The Island Online

Growth expected to dip this year

January 2, 2011, 12:00 pm

A senior economist says Sri Lanka’s economy could dip this year as the global economy is set to decline.

Executive Director of the Institute of Policy Studies Dr. Saman Kelegama said Sri Lanka’s growth, estimated between 7.5 percent and 8 percent for 2010, could decline this year along with the global economy.

"With the global economic growth predicted to decline from 4.8percent in 2010 to 4.2percent in 2011, and growth rate of Asia-Pacific predicted to decline from 8.3percent in 2010 to 7.0percent in 2011, Sri Lanka will also show a decline in its growth from the 7.5percent level of 2010," Dr. Kelegama said in an interview published on page 8 of this edition of The Island Financial Review.

"With the good rains the country received in 2010 and which is predicted to continue in 2011, agriculture will show a good performance in 2011. The services will show the most promising growth performance with tourism, communication, transport and banking showing high growth rates. The North/East reconstruction will also contribute to stimulating the services sector growth. Manufacturing growth may decline with slackening demand for exports in developed country markets, but we will have to see how the 2011 Budget package will work in reviving the manufacturing growth," Dr. Kelegama said.

"In order to achieve the 8percent growth target, Sri Lanka will have to focus on factors that will enhance the level of investment to 32 – 36 percent of GDP. In this context, improving the "Doing Business Indicators" and giving the correct signals to the private sector will go a long way in attracting more domestic and foreign investments," he said.

According to the Central Bank, the economic growth is estimated at 7.6 percent for 2010 and 8 percent for 2011. However, in a recent report the Central acknowledged the fact that the global economic growth would dip in 2011.

It said the global economy would grow 4.8 percent in 2010 and 4.2 percent in 2011. Advanced economies would grow by 2.7 percent and 2.2 percent in 2010 and 2011 while emerging economies would grow by 7.1 percent and 6.4 percent in 2010 and 2011.

....

Global Economic Outlook for 2011 and Emerging Concerns for Developing Countries

The Island, Financial Review, spoke to Dr. Saman Kelegama, Executive Director of the Institute of Policy Studies of Sri Lanka (IPS), on the global economic outlook for 2011 and emerging challenges.

Q: After the 2008/2009 global economic slowdown we are now seeing a gradual economic recovery. What are the main characteristic of this recovery ?

A: The recovery that took place in 2010 was quite swift and better than what was expected earlier. But all indications are that there will be a slowdown in the recovery process in 2011 due to the sluggish demand and growth in the developed countries. Two factors need to be emphasized:

(1) The developed countries came out of the crisis by using a large fiscal stimulus in 2009. But now, these countries have abandoned the use of fiscal policies to stimulate their economies, fearing high budget deficits and the ballooning public debt. Now most of these developed countries are using a relaxed monetary policy with very low interest rates to increase liquidity in the market and sustain the recovery. The USA calls this policy Quantitative Easing (QE -'quantitative' because the US Fed is changing the quantity of money in the economy, and 'easing' because it is easing the pressure on the market), and it is nothing but increasing liquidity by putting more currency into the market . But the desired impact of this policy is slow to manifest in the real economies of all these developed countries.

(2) The EU debt crisis manifested after the lagged impact of some of the EU country investments in US toxic assets. First, it was Greece and then it was Ireland, and now it is said that Spain and Portugal may also face a serious debt crisis. A Euro 110 billion rescue package by the IMF and European Central Bank was put in place in May 2010 for Greece, and a Euro 85 billion package was put in place for Ireland in November 2010. How long these two countries will take to recover is not clear, but what is very clear is that the contagion of the European debt crisis will be felt by the rest of the world, in particular, developing countries whose exports are heavily dependent on the EU market.

So these factors basically point to a lower economic growth in the global economy compared to that of 2010. The global economic growth is predicted to decline from 4.8% in 2010 to 4.2% in 2011, US growth is predicted to decline from 2.8% in 2010 to 2.5% in 2011, EU growth is predicted to stagnate at 1.3% in 2010 and 2011, and Asia Pacific region's growth is predicted to fall from 8.3% in 2010 to 7.0 % in 2011. Thus, the type of economic recovery we will see is not be a straight forward 'V' shape but a disturbed' V' or a lop-sided 'W' shape. Marxian economists say that there will be triple dips as this is a deep rooted problem of capitalism manifesting in the global economy. However, I think after the second dip, growth will become sustainable like during the 1930s Great Recession, where we had the first dip during 1929 to 1933 and the second dip during 1937 to 1938.

Q:What type of economic growth will we see in 2011 ? Will it be driven by a particular region and will it be driven by a new economic strategy ?

A: This crisis has put the Asian region in the global map as it is the region that is giving the lead to the global economic recovery process, in particular, the two large economies, China and India. China grew at 9.1% in 2009 and increased the growth to 9.8% in 2010, and the growth predicted for 2011 is 9.0%, while India grew at 7.4% in 2009 and increased the growth to 8.7% in 2010, and the growth predicted for 2011 is around 8.5%. Thus, we see that despite decline in growth in US and EU, the two giants in Asia, although growing at a lower rate than in 2010, will still show relatively high growth rates in 2011 and provide the lead to the global recovery process.

We will also see less emphasis being paid to the pure export-led growth model in the coming years, and developing countries will use a combination of export-led growth and domestic demand driven growth model. The latter works best in large countries like China and India, and that is how these two economies managed to show high growth during the global economic crisis by focusing more on domestic demand driven growth than excessively relying on export-led growth. This model also works for smaller developing countries if they are able to reap economies of scale via deep economic integration in the region with larger markets. For the renewed export-led strategy, developing countries will increasingly look for Southern markets and in this context, again the regional markets become important.

Q:What are the major concerns for developing countries like Sri Lanka in the coming months in the context of the global changes that are taking place ?

A: I think the major concern is that the recovery strategy put in place by the USA is incurring a huge cost on all developing countries. In other words, the monetary easing while not effectively reviving the private sector sentiments in the developed countries and not making the desired economic impact, is causing problems for developing countries. Here, four points could be highlighted.

1) The QE strategy has increased liquidity in the US market but a portion of this capital is not invested in the US market (in Banks, Treasury Bonds, Real Estate, etc.). Rather it is taken out of the US market in search of more attractive returns overseas. In this context, developing country share markets and Guilt Edge Securities have become prime sources of investment. These flows have been accommodated by most developing countries by boosting their reserves, but some countries like Brazil and Thailand have restricted such inflows by imposing capital controls. Accommodating these capital inflows by boosting the reserves have adverse consequences, viz., appreciation of the local currency, generating asset price bubbles, creating inflationary pressure, and creating financial instability. In many developing countries, we have clearly seen the appreciation of the exchange rate – from January 2009 to November 2010, Indonesia, Korea, Thailand, and Malaysia have seen their currencies appreciate by 22.7%, 17.4%, 16.5%, and 12.4% —

while in some other countries, we have seen consequences such as asset bubbles and inflation due to incomplete sterilization of capital inflows.

2) If we are to expedite the global economic recovery, what we need to do is some rebalancing of the global economy. As is well known, the US growth during 2000-2008 was maintained by a debt driven investment and consumption boom, and the debt capital came mainly from Asia. The US incurred a large trade deficit as a result of this growth. This model is no longer workable for the USA and it must reduce its large trade deficit, and the trade surplus countries like China, Japan and Germany have to bring down their surplus. In other words, the US has to reduce domestic consumption-led growth and focus more on export-led growth to bring down the trade balance, while surplus countries should encourage more domestic consumption-led growth and focus less on export-led growth to bring down their massive surpluses. This was what the G-20 was supposed to implement and give the IMF the surveillance power to ensure that such rebalancing was taking place.

However, the G-20 never empowered the IMF to do the surveillance so what has now manifested is not trade rebalancing but a potential ‘currency war’. This is because the QE strategy is basically depreciating the value of the US dollar to support the policy of the Obama Administration to double the US exports by 2015. And the US is arguing that the Chinese Yen is artificially depreciated and putting pressure on China to readjust the Yen. This pressure is not seen favourably by China, which argues that the Yen has already appreciated and that the US should further reduce domestic consumption to fully recover, rather than pointing the finger at the Chinese currency. These verbal exchanges are laying the foundation for a potential currency battle with tit-for-tat devaluations. Some developing countries are now contemplating devaluing their currencies to make their exports more competitive. This may lead to "competitive devaluations" among countries and it will generate currency instability which will be very detrimental to attracting FDI to developing countries.

3) With USA following an aggressive export boosting strategy, the likelihood of the WTO Doha Development Agenda (DDA) coming to an end, is very bleak now. The G-20 only pays lip service to the DDA, and nothing happens with the key issues in the DDA such as reducing the agricultural subsidies in developed countries, and improving market access in developed countries for exports of developing countries. The USA will now use all the agricultural subsidies at its command to drive its agricultural exports and use anti-dumping and other non-tariff barriers to restrict imports, and this does not augur well for developing countries. Since the on-set of the global economic crisis, the USA and EU have already implemented 240 and 299 protectionist measures, respectively.

4) The depreciation of the dollar has led to looking for alternative sources of investment by speculators like the commodity markets. Consequently, the food and oil prices are on the increase once again. The price of an oil barrel has increased from $ 33 per barrel in December 2008 to US $ 90-plus in December 2010. Wheat, sugar, pulse prices are on the increase in the global market. This is not a healthy situation for net food importing countries like Sri Lanka.

Q:What are the key lessons from the global economic recovery that we saw in 2010 ?

A: Basically, the recovery has shown that without a regulatory framework in place we cannot have profound faith on the market mechanism to bring about economic recovery. The tax cuts are not necessarily self- financing and deregulated financial markets are not necessarily self-correcting. The world still does not have an international financial architecture in place to govern global financial flows, and without such a framework we have to be very careful in opening up the capital account of the balance of payments further to allow the inflows and outflows of capital.

Another lesson that has emerged with the ongoing global recovery, is the less effectiveness of monetary policy in bringing about economic recovery. Despite loose monetary policy, demand has still not picked up either in the US or EU. While monetary policy is effective in terms of curtailing demand, controlling credit and bringing down inflation, it is not that effective in expanding demand and expanding credit flows because it is a highly private sector sentiment dependent policy tool. Whereas fiscal policy, which is government-led, with its multiplier impacts, is a more effective tool in bringing about economic recovery.

In fact, Nobel Laureates, Paul Krugman and Joseph Stigltz argued that developed countries are making a big mistake in moving too quickly from the consensus in 2009 that they should undertake a ‘fiscal stimulus’ to get out of recession, to the present consensus that they should now go on a "fiscal austerity" drive. The withdrawing of the fiscal stimulus before recovery becoming sustainable, will make the overall recovery very difficult. In fact, Krugman, criticized the George Osborn Budget of the UK in October 2010, saying that the premature fiscal austerity will lead to a renewed economic slump in Britain. The Krugman argument is that the turning point at which fiscal stimulus is withdrawn in favour of monetary policy easing, should be carefully identified because creating sustainable growth is important over and above short-term fiscal consolidation.

A large fiscal package, although it would lead to a budget deficit and increase public debt, will generate sustainable recovery, and the growth from such recovery will increase revenue to pay back debt and bring down the budget deficits. This is how the world came out of recession in the 1930s based on the formula suggested by the well-known economist John Maynard Keynes.

The third lesson from the recovery, is that developing countries should no longer depend too much on the Northern (developed) country markets but explore new markets in the Southern countries. In this context, the regional markets become important and the case for regional integration becomes stronger.

Q:What are the prospects for the Sri Lankan economy in 2011?

A: Sri Lanka will record a growth rate between 7% and 8 % in 2010. In the first quarter of 2010, Sri Lanka grew at 7.1%, 2nd quarter at 8.5%, 3rd quarter at 8.0% and the estimate for the 4th quarter is around 6.4%. So this will give an average growth of about 7.5% for 2010. With the global economic growth predicted to decline from 4.8% in 2010 to 4.2% in 2011, and growth rate of Asia-Pacific predicted to decline from 8.3% in 2010 to 7.0% in 2011, Sri Lanka will also show a decline in its growth from the 7.5% level of 2010.

With the good rains the country received in 2010 and which is predicted to continue in 2011, agriculture will show a good performance in 2011. The services will show the most promising growth performance with tourism, communication, transport and banking showing high growth rates. The North/East reconstruction will also contribute to stimulating the services sector growth. Manufacturing growth may decline with slackening demand for exports in developed country markets, but we will have to see how the 2011 Budget package will work in reviving the manufacturing growth.

In order to achieve the 8% growth target, Sri Lanka will have to focus on factors that will enhance the level of investment to 32 – 36 % of GDP. In this context, improving the "Doing Business Indicators" and giving the correct signals to the private sector will go a long way in attracting more domestic and foreign investments.