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Accelerating economic growth in Sri Lanka

The synopsis of Dr. N.M. Perera's 106th Birth Anniversary Memorial Lecture delivered at the Dr. N.M. Perera Centre on 6 June 2011 by Dr. Saman Kelegama is produced below:

SRI Lanka is at a threshold of economic growth and development in the aftermath of three decades of war and conflict. Slogans such as "winning the economic war" and making the nation the "Wonder of Asia" have been frequently used to describe the priority that economic development has received in recent years.

Sri Lanka's current strategy as articulated in the 'Mahinda Chinthana: Vision for the Future' is to achieve growth rates of above eight per cent per annum and thereby aim at doubling the current per capita income to reach around US$ 4000 by 2016. Mention is also made that Sri Lanka will aim at achieving US$ 18 b exports by 2016.

My focus today will be on achieving growth rates above eight per cent in the next five years. If we examine Sri Lanka's growth rates during the last decade, the following facts become clear. The average growth that the country achieved during 2000-2005 was four per cent (could have been more if not for the -1.6 per cent very low growth the country saw in 2001), whereas during 2006-2010 Sri Lanka achieved an average growth of 6.4 per cent (could have been more if not for 3.5 per cent growth in 2009). The high growth rate in the latter period was a significant achievement despite the war inflicting the economy from 2006 to part of 2009.

A closer examination shows that the following factors contributed to the high growth during the period: rapid growth of the global economy during this period, especially during 2006-2008; increasing public investment to average close to six per cent of GDP and the fiscal stimulus associated with it; improved connectivity associated with rapid progress in infrastructure: road development, telecom and electricity sectors; stimulus from underdeveloped areas of the north and east rapidly taking off in the aftermath of the war, etc.

These achievements have clearly shown that the mixed economy model based on the twin engines of growth (both private and public sectors) is workable in Sri Lanka as was the case in most East Asian countries during the 1980s and 1990s. The current economic model of Sri Lanka has all the features of a mixed economy with elements of neo-liberalism, state intervention, Keynesian fiscal stimulus, and so on.

The private sector performance as indicated in the annual reports of various companies show record profits, where 45 companies showed profits over Rs. 1 b in 2010/11 compared to 20 companies in 2009, clearly indicating that no 'crowding out' is taking place due to the relatively larger presence of the public sector.

We are seeing today US$ 6 b worth of infrastructure projects on the move – the second infrastructure revolution in the country after the accelerated Mahaweli Development Programme and the Urban and Housing Development we saw from late-1970s to mid-1980s. Just like during that period, large public investment and foreign assistance are playing a key role in the infrastructure drive although we could see some differences in regard to sources and quantity of foreign assistance then and now.

Boosting investment to 33% of GDP

We have seen a growth of eight per cent in 2010 and sustaining high growth momentum in the first quarter of 2011. The question remains whether we could sustain this trend and aim at a higher level of growth under the current economic strategy. The aggregate level of growth is mostly determined by the level of investment in the economy and the efficiency of the economy in converting that investment to output (called the incremental capital output ratio or ICOR).

The current ICOR in the economy is close to five but if we assume that with all the improvements made in economy and with better connectivity that the ICOR reduces close to four, then with a level of investment between 32-35 per cent of GDP, Sri Lanka will be able to sustain a growth rate of above eight per cent. The challenge therefore is to increase the level of investment to this level from the current 27.8 per cent of GDP (the 2010 level).

If we disaggregate this 27.8 per cent of GDP investment level, we find that 21.6 per cent of GDP investment has come from the private sector and the remainder of 6.2 per cent of GDP from the public sector. I will show later that there are limits to increasing public investment above the current average of six per cent of GDP. Therefore the increase in investment has to come from both the domestic and external private sector, in other words, from the local private sector and FDI.

For overall investment to reach the level of say 33 per cent of GDP, the additional investment should be around five per cent of GDP – and realistically three per cent GDP of this additional investment has to come from the local private sector and the remaining two per cent of GDP from FDI. The current FDI level of 1.5 per cent of GDP should therefore increase to a level of 3.5 per cent of GDP. Can we enhance both local private investment and FDI in the coming years and what are the key impediments? This is the challenge for Sri Lanka.

The traditional determinants of investment are well known: macroeconomic stability, consistent and predictable economic policy, low interest rates and taxation, stable exchange rates, investment friendly labour and other laws, minimum red tape and bureaucracy, etc. The investors always examine these areas before they put their money on risky long-term ventures. And it is all the more in the case of FDI.

It is unfortunate that Sri Lanka does not rank highly in Doing Business Indicators (DBIs) report produced by the World Bank and neither does Sri Lanka rank favourably in the World Competitiveness Report produced by the World Economic Forum. Sri Lanka ranked 102 out of 181 countries in the Ease of Doing Business Index prepared by the World Bank.

A recently released World Bank's Logistical Performance Index (LPI) report ranks Sri Lanka 137 out of 154 countries and Sri Lanka ranks lower than a least developed country like Bangladesh. We can criticise these reports as we usually do, and say that they are not accurate and they have not considered various other factors, but at the end of the day it is the ranking of these reports that the potential investors take into account before taking a decision to invest.

While infrastructure development improves connectivity and improves DBIs, that alone is inadequate. Specific problems in regard to delays in doing business have to be addressed at the root. The initiative taken by the Central Bank to release the document called 'Step-by-Step Guide to Doing Business in Sri Lanka' in April this year is a positive step. The aim seems to be to take Sri Lanka among the top 30 in DBIs by the next two to three years. Improving DBIs will not only enhance investment but it will also contribute to improving the efficiency in the economy, i.e., lowering ICOR.

Equally important is the consistency and predictability of policy. Ad hoc policy reversals and frequent change of policy have to be avoided as far as possible to give the best signals to the private sector. Perceptions matter in regard to attracting FDI and in this context, managing perceptions on governance becomes a vital area to focus in the coming months.

Limitation on enhancing public investment

I mentioned earlier the limitations of enhancing public investment. Sri Lanka's revenue (with grants) amounts to 15 per cent of GDP, while the current expenditure amounts to 17 per cent of GDP. So the overall revenue is still not adequate to cover the current expenditure, thus leaving a current account deficit in the Budget. Late Dr. N.M. Perera used to say that good budgeting means producing a surplus in the current account so that you borrow only for your capital expenditure, but today you borrow not only to meet capital expenditure but also to meet part of your current expenditure.

The Presidential Taxation Commission report was submitted in October last year and it came with a number of proposals to enhance revenue to a level close to 18-20 per cent of GDP. Some of its recommendations (in adjusted form) were implemented in the 2011 Budget presented in November last year but a lot more needs to be done.

While implementing the rest of the recommendations, concerted effort must be made to restructure current expenditure. Wages and salaries (5.4 per cent of GDP), interest payments (5.6 per cent of GDP), and subsidies and transfers (3.3 per cent of GDP) amounted to 14.3 per cent of GDP overall in 2010.

This is almost 95 per cent of the revenue earned and in some years they accounted for the entire revenue collected. This means that three expenditure items are cutting into all other areas of current expenditure and dominating the expenditure patterns in Sri Lanka. It is high time this anomaly is rectified. Interest payment on public debt has thankfully come down from a level of 6.4 per cent of GDP in 2009 to 5.6 per cent of GDP due to the lower interest rates, if not it would have remained a burden on the expenditure side.

Subsidies and transfers occupy a significant position because of the large sums allocated to the loss making state owned enterprises (SOEs). In 2007, the losses in these SOEs amounted to 1.7 per cent of GDP and there are reasons to believe that this level has not come down significantly by 2010. In this context, the recent announcement by the Secretary of the Ministry of SOE restructuring that six SOEs will be leased out for 30 years to the private sector and that a Voluntary Retrenchment Scheme will be introduced to some other SOEs is a positive step. Wages and salaries are also a large expenditure item with a 1.2 million large public sector work force. This expenditure is bound to go up with recent demands for wage increases by University academics and others. As long as public sector workers are productively engaged and contributing to economic activities, such large sums can be justified but not otherwise. In this regard the recent deployment of armed forces for urban development and infrastructure development activities is a positive step.

Given this situation in regard to lopsided current expenditure and borrowing to meet all capital expenditures, there are limits to borrowing to enhance public investment especially when the debt to GDP ratio is still above 80 per cent. Thus, the government has to seriously look at various public-private partnerships (PPP) models to embark upon to develop various areas of infrastructure than relying solely on the public investment.

At the Colombo Port a PPP is in operation with a leading Blue Chip company and it has so far proved a successful model, but such systems have to spread to other sectors as well and be a model that takes a burden out of the government. For this purpose, there is a need to strengthen the independent multi-sector regulatory body – the Public Utility Commission – to overlook all regulatory issues relevant to the investor and well as the consumer.

Dr. Saman Kelegama delivering Dr. N.M. Perera's 106th Birth Anniversary Memorial Lecture at the Dr. N.M. Perera Centre

Exports: Key generator of growth

New investment will lead to multiplier investments if competitiveness of the final products could be maintained. In this context, export investment becomes particularly important as this is one area of investment that contributes to rapid growth, as the East Asian success story demonstrated. The level of exports reaching nearly US$ 900 m in January 2011 and the rapid growth in the first quarter of 2011 at around 50 per cent are remarkable. But a note of caution is necessary here.

First, exports are falling as a share of GDP making Sri Lanka a more domestic oriented economy under which growth potential is limited once existing capacity is utilised. Sri Lanka has also not done well on competitiveness as reflected by the size of exports for its stage of development. For instance, Vietnam with a per capita income of US$ 1174 recorded exports amounting to US$ 72 b in 2010, whereas Sri Lanka with a per capita income of US$ 2435 recorded exports amounting to US$ 8 b in 2010.

Second, although exports grew by around 17 per cent last year and 50 per cent in the first quarter of 2011, our growth is much smaller than our competitors, further shrinking our share in world exports. Third, real growth in exports is much lower as significant growth in nominal US dollar terms is due to depreciation of the US dollar against other major currencies. In this context, the appreciation of the Sri Lanka rupee vis-à-vis the US dollar is a concern because the value of the rupee against the US dollar is more important for Sri Lanka's exports, as over 70 per cent of trade takes place in US dollars and even exports to other regions such as Euro are priced in US dollars. There are some who argue that the Sri Lankan rupee has depreciated against some major currencies but these are not our major trading currencies and therefore such depreciation does not give much benefit to exporters. Amidst large capital inflows, managing the exchange rate is not easy.

What is important here is to make a clear distinction between appreciations against maintaining a stable currency and some flexibility. It is the latter that needs attention in the context of sustaining the growth momentum of the export sector which is vital in the long run.

Missing the demographic dividend but all is not lost

While speaking about investment's contribution to growth, we must not forget about social transformations taking place in Sri Lanka and their impact on the growth process. Here, I would like to speak a few words about the demographic dividend. What do economists mean by a demographic dividend? It is meant to indicate the gains to a nation consequent to the change in the age-wise composition in the population.

For example, if youth workers are urgently required in a large number at a particular juncture in economic development and they are readily available in the market due to demographic transition, then the situation will generate a demographic dividend. The magnitude of the demographic dividend appears to be dependent on the ability of the economy to absorb and productively employ the extra workers, rather than be a pure demographic gift.

ADB analysis shows that a large part of East Asia's spectacular economic growth derives from a working age population bulge. This bulge represented a demographic dividend or a demographic "gift" because it carried with it an increased space for economic growth. East Asia has had relatively more workers (and savers) and relatively fewer non-workers (and non-savers) compared with other parts of Asia, and with the rest of the world at the time of economic take-off (Emerging Asia: Changes and Challenges, ADB, 1997).

According to Ghani (2011), demographic dividend impacts growth through five different channels. First, swelling of the labour force, as baby boomers reach working age. Second, society being able to divert resources from spending on children, to investing on physical capital, job training, and technological progress. Third, rise in women's workforce activity that naturally accompanies a decline in fertility. Fourth, working age also happens to be the prime years for savings, which are key to accumulation of physical and human capital and technological innovation. Fifth, boost to savings that occur as an incentive to save for longer periods of retirement increases with greater longevity.

Sri Lanka missed the demographic dividend when the workforce was at a peak level due to a number of factors and the country is now witnessing a rapid ageing of the population. The above 60 years population is going to increase from the current 11.5 per cent to 18.6 per cent by 2021. Thus, the working force is ageing and growing slowly than in the past compared to competitor countries in the neighbourhood. The ratio on working population to total population peaked in 2005 and it will now only decline. The dependency ratio is projected to increase over the next 40 years while the rest of South Asia, especially India, will benefit from a decrease in dependency ratio and a demographic dividend. But there are two redeeming aspects for Sri Lanka. First, is the relatively low female participation rate of about 35 per cent. Second, a large stock of skilled migrants will return if improved growth generates new opportunities. So there exists scope to offset some of the loss of the demographic dividend by policies aimed at raising the female labour force participation rate and number of returned migrants.

Five hubs need more opening of the economy and stronger regional linkages

My next submission is to address an equally important area where the growth in the next half a decade will be enhanced by other frameworks that the government is intending to promote. The area that immediately comes to mind are the five hubs: knowledge, maritime, aviation, energy, and commercial. The hubs will certainly boost the overall economic growth but there are a number of questions that we must ponder about. Can we promote Sri Lanka as a hub without selectively liberalising the economy in specific sectors? Can we bypass regional powers like India and become a hub in shipping and aviation?

Take for instance the objective of promoting a knowledge hub. Can we create a knowledge hub by just inviting foreign universities and the ongoing higher education reforms? How are we going to promote more of the IT industry, and encourage more BPOs? Are we increasing R&D expenditure with focus on Ayurvedic medicine, bio-technology, nanotechnology, etc.? We will have to seriously look at various global models and take a cue and should not assume that the geographical location per se will be adequate for the hubs to take off.

Concluding remarks

Moving from a middle-income country to a high income country is more complicated than moving from a low-income to middle-income range. Moreover, growth strategies that proved successful in the early stages of development are less effective when moving up to high income level.

While focusing on strategies to enhance growth, Sri Lanka should ensure that it does not get into a "middle income trap" where reliance on cheap labour based competitiveness and traditional ways of doing business no longer work. Many developing countries like Argentina, Thailand, and others have got into this trap. Sri Lanka should innovate and upgrade its production process and move up market with value addition and enhanced productivity.

I think if luck turns in favour of Sri Lanka there are two events that could give a tremendous boost to the overall growth scenario in Sri Lanka. First, if oil is discovered in the Cauvery basin it could give a significant boost to the economy and save about 5 per cent GDP on the import bill. Second, if the bid to host the Commonwealth Games in 2018 is successful, it will give a stimulus to the growth process via the Keynesian multiplier effect just as it did to Malaysia in the late 1980s and early 1990s. It will be always better to focus on the vital determinants of growth than depending on luck, for that is what will make high growth sustainable.

(Dr. Saman Kelegama is the Executive Director of the Institute of Policy Studies of Sri Lanka. He is a Fellow of the National Academy of Sciences of Sri Lanka and was the President of the Sri Lanka Economic Association during 1999-2003. He serves and had served in a number of Government and private sector boards as an independent member. He is a member of the National Economic Council under the President of Sri Lanka. He received his Doctorate (D.Phil.) in Economics from University of Oxford, U.K. and his Masters degree in Mathematics from the Indian Institute of Technology in Kanpur, India.)

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FT Alert

An article titled "Killing and State Intervention into a funeral – A new form of suppressing liberty" by J.C. Weliamuna will be featured in the Weekend FT tomorrow (11 June).