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2016 economic growth seen lower at 5.0-5.5 per cent, says IPS chief

View(s):

Travellers at the Fort Railway Station

As the year comes to a close, the Business Times this week sat down with economist and Head of the Institute of Policy Studies of Sri Lanka, Dr. Saman Kelegama to discuss the economy in 2015 and the prospects and challenges for 2016. On the year 2015, the global economic recovery and global growth prospects for 2016:The global economy slowed down to a growth rate of 3.1 per cent in 2015 compared to 3.4 per cent in 2014 due to the slow recovery in the developed world and slowdown in the Chinese economy. The United States has shown an improvement of growth from 2010 onwards but this recovery is offset by slow growth in European Union and Japan. China's exports depend heavily on the demand of the US and the European Union and with the gradual decline in such demand, Chinese exports have slowed down.

Moreover, Chinese imports have declined as there is less demand for intermediate inputs for processing in China and onward export to developed economies. China is now finding a "new normal" in its growth which has stabilised around 6.5 per cent. China is also demanding less final goods from the region as the role of investment in the economy has declined. In fact, the import contraction in China has been larger than the export contraction. China is the largest trading partner for many Asian countries and hence consequent to its demand contraction for imports, regional trade in Asia has slowed down. Overall, emerging and developing Asian growth declined from 6.8 per cent in 2014 to 6.5 per cent in 2015.Nevertheless, I think some positive steps have been taken in 2015 to put all countries in a sustainable development path.

Four major international conferences took place during the year making decisions on global economic architecture, viz; (1) Third Development Finance Conference in Addis Abba in July; (2) UN Summit on 2030 Agenda for Sustainable Development in New York in September; (3) CORP 21 Conference on Climate Change in Paris in November/December; and (4) 10th Ministerial of the WTO in Nairobi in December.The 2030 Agenda for Sustainable Development set economic, social, and environment targets to be achieved together in harmony by 2030. For achieving the targets, funding is required and these development finance meetings suggested new ways and means of mobilisation of funds for, among others, to meet the Sustainable Development Goals. With both binding and voluntary commitments to keep the increase in global temperature below 2 degrees Celsius, the CORP 21 further emphasised adaptation and mitigation measures to cope with climate change. Mainstreaming trade to development was once again the dialogue in Nairobi although concrete results like in WTO Bali were not achieved, a deal was worked out for the residuals of the Bali Package and impending Special Safeguard Measures under Agriculture. In short, a new agenda has been set after the MDGs ended in 2015, which is more broad-based and inclusive. This has to be welcome.

Having said this, there are also serious concerns: (a) the G-20 discussions on global financial architecture has not made much progress, (b) China's growth has slowed down and it is in a "new normal"; (c) EU recovery is slow and the new migrant influx and the Paris bomb attack have raised new security concerns, (d) US tightening monetary policy this month can trigger more capital outflows from developing countries. The projection of the IMF indicates a recovery of global growth from 3.1 per cent in 2015 to 3.6 per cent in 2016, but these projections will be subject to revisions according various changes in the global economy. In short, there won't be a significant global recovery in 2016.

Growth trends and prospects for 2016 in Sri Lanka:

Since there was a sharp decline in public investment in 2015 (and private investment not increasing significantly) the bulk of the growth in 2015 was consumption-led. Motor vehicles and consumer durables played a major role in this consumption pattern. This is partly reflected in the 21 per cent growth of credit during the first 10 months of 2015. Sri Lanka may record a growth rate close to 5.5 per cent in 2015.Domestic demand will most probably be buoyant with the tech savvy younger population, rapid urbanization and the growing middle class. Public sector recent wage increases as well as the proposed private and plantation sector wage increases will also contribute.

To take advantage of rising demand, the supply side of the domestic economy will have to be improved as there will be less demand for imports with depreciating currency. Barriers in the supply side such as excessive regulations, infrastructure bottlenecks, etc need to be addressed with a focused economic reform programme. Both the Economic Policy Statement of the Prime

Minister and the Budget 2016 emphasised these areas and improving doing business indicators in the country. How much of these could be done next year remains to be seen.
Growth will be lower in 2016 compared to 2015 and my forecast is somewhere between 5 per cent to 5.5 per cent. As the macroeconomic situation is tightening, Sri Lanka needs to stabilise the economy in 2016 and in this process there is bound to be an economic slowdown.

Pressure on macroeconomic situation:
The budget deficit has expanded in 2015. The expected budget deficit for 2015 will be close to 6.8 per cent of GDP compared to 5.7 per cent of GDP in 2014. Given the revenue shortfalls from the reversals of 2016 Budget proposals, the targeted 6 per cent of GDP budget deficit for 2016 can go further up and can be kept under control only by cutting capital expenditure from the budgeted amount. The expected current account deficit reduction of the balance of payments with the decline in global oil prices did not take place – and this is clearly indicated in the balance of payments in the first nine months of 2015, which showed a US$2.3 billion deficit compared to a surplus of $2 billion in the first nine months of 2014. As long as these imbalances remain out of control, there will be pressure on the interest rates to go up and the exchange rate to depreciate and that is how stabilisation works in the market economy. This in turn, will slow down growth and hence the major macro imbalances in the government budget and external current account need to be addressed.

Pressure on interest rates:
Lower international commodity prices have encouraged many commodity importing countries like Sri Lanka to support domestic consumption. Remember that the January 2015 Budget reduced the price of 13 commodities of the food basket. Taking low inflation and slowing down of the growth, many economies have lowered the interest rates. In Sri Lanka, this has encouraged more consumption in terms of the purchase of vehicle and consumer durables rather than investment.There are challenges for monetary policy — on the one hand, slower growth and lower inflation favours interest rate reduction, on the other hand,

capital outflow and exchange rate depreciation calls for increase in interest rate. When balancing both, sometimes a ‘do nothing’ scenario is also possible — that is what we saw in Sri Lanka from April to December 2015.Close to $8.5 billion bond maturities in 2016 and new funding requirements for the budget deficit where there is already a heavy revenue leakage due to budgetary policy reversals, will put pressure on the interest rates to go up by anywhere between 50 to 200 basis points. Inflation gradually picking up and excessive pressure on the exchange rate to depreciate are the other two factors that will make the interest rates to go up.

Exchange rates depreciated by about 9 per cent in 2015. Will such trends continue?
The positive impact of lowering international commodity prices on the trade balance has been to an extent offset by low demand for the two main commodity exports that make up 14 per cent of Sri Lankan exports (tea and rubber) and the slow pickup of manufacturing exports due to overall slow growth of international trade. It has also been offset by the encouragement of domestic consumption by the public sector wage hike and lowering of import duties on motor vehicles after the 28 January Mini Budget. So the trade deficit has expanded.Low commodity prices have also led to slower growth in remittance flows to Sri Lanka where the growth of remittances flows has declined in 2015 compared to 9.5 per cent growth in 2014. Less prosperity in the Gulf

countries with lower oil prices means less demand for additional overseas labour which is reflected in lower remittances. The net result of all this is the widening of deficit of the balance of payments.

This in turn, puts pressure on the exchange rate to depreciate. You can prevent the depreciation by making use of your foreign reserves but it is counterproductive and unsustainable. That was why the rupee was given more flexibility in early September to move towards a more market determined value. Now if this policy is combined with a hike in interest rate there will be less pressure for the exchange rate to depreciate further in 2016, but if policy rates are held at its current level there is no doubt that the bulk of the adjustment burden of the economy will be on the exchange rate and it will depreciate further in 2016.However, it must be stated that due to the decline in export demand, currency depreciation is not going to make a major impact on export growth as the other competing economies have done the same.

Low inflation trends

Compared to July 2014, oil prices are 50 per cent lower – lowest since 2009.Slowdown in China is one factor for the decline in oil prices, but the key factor is the increase in global supply due to shale oil production in the US and planned lifting of sanctions on oil production in Iran (following agreement on Iran's nuclear proramme). The FAO food price Index stood at its lowest (since 2007) in mid-2015. Even metal, coal, etc prices recorded their lowest since 2009 in mid-2015. All indications are that global inflation will remain low in 2016 as was the case in 2015 due to low commodity prices and subdued global demand.

In Sri Lanka, however domestic factors will contribute to higher inflation in 2016 compared to that of 2015. After September 2015, both the year-on year and core inflation picked up partly due to the depreciating rupee and high consumer spending. If buoyant demand for consumer goods continues in the economy, there is bound to be a further price increase but a depreciating currency and possible hike in interest rate will curtail demand and keep inflation under control but certainly at a higher level than in 2015.

On space for further debt financing with global hike in interest rates:

Our debt service ratio is now above 20 per cent – it was 23.5 per cent in 2013 and 20.2 in 2014. When this ratio exceeds 20 per cent the country's external indebtedness becomes an issue. It becomes a major constraint on foreign reserves. During the past decade, without implementing economic reforms we kept on borrowing to roll over debt. This is no longer possible.2015 is a year that we engaged in the largest foreign borrowing to boost up reserves, viz., US$1.1 billion swap arrangement with India in March, US$650 million at 6.125 per cent in May, and US$1.5 billion at 6.85 per cent in October, which altogether amounted to US$3.25 billion. This type of borrowing can no longer go on with the global interest rates increasing after the US interest rate hike in December.

We faced a higher rate of 6.85 per cent for sovereign borrowing in October due to two key factors: (a) prevalent speculation of impending tightening of monetary policy in the US, and (b) Sri Lanka's sovereign rating not improving due to high debt and macroeconomic imbalances in the external and internal deficits. Given the high rates that Sri Lanka is facing for international sovereign borrowing and the high annual debt repayments, it is time to make a gradual shift from debt financed development strategy to more export oriented FDI strategy while also encouraging domestic demand. The third component is essential as export growth will not be significant given the sluggish growth of global trade. While doing such switching, Sri Lanka will have to consider signing a package with the IMF as the situation in regard to foreign reserves is going to be tight in 2016 with approximately $4.5 billion payment commitments during the year.

Major challenges for the local economy from the international front There are a number of challenges:
(a) We will have to work on obtaining GSP+ as the EU market is becoming increasingly competitive with its growthslowing-down;
(b) we will have to get the fisheries export ban in EU lifted;
(c) re-build Sri Lanka's economic relations with China and re-start the Colombo Port City project without further delay – keeping in mind that it is not the US or EU that can provide large infrastructure support for Sri Lanka, and it is countries like China that will do so, (d) move towards more value added products in tea and rubber given the sharp decline in international prices; (e) build deeper economic relations with both China and India – the fastest growing economies in the world with the proposed FTA and ETCA, respectively, and (f) with tightening of US monetary policy some of the foreign funds parked in Sri Lankan treasury bills and bonds will flow out, so will some funds from the share market. These outflows together with debt repayments and other foreign payments will put pressure on the exchange rate to depreciate. Such pressure could be minimised if Sri Lanka can attract new foreign funds in the form of FDI and new portfolio capital to the share market as well as by increasing the policy rates.

Major challenges on the domestic front.
There are two priority items: (a) Domestic resource mobilization has remained unsatisfactory for the last five years. Sri Lankan revenue as a percentage of GDP is only 13 per cent and we need to increase this to about 20 per cent in the next 3 years. Moreover, as in the Economic Policy Statement as well as the Presidential Taxation Commission of 2010 argued, the ratio of direct to indirect taxation should be reduced from the current 80:20 to 60:40. I am concerned that the Budget 2016 has not encouraged this turnaround as has been highlighted by various commentators. (b) Loss-making state-owned enterprises like CPC, CEB, Sri Lankan Airlines, etc have to be turned around either under a Performance Contract or Private Public Partnerships or Singapore's Temasek model or listing them in the share market. They are a huge drain on the economy in their present state of affairs and with the current high debt servicing costs, sustaining them is a huge problem.In addition, there are also other sectorial issues like: (i) the current state of Regional Plantation Companies, (ii) the growing informal sector in tourism without an effective regulatory framework, (iii) low productivity in the agriculture sector, (iv) growing traffic congestions in the roads, etc.
All these are challenges that need to be immediately addressed.