GROWTH WITHOUT CONSUMPTION

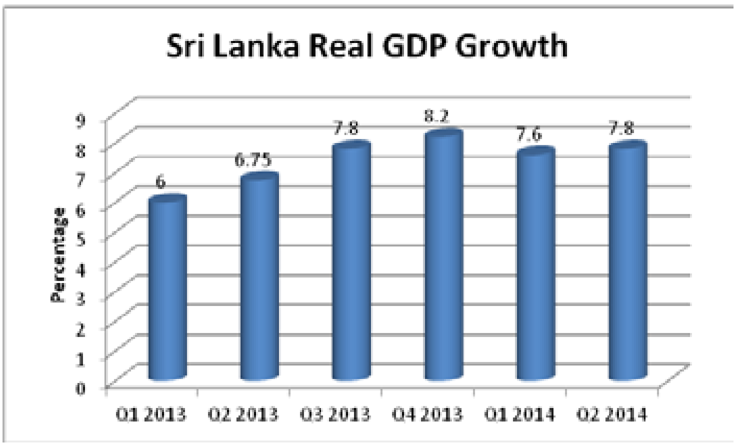
Deshal de Mel

Director, Sampath Bank PLC

Background

Having posted robust above 8% growth in the first two years after the end of the war, Sri Lanka's growth moderated to 6.3% in 2012. Growth recovered in the latter part of 2013, with growth in the third and fourth quarters recording 7.8% and 8.2% respectively, resulting in full year growth of 7.3%. This momentum has carried on into the first half of 2014, with growth of 7.6% and 7.8% in the first two quarters of the year.

Chart 1: Sri Lanka Real GDP Growth



Source: Central Bank of Sri Lanka data

Therefore, during the last 12 months, Sri Lanka has seen very strong growth, both by historical and international benchmarks. It has therefore been puzzling that this growth has not translated into significant improvement in demand for goods and services and eventually into corporate bottom lines. In fact, during the calendar year 2013, listed corporate earnings declined by 13%[1]. It is therefore important to understand the reasons for this incongruence between headline GDP growth numbers and the more tangible impacts of this on the general population, the corporate sector and the government.

A number of factors have contributed to this phenomenon observed over the last 12 months or so. These include a moderation in consumption, which in turn is influenced by weak private sector credit growth, limited growth in household incomes compared to GDP growth and the residual impacts of macroeconomic tightening measures in 2012.

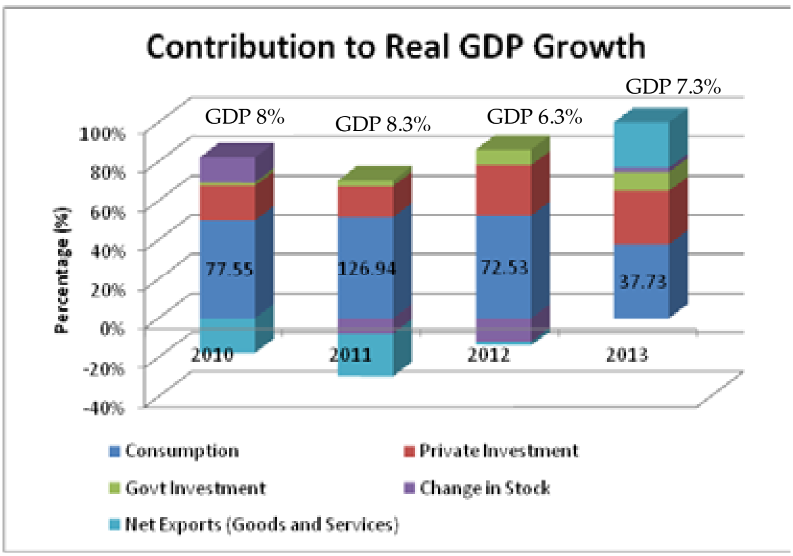
1 Capital Alliance Research, Corporate Earnings Update Q4 2013.

These developments have important implications for the banking sector, particularly those relating to low consumption and low credit growth. Lower inflation, lower interest rates and high levels of liquidity in the banking system have all contributed to a sharp decline in interest income and lower profitability. However, at the same time, in global markets interest rates are likely to begin normalizing from mid-2015, which could have knock on impacts in Sri Lanka as well in the medium term. In this context, it is important to understand the underlying factors influencing these recent developments and contextualize them to gain a fuller grasp of the operating environment for the banking sector in the medium term.

The Decline in Consumption

In most years that Sri Lanka has had strong GDP growth consumption has been one of the key drivers of this growth. As indicated in Chart 2, in high growth years 2010 and 2011, the major driver of this growth was growth in consumption. Private investment and government investment were secondary contributors. Net exports were a drag on GDP during these 2 years since high import growth resulted in negative net exports.

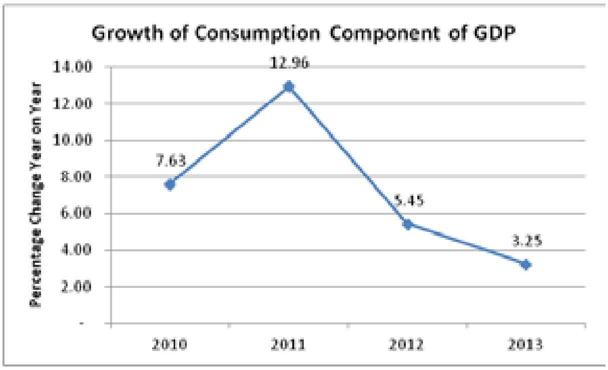
Chart 2: Contribution to Real GDP Growth



Source: CBSL data

In 2012 and 2013, this pattern changed. The contribution of consumption to GDP growth declined in both years, contributing just 38% to the increase in GDP in 2013. Furthermore, in 2013, the rate of growth of the consumption component of GDP was just 3.25%.

Chart 3: Growth of Consumption Component of GDP

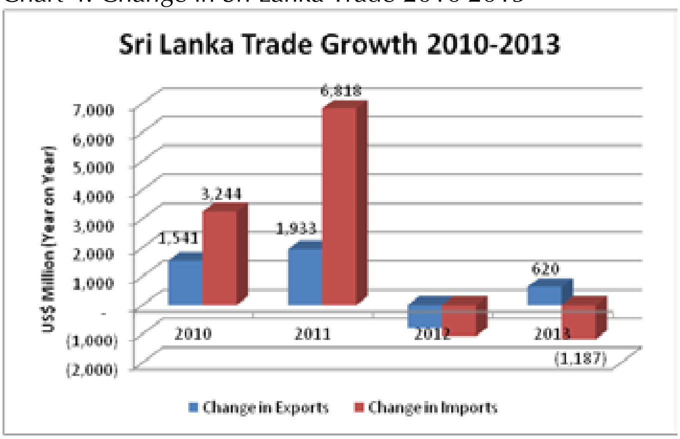


Source: CBSL data

In 2013 and to a lesser extent in 2012, Sri Lanka's headline GDP growth was driven largely by an increase in net exports, which in previous years was a major drag on GDP. The rise in net exports is a reflection of growth in exports, but more significantly by a contraction of imports. In 2013, exports increased by US$ 620 million whilst imports decreased by US$ 1,187 million (see chart 4). Lower imports are also a reflection of a decline in consumption and overall demand in the economy.

The limited consumption growth helps explain why despite strong headline GDP growth, this was not felt to the same extent by consumers and in corporate bottom lines. It is also necessary to understand some of the causative factors behind the dearth in consumption growth, to ascertain the likelihood of persistence of modest consumption.

Chart 4: Change in Sri Lanka Trade 2010-2013



Source: CBSL data

Some Causative Factors Behind Low Consumption

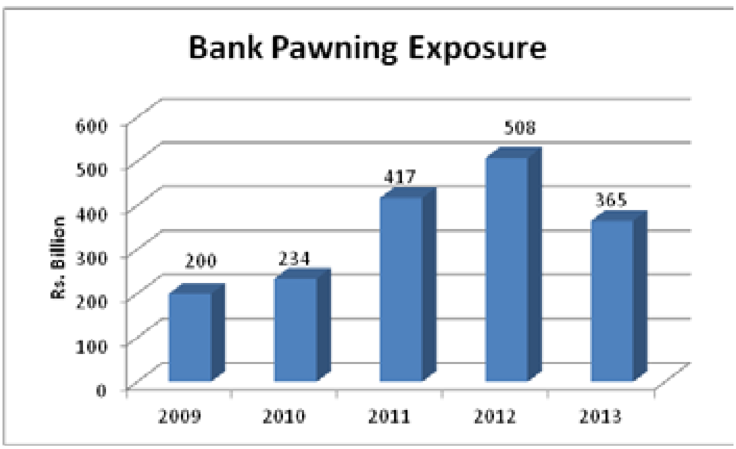
1. Pawning

One of the important developments affecting the banking sector in 2013 and continuing in 2014, has been the weakness in demand for credit. The decline in pawning has been the major contributor to this. Pawning is the practice of lending by using gold as collateral. This has been going on in Sri Lanka for many years, and has been an important aspect of financial inclusion since for most of rural Sri Lanka, gold jewelry has been the only plausible asset that can be used as collateral to access financial markets. The commercial banking sector had limited involvement in pawning until recently, when along with the rise in the price of gold, pawning increased exponentially.

Traditionally, the practice has been to lend up to around 65% of the value of pawned gold (loan to value ratio), and as the price of gold increased post 2008, the lending against gold increased significantly. As more banks got involved in pawning, competition increased, with the key element in competitiveness being the quantum of lending per sovereign. Accordingly, loan to value ratios also edged up beyond 85% in some cases.

This resulted in a massive expansion in credit due to pawning. In effect there was an approximately Rs. 300 billion monetary stimulus between 2010 and 2012.

Chart 5: Pawning Exposure

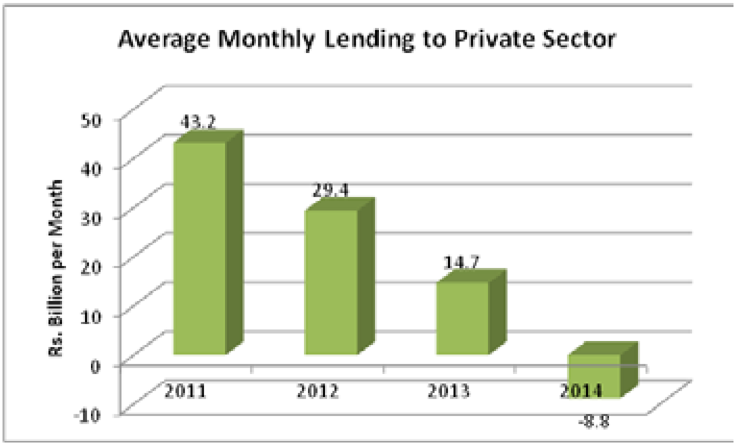


Source: CBSL data

Furthermore, a significant proportion of borrowing against gold is by lower income rural and agricultural communities, therefore much of this borrowing is for consumption, which has significant multiplier effects on overall aggregate demand as well. The period in which pawning expanded coincided with some of the sharpest increases in lending to the private sector. In the three years between 2010 and 2012, out of total growth in lending to the private sector of Rs. 1,156 bn, approximately 27% was due to growth in pawning. This would have no doubt contributed to the rapid rise in economic activity seen during that time as well.

With the crash in gold prices since 2013, lending against gold has declined significantly in Sri Lanka. This has been due to a decline in both the value of gold against which credit can be lent and a decline in loan to value ratios to past levels. As of mid-2014, there had been a further Rs. 150 billion worth of reduction in pawning exposure. The decline in pawning had a significant impact on overall lending to the private sector and would have had a significant impact on overall consumption in the economy.

Chart 6: Monthly Lending to the Private Sector



Source: CBSL data

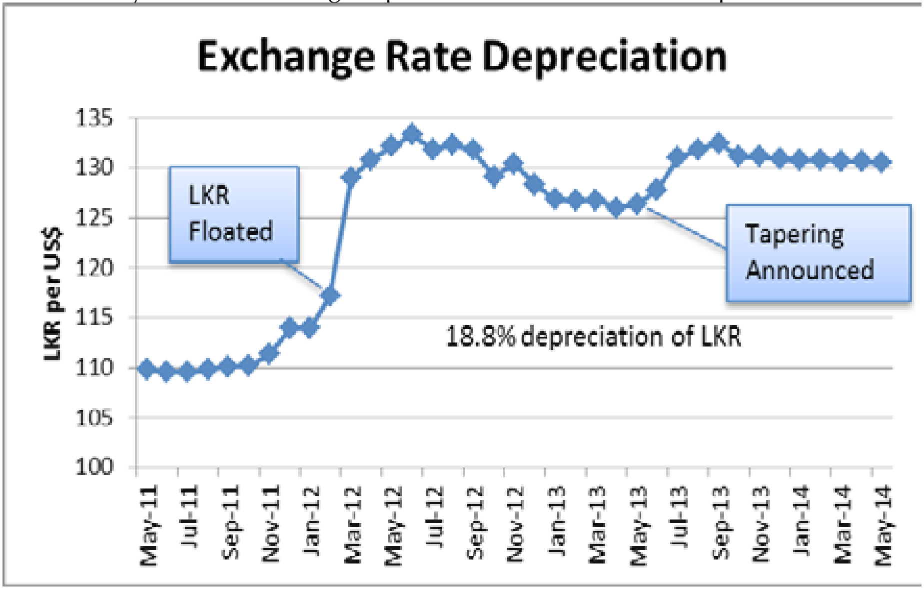
2. Impact of Macroeconomic Tightening in 2012

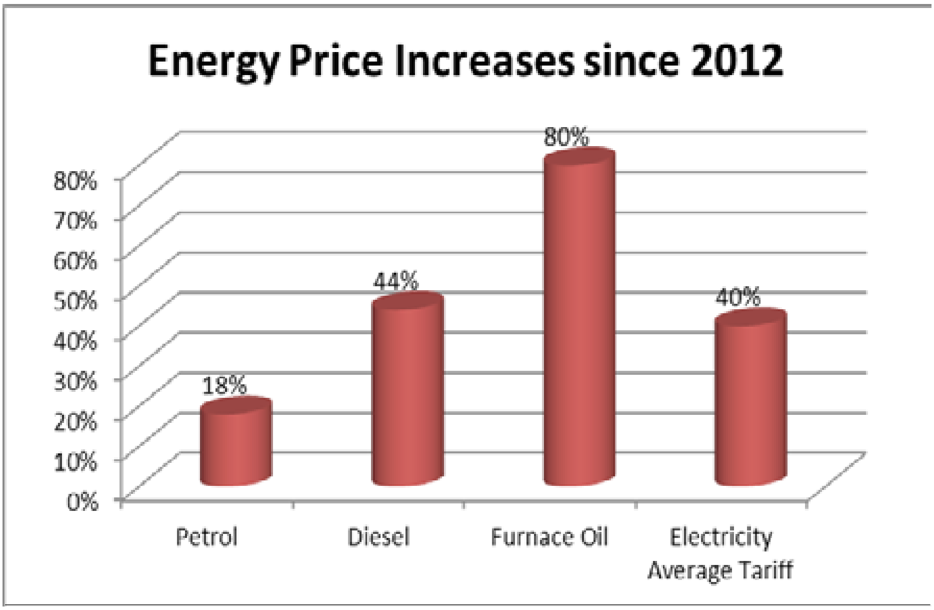
In February 2012 the Central Bank and Treasury instituted a number of measures to cool down what was then an economy demonstrating signs of overheating. With the widening current account deficit in the latter part of 2011, it was necessary to allow the Rupee to float in February 2012. This resulted in a significant depreciation of the Rupee. During the same period the Central Bank raised policy interest rates and imposed a ceiling on credit growth, resulting in higher cost of borrowing and lower access to capital. Fiscal tightening also took place at the same time, with energy prices being increased across the board in 2012 and 2013[2]. All of these factors would have combined to squeeze consumer disposable income through 2012 and leading into 2013, and would have naturally led to lower consumption as well.

---

2 In September 2014 electricity prices were subsequently revised downwards.

Chart 8: Key Factors Affecting Disposable Income and Consumption



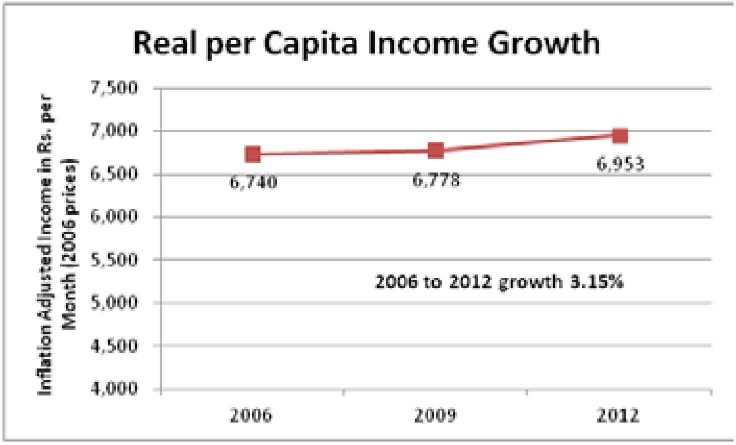


Source: Central Bank Annual Reports 2012/2013

3. Limited Growth in Household Incomes

Whilst GDP provides an indication of gross national product, it is not necessarily the case that a growth in headline GDP immediately filters down to actual income at household level. The Household Income and Expenditure Survey, conducted every 3 years by the Department of Census and Statistics, provides an alternative measure of per capita income. According to this survey, inflation adjusted household income has increased just 3.15% between 2006 and 2012.

Chart 9: Real Per Capita Income Growth



Source: Department of Census and Statistics – HIES 2012-13

In 2012-13 household income in real prices (2006 prices) was Rs. 27,115 per month whilst in 2006-7, real household income was Rs. 26,286[3]. This indicates that incomes have only just exceeded increases in inflation, and therefore there has been limited scope for real increase in consumption, other than through borrowing.

Other Implications

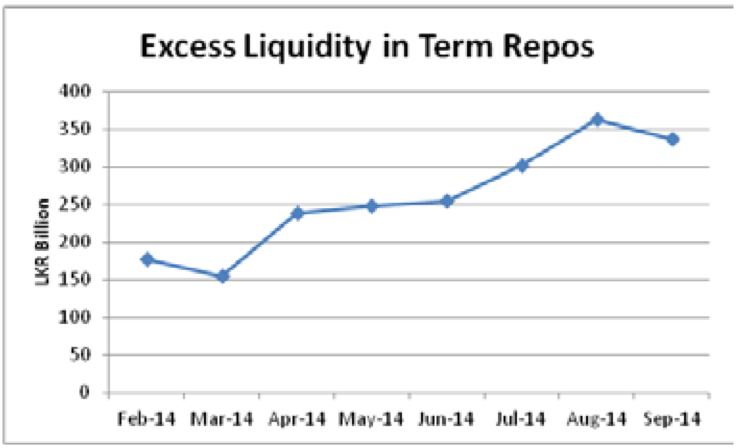
Whilst the decline in consumption has led to lower economic activity, it has also had some positive effects. Inflation has declined significantly from historical levels and it appears that inflation expectations have been anchored around mid-single digit levels. Accordingly, interest rates and interest margins have also declined to single digit levels. Lower import demand has also led to a decline in the current account deficit, which has eased pressure on rupee depreciation and has enabled the Central Bank to build up foreign reserves. Therefore, overall macroeconomic fundamentals have improved significantly. It remains to be seen the extent to which these macroeconomic improvements can be sustained if and when consumption growth picks up again. One negative impact on macroeconomic stability is the fact that consumption

3 Average household size in Sri Lanka is 3.9

based taxes account for around 80% of government tax revenue, and low consumption has contributed to a decline in government revenues in recent years. The government has managed to maintain fiscal deficit targets despite this, but spending on crucial areas such as health and education could be compromised by the difficulty in generating sufficient revenue.

The decline in demand for credit has also led to a significant build up of excess liquidity in the banking system. This has had substantial downward pressure on interest rates and has squeezed margins in the banking sector. As long as this excess liquidity remains in the market, it is likely that interest rates will remain low. To place this in context, in 2013, the total new loans to the private sector amounted to around Rs. 175 billion. This suggests that it will take several months to clear the prevailing excess liquidity of over Rs. 300 billion, keeping interest rates moderate. However, it should also be kept in mind that at the same time, global interest rates are likely to start increasing from 2015 as the US Federal Reserve begins normalizing rates. However, as long as domestic consumption remains low, global interest rates are unlikely to have an impact on the domestic market.

Chart 10: Excess Liquidity Parked in Term Repos



Source: CBSL data

Enhancing Productivity to Generate Higher Incomes

The pawning decline and energy price hikes are likely to have been transient issues. The deleveraging process from the pawning bubble appears to have come close to completion and energy price increases have also already begun to reverse, with a 25% decrease in electricity prices announced in September 2014. The more troubling issue is the fact that real income growth has been flat despite strong headline GDP growth. Consumption is unlikely to recover until real incomes start to increase.

Higher incomes are ultimately derived from greater output per capita. This entails a requirement for greater productivity. There are three key principles that could yield greater productivity – market based pricing, accountability and competition.

Market Based Pricing

There are a number of pockets of unproductive labour which have formed as a result of price distortions in the economy. The agriculture sector for instance employs 2.5 million people, or 30.6% of the labour force as of 2013. Agriculture as a sector accounts for just 10.8% of GDP. High subsidies and minimum prices given in this sector result in an inefficient allocation of labour into this sector, drawing resources away from more productive sectors. Whilst reforms to agricultural prices will not take place overnight, it would be prudent to gradually shift away from agricultural subsidies, such that resources in agriculture are focused in higher value agriculture that creates sustainable returns.

The same applies to employment in the public sector. This sector accounts for 1.3 million employees, or 15% of the labour force. Government services account for 6.5% of GDP[4]. These two sectors combined account for 46% of the labour force. Diverting more resources from these relatively unproductive sectors to exportable manufacturing and exportable services is likely to generate a significant increase in overall output per worker and therefore higher national incomes.

Whilst the above may appear to be incongruent with the principle of income distribution and egalitarianism, it is more efficient to deal with income distribution using targeted transfers rather than distorting market prices. Market price distortion results in inefficient deployment of resources which results in sub-optimal productivity which ultimately leads to lower incomes in the long run. The same principle applies to administered prices. The price signal is crucial for efficient allocation of resources and often leads to shortages or over-supply. Administered prices end up subsidizing the wealthy, since even those with higher incomes benefit from lower prices, whereas targeted income transfers do not have this issue. Prevailing technology has significantly reduced the administrative costs of such targeting.

Competition

Innovation, creativity and productivity thrive when industry is exposed to healthy competition. At present, several industries in Sri Lanka are protected from competition in an indefinite manner. Sri Lanka continues to have high tariffs on several imported products in sectors where the domestic industry is mature (for example shoe manufacturing). High tariffs on imported products result in higher costs for consumers as well.

4 Government owned business enterprises (including state banks, state energy utilities) may not be captured in this figure of 6.5% which deals government services. However, employment within these entities is a relatively small component of the 1.3 million government labour force – the majority of whom are in government services.

With regard to import substitution industries, if such industries require indefinite government support to be competitive, they are unsustainable and untenable in the long run. Resources would be more efficiently deployed if they were deployed in uses where Sri Lankan enterprise is competitive globally. The market should be allowed to determine this, however there is a case for investing Sri Lanka's factors of production (land, labour and capital) to make Sri Lankan enterprise more competitive.

Accountability

Another important element in encouraging productivity is to institutionalize accountability in both the public and private sector. In the private sector in Sri Lanka, the cost of firing workers is above average. As a result, it becomes more challenging to instill a culture of accountability. The severance cost for a worker with 5 years tenure is 54 weeks of salary, only lower than Sierra Leone (56 weeks), Indonesia (61 weeks) and Zimbabwe (65 weeks) according to the World Bank's Doing Business Indicators. A more flexible labour market would be conducive to business and make Sri Lanka a more attractive destination for economic activity. Reducing cost of severance would be a useful step in this regard. In the public sector, prioritizing greater accountability should start with public entities that are service providers to the economy. Public bodies which are responsible for providing approvals, testing services and so on, to private entities should institute performance monitoring, such as time taken for service delivery, bench marked against acceptable industry standards.

Conclusion

Cyclical effects and the prevailing low interest rates are likely to lead to an uptick in consumption in the coming months (late 2014). However, for a sustainable rise in consumption it is necessary to generate higher real incomes on a persistent basis. In addition to the points raised on productivity, it will also be necessary to generate investment opportunities, leveraging Sri Lanka's comparative advantages. There is tremendous potential in sectors such as logistics and tourism, which could be seen as low hanging fruits and could lead to benefits in the short term through creating job opportunities and generating income.

Therefore, the prevailing low consumption environment need not prevail for a prolonged period. It will be important for policy makers to ensure that the wins created in terms of macroeconomic stability can be maintained once consumption does pick up. However, to ensure a sustained growth in consumption and living standards, it will be necessary to enhance productivity on a sustained basis. This is what will lead to sustainable growth in real income and will thus enable higher consumption and welfare.

The views expressed in this paper are those of the author alone and do not necessarily represent the views of any of the institutions that he is associated with.