SRI LANKA'S ECONOMY IN A NEW POLITICAL PARADIGM

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Background

Between 2005 and 2015, a period which coincided with the end of the war and the resultant post-war economic boom, Sri Lanka was under the leadership of the Mahinda Rajapaksa led UPFA. During this decade Sri Lanka went through numerous economic transitions and there were many positives that emerged, particularly in the last 5 years. Sri Lanka moved out of double digit inflation and inflation expectations have been anchored within mid-single digit levels. This enabled interest rates to decline to moderate levels and capital markets to develop, enabling new financing instruments to help long term investment activity. There was also public investment in much needed physical infrastructure such as power and expressways.

Nonetheless, there were shortcomings as well. The fiscal situation deteriorated in important aspects whilst improving on certain measurements. Whilst debt to GDP and budget deficit to GDP figures improved, government revenue weakened and Sri Lanka became one of the weakest globally in terms of government revenue to outstanding debt ratio. Sri Lanka also failed to invest enough in social infrastructure such as education and health – for example, there was a 49% failure rate in Advanced Level sciences in 2014. The focus of the economy also shifted away from an outward orientation to an inward one – which is not feasible for a country of US$ 75 billion GDP and 20 million citizens. There was an emphasis on import substitution and naturally exports as a percentage of GDP declined significantly. Despite the end of the war, foreign direct investment did not increase appreciably. This was symptomatic of another important shortcoming, the deterioration of public institutions. A lack of transparency and simplicity in investment and general business procedure led to an increased culture of graft at several levels of government, which impeded economic activity.

Post-war growth story

With the end of the war in 2009 there was expectation of a re-bound in growth, which did indeed materialise. There was a boom in consumption, imports, and construction which held strong between 2010 and 2012. In the 5 years post-war, economic growth was dominated by the non-tradable services sector. Construction, wholesale and retail trade, transport, mining and financial services combined to account for around 60% of the increase in GDP during this period. Job growth was also weak with the employed population increasing by only 363,682 between 2010 and 2014 and household incomes grew at a far slower pace than GDP growth. The inability of the strong headline economic performance to translate into a concomitant improvement in household wealth and economic upward mobility would have played a role in the defeat of the UPFA government in 2015.

The spike in imports and resultant weakening of the balance of payments led to several macroeconomic tightening measures in 2012 which ended the consumption cycle until mid-2014. The new government which came into power in 2015 was fortunate to inherit the cusp of a fresh consumption cycle. Credit growth which had been anaemic through 2013 and 2014 began to pick up in Q4 2014 and accelerated in the first half of 2015. A lot of this lending was to the retail segment, with strong growth in vehicle leasing loans and other consumption related sectors. However, as has been the experience of history, this kind of credit fuelled consumption bubble usually leads to a weakening of the balance of payments, pressure on the currency and an increase in interest rates. This is the stage at which the incumbent government finds itself today. The credit fuelled growth enjoyed over the last 12 months will dissipate from 2016 unless it is replaced by a rebound in investment. This however requires some challenging reforms, particularly in the context of a national government where the two parties do not necessarily have substantial ideological congruence with regard to the economy. The UNP, which one assumes leads the economic agenda of the national government, has laid out its economic framework in their 60 month plan for the country. This paper will attempt to unpackage the elements of this manifesto and determine whether it is in line with the steps that need to be taken to place Sri Lanka on a sustainable growth path.

Global market integration

Market access - The emphasis on the UNFGG's economic manifesto is the creation of a million jobs by tapping into global markets. Reference is made to re-establishing GSP + and entering into trade agreements with the US, China, India and East Asia. GSP+ will be a welcome short term relief for exports that have remained stagnant in the first half of 2015. However, GSP + will be only a short term relief and not a long term solution to the export malaise, which will not be found through non-reciprocal trade preferences. New trade agreements as well will be helpful in acquiring market access, particularly in the context of many of Sri Lanka's export competitors (such as ASEAN and South Asian countries) already having access to East Asian markets. It is essential that these agreements touch real barriers to trade such as para tariffs, non-tariff barriers and achieve mutual recognition agreements on standards. However market access alone will not be sufficient in building export capacity.

Competitiveness - The manifesto also refers to enhancing competitiveness of local enterprise with a view to connecting SMEs to global markets to supply goods and services. Not a lot is said about how this competitiveness can be achieved. Global experience suggests that competitiveness is optimised in an environment where there is healthy competition and accountability. In Sri Lanka we still have a lot of industries being protected from competition over prolonged periods of time, with high tariffs on imported competition. Such conditions are not conducive to building the competitiveness that is needed to succeed in global markets. Competition motivates innovation and constant improvement in order to provide consumers with a better product or service at an acceptable price. In protected industries these motivations are dampened, and therefore the ability to create products and services that will thrive in a global market place is limited.

Exposure to competition is not something that should happen overnight, but occur in a gradual manner, to enable local producers to adjust to a new environment and to develop sufficient safety nets to minimise the ill effects of increased competition.

Export oriented FDI - In addition to competitiveness, it is also necessary to have access to technology and knowhow to create products or services in demand and access to the relevant entry points in these markets. A short cut to achieving this is through FDI in export-oriented manufacturing, agriculture and services. Such FDI would bring with it the technology and knowhow and access to its existing distribution networks in target markets. Sri Lanka will not be able to position itself as an export manufacturer on a large scale or at low cost, therefore it will likely be in niche segments in certain parts of the manufacturing value chain. The biggest advantage that Sri Lanka has is its location and logistical advantage, particularly with regard to the Indian sub-continent.

To take a hypothetical example, there could be a German manufacturer of vehicle components that it exports to India from Germany, catering to the South Indian motor vehicle industry. That manufacturer could be approached to set up an operation in Sri Lanka for a component that say requires natural rubber (which is available in Sri Lanka), taking advantage of Sri Lanka's logistical advantage in reaching the Indian sub-continent. A Sri Lankan manufacturer trying to achieve the same objective would probably take far longer to achieve the technical capacity and market entry to achieve a comparable level of exports.

The manifesto makes reference to the need to attract FDI and intention of creating 45 economic development zones with a view to attracting investment. That these zones will have facilities comparable to those of East Asia is also mentioned. The latter point is crucial, particularly with regard to quality of infrastructure and access to factors of production. There remains much to be done with regard to infrastructure development, and given the government's increasing fiscal bind, it will become essential to develop a robust framework for public private partnerships for infrastructure development. This requires a transparent, competitive and simple governance framework outlining the rules of the game for PPPs. Furthermore, PPPs could be another major source of enhancing FDI into Sri Lanka, and develop infrastructure without over-burdening public finances.

Creating economic zones alone will not lead to an increase in FDI. The process of investment needs to be transparent and simple, with minimal room for discretion and thus graft. For example with construction permits, there are still a multitude of approvals required at different sub-national government levels, much of which can be reduced, automated and further simplified. The BOI needs to be empowered to fulfil its envisaged role. Furthermore, promotion of FDI opportunities needs to be carefully targeted (for example targeting companies that fit profile of the hypothetical German vehicle component exporter to India). It is positive that the role of Sri Lankan foreign policy is being re-positioned to fulfil the objective of improved economic diplomacy.

Agricultural exports - The creation of agricultural export zones is also mentioned, along with appropriate objectives such as developing higher value agri-exports, floriculture, animal husbandry and developing extension services. However, the entire structure of agriculture would need to be reconsidered with this in mind. At present, Sri Lanka has highly protected agriculture that results in a lot of resources being absorbed by the sector to produce agricultural products that Sri Lanka is not necessarily globally competitive in producing. As a result, these activities do not lead to optimal returns to labour and capital engaged in such activity. In the longer term, agricultural policy would need to be shifted from a focus on the protected domestic sector to entering global export value chains, which would entail a gradual reduction of across the board protection, with the appropriate safety nets and re-skilling for workers. Like other types of higher end exports, agri-exports require technology, knowhow and access to markets, where again the role of FDI or foreign partnerships would be supportive. Agri-biz in countries such as Israel have achieved significant progress in agricultural technology, and Sri Lankan agri-exporters could benefit from partnering with such entities.

Diaspora - To help develop market access for Sri Lankan exporters in general there are several steps that would be useful. Sri Lanka has an extensive diaspora population, and this is an extremely useful resource given the international business network that can be leveraged. The success of India's software industry has a lot to do with the role of Non-Resident Indians of Silicon Valley, San Fransisco. In Sri Lanka, the word diaspora carries a lot of negative baggage and it only benefits usually being seen as a source of remittances. However, the untapped business network advantage of this community is substantial. By creating platforms for engagement between Sri Lankan exporters and relevant segments of the diaspora community, exporters would be able to gain valuable access to distribution channels, product development teams and so on in companies in target markets.

The government in recent months has been encouraging members of the diaspora community to return to Sri Lanka, and this is also a positive. However, the ground conditions are still not conducive for such a return. For example, a spouse of a foreign passport holder is unable to work on a spouse visa, foreign nationals are not allowed to own freehold land, and so on. Such restrictions could be eased, at least for expatriate Sri Lankans, in a manner similar to what has been done for NRIs in India. At the same time it is also necessary to enhance the capacity of the commercial arms in Sri Lanka's foreign missions overseas. These stations need to be manned by professionals with expertise in marketing or business development, and include local staff who can help break language and cultural barriers and help build networks among the business community in that country.

Education

The entire narrative on shifting to a higher skill, higher technology oriented economy, rests on the assumption that enterprises will have access to a skilled labour force. Sri Lanka has had a history of good access to education at primary and secondary level, resulting in excellent literacy rates.

Unfortunately, Sri Lanka has also become complacent on education based on these positives metrics. Outcomes in secondary education are weak and access to tertiary education is extremely poor at around 10% of those who qualify for admission. The manifesto makes some constructive proposals including improvement of school facilities, limiting class size to 35, adding technical and vocational skills to Advanced Level subjects, emphasis on English language education, and shifting away from an exam-centric education system.

There isn't much elaboration on the final point, but what is needed is an education system that encourages creativity, challenging norms, problem solving skills and the ability to learn independently. It is these skills that help derive a work force that is innovative, capable of adapting to the needs to economy and the ability to solve the problems of tomorrow. It is also necessary to foster a spirit of entrepreneurship, which needs a change in social expectations among parents and to eradicate the fear of failure among students. All of this would require a comprehensive overhaul of existing syllabi and extensive teacher training. It is commendable that the government intends to increase education spending to 6% of GDP, however it would be more constructive to focus on targeted outcomes rather than a monetary figure as has been done. There is also a case to be made for a better mix between private and public delivery of education, to enhance competition within the sector to create the best opportunities for students. This would also help create greater demand orientation in terms of supply of education. The manifesto mentions a number of subject areas for university education and vocational training, however unless these are in line with market demands of the future, it would not be a productive use of resources.

The manifesto also touches the importance of pre-school education, which ought to be seen as an area of priority for two reasons. First, early childhood development plays a crucial role in future learning outcomes, and therefore this segment of education warrants investment and assurance of quality. Secondly, the prevailing lack of sufficient pre-school facilities is one reason why women tend to drop out of the labour force. Current statistics (June 2015 DCS Labour Force Survey) indicate that the labour force participation rate among women is just 36%. This is influenced by the fact that women tend to leave the labour force during child bearing age due to difficulties of managing both activities. Improved pre-school facilities will reduce this negative effect. Other steps ought to be taken to enhance the participation of women in the labour force, such as subsidisation of maternal leave costs, encouraging greater participation of men in child care activity with concomitant paternity leave, and flexible working conditions for women during child bearing age (work from home options).

Labour

The low rate of female labour force participation is one negative factor that contributes to a low overall labour force participation rate in Sri Lanka (54% as of June 2015). This shortage of labour acts as a constraint for Sri Lankan enterprises looking to expand. There are other factors as well, such as the large number of workers that are absorbed by the public sector.

The total public sector work force is around 1.4 million, and this is not only a significant burden on public funds, but it also draws away resources that could be used by the private sector. The manifesto suggests further incentives for public sector workers such as low cost housing loans. Measures such as this could have unintended consequences since they indirectly increase the cost of labour for the private sector who have to provide comparable monetary/ non-monetary incentives to compete to attract workers. This in turn makes Sri Lankan enterprises less competitive with regard to global competitors and harms export prospects.

In the longer term it is necessary to gradually free up public labour resources for use by private enterprise and the manifesto's stated intention to train military personnel with alternative skills is a step in the right direction. In the interim, it is necessary to optimize productivity in the public sector by enhancing service accountability. Tools such as citizen report cards can be deployed to measure performance and certain elements of pay could be linked to this as well. Even with regard to the private sector, whilst the government has requested a Rs. 2,500 pay rise for the private sector, it would be best if this is linked to a measure of productivity in order to maintain market based competitiveness of these enterprises.

Safety nets

What is proposed as a way forward for the Sri Lankan economy would entail a structural shift in the economy's orientation. This in turn would create shocks that would tend to have an asymmetric detrimental impact on the most disadvantaged in society. It is therefore necessary to implement robust safety nets to help absorb such shocks. The manifesto makes reference to the de-politicisation of Samurdhi, which would be an important first step. An effective targeting mechanism with transparent selection processes will help ensure that funds are allocated to the most needy. This would also help phase out the undesirable practice of fixing maximum and minimum prices of products as a means of welfare distribution. Tampering with the market price signal is a highly inefficient and detrimental way of welfare distribution and this should be replaced by direct cash transfers for those who are disadvantaged.

Another important aspect is the improvement of financial inclusion. Disadvantaged people and small businesses often lack the asset base to obtain loans from financial institutions. An important step in overcoming this is to improve financial reporting in the country. At present, financial reporting can be unreliable, making it difficult for banks to lend on cash flows and instead seek refuge in assets as collateral. It is important that accounting bodies take steps to improve the quality of financial reporting assurance to improve the overall standards of financial reporting. Furthermore, a more robust credit information system would also help lenders better ascertain creditworthiness of borrowers and facilitate lending decisions to suitable borrowers. The CRIB could leverage data analytics and use big data to understand consumer/business spending/borrowing behaviour from credit card patterns, utility bill payments and so on to provide useful information on credit worthiness which would act as a public good, enabling more effective financial inclusion.

Conclusion

Many of the necessary reforms including public sector reform, trade policy reform (particularly import liberalisation), agricultural reform and so on, are politically challenging. However, in the context of a national government, in spite of ideological differences, there is a chance to implement some of these. A key to success of the reform programme would be appropriate packaging and communication of this agenda, identifying winners and losers and addressing them appropriately. A failure to communicate the long term benefits of some of the challenging aspects will lead to a political backlash which would undermine the entire process.

Reference

- Labour Force Survey 2014, excluding North and East in order to compare over time.