Sri Lanka
State of the Economy Report 2013

Chapter 16
Prospects

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16. Prospects

In January 2010, the IMF recognized Sri Lanka as a middle income emerging market, graduating it from the list of Poverty Reduction and Growth Trust (PRGT) countries. A country is considered ready for graduation from PRGT if it has an income per capita well above the IDA threshold for a number of years, shows capacity for durable and substantial access to international financial markets, and does not face serious short term vulnerabilities. Sri Lanka, at the end of a 30 year armed-conflict in 2009, having already crossed the per capita income of US$ 2,000 in 2008 subsequent to a continuous improvement over time, and with an IMF SBA facility approved in July 2009 was clearly in a better position to ensure a greater degree of economic stability in the medium term. Indeed, the country had already demonstrated international financial market confidence in the Sri Lankan economy as far back as 2007, with its first successful issuance of a US$ 500 million 5 year Sovereign bond.

> ***Sri Lanka has reasons to be hopeful for its long term growth prospects. A belief in reform and the strength of resolve to push them through will be the biggest hurdle to be overcome***

International experience suggests that graduation to a middle income status is the easier bit. Many countries in Latin America and the Middle East reached middle income status in the 1960s and 1970s. However, after the initial rapid ascent, the great majority have not made the transition to a high income status. In fact, it is estimated that only a handful of countries have done so successfully. A study by the World Bank indicates that of 101 middle income economies in 1960, only 13 countries – Equatorial Guinea, Greece, Hong Kong, Ireland, Israel, Japan, Mauritius, Portugal, Puerto Rico, South Korea, Singapore, Spain, and Taiwan – had managed the successful transition to a high income economy by 2008.[1]

According to thresholds set by the IDA, Sri Lanka with a per capita GDP of US$ US$ 2,923 in 2012 finds itself in the category of lower middle income

[1] Agénor, P., and O. Canuto (2012), "Middle-Income Growth Traps", World Bank Policy Research Working Paper 6210, World Bank, Washington, D.C.

and would need to cross a US$ 4,000 to be considered for graduation to upper middle income. It is the transition thereafter to a high income economy (approximately US$ 12,000 and above) that will be the most difficult. That, however, is too far ahead for serious analytical consideration. Of more immediate interest is the country's stated policy intension to double per capita GDP to US$ 4,000 by 2016, and thereafter to work up the ladder to an upper middle income economy. While it is helpful to set medium to long term economic goals, a targets-oriented approach must not drive policy to the exclusion of sound economic management.

After years of underachievement – witnessed by the relatively low growth economic equilibria that persisted for much of the conflict-affected decades – Sri Lanka seems set on a promising path in many ways, most notably with the dawning of both social and political stability, and significant government initiatives on the economic front – especially improving access to advanced infrastructure. If managed properly, the country and its people could see a prosperous period ahead in terms of rising living standards and the social mobility that comes with it.

When countries are growing fast there is a lot of absolute upward economic mobility. The changes emerging from these structural social changes would result in the formation of a potentially influential economic, social, and political middle class. This middle class is defined in both economic and political terms, and can often be a mixed blessing. A rising middle class can lead to a heavily consumption-led economy with repercussions for already strained resources. Yet, it can also be a necessity for further growth, especially driving demand in the services sector of an economy. The related social mobility that comes with a rising middle class is a key a factor conditioning its social and political behaviour. In turn, a large middle class can have a beneficent influence on a country's democratic institutions and governance structures. Thus, in many ways, a successful economic transition, and even development more broadly, requires the presence of a significant and stable middle class.

For a sizeable middle class to emerge, sustained economic growth and development is a must. In fact, studies indicate that economic volatility has detrimental effects on the formation of an incipient middle class.[2] For Sri Lanka, even as the economy is going through a tougher patch, the challenge is to manage a menu of economic reforms to boost confidence and raise investment and growth.

What could stop Sri Lanka on its march to growth? What is most worrying is the inexorable decline in the competitiveness of the country's manufacturing industrial sector, which has a direct bearing on growth. There have been sweeping changes in the world economy since the 1980s. Globalization, deregulation, and the IT revolution have brought about swift changes in trade, capital flows and production networks. Skill-biased technological change is a driver of productivity and economic growth in the new global economic landscape. For a country like Sri Lanka, undergoing a rapid demographic transition associated with an ageing population and dwindling numbers entering the labour force – at a comparatively low level of per capita income – the importance of productivity in driving growth cannot be overstated. This means equipping workers with the right sort of skills, within a context where

[2] Birdsall, N., (2007), "Reflections on the Macro Foundations of the Middle Class in the Developing World", Center for Global Development Working Paper, No. 130, Center for Global Development, Washington, D.C.

technological learning and research and development (R&D) are central to enhancing innovation.

To achieve more rapid growth Sri Lanka will need to introduce a series of economic reforms that will tackle major structural/supply bottlenecks. The critical initiatives needed include education reforms to enhance access to and the quality of education; reforming labor markets to reduce rigidities; deregulating and/or restructuring the public utilities sector, especially the energy sector; and overhauling the country's tax system.

These can be politically controversial and often painful reforms. But given that Sri Lanka at present has a political class with an enviable electoral mandate than at any time in recent history, a belief in reform and the strength of resolve to push them through will be the biggest hurdle to be overcome. Thereafter, the reform path will depend on persuading entrenched interests to accept them. The former, however, is the key: without leaders who really believe in what they are doing, it will cause good initiatives to fall at the last hurdle.

Without a reform effort, sustained economic stability will prove elusive. If the outlook for growth deteriorates, Sri Lanka will find it difficult to raise the volumes of financing needed for its long term physical and social infrastructure investments. Not only will there be a further deterioration of tax revenues, but access to all forms of foreign capital can either dry up or become exorbitantly expensive. Implementing tax reforms when the growth outlook for the country is positive is easier and more manageable than in a harsher economic climate. In the final analysis, a country that does not tax sufficiently to cover its spending faces the risk of eventually running into all manner of debt-generated trouble.

Instability on the growth front will also cause more volatility in the business climate. Indeed, Sri Lanka's private sector is yet to fully engage in the country's post-conflict growth revival efforts. To some extent, businesses have been fighting with one hand tied behind their backs. They have been subject to stop-go policies as the CBSL aggressively pushed private commercial banks to lower interest rates and support credit uptake by private entities in 2010. Consequent to emerging macroeconomic instability and corrective policy adjustments, the corporate sector was subject to a credit drought in 2012 just as the economy began to show sustained growth. By mid-2013, there are moral suasion attempts once again to persuade commercial banks to ease lending rates. Besides monetary policy swings, Sri Lanka's corporate entities, have also had to deal with significant uncertainty with regards to policy direction viz. the country's exchange rate.

Underpinning these developments has also been a trend towards greater state control over resources, including through SOEs, monopoly control of industries or through the financial sector. As the role of the state in an economy expands, it can often mean that the beneficiaries also tend to be close to state power. If the corporate sector is to play the role of a full partner in meeting Sri Lanka's post-conflict development aspirations, it must have confidence in the prevailing transparency and accountability mechanisms and rule of law in the country. Any weaknesses, if not effectively managed by deterring 'cronyism' that enriches insiders, can undermine the establishment of solid and durable institutions, and democratic governance and economic management in the country.

Sri Lanka has reasons to be hopeful for its medium to long term growth prospects. It takes time for results from recent investments in productive public investments that have passed cost-benefit tests to come through, and many such benefits have yet to materialize. These, coupled with the forces driving modern economies – technological innovation and globalization – benefit the skilled and educated of which the country has an aspirational young, urban and literate population. Given that skill-biased technological change can have a significant impact on wage dispersion, it is also encouraging that Sri Lanka is making strides in tackling poverty and inequality. Indeed, narrower income gaps themselves are more likely to spur both social mobility and future prosperity.

As Sri Lanka aims to revive GDP growth in the medium term in the midst of weak global growth, it must be recognized that monetary policy cannot fix problems in the real economy. Only policy changes affecting the real economy can address supply-side constraints to growth. Policy choices matter and the Sri Lankan economy is ready for reforms that are in fact overdue. The economic reforms made today will determine whether Sri Lanka will continue to enjoy rapid growth and stability, accompanied by a growing and stable middle class that will allow the country to successfully make the additional leap to become an upper middle income economy.