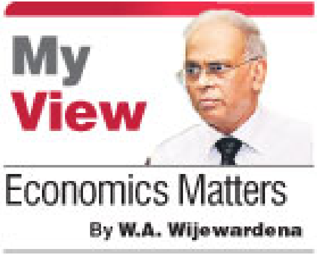
State of SL economy according to IPS: Grow but make it inclusive

Daily Financial Times - October 31, 2011

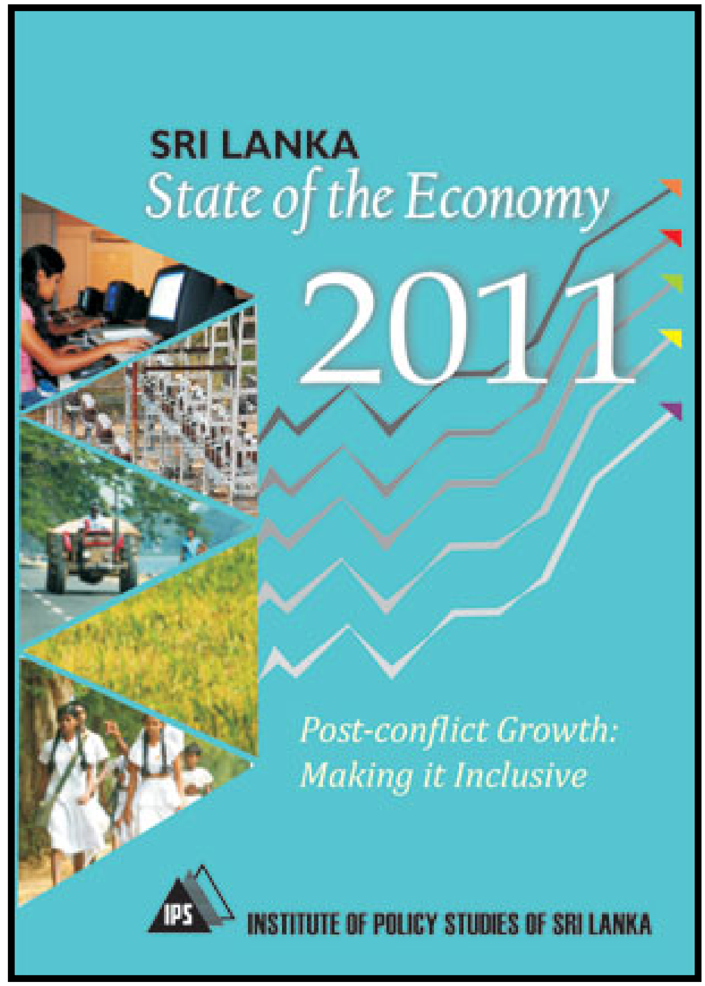


The Institute of Policy Studies or IPS has once again issued its annual assessment of the Sri Lanka's economy in 2011 six months before the Central Bank of Sri Lanka would do so in March next year.
Though the report contains a fair, constructive and elaborative assessment of the state of the economy, no adequate discussion has been made of the report in the mainstream business media and it appears that it has largely been ignored.

IPS mission: Give an independent view on policy

IPS was created in late 1980s with the support of the Dutch Government as an autonomous think tank that could conduct policy oriented economic research and evaluate the country's economic policy framework from an independent point of view.

This role in the country had long been played by the Central Bank of Sri Lanka which also functions as the fiscal and financial advisor to the Government. However, in doing so, the Central Bank was perceived to have an obvious shortcoming: the bank conducts two important policies, namely, policies to fight inflation and policies to stabilise the exchange rate and, therefore, it was felt that an element of bias could creep into bank's evaluation of its own policies.



This is because however much the bank may endeavour to conduct an independent and impartial policy evaluation, to an independent reviewer, it is simply an insider's view and not like an evaluation conducted by an outsider who has no interest in the bank's two policy functions. IPS, not being an institution charged with any policy, was, therefore, considered to possess the best qualification to evaluate the country's policy framework since it did not have ownership of or affiliation to any such policy.

But an independent reader may have the same doubt about IPS' ability to make an impartial evaluation of the country's policy framework on account of its getting a small amount of government funding for its upkeep and it being listed as an institution functioning under the Ministry of Finance.

Sri Lanka: The State of the Economy 2011

The State of the Sri Lanka's Economy 2011 just released by IPS has as its theme how the country should proceed with its economic growth after the end of the 30-year-old ethnic conflict with a special focus on the need for ensuring 'inclusive growth'. In its 2010 evaluation, IPS looked at 'Post-conflict Growth and Recovery'; hence, the 2011 evaluation is a further continuation of that analysis focussing on inclusive growth considerations.

To its credit, the Central Bank too in its Annual Report 2010 talked about providing social, economic and financial infrastructure for inclusive growth in a special box article in the Report. This article provided an excellent summary of the issues involved in the concept of inclusive growth and its main prerequisites.

But the bank did not have any particular theme for its Annual Report and, therefore, IPS' treatment of the subject is a novel idea for Sri Lanka's economic policy makers. Fifteen out of the 17 chapters in the IPS Report have been devoted to inclusive growth requirements: the importance of attaining inclusive growth in the country, how its accelerated growth could be made inclusive and the policy framework necessary for the country to ensure inclusive growth.

Since IPS does not compile its own primary data, its analyses and presentations have been based on the secondary data collected from other sources, mainly, the Department of Census and Statistics and the Central Bank of Sri Lanka. The Report has been prepared in the middle of 2011 and IPS, as in the case of the Central Bank, did not have the benefit of the full year data to make any worthwhile evaluation of the existing policies.

It has, therefore, overcome that deficiency by making its analysis and evaluation on the basis of the trend development of the economic sectors up to the middle of the year and using information and material on qualitative changes which the economy has undergone so far and the announced policies of the government for the future. This is a fair enough evaluation because any economic evaluation need not be confined only to what has happened in a given calendar year.

Inclusive growth: the latest catchword

Why should IPS talk about the need for ensuring inclusive growth at this point of Sri Lanka's growth momentum? There are many reasons, but let's look at the historical evolution of the concept and its place in current global policy making for raising prosperity of people in poverty stricken developing countries in the world.

'Inclusive growth' was not in the terminology of the economists who talked about the issues of raising prosperity of people in developing countries till about early 1990s. For them, a faster and continuous economic growth over a considerable period was the sure way to increase the prosperity and the well-being of the poverty stricken people in those countries.

Four East Asian countries, namely, Singapore, South Korea, Hong Kong and Taiwan had shown that a high economic growth in the region of nine to 10 per cent year after year for over two to three decades could ensure a sufficient build up of wealth and prosperity to elevate their people to enjoy a high living standard equal to that enjoyed by people in developed countries. Malaysia also with a similarly high economic growth rate was on its way to join this league within another decade or so. Hence, talking about inclusive growth was totally irrelevant.

Developing countries at large: No significant poverty reduction

However, many of the countries in East Asia and almost all the countries in South Asia and Africa had had a different kind of an experience. Despite the conscious efforts made to attain and sustain a high economic growth rate, these countries had had growth rates which were unimpressive when compared with the growth rates recorded by those fast growing East Asian countries.

With low growth rates, they could not reduce the prevalence of poverty too in their respective countries to acceptable levels. This led to social tension, political instability and violent military conflicts that in turn contributed to record further low economic growth in many of those countries. Thus, the high economic cost of economic growth becoming 'exclusive' was for the first time felt by donors, policy makers and multilateral lending agencies. The result was the coining of a new concept of economic growth called 'inclusive growth'.

Though the concept of inclusive growth was coined in mid 1990s, no attempt was made to precisely define what it is and how it works. This led to much confusion and many attempted to use the concept to describe several other aspects of deficiencies that had been created by normal operations in markets or social systems.

Thus, it was fashionable to call for adopting policies to rectify any economic or social development which had brought their fruits to some selected exclusive groups: Inclusive banking when the formal banking institutions catered only to a selected few and inclusive education when educational opportunities were available to some exclusive groups and so on.

Commission on growth and development

In 2006, the governments of Australia, Sweden, the Netherland and the UK together with the William and Flora Hewlett Foundation and the World Bank thought it fit to assemble a global think-tank of 22 leading academics, policy makers and business people from all around the world in the form of a Commission on Growth and Development under the chairmanship of the 2001 Economics Co-Nobel Laureate Michael Spence to study these issues and come up with suitable policy prescriptions.

The Commission was to study and report on how rising prosperity and expanded opportunities could solve several key global challenges that are pressing the global community today. These challenges are the rampant poverty, deteriorating environment, misunderstandings within and across the nations and vast differences in living standards within and across the countries.

The Commission released its report in 2008 under the title 'Growth Report: Strategies for Sustained Growth and Inclusive Development,' elevating inclusive development to the same status as sustained growth. According to the Commission Report, inclusiveness covers three important aspects relating to fair and just development: equity, equality of opportunities and protection of vulnerable groups when there are changes in employment and markets due to economic transitions.

The report also warned that 'systematic inequality of opportunities' is highly toxic to a society since it would derail the growth processes undertaken by countries through political channels and ensuing conflict.

Pro-poor growth is strictly not inclusive growth

Two World Bank economists, Elena Ivanchovichina and Susanna Lundstrom, following the Commission's definition of inclusiveness in growth have clarified in a note released in 2010 the concept of inclusive growth and how it differs from other popular concepts like 'pro-poor growth', 'broad-based growth' and 'shared growth'.

According to them, inclusive growth arises from both the pace and the pattern of growth of a country. The pace recording a continuous high growth will surely reduce poverty. The pattern which focuses on how diversified the economy is and the qualitative changes that take place in the economy enhances economic opportunities.

Pro-poor growth can be attained by giving subsidies to the poor people or giving government jobs to those who join the work force. But it does not ensure inclusive growth because such measures are not sustainable and it focuses only on the poor. Inclusive growth is providing productive and sustainable employment channels to both the poor and the middle class which too is sidelined in normal growth processes and therefore could become dangerous breeders of social unrest and tension.

Sri Lanka has gone through several of such violent conflicts in the last few decades mainly because of its failure to ensure equality in productive employment opportunities to all segments of the society. It has now come out of one such conflict after much pain and self-destruction. So, in the post-conflict growth strategies to be pursued by the country's authorities, inclusive growth should be the main focus of growth if the country is to regain social and ethnic cohesion and ensure sustained growth.

IPS, a critical but a constructive evaluator

IPS has made a critical, but constructive risk assessment of the state of Sri Lanka's economy today. Unlike the Central Bank reports which highlight only the good factors and praise all achievements in flowery language, the IPS Report has presented the other side of the story in a polite and subtle way so that the authorities could take timely action to avoid the pitfalls that lay ahead of their journey toward prosperity.

In comparison, the Central Bank reports are similar to the assessment of the academic achievements of a child by his mother who knows only the child's achievement and his efforts and strengths. The IPS report is like the assessment made by the child's teacher who knows both the strengths and the weaknesses of the child in comparison to those of other students and emerging trends in educational standards. But like a good teacher who does so without de-motivating the child or frustrating his mother, IPS too has presented its critical assessment on the state of the economy with a positive tone built into its analysis and evaluation throughout.

What are the critical factors that have been highlighted in the IPS Report? There are many, but due to the limitation of the space, only the important ones are assessed here.

Critical factors in IPS analysis

IPS has in fact praised the Government's efforts to raise the capital expenditure and provide the key infrastructural facilities to help the economy to kick start its growth momentum and attain a high growth. But it has two limitations in the medium to long term.

First is 'the relatively weak recovery of the private investments to take advantage of the country's new stability'. The second is the need for moving the government's current emphasis from infrastructure to the development of the technology base and knowledge transfer to raise productivity to ensure the long term sustainability of the current high growth momentum.

What IPS highlights is that the current public investment and infrastructure driven growth will fizzle out pretty soon unless the private sector initiatives and talents are harnessed. In the words of IPS, “here, private sector investment, and FDI especially, has a particularly important role to play”.

IPS report has also drawn attention to an unseen pitfall that may be created as a result of too fast credit growth in 2005-07. The credit growth resulted in “not only the unravelling of some important financial organisations and illegal ‘ponzi schemes’, but over-leveraging of households and firms”.

The result of this over-leveraging or in laymen’s words, borrowing beyond one’s capacity, was the increase in the bad loans of banks from five per cent in 2007 to 8.5 per cent in 2009. Hence, private sector credit may be increased through a liberal policy. But, such increases also impose unnecessary burdens on the banking sector in the form of an unexpected deterioration in the quality of loans.

Even the aggressive reduction in interest rates too brings about mixed blessings. The objective of the interest rates was to stimulate the private sector to borrow more and invest in productive investments which bring in additional output and employment. But this objective was partly defeated by the previously over-borrowed firms and households repaying old loans they had borrowed at high rates and locking them up in new low interest carrying loans. Hence, cheaper credit was less likely to provide the required stimulus in adding new production units to the economy.

The risks of foreign commercial borrowings

IPS has given credit to the Government for its commitment to reduce the budgetary imbalance which had plagued Sri Lanka for a long time. However, the new financing method of shifting from domestic financing to foreign commercial financing poses a severe risk to the economy in the form of rising exposure to external debt.

IPS has also drawn attention to the external debt indicators giving a misleading picture. Sri Lanka’s external debt to GDP ratio has shown a marginal decline from 36.5 percent in 2009 to 36.1 percent in 2010. But, IPS has noted that movements in the exchange rate have a clear bearing in the external debt indicators.

It has thus concluded that “an appreciating currency, as was the experience of the Rupee in 2010, helps to improve fiscal indicators by lowering the external debt to GDP ratio”. This is because, in laymen’s language, the rupee value of the external debt does not rise despite the new debt raised but the figure below the line representing the GDP in nominal terms rises faster due to the domestic inflation. Hence, naturally the ratio should decline and it is not a matter for complacence.

Is the Central Bank becoming irrelevant?

This type of critical analysis is salutary and essential for Sri Lanka to make appropriate risk assessment of the current state of its economy. IPS has therefore made a significant value addition to the raw data published by both the Central Bank and the Department of Census and Statistics.

Its publishing a critical review of the economy before the Central Bank publishes its Annual Report has satiated the appetite which the external users have for the country’s economic data and analyses of same. But, does this mean that the Central Bank has become irrelevant as the country’s prime storehouse of economic data? The answer is both ‘yes’ and ‘no’.

Yes, because IPS has come to the market well before the Central Bank and that presence in the market has been made with a critical analysis of the state of the economy. This is the type of the analysis demanded by both the domestic and external users of the country’s economic data.

No, because the Central Bank continues to provide a vast array of economic data collected from various sources in a single document, albeit its report is released after the IPS report not because of any inefficiency on the part of the Central Bank, but because it has comply with the Monetary Law Act by providing some selected annual and monthly data series.

As for inclusiveness, the Central Bank is more inclusiveness-friendly with its report being published in all the three languages and its report being the main subject matter of those students reading for the economics and business studies papers at the GCE Advanced Level Examination. The IPS Report which is published only in English lacks this inclusiveness, though its theme happens to be inclusive growth.

(W.A. Wijewardena can be reached at waw1949@gmail.com.)

You may also like to read

1. IPS releases 'Sri Lanka: State of the Economy 2011' report
2. Making employment count
3. Objectives of monetary policy
4. From poverty to sustainability in Sri Lanka
5. ADB's new Sri Lanka partnership to target inclusive growth