moving away from the traded sector and into the non-traded sector – where longer term growth prospects are weaker due to limitations of Sri Lanka's domestic market.

Figure 2: Appreciation of the Real Exchange Rate 2005-2011



Source: CBSL data

[2] In a free float currency regime when there is high domestic inflation relative to competitors, exports will decline as competing products become relatively cheaper, and imports will increase as imported goods become cheap compared to domestic goods. A fall in exports and a rise in imports will cause the domestic currency value to depreciate in nominal terms, adjusting to the inflation differential and enabling exports to regain a degree of competitiveness.

v) Market Access – Another policy measure that is required to create a conducive environment to attract investment into the export sector is the issue of market access. Investors can broadly be categorized into resource seeking investors (for instance the surge of recent investment into Mongolia and now Myanmar) and market seeking investors (seeking large domestic markets such as India and China). Sri Lanka neither has an abundant natural resource base or a substantial domestic market. A large market is required to achieve the necessary scale to make viable large capital intensive investments Whilst Sri Lanka itself does not have a large domestic market within its shores, it is in close proximity to some of the fastest growing economies in the world. By enhancing its connectivity to these large markets, it is possible for Sri Lanka to compensate for the lack of a significant domestic market. Formal trade agreements can provide useful signals for investors, but at the same time it is necessary to address administrative and logistical barriers to trade.The country's foreign policy should also be aligned with these economic goals. Sri Lanka of course has the prime advantage of location – at a centre point in global trade routes, having (unique) easy access to both the East and West coasts of India and also cohesive political relations with all countries in the Indian sub-continent. This makes Sri Lanka an ideal investment location for those looking to access fast growing markets in the Indian sub-continent. It is now necessary to further enhance such integration through deeper far reaching formal agreements that would institutionalize such integration – providing a strong and clear signal to potential investors.

vi) Human Capital -Sri Lanka is no longer a low cost investment destination. As incomes grow labour costs and the costs of other factors of production will increase accordingly. Sri Lanka also lacks the scale of factors of production to enable relatively low cost manufacture. Accordingly, in order to remain competitive it will become necessary to compete on a level other than price. Sri Lanka's export future would be as a supplier of relatively low volume but high value goods and services. A key pre-requisite for this would be an enhanced human capital base. Whilst Sri Lanka has long boasted the highest literacy rate in the region – it has not kept up with global standards in tertiary education. In order to engage in higher value, technologically intensive manufacturing, it is necessary to produce more scientists, engineers, mathematicians and those competent in global languages, particularly English. At present Sri Lanka's output of tertiary qualified science and engineering graduates is limited. For instance in 2010 according to UGC statistics, Sri Lanka produced approximately 3000 graduates in science and engineering from the state universities, this amounts to approximately 1.5% of those who qualify for university each year. In order to scale up our production of higher value, higher technology goods and services, it is necessary to invest in education at all levels. A simple example of this is that as of 2011, out of 9715 schools in the country, only 718 had GCE Advanced Level science teaching (7%). It is necessary to invest more in facilities for teaching science at all levels in schools across the country – both in terms of physical infrastructure and in terms of teacher training.

Concluding Remarks

The issues discussed in this article are not a panacea for consistently achieving growth rates above 8%. These are some macro level factors that are necessary but not sufficient to achieve the desired objectives. Whilst addressing these areas, it is also necessary to pay attention to some challenges that have emerged in the Sri Lankan context.

Sri Lanka's age old macroeconomic challenge has been the fiscal deficit and accumulated debt. The government has quite rightly targeted a sustained reduction in budget deficits and accumulated public debt, recognizing the role this plays in creating underlying macroeconomic fundamentals that would support a low inflation, low interest rate environment. In the last 2 years debt as a percentage of GDP and the fiscal deficit have been curtailed, driven by high GDP growth that has helped revenues. A significant part of this growth however has come from tariff and excise revenue from imported goods. In 2012 we could expect the budget deficit to widen beyond targeted levels as GDP growth would be slower and imports have declined. Government Revenue as a percentage of GDP has in fact declined in recent years from 16.3% of GDP in 2006 to 14.3% of GDP in 2011. In this context it is necessary to continue to explore options of rationalization of expenditure, particularly recurrent expenditure, in order to maintain a more sustainable fiscal balance.

Going forward, other challenges would include an ageing population which would create further fiscal burdens, both in terms of higher demands on health expenditure and also in terms of having a higher dependency ratio as labour market growth would be constrained. Another long term problem has been domestic supply constraints that have hampered growth. The 1977-1983 growth spurt has another similarity with the current period as growth was accompanied by a sharp increase in the current account deficit. Accelerated infrastructure expenditure tends to suck in imports – particularly of intermediate and investment related imports – which can lead to significant depreciation of the Rupee, which in turn puts pressure on price levels through imported inflation.

Sri Lanka also finds itself in a highly constrained global economic environment. Traditional export markets are in the process of recovering from a major global financial crisis which entails a prolonged period of stagnation. Exporters would therefore need to find markets in emerging economies where growth prospects are stronger. However this is not an easy task as it requires tailoring traditional exports to different tastes, preferences and price structures.

The policy reform package introduced in February 2012 has been very encouraging indeed. The range of policy reforms include floating the Rupee, re-pricing fuels and energy to better reflect market prices and tightening monetary policy to check excess growth in credit. Floating the Rupee helps exporters regain some competitiveness and helps mitigate a widening current account deficit of the balance of payments, re-pricing energy supports the financial viability of state owned energy companies which have hitherto been a burden on the state fiscal position, and it also helps manage demand for imported fuels. Tighter monetary policy helps manage inflation and also prevents excess credit growth that feeds into a higher imports and a weaker current account.

These policies have collectively helped to re-balance the macro-economy and also helps to create a more stable policy environment for longer term economic growth. This is a strong positive signal for future investment. Sri Lanka has all the necessary advantages for attracting investment, particularly in terms of its geographic location, market access and a population that is hospitable and easy to work with. It is now important that the government consolidates this signal of commitment towards a stable long term macroeconomic environment in order to achieve that magic eight percent on a consistent basis.

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[3] The views expressed in this article are the views of the author alone, and do not necessarily represent the views of any institutions that he may be associated with.