Spotlight: Econ Op-eds in Summary

Week ended 12th May '21

In Summary

The underneath contains summaries of the articles given above, including key extracts from these articles.

1. Investment efficiency crucial for post-pandemic economic recovery
By: Professor Sirimevan Colombage

- COVID-19 led to the country recording its deepest recession since independence and crippling other economic indicators with subsequent lockdowns being implemented. Despite this the real GDP growth is expected to rebound to 6% in 2021 by the CBSL, an optimistic target which could only be achieved through the improvement in investment efficiency which has been low in the country.

- The low investment efficiency is an outcome of several factors. A main reason would be that the rates of return on some of the major infrastructure projects such as highways are not immediately transmitted to production increases. Huge debt-funded investment allocated for certain less-productive public infrastructure projects in the recent past is also a matter of concern.

- However, it is not an easy task to improve investment efficiency at this critical stage, given the country's long standing less-efficient production structure and the pandemic-hit economic activities. As such companies must invest heavily in R&D in combination to the CBSL maintaining debt sustainability to be able to lift up the economy.

The outbreak of COVID-19 pandemic has caused severe adverse effects on the Sri Lankan economy, which had already encountered multiple economic setbacks even before the pandemic. These include low economic growth, fiscal and balance of payments deficits and excessive debt commitments. The lockdowns and mobility restrictions imposed to prevent the spread of the pandemic have aggravated these economic problems.

The economy contracted by 3.6% in terms of real Gross Domestic Product (GDP) in 2020, recording the deepest recession since independence. Sri Lanka continues to remain in the lower-middle income country category, as her GDP per capita declined to $ 3,682 in 2020 from $ 3,582 in the previous year as a result of the economic contraction and the rupee depreciation against foreign currencies.

The real GDP growth is expected to rebound to 6.0% this year, and to reach 7.0% by 2025, as per the medium-term macroeconomic framework presented in the Central Bank's Annual Report 2020. Given the subsequent waves of the pandemic and the country's inherent growth constraints, the targeted economic recovery seems to be over-optimistic.

It should be emphasised here that the country's low level of investment efficiency in the past has had detrimental growth effects, and as a result, GDP growth had remained low even before the pandemic. An improvement in investment efficiency, therefore, is essential to attain the envisaged post-pandemic economic recovery.

Low investment efficiency in public sector projects

The conventional economic theory implies that investment generates high economic growth. Public infrastructure investment in developing countries, in particular, is expected to drive high economic growth since inadequate infrastructure is often viewed as a key bottleneck to economic progress.

Nevertheless, there is wide disagreement about the contribution of infrastructure investment on economic growth. Several empirical studies have found insignificant or negative impacts of infrastructure investment on growth possibly because public investment in developing countries often fails to generate productive capital due to corruption and the presence of "white elephants".

A dollar's worth of public spending often does not create a dollar's worth of public capital, as argued by development economist, Lant Pritchett (1996). That means productive capital is sometimes not created at all. Even the created productive capital may be subject to implementation weaknesses and/or operational inefficiencies raising the cost higher than the minimum required to build the capital.

Thus, a country's GDP growth depends not only on the size of investment but also on the quality or efficiency of investment.

Sri Lanka's low investment efficiency

An economy's investment efficiency or rate of return on capital can be measured by using the metric called the incremental capital-output ratio, abbreviated ICOR, which is the ratio of investment to GDP growth. It is equal to the reciprocal of the marginal product of capital. The higher the ICOR, the lower the investment efficiency. In other words, lower score of ICOR implies that investment is more efficient.

In the case of Sri Lanka, ICOR rose continuously from 2.99 in 2011 to 5.57 in 2019. This indicates that Rs. 2.99 worth of investment was needed to generate Rs. 1 of additional production in 2011 while Rs. 5.57 investment was needed for the same amount of additional production in 2019. This implies that the Sri Lankan economy has become less efficient in using capital.

The low investment efficiency is an outcome of several factors. A main reason would be that the rates of return on some of the major infrastructure projects such as highways are not immediately transmitted to production increases. Huge debt-funded investment allocated for certain less-productive public infrastructure projects in the recent past is also a matter of concern.

Prior project evaluation procedures would have prevented such inefficient investment. Cost escalation due to administrative irregularities including corruption too would have reduced investment efficiency to a certain extent, as discussed above.

Less-productive investment allocation

The bulk of the gross domestic capital formation (GDCF) is allocated in less-productive sectors such as construction and transport equipment. Investment in the construction sector accounted for 43% and transport equipment 14% of GDCF in 2020.

A similar pattern can be seen even with regard to Foreign Direct investment (FDI) of the enterprises under the Board of Investment (BOI). Housing, property development, shop office, and hotels and restaurants accounted for nearly 50% of FDI inflows in 2020. This indicates the poor quality of FDI which fell by 42% to $ 687 mn in 2020.

In contrast, fast-growing countries heavily invest in the production processes with greater knowledge-inputs, and such investment helps to improve production efficiency.

Investment in Research and Development (R&D) is essential for innovation of knowledge-intensive products and to move the country towards a knowledge-driven economy.

SL caught in middle-income trap

The concept of "middle-income trap" means that it is easier for a country to climb from a low-income to a middle-income economy than to make a big jump to a high-income economy.

Sri Lanka graduated from the low-income status to the middle-income status in 1998 taking advantage of the high investment efficiency emanated from the initial wave of economic growth. Low wages prevailed during the 1980s and 1990s made the economy more competitive for labour-intensive and low-tech manufacturing industries, mainly apparel industry. The resulting increase in export earnings provided a major impetus to surge economic growth up to around 2000.

Since then, the economy has continued to rely on low value added and low-tech industries, and as a result, the initial wave of economic growth ran out of steam. Eventually, a considerable deterioration in investment efficiency has been evident since 2001. As explained earlier, heavy concentration of investment in low knowledge-based sectors such as construction depressed the prospects of economic growth.

The average annual GDP growth was only 3.9% during the pre-pandemic period of 2013-2019, largely as a result of low investment efficiency. Thus, the pandemic alone is not responsible for the country's growth slowdown.

Debt commitments of inefficient projects unbearable

Some of the major infrastructure projects implemented by the Government since the cessation of the conflict in 2009 were funded through heavy borrowings from foreign capital markets at commercial rates. These projects have not helped much to generate adequate production or export earnings due to poor investment efficiency. Hence, the Government now faces severe problems in repaying those maturing debts.

The total debt service payments exceeded Government revenue by 142% in 2020. Interest payments alone account for 72% of the revenue reflecting the gravity of the debt burden. Foreign debt service payments absorb one third of the country's export earnings thus making the balance of payments extremely vulnerable.

How to improve investment efficiency?

It is not an easy task to improve investment efficiency at this critical stage, given the country's long standing less-efficient production structure and the pandemic-hit economic activities.

The old-styled manufacturing ventures dependent on cheap labour and backward technology would not be sufficient to accelerate GDP growth. Labour and capital have to be used more productively, and in this regard, creativity and innovation become critically important.

An entirely new modus operandi of production process is required. Companies need to invest heavily in R&D to innovate high-tech products with own brand names, instead of merely assembling foreign products using imported technology and foreign capital.

Sri Lanka would have been in a better position to tackle the economic fallout from the pandemic, had it achieved technology and innovation-driven growth by means of a knowledge-based economy.

Looking forward, the COVID-19 pandemic has provided an opportunity to reprioritise the development activities so as to improve investment efficiency and thereby to promote economic growth.

Whilst accelerating economic growth along those lines, sufficient attention should be given in the post-pandemic economic strategies to ensure macroeconomic stability so as to reduce the twin deficits in the fiscal sector and balance of payments keeping debt sustainability on top of the economic recovery agenda.

For the full article – Refer The Daily FT

2. Reviewing a lost year and expecting an economic revival
By Nimal Sanderatne

- Last year has been a challenging year for Sri Lanka as the local and global priority was to avoid an economic disaster which seemed inevitable. Manufacturing, construction and agriculture industries were significantly affected in Sri Lanka and its GDP per capita, size of economy and per capita income all fell significantly compared to 2019

- However, the country's export industry showed resilience through diversifying into PPE, gloves and masks. Import expenditure was reduced due low global oil prices and extreme import restrictions. Despite an improvement in the trade account, the BOP deteriorated mostly due to the net capital outflow.

- Despite these negative indicators the Central Bank seems to have an optimistic outlook on the economy based on the prospect of a global economic recovery that would enhance the country's exports and revive global travel and tourism. This is unlikely with the increasing spread of the virus in the country as well as its spreading in other parts of the world. As such, appropriate policy responses that should be put in place that would mitigate the global and local setbacks and the economy should find ways and means of increasing production in the country.

Global context

In March 2020 the COVID-19 pandemic struck the world economy in numerous ways. The containment of the pandemic became the foremost priority to avoid a precipitous global economic downturn that seemed inevitable. Global economic growth fell sharply.

This global context impacted heavily on Sri Lanka's export and tourist dependent economy. Sri Lanka's economic growth shrunk by 3.6%, employment and incomes fell drastically and poverty increased.

In the words of the Annual Report "Mobility restrictions and other containment measures imposed locally and internationally, with a view to preventing the spread of COVID-19, hampered real economic activity across all sectors."

Three sectors

There was a sharp contraction in the industry due to a significant slowdown in manufacturing and construction. Services contracted sharply and agricultural production fell despite favourable weather. (Annual Report 2020)

Incomes

Sri Lanka's GDP per capita declined to US$ 3,682 in 2020 from US$ 3,852 in the previous year. The size of the economy fell to US$ 80.7 bn in 2020 from US$ 84.0 bn in 2019. The per capita income of US$ 3852 last year was below the threshold for a high middle income level of US$ 4000 reached earlier.

Unemployment and poverty

The Central Bank Annual Report for 2020 seeks to capture this story of last year's economic collapse in facts and figures. According to it, the economy shrunk by 3.6%, unemployment increased to 5% and poverty increased. In fact the actual plight of people is likely much worse than statistics could capture. The statistics are best taken as ordinal indicators of last year's economic depression rather than cardinal measures.

Unemployment was rampant, incomes dwindled and poverty and hunger was widespread. Government's free food packages and allowances tried to alleviate the tragic conditions of a large number of persons deprived of their livelihoods, though inadequately.

The global downturn jolted the country's export-dependent economy severely. The loss of markets for manufactured exports and cessation of tourism were the severest external shocks.

Export resilience

The resilience and adaptability of the country's export manufacturing industries was noteworthy. "The slump in merchandise exports due to the mobility restrictions and lockdown measures was swiftly overcome, demonstrating the resilience of Sri Lankan exporters." (Annual Report 2020).

Furthermore, the Report underscores the rebound in export earnings" within a relatively short span of time to reach pre-pandemic levels."

This revival of exports was achieved by exporters diversifying into the new demand for personal protective equipment such as surgical gloves, rubber gloves and masks.

Consequently, exports dipped only slightly last year compared to pre-COVID 2019.

Import restrictions

Facing low foreign exchange reserves, large foreign debt repayment obligations and expectation of an export decline, the government adopted measures to curtail non-essential imports. This together with the significantly low global petroleum prices, helped reduce import expenditure and reduce the trade deficit from US$ 8 bn in 2019 to US$ 6 bn in 2020.

Balance of payments

Despite the reduced trade deficit, the balance of payments deteriorated last year owing to reduced incomes from services and net capital outflows. The saving grace was that workers' remittances that have been the most important strength to the balance of payments for several years, increased last year.

In 2020, there was a balance of payments deficit of US$ 2.3 bn compared to a surplus of US$ 877 mn in 2019. Net capital outflows were mainly responsible for this deterioration. The expected revival of tourism did not materialize. Workers' remittances that were expected to decrease, increased to US$ 7.1 bn.

Other services

In contrast, other earnings from services and workers' remittances increased. Foreign inflows from services relating to Information Technology and Business Process Outsourcing (IT/BPO) sector, increased significantly. A new source of foreign earnings was the surge in novel work arrangements amidst the pandemic. External reserves were US$ 5.7 billion at end 2020.

Fiscal outturn

The adverse impacts of the COVID pandemic had serious repercussions for the fiscal outturn. The trend of increasing fiscal deficits in recent years, especially since 2018, was compounded by the responses to COVID that "resulted in lower-than-expected revenue mobilisation and high recurrent expenditure."

The increased recurrent expenditure and shortfall in revenue curtailed capital expenditure and limited fiscal space to alleviate the impact of the pandemic on economic activity as well as essential social expenditure.

The overall budget deficit at 11.1% of GDP in 2020 was extremely high. The outstanding public debt increased to 101.0% of GDP at end 2020, from 86.8% of GDP at end 2019.

Fiscal challenges

Especially significant was the Central Bank's attention to these fiscal challenges. ahead that requires to be addressed by the Government. "The fiscal weaknesses of the country have been aggravated by the persistently low revenue, rigid and increasing recurrent expenditure, rising gross financing needs and the resultant elevated debt level, as well as the need to improve the financial performance of State-Owned Business Enterprises (SOBEs)."

Policy prescriptions

The Central Bank advises: "Policy adjustments in the period ahead must give due consideration to the fact that the COVID-19 pandemic has had a disproportionate impact on underprivileged segments of the population and has aggravated inequalities, not only related to income, but also in relation to other aspects that affect socio-economic wellbeing in the short run and productivity in the long run."

Economic prospects

The Central Bank is quite optimistic of the economy bouncing back in 2021. It states, "The Sri Lankan economy is expected to rebound strongly in 2021 and sustain the high growth momentum over the medium term, buoyed by growth oriented policy support.

While addressing near term vulnerabilities stemming from the pandemic remains an immediate priority, resolving the persistent structural impediments that hinder the country's long term growth prospects is essential in the period ahead.

Concluding reflection

This expectation of economic rebound was based on the prospect of a global economic recovery that would enhance the country's exports and revive global travel and tourism. This is unlikely with the increasing spread of the virus in the country as well as its spreading in other parts of the world.

We must hope for appropriate policy responses that would mitigate the global and local setbacks and find ways and means of increasing production in the country.

For the full article - Refer The Sunday Times

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