Sri Lanka
State of the Economy Report 2014

Chapter 13
Prospects

by
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13. Prospects

Over the past half-century, Asia has seen the most spectacular examples of economic development spanning from Japan to South Korea, Singapore and Hong Kong. In more recent decades, China and India have led the way as fast growing economies, spearheading Asia's seemingly relentless economic rise. While there seems little disagreement that Asia will continue to be a dynamic centre of global growth, the pace at which countries will grow to lay claim to a collective 'Asian Century' is debated. Indeed, some studies speculate on the possibility of two Asian futures: one that will see uninterrupted steady growth whereby Asia will account for a half of global GDP by 2050; the other, a less optimistic scenario where Asia will account for less than one-third of global GDP by 2050.[1]

The uncertainty relates to many factors: the pace of global economic recovery following the turmoil of the financial crisis of 2008, the appetite for reforms in Asian economies, the future of regionalism in Asia, and the risks from ever present political tensions amongst leading Asian countries.

Asia's fortunes are inextricably linked to that of advanced economies. This is because today's global economy is highly interdependent, with both broader and deeper linkages through trade, finance and production networks. Thus, despite growing intra-Asian trade volumes, the region still depends significantly on advanced economies to drive end-demand for its goods and services. A prolonged and weak recovery of the US and Euro Zone economies as they grapple with a relative economic decline post-2008, is not helpful to Asia's ambitions to see high and uninterrupted growth over the long-term.

External conditions are also closely aligned to country-specific reform agendas, necessary to sustain and drive growth in the face of ageing populations, rising wages and other costs. Indeed, the efficacy of such reform efforts will have a telling effect on whether today's aspiring Asian 'tigers' will emulate their predecessors in avoiding a middle-income trap. To avoid this pitfall, Asia has to navigate competition in export markets from other low-cost producers and yet catch up with advanced economies in higher value added goods and

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[1] ADB (2011), *Asia 2050: Realizing the Asian Century*, Asian Development Bank, Manila.

services. Asia's rising sense of regionalism - finding concrete expression in the proposed RCEP process, for example - may help the region to stay ahead of its competitors. It has, however, to address a litany of seemingly intractable disputes - the Koreas, Taiwan, Kashmir and the South China Sea are just a few - threatening to derail meaningful integration.

For Sri Lanka, the prospect of an invigourated Asia is clearly important as the country seeks new development partners, markets, and investors in its post-war economic expansion efforts. The most telling change in Sri Lanka's strategic political and economic relations over the last five years has been a strengthening of relations with China. On the economic sphere, a greater Chinese presence is immediately visible as the foremost source of external development finance behind many mega infrastructure projects in Sri Lanka. China is also increasingly becoming a key source of FDI through state-linked projects such as the Colombo port city expansion. A proposed FTA between Sri Lanka and China is expected to be signed before end 2014 as the next step forward in building a strong economic partnership.

Sri Lanka's growing economic relations with China has tended to overshadow the country's bilateral partnership with India. Whilst trade and investment volumes have strengthened, there has been no marked shift in economic cooperation since the aborted negotiations in 2008 to close a deal on a Comprehensive Economic Partnership Agreement (CEPA). India's economic star also waned in the interim as the aftershocks of the global economic crisis and domestic reform inertia took its toll on the country's growth prospects. However, with a new and confident 'pro-business' government in power, India's more recent dismal economic performance is expected to reverse. Regionally, the new government is also expected to provide stronger political and economic leadership to South Asia. This may bode well for any ambitions that smaller South Asian countries like Sri Lanka may have, to benefit from a larger Pan-Asian integration process.

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In other ways too, Sri Lanka is increasingly looking East. The development experiences, policies and institutions of its neighbours in Southeast Asia - such as Malaysia and Singapore - are being examined more thoroughly than ever before. An integral part of this 'learning curve' is not only to emulate the successes, but also to avoid the failures. For a country like Sri Lanka, this means not only pursuing policies that temper growth with sustainable resource management, but importantly, instituting reforms that enhance productivity in driving economic growth.

Reforms to raise productive growth in Sri Lanka are a must. The ADB (2011) study on 'Asia 2050: Realizing the Asian Century' classifies 49 economies into high income developed economies (7), fast-growing, converging economies (11), and slow or modest growth, aspiring economies (31). From the latter group, Sri Lanka is identified as a country that "exhibits the classic signs of the middle income trap".[2] The determinants of falling into a

[2] *Ibid*, p. 30.

middle income trap are many: demography, infrastructure, institutions, macroeconomic environment and policies, and economic structure are perhaps some of the most important.

Of the above, the clearest progress for Sri Lanka is on the infrastructure front. Notwithstanding a 'mixed-bag' of infrastructure projects, economically beneficial improvements are to be seen in ports, roads and energy sectors. Over time, these investments will boost productivity by enabling swifter movement of goods, as well as people. More immediately, it is creating jobs and boosting economic activity.

Sri Lanka could also point to a better macroeconomic environment and policies; these include higher GDP growth, improvements in broad fiscal indicators, a moderate inflationary environment, to name a few. But here, the headline numbers mask some troubling developments that suggest the lack of a serious attempt at reform. The most telling is fiscal reform, not least to increase revenues sufficiently to reverse a low and weakening revenue ratio. Fiscal constraints have been overcome by resorting to foreign borrowing to finance Sri Lanka's public infrastructure investment programme, exposing the country to a hefty external debt repayment schedule in the medium to long-term.

Central government fiscal consolidation efforts have also largely by-passed attempts to reform the state sector. Loss making SOEs are haemorrhaging funds, with spillover effects on other state entities, such as banks, impinging on productivity across the economy. Reforming the state sector is by no means an easy task. But it is all the more important for Sri Lanka as government efforts to stimulate the economy through infrastructure investment bring elements of greater state activity in the economy. For instance, state-run banks are raising development finance from abroad, and facilitating government directed lending. If the absorption of resources by the state - be it in terms of workers or finance - is not matched by revenue mobilization, Sri Lanka will not have the fiscal manoeuverability to address other critical areas necessary for sustained rapid growth.

One of these relates to the country's unfavourable demographics going forward. Increasingly, the state will have to support a larger population of elderly and pensioners. Sri Lanka's welfare net, inadequate at best, will need a serious revamp. At the same time, the contraction of the country's working age population will require higher and better quality investments in education and training to make this group of people more productive. The Asian tigers made the most of their demographic dividend by creating some of the world's best schools. With past investments in education and health yielding high human development indicators, Sri Lanka has been worryingly complacent so far. But with less than 15 per cent of 20-24 year olds engaged in tertiary education, reforms to improve access to and the quality of education remain a high priority.

Skills upgrading is a necessary prerequisite if Sri Lanka is to see a transformational change in the structure of its economy. Growth boosting infrastructure spending is skewing economic activity towards non-tradable sectors such as construction, mining, utilities and in services sectors such as tourism and retail trade. The related employment opportunities tend to be in low skilled services sectors with limited productivity gains for the economy at large. These employment opportunities may assist a country's structural transformation in the early stages, moving surplus agriculture labour to more productive jobs in services and labour-intensive manufacturing. In Sri Lanka's case, non-agriculture job creation has not been sufficient to decrease its overall share of employment in the economy which still stands at over 30 per cent. More such workers will have to be moved into more productive jobs over time, especially as the country's labour force growth slows.

Skills upgrading has to be matched by efforts to diversify, upgrade, and deepen Sri Lanka's production and export base. So far, the country has not seen any notable successes in drawing investments into manufacturing or high value services for export, with much of the FDI coming into leisure and mixed-development projects that bring little skills upgrading or technology transfer. Indeed, Sri Lanka's declining share of exports in GDP is a reflection of the fact that growth has depended much less on trade than on domestic consumption. This is to squander the country's post-war comparative advantages - a relatively stable political outlook for the country, improved infrastructure services, and a labour force that is still young and highly literate.

To sustain continued economic prosperity, Sri Lanka must institute reforms that will reallocate factors of production across sectors of different productivity. Here, the quality of a country's institutions matter. Incentives built into institutional structures determine whether they act more as rent seeking entities, influencing the allocation of resources, including physical and human capital. Weak institutional structures also lead to administrative confusion and entrench privileges of the political elite over time. In contrast, institutions, based on transparent rules and governance structures will help instill confidence in investors and businesses to undertake productive investments rather than in rent-seeking.

For Sri Lanka, stability tempered with modest reform has yielded some early gains. The prognosis for the near term outlook also looks positive. GDP growth remains robust at 7.6 per cent in the first quarter of 2014, with a moderate inflationary outlook, fiscal targets on track, an improving external current account position and a steady exchange rate. The slow pick-up in credit growth to the private sector - estimated at a low 2 per cent in June 2014 year-on-year - is the most pressing challenge in macroeconomic policy management.

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Further policy rate cuts could fuel a consumption-led credit spiral and/or encourage investments with low returns. As interest rates fall, so too might future inflows by foreign investors into Treasury bills and bonds.

Assuming that a prudent mix of monetary, fiscal and exchange rate policy will be used to manage and maintain macroeconomic stability, the other most obvious threat to the Sri Lankan economy in the near term is a potential external shock that holds ramifications for its exchange rate. Greater dependence on foreign sources of finance to bridge current and fiscal account deficits and a growing external debt portfolio on non-concessionary terms have weakened the country's ability to withstand and ride-out a significant external shock to the economy. A seemingly solid official reserves position - estimated at US$ 9 billion in mid-2014 - that would normally act as a bulwark against external shocks is another source of potential stress in view of its composition, made up almost entirely of borrowed funds.

Notwithstanding any unforeseen shocks to the economy, the short to medium term outlook thus far appears more assured than the long-term

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prognosis for the economy. Beyond the immediate headline macroeconomic numbers, the Sri Lankan economy continues to show skewed growth, high levels of external indebtedness, modest export earnings growth and limited private investor appetite to expand production capacity. These are reflective of underlying risks that can stymie Sri Lanka's ambitions to swiftly progress along a middle income transition - with plans already afoot to position the country towards a US$ 7,000 per capita income level by 2020. Lack of innovation and skills, low level of investments in technology, declining standards in education, rising labour costs and sluggish productivity growth are some of the weaknesses that threaten high and stable long-term growth. If these can be addressed through productivity-enhancing reforms, Sri Lanka stands a better chance of harnessing gains already made in infrastructure and socio-economic conditions to meet its interlinked goals of sustained economic prosperity and social harmony in the years to come.