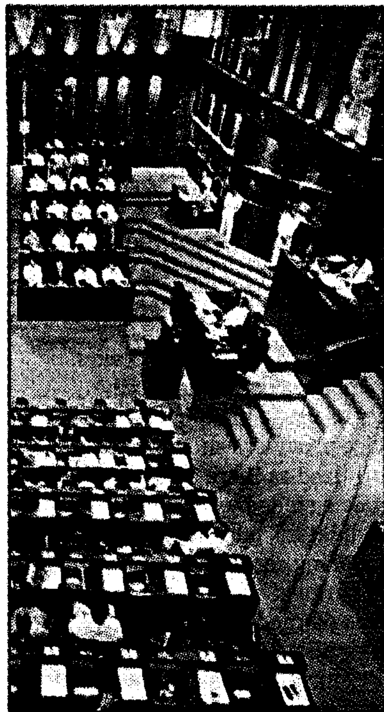
The Way Forward for Sustained Growth

• Presidential address delivered by Prof A D V de S Indraratna at the Sri Lanka Economic Association Annual Sessions last week

Prof A D V de S Indraratna



Background

This century dawned with a much depressed year 2001, with a negative growth rate ever, in the known economic history of our country, of 1.5 %, but with an almost zero deficit in the current account of the balance of payments (-1.4 of GDP) and merchandise exports still accounting for nearly one third of the GDP (30.6%). The economy started picking up since then up till 2007. With the setting in of the Global recession, the economy took a downward swing until the third quarter of 2009 when the growth rate had fallen below 3.5 % of GDP. Despite the still unabated recession in the West (A D V de S Indraratna "The Impact of the Global Recession on the Sri Lankan Economy" in Sri Lanka Economic Journal, Vol.12 (2011). pp.1-30), the Sri Lankan economy reversed upward in the third quarter of 2009 and attained a high growth rate of more than 8 % (Table 1), with falling unemployment and poverty, in the following two consecutive years. This, however, it must be noted, the Government was able to achieve , not by mobilizing savings (refer the budget deficit) but by increasing the debt burden (both debt and debt service- Table 2) and allowing the trade deficit to deteriorate with increasing pressure on the exchange rate.

In the context of deteriorating external imbalance, it was difficult to sustain such high growth, and the growth began to decelerate from the last quarter of 2012, the growth rate reaching as low as 6.1 in the first quarter of this year, 2013. Even though we see an upward reversal in the second quarter with the growth rate rising to 6.8 %, it cannot be taken as ominous of sustainability of high growth of 7.0 %-8.0%, in the four years, ending in 2016 so as to see a doubling of Sri Lanka's per capita income of five years ago! Is there a "virtuous circle" (the opposite of the vicious circle of poverty) working which would automatically ensure it? Unfortunately we do not see any such circle! Or, will a mere doubling of exports to US $ 20 billion help to achieve it? Certainly not, without positive action on relatively fast rising import expenditure. In fact, income from exports had more than doubled during the last ten completed years, from 2002 to 2012, but import expenditure had more than tripled during the same period and the country ended up with the growth rate falling substantially from more than 8% to 6.4 % (Table 1). What is the way out then? Or, what is the way forward? This is the theme of our Sessions this evening and tomorrow.

As stated earlier, Sri Lanka could not have sustained the high growth, because she did not generate sufficient domestic resources, sufficient domestic savings of her own, to sustain the required domestic investment, without recourse to borrowing. There was a continuous huge resource gap between domestic savings and domestic investment which had increased from an annual average of 7.5 % of GDP in 2001-2005 to 11.2 % of GDP in 2006-2012. This gap was manifest in the corresponding trade deficit, and the gap was met largely by borrowing. This is a strategy I would call spending or investing by borrowing. For, even though as a percent of the GDP, the total debt has come down from more than 100 % of GDP to around 80 % and the foreign debt from 43% to 36 %, in absolute volume the debt has tripled (in Rupee terms almost quadrupled), and interest rates had been on the rise and the debt service ratio or foreign debt burden as a per cent of the income from export of goods and services has increased from around 13 % to 21 % (Table 2). This debt service is more than one fifth of the export income. This cannot go on much longer, without either getting into a serious debt crisis or cutting down gross domestic investment. What is the way out then?

The way out is to change the growth strategy to one of investing with savings rather than with borrowing or in other words by bridging the huge resource gap. The success of countries like, Korea and more recently China was due to their domestic savings being much higher than their domestic investment, or there being no resource gap. Even India has a much higher savings rate with a narrower gap than Sri Lanka.

For this strategy to be implemented, Sri Lanka has first to reduce the budget deficit, curtail the aggregate demand and thereby the import demand while at the same time strategize exports , (a debate we had at the last year's Annual Sessions). This will help to contain inflation as well as interest rates. While the reduction of the budget deficit decreases dissavings of the public sector, the low money interest rates and still lower inflation with a resulting positive real interest rate, would encourage private savings. The increase in public sector savings or decrease in its dissavings i.e. reduction of the budget deficit, should come from the increase in current revenue and curtailment of current expenditure. Increase in current revenue should come from the increase in direct tax revenue via better and greater coverage of the tax net and increase in efficiency of tax collection, rather than from increase indirect taxes. Increase in current revenue this way is to safeguard equity. It may be noted here that external borrowing at high interest rates like the NSB's US $ 750 million debenture loan at 8.875 % interest would certainly be counter to this strategy – specially, NSB being the state-owned premier institution for savings mobilization.

Decrease in current expenditure should result from the reduction in waste, corruption, and ostentation in the public sector and improvement in the management and productive efficiency of the public sector institutions. These things do not happen automatically; positive action, on both fronts of revenue and expenditure, is necessary on the part of the relevant authorities.

The reduction of the budget deficit would augment resources internally, while at the same time, the restraint of import demand and positive action both by the private as well as the public sector towards increasing exports relatively fast to imports should help to restore the balance in the current account of the balance of payments.

Then, the resources mobilized on the savings side can be augmented on the investment side by more FDI. Despite the cessation of terrorist hostilities, almost as far back as four and half years, in May 2009, the FDI has been flowing very slowly. (Ref: Table 3). From an annual average of US$ 675 million in the last two prewar years, it has increased to an average of only US $ 777, in the first two post-war years. This was an increase of only US $ 100 million (rounded). The situation is not likely to be any better in the current year; in fact, it could be even worse : For in the first half of this year, FDI has been only US $ 344, less than half of the annual flow in the previous two years. Why is this so, particularly when there is peace, a strong Government, and greater connectivity within and without the country, with more and better roads, sea ports and air ports in these post war years?

Apparently, foreign investors still do not find the necessary environment for their investment. Above all the salutary conditions I have mentioned, foreign investors still look for what is called an enabling environment. What is an enabling environment? Enabling environment, comprises not only a society of peace, security and law and order, but also a government with good governance, (what is good governance?) with efficient, honest and independent public sector institutions, and an atmosphere where the rule of law prevails, the act of right to information operates, with an enlightened free media and rules and procedures of customs and immigration, etc. are simple and hassle-free (According to Minister Basil Rajapaksa "some SMEs have to go through some 29 institutions in Sri Lanka and fill countless forms before they get the go ahead" to commence and start up their business) (The Island, 08 th October, 2013, Financial Review, p.1). Sri Lanka has been making some progress in this direction, as reflected in the Index of Ease of Doing Business and in the Global Competitive Index, but has much more to do for creating such environment. I will not elaborate on this as there will be a whole session devoted to this aspect tomorrow. Suffice me to say that, with the coming into existence of such environment, it will not at all be difficult to attract more than double the present level of FDI in to our country, i.e., more than US $ 2 billion a year. This is necessary to augment the gross domestic investment to boost up its rate to around 35 % of the GDP.

35% of GDP is about the level of annual gross investment required to sustain a growth rate of 8 %- 10 % annually. Of course, there is a caveat here : That is, while resources are being mobilized to minimize the dependence on expensive borrowing, largely short-term, the other challenge of enhancing the productivity of investment (increasing output per unit of input) is being addressed so that the marginal productivity of capital or its reciprocal capital-output ratio is maintained at a level of 4.0-3.5, and also at the same time there is sufficient investment diverted to produce tradable goods to earn more export income relatively to import expenditure Moreover, In order to significantly reduce the existing huge trade deficit (Table 1), growth of export income would have to be boosted with structural changes both in the production and trade patterns of Sri Lanka's exports : The former, in the way of creating value addition and supply chains and increasing high-tech manufactured and knowledge or IT-based goods, relatively to primary and less sophisticated agrarian products.

(These challenges was the focus of discussion at the Annual Sessions of the last year and the year before on Export Growth for Sustained Development, and Achieving Economic Goals amidst Global Challenges, respectively Ref.: 2011 & 2012 Annual Sessions publications of SLEA.)

The latter, the changes in the trade pattern, should be in the way of shifting the emphasis on trade direction from US and EU in the West, more to the emerging markets of Asia such as China, India and Indonesia and the other two BRIC countries of Brazil and Russia, as well as the third biggest economy of Japan. The change in trade pattern also should include renegotiation of the existing trade pacts with Pakistan and India, and negotiation of the newly conceived FTA with China, to Sri Lanka's advantage, for reduction in her present huge trade imbalances with them. Fortunately, China, like a true friend, has already agreed for negotiation with a view to reduce the imbalance. Sri Lanka should not go ahead with CEPA on India's insistence, until some special and differential treatment for Sri Lanka is agreed upon between them which would reduce the Sri Lanka's growing huge trade imbalance with India.

TABLE1: INDICATORS OF GROWTH, TRADE, CURRENT ACCOUNT AND BUDGET DEFICITS

Year	GDP Growth	Exports US $ mn.	Imports US $ mn.	Trade Deficit US $ mn.	Remittances US $ mn.	Tourist Earnings US$ mn	Current Account Deficit US$ mn	Budget Deficit % of GDP
2001	-1.5	4,816.9 (30.58)	5,974.4 (37.93)	-1,157.5 (7.35)	1,155	213	-215.1 (1.4)	10.4
2002	4.0	4,699.0 (28.42)	6,105.6 (36.92)	-1,406.6 (8.51)	1,287	363	-236.5 (1.4)	8.5
2003	5.9	5,133.3 (27.19)	6,671.9 (35.34)	-1,538.6 (8.15)	1,414	441	-71.0 (0.4)	7.3
2004	5.4	5,757.2 (27.86)	7,999.8 (38.72)	-2,242.6 (10.85)	1,564	513	-648 (3.1)	7.5
2005	6.2	6,346.7 (26.00)	8,863.2 (36.32)	-2,516.5 (10.31)	1,919	429	-650.2 (2.7)	7.0
2006	7.7	6,882.7 (24.35)	10,253.0 (36.27)	-3,370.3 (11.92)	2,161	410	-1,498.6 (5.3)	7.0
2007	6.8	7,640.0 (23.62)	11,296.5 (34.92)	-3,656.5 (11.30)	2,502	385	-1,401.5 (4.3)	6.9
2008	6.0	8,110.6 (19.92)	14,091.2 (34.61)	-5,980.5 (14.69)	2,918	342	-3,885.7 (9.4)	7.0
2009	3.5	7,084.5 (16.84)	10,206.6 (24.26)	-3,122.1 (7.42)	3,330	350	-214.4 (0.7)	9.9
2010	8.0	8,625.8 (17.40)	13,450.9 (27.14)	-4,825.1 (9.73)	4,116	576	-1,075.0 (2.2)	8.0
2011	8.3	10,558.8 (17.84)	20,268.8 (34.25)	-9,709.9 (16.41)	5,145	830	-4,615.4 (7.8)	6.9
2012	6.4	9,773.5 (16.44)	19182.6 (32.28)	-9,409.1 15.84)	5,985	1,039	-3,915.3 (6.6$)	6.4
2013*	6.4+	4,661.0	9,217.6	-4,556.5	3,208	565.3	-1,583.0	5.8

Sources: Central Bank of Sri Lanka
Department of Census and Statistics
Notes: (a) 2012 Data Provisional
* For the first six months only; + with 6.1 % in the first quarter and 6.8 % in the second
Figures within brackets are percentages of GDP.

TABLE 3: Foreign Direct Investment - 2001 -2013

Year	Amount in US $ mln. (without loans)
2001	[illegible]
2002	[illegible]
2003	[illegible]
2004	223
2005	272
2006	480
2007	603
2008	752
2009	404
2010	478
2011	956
2012	898
2013*	344

Source: Central Bank of Sri Lanka
Note : *First six months only

Table 2. Debt Burden 2000-2012

Year	Total Domestic Debt (Rs.Mil)	Domestic Debt/ GDP %	Debt Service Payment (RS.Mil)	Total Foreign Debt (US$ Mil)	Foreign Debt/ GDP %	Foreign Debt Service Payment (US$ Mil)	Debt. Service Ratio*
2001	815,965	58.0	179,072	8544	45.3	813	13.2
2002	958,386	59.8	284,358	9291	45.6	788	13.2
2003	1,019,969	57.9	344,654	10755	47.9	761	11.6
2004	1,143,389	56.4	300.563	11346	49.1	843	11.6
2005	1,265,721	53.5	344,866	11354	40.4	623	7.9
2006	1,479,230	52.7	381,324	12214	37.5	1080	12.7
2007	1,715,199	47.9	415,089	14252	37.1	1232	13.0
2008	2,140,228	48.5	440,918	13646	32.8	1826	18.0
2009	2,400,955	49.7	675,274	15564	36.5	2009	22.4
2010	2,565,662	45,8	686,800	18823	36.1	1863	16.7
2011	2,804,085	42.9	728,028	21065	35.6	1739	12.7
2012	3,232,813	42.6	733,100	23604	36.5	2879	21.2

Sources: Central Bank of Sri Lanka
Department of Census and Statistics
Note : * As % of exports of goods and services.