The Nation

Services-led economic growth: How stable and sustainable?


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With the five hubs concept of the government in the pipeline, the services are going to play an important role in the Sri Lankan economy in the near future. How stable is services-led growth and can such growth have a momentum of its own? The Nation's Economist spoke to Executive Director, Institute of Policy Studies of Sri Lanka and the editor of the recently published book Dr. Saman Kelegama: ' (Sage Publications, 2009).

Q :Are services going to play an important role in Sri Lanka's future development strategy?
A : Yes, services already account for 58% of GDP. Its share in GDP has increased over the years. At the time of independence, the service sector amounted to 34% of GDP. Its share in GDP increased marginally over the years and amounted to 41% by 1977. But after the market economy came into place, the share increased dramatically and amounted to 58% by 2009. Its share will further increase in the coming years with the rapid development of infrastructure and the initiation of five hubs under 'Mahinda Chintana Vision for the Future' (MC – Idiri Dekma). These five hubs are: Ports, Aviation, Energy, Knowledge and Commercial (trading and banking/finance).

Q : Is service-led growth sustainable?
A : With modern technology, services are no longer non-tradable (or non-transportable or non-scalable), and are increasingly becoming a tradable area: services can now be produced and exported at low cost. That services can be driven only by domestic demand, in other words, that domestic growth mostly drives services expansion is a myth. There has been a 'services revolution' during the last decade but compared to global output in services which is 70% of global output, only 20% of international trade are in services, thus the trading aspect of services is still at its early stages.

India's growth is today mainly service driven. Empirical evidence shows that the impact of services growth is stronger than manufacturing growth on the overall economic growth of India. India has virtually leapfrogged over the manufacturing sector, going straight from agriculture to services. India is today the largest exporter of services in the world and Ejaz Ghani of the World Bank calls this a 'services revolution'. The Indian experience has also shown that the belief industrialisation is the only route for rapid economic development in developing countries is no longer valid. The promise of this revolution is that late-comers to development are provided new opportunities to find niches, beyond manufacturing where they can specialise, scale-up and achieve growth just like in industrialisation. Thus, services-led growth in the contemporary world is sustainable because of rapid globalisation of services, which is in its early stages as explained earlier.

Q :Can you elaborate on the classical views on services that are no longer valid?
A : First one, that services are only driven by domestic demand is no longer valid. Services are now responding to export opportunities. Sri Lankan hoteliers are investing in India, banks are investing in Bangladesh, etc. Moreover, services are generating foreign exchange over and above the traditional tourism and worker remittances. For example, US patients who cannot afford medical care in US are now coming to India/Thailand, etc., to obtain medical treatment.

Second, when services can be traded with globalisation, the possibility for a developing country to develop services based on its comparative advantage has become a reality. Thus, the theory that industrialisation is the only means for rapid development is less valid in the contemporary world.
There are two other myths on services that need highlighting, and they would be the third and fourth. The third myth is that services in developing countries have lower productivity than industry. This is not the case and according to available data, India’s productivity growth in services matches labour productivity in the manufacturing sector in China.

Fourth, is that services generated jobs in developing countries are thought of as menial and poorly paid. This is no longer the case and services-led jobs are not necessarily menial. A worker in a Business Process Outsourcing (BPO) or Knowledge Process Outsourcing (KPO) in India earns a much higher wage that an engineer working in an Indian industry.

Q :Are services becoming tradable the only factor that has contributed to their significance in the modern world?
A : No, services contribute to the efficiency of both the industrial and agriculture sectors. Services such as banking, insurance, shipping etc., are vital to support the production and sale of both agriculture and industrial sectors. For example, when the plantation sector kicked off during the British colonial era, the banking, insurance, and shipping services emerged to cater to the plantation sector. If I am to give an example from the industrial sector, if a car is produced, its after sale services are vital for its salability.
The modern production format starts with basic research going to applied research; testing; commercial development; planning and financing; manufacturing; warehousing, transport, and marketing; after sale services and maintenance; and continued research and development for next generation products. Only one in the nine stages is industry specific (i.e., manufacturing) and the rest are services. So one cannot ignore the role of services in the modern manufacturing process. Its link is stronger to the two production sectors (industry and agriculture) today than two decades ago. Thus, without services it is impossible for both industry and agriculture to survive.

Q :What should be the positioning/status of the Sri Lankan services sector?
A : The sector is dominated by wholesale and retail trade, transport and communication, banking and finance, and hotels and restaurants sectors. Of course, services respond to domestic demand whether it comes from the government or the private sector. If the services growth is too much driven by the expansionary fiscal and monetary policies, such services growth will not be sustainable. The domestic demand generated services growth should be more driven from the private sector and less from expansionary government policy.
There is trade in services – ports services, tourism, manpower services (remittances), etc., that is mostly private sector driven but we are yet to reap the full potential in these sectors. More trade in services income can give Sri Lanka a current account surplus in the balance of payments, instead of running a 4-5% of GDP current account deficit. If we can increase our remittances per annum to 15% of GDP from the current 9 % of GDP, tourism income to about US$ 2 bn. from the current US$ 400 mn, and ports income to a higher level, then a current account surplus will be a reality.

But while achieving this, we have to make our other services more tradable. IT services income should be increased to US$ 1 bn. in the next 2-3 years, banking/insurance services should become exportable, etc.
What was attempted by the India-Sri Lanka Comprehensive Economic Partnership (CEPA) was to give liberal access to Sri Lankan services in the Indian markets and vice versa while taking due account of the asymmetry between the two countries. CEPA was designed to give a stimulus to trade in services of Sri Lanka and thereby gain some “early mover advantage” in the Indian market.

Sri Lanka requires a domestic demand driven (but not excessively government fiscal expansionary policy dependent) and externally tradable services sector. That would give the service sector the real strength.
How can we further strengthen our service sector?
We can strengthen the sector by making it internationally competitive so that the service sector is both exportable and can withstand international competition. It is true that the Sri Lankan services are not developed adequately as in advanced economies like US, France or UK (where services in GDP amount to 75%, 73% and 72%, respectively) and thus will not be able to withstand full competition if the services sector is opened for foreign services. That is why the WTO framework GATS (General Agreement in Trade in Services) provides a very flexible framework and operates under an ‘offers’ and ‘requests’ basis, which gives adequate ‘policy space’ for developing countries like Sri Lanka on liberalising services.

While giving some protection to our services, we must also expose the sector to some degree of international competition on a gradual basis. Then only will the services sector become internationally competitive and strong. It will happen by the regulatory framework governing various services gradually falling into place so that individual service sectors will be in a position to sign Mutual Recognition Agreements with other countries to engage in trade in services. This is what we attempted under the India-Sri Lanka CEPA, to give a slight exposure to competition from India and giving better market access to India for our services. But this was opposed by some stakeholders claiming that Indian services will flood our market and destroy Sri Lankan services, which was not at all the case. Today, 63% of Indian FDI in Sri Lanka is in services (Bharathi Airtel, IOC, Apollo, Taj Hotels, etc.) and I do not think any of them had an adverse impact on domestic services.

Q : The five hubs articulated in Mahinda Chintana Idiri Dekma are all in services. Will these hubs strengthen our services?
A : The five hubs idea is excellent and they will certainly strengthen the other services in Sri Lanka. Already via the market and correct economic policies, Sri Lanka has become a transshipment hub and increasingly there are signs of Sri Lanka emerging as an aviation hub between Dubai and Singapore. These areas can be consolidated while other hubs are developed. But development of the five hubs requires increase in global and regional integration and in this context, the proposed India-Sri Lanka CEPA can play a vital role. Already 70% of transshipment at the Colombo seaport is from India, and 40% of revenue of Sri Lankan Airlines comes from flights to Indian destinations. CEPA will trigger regulatory reforms in most service sectors and facilitate them to trade with not only India but also with the rest of the world and thereby facilitate the five hubs.
It has been estimated that by 2050 the four largest economies in the world will be China, India, USA, and Japan. It is noteworthy that three of them are in Asia, and India is our nearest neighbour. This augurs well for Sri Lanka's proposed five hubs. So the challenge is how to move forward to activate such hubs in terms of policy, infrastructure, and institutions.

Q :Where can we find more literature on the services sector in Sri Lanka?
A : You can refer to the 2006 Sirisena Tilakaratne Memorial Lecture, delivered by former Deputy Governor of the Central Bank W.A. Wijewardena for an overview on the subject. More specific areas such as trade in services in Sri Lanka can be found in my book.