Spotlight: Econ Op-eds in Summary

Week ended 02nd June '21

In Summary

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

1. Sri Lanka unlikely to reach speedy V-shaped economic recovery amidst structural imbalances
By: Professor Sirimevan Colombage

- Sri Lanka's GDP growth was adversely affected by COVID-19 and the government implemented a series of relief measures in light of this. However, apart from the pandemic, economic recovery has been difficult given the macroeconomic constraints faced. Contrary to this, the Central Bank expects a 'V-shaped' recovery with GDP growth jumping to 6% in 2021. This forecast seems over-optimistic given the historic trend in GDP growth over the past five years.

- The country needs to undertake investment in a knowledge-based economy to bolster growth. According to 'Thirlwall's Law', the country is able to benefit from economic growth through a positive and growing trade surplus, however, in Sri Lanka's case, this growth is curtailed by high foreign borrowings and budget deficits. In a bid to stabilize the exchange rate, the CBSL revised upward the rules on the repatriation of export proceeds.

- To help ease debt repayment pressure, the government sought funding from several countries over the year through the form of currency swaps. However, with the launching of more debt funded infrastructure projects, Sri Lanka will face even higher debt repayment pressures in the future. These policy decisions could result in Sri Lanka having an 'L-shaped' recovery, with the recession faced by the country being prolonged.

Sri Lanka's economy contracted by 3.6% in terms of Gross Domestic Product (GDP) in 2020 in the aftermath of the outbreak of COVID-19 pandemic, recording the worst economic performance, as in the case of many countries. Industrial output declined by 6.9%, largely reflecting the adverse performance in apparel, manufacturing and construction. The services sector contracted by 1.5% due to the setback in tourism, transport and personal services. Agricultural production too fell by 2.4% in 2020.

In an effort to revive the economy and to mitigate the adverse impact of the pandemic on individuals and businesses, the Government has implemented a series of measures including health allocations, cash transfers and tax postponements. These have been supplemented by the monetary easing policy adopted by the Central Bank since last year.

Despite such proactive measures, Sri Lanka is experiencing a prolonged economic recession due to the outbreak of the third wave of the pandemic. Even before the pandemic, the economic recovery has become even more difficult due to the macroeconomic constraints faced by the country. They include growth slowdown, high fiscal deficit, debt burden and balance of payments difficulties.

Alphabet of economic recovery

Questions have been raised across the world regarding the shape of the economic recovery from the COVID-19 pandemic applicable to different countries; whether it is V-shaped, U-shaped, W-shaped or L-shaped.

The best-case scenario is the V-shaped recovery in which the economy rebounds quickly after a sharp decline. In a U-shaped recovery, it takes months or years to revive economic activity. In a W-shaped recovery, the economy recovers quickly but falls into a second recession. Hence, it is known as a double-dip recession.

The worst-case scenario is the L-shaped recovery in which the economy fails to recover in the foreseeable future.

Central Bank's V-shaped projection unrealistic

As per the medium-term macroeconomic outlook presented in the Central Bank's Annual Report-2020, 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.

Accordingly, the economy is expected to achieve a V-shaped recovery with GDP growth jumping exorbitantly to 6.0% this year from the negative growth experienced last year, as shown in the chart. The growth momentum is projected to remain in the next five years accelerating the growth to 7.0% by 2025.

The Central Bank's above projection seems to be over-optimistic, given the structural economic imbalances that have been prevailing in the country for a long time, leaving aside the adverse effects of the pandemic. This is clearly reflected by the fact that the economy was already on a downward path even before the pandemic.

GDP growth averaged only 3.7% during 2015-2019. The average growth rate was down to mere 3.1% in 2017-2019, the period immediately preceding the pandemic.

The annual GDP growth would not have been more than 2% from this year onwards, assuming there is no COVID-19 pandemic. The scenario appears even worse when a non-linear trend projection is applied, which indicates negative growth in the medium-term even without the pandemic.

Thus, Sri Lanka's economic downturn is deeply rooted in factors beyond the pandemic which call for immediate policy action.

As the pandemic has exacerbated the economic slowdown, it is highly unrealistic to anticipate a V-shaped economic recovery overtaking the pre-pandemic growth, as projected by the Central Bank.

SL's poor growth record

Following the cessation of the war in 2009, the economy followed a high growth path supported by the revival of production activities in the north and east together with post-war reconstruction and infrastructure development. However, that construction-based economic recovery was short-lived due to the lack of sustainable growth strategies, fiscal imbalances and export setback.

SL lacks technology-driven growth

Economic growth achieved thus far has been driven by using more factors of production – capital and labour. Such growth is identified as 'factor-driven growth'. The economic slowdown immediately prior to the COVID-19 pandemic indicated that the economy could not grow any further solely depending on labour and capital inputs.

In other words, Sri Lanka has reached the 'Production Possibility Frontier' (PPF), in economic terminology. Raising the output beyond PPF requires application of technology and innovation thus enabling the economy to materialise 'technology and innovation-driven growth'.

In the current global set up, technology and innovations based on human capital are the core growth drivers in many fast-growing countries, which have achieved the knowledge-economy status. Sri Lanka has been lagging behind in terms of knowledge economy indicators: economic and institutional status, education and skills development, Research and Development (R&D) and information and communication technology.

Unless appropriate policy measures are adopted to fill such gaps targeting technology and innovation-driven growth without further delay, it would be impossible to revive the country's economic growth hampered by the pandemic in the near future.

Import-dependent export growth

A country's long-run growth rate is constrained by its export capacity and import demand, according to the well-tested theory introduced by Prof. Anthony Thirlwall of University of Kent in 1979. It is known as 'Thirlwall's Law of 'Balance of Payments – constrained economic growth'. The larger the trade surplus (exports minus imports), the faster the economic growth.

In the long run, therefore, no country can grow faster than that rate consistent with balance of payments equilibrium on current account, unless it can continuously finance ever-growing deficits by foreign borrowing which, in general, is impossible, as evident from Sri Lanka's experience.

The country's envisaged economic recovery largely depends on its ability to raise exports. The pandemic-hit export sector showed some resilience in the first quarter of this year recording a 12.6% increase in total export earnings; industrial exports rose by 7.9%, and agricultural exports by 31.0%. Nevertheless, the trade deficit expanded in the first quarter due to a 12% increase in import outlays.

The Government has imposed import restrictions on a variety of goods since last year to ease the balance of payments difficulties. Given the high import content of domestic production, such restrictions have downside effects on the export sector as well as on overall economic growth. The recently-announced import ban on chemical fertiliser will adversely affect the agriculture sector, causing food security problems during the pandemic.

Thus, import controls are likely to prolong the pandemic-led recession, as per Thirlwall's law.

CB's frequent tinkering with export proceed conversion rules

Last week, the Central Bank once again revised the rules on repatriation of export proceeds, requiring 25% of the proceeds to be converted within 30 days after receiving such proceeds.

The Monetary Board keeps its discretion to determine the specific export sectors or industries or individual exporters, who or which may be permitted to convert less than 25% of the total of the export proceeds received. This, however, will continue to be subject to not below 10% conversion of the export proceeds and received no later than 180 days from the date of shipment.

Such discretionary rules introduced in a bid to salvage the country's foreign exchange situation have severe detrimental effects on the export sector hit by the pandemic, as reiterated in this column earlier.

Fiscal deficit and debt burden

A crucial macroeconomic imbalance that impinges on Sri Lanka's growth recovery is the fiscal deficit and the accumulating debt service payments. The budget deficit rose to 11.1% of GDP in 2020 and the available indicators show even a higher increase in the deficit over 13% of GDP this year.

The continuation of the arbitrary tax cuts and the expenditure hikes already worsened the fiscal situation requiring frequent borrowings from domestic and foreign sources. Annual debt service payments amounting to around 150% of the Government revenue exert enormous pressure on budgetary management.

While the Central Bank's low interest rate policy helps to ease the domestic debt service burden, the depreciation of the rupee in recent weeks makes external debt service payments extremely costly.

Overdependence on foreign loans and swaps

Instead of pursuing the Government to stick to a fiscal consolidation programme targeting a lower fiscal deficit so as to ease the debt burden, the Central Bank continues to rely on short-term foreign borrowings and swap arrangements. This is in addition to its accommodative monetary policy stance with regard to Government's domestic borrowings.

Last week, the Bangladesh Bank has agreed to provide a swap facility of $200 mn. Sri Lanka received renminbi-denominated swap of $1.5 bn from China last month. In addition, the Republic of Korea last month agreed to provide concessional loans amounting to $ 500 mn to finance the identified projects.

More swap facilities are in the pipeline, according to the Finance Ministry sources, as reported in the media.

Fresh debt-funded infrastructure projects

Meanwhile, the Government is reported to have launched several major debt-funded infrastructure projects including highways a few days ago amidst the pandemic and severe external debt problems. Such borrowings will certainly aggravate the country's staggering macroeconomic imbalances.

U- or L-shaped recovery for Sri Lanka?

In the backdrop of Sri Lanka's growth slowdown even prior to the pandemic, the V-shaped recovery projected by the Central Bank is far from reality.

Assuming a best possible scenario, hopefully the economy would revive after two to three years characterised by U-shaped recovery. The bottom of the U shape represents the extended period of the recession before recovery.

A longer post-pandemic U-shaped recovery implies that the economy will take a number of years for recovery. First and foremost, the length of the economic recession depends on how long it takes to eradicate the coronavirus at the national and global levels.

Proactive policies are essential to correct the macroeconomic imbalances, specifically the fiscal deficit, bad debt dynamics and the balance of payments deficit so as to revive the Sri Lankan economy at least with U-shape recovery, which is considered to be the second-best option below V-shape recovery.

There is an impending danger that delaying corrective policy decisions might push Sri Lanka towards an L-shaped recovery, prolonging the pandemic-led recession indefinitely.

For the full article – Refer Daily FT

2. An alternate economic development strategy for the country
By Lloyd F. Yapa

- A large part of Sri Lanka's employment is attributed to the rural agriculture sectors. This sector is also recorded as one of the most poverty-stricken sectors in the country due to low productivity. Development of agriculture will allow the country to achieve self-sufficiency in food production while also protecting the natural environment.

- Fragmentation of land and mixed cropping seems to be one of the main factors negatively affecting the productivity. Further issues in value chains such as the lack of quality plant material, no proper irrigation work, lack of secured warehouses all increase wastage and decrease productivity. Solutions provided by authorities to these issues remain dissatisfactory as they are often underfunded, poorly coordinated, inefficient and corrupted.

- The way out appears to be to find solutions particularly for improvement of the productivity of land and developing manufacturing, especially further processing of primary agricultural produce, mainly for export, to create better paid employment opportunities for those leaving farming and not to resort to simplistic solutions like increasing the extent of cultivated land which would lead to the destruction of the natural environment as well.

In the previous article that appeared in this paper on 10 May under the caption, 'Attraction of Foreign Investments', the strategy of attraction of such investment was discussed. Two notes should be added to it. The Port City project is brilliant as a concept. It is like providing a liveable place to live in in an inhospitable environment, as in the case of the Arctic or the moon, the rest of the country being unsuitable for FDI due to several missing rungs in the economic development ladder. It is also a 'trickle down' process of development like all FDI.

There is an alternate development strategy that may not need much by way of FDI. The reference is to rural agricultural development, the objective of which should be increasing the earnings of some 81% of people out of the total (World Bank, 2019), living in the rural areas of the country.

So far, the objective of development of agriculture has been realizing self-sufficiency in food production which can be described as being a selfish motive of feeding the urban masses as in the case of reaching self-sufficiency in rice; the farmers remained poor as before the project began although rice yields increased tremendously. Besides increasing the earnings of farmers as well as of food production, the other objective of what is discussed in this paper is the protection of the natural environment.

The process of achieving these objectives involves: a) studying the subject thoroughly to identify the pros and cons and the stakeholders b) deciding on the areas of land to be set apart for an adequate forest cover including an elephant corridor, the area to be used as arable or cultivable land, the areas to be set apart for infrastructure and for urban purposes c) introduction of land reform for consolidation of fragmented holdings to increase their returns/productivity (more outputs from the same inputs) and d) construction of infrastructure and urban facilities. It is suggested that implementation of the project should start after setting up a pilot project to check its feasibility.

Present position

About 42% of the population of about 22 million people in the country earn less than $ 5.5 a day per person (World Bank, 2019); these are Sri Lanka's (SL's) poor; the same number for Malaysia which gained its independence a couple of years after SL, was 3%. Roughly 8 out of 10 persons in rural areas might be poor in SL. Undernourishment and malnutrition are reported to be rampant among them.

The main reason for this serious situation could be low productivity in rural agriculture. In fact, agricultural value addition per employee in SL was $ 2,789 as against $ 18,008 in Malaysia and $ 91,547 in Israel, in 2018, (World Bank 2010, constant). In addition, the number employed in rural agriculture is too high in SL being 25.0% of total employment, (CBSL, 2018), due to low productivity, while it is 10% in Malaysia and just 1.0% in Israel, (World Bank, 2019).

Since other sources of employment in rural areas are rare, the youth tend to encroach illegally on forested areas for cultivation. At present this appears to have been made legal and encroachment of forested areas is reported to be taking place on a vast scale, when the better alternative would have been increasing the productivity of the limited availability of cultivable land as in Israel for instance.

The bulk of land (over 80%) especially in rural areas is owned by the Government which has leased out (later most of it converted to grants) in small lots under the Land Development Ordinance (1935); the tenure conditions are so restrictive that holders find it difficult to improve the productivity of the land while incurring much expenditure especially for bribing officials to get over the red-tape; in fact the rank of the quality of land administration in SL is one of the worst in the world being 135 out of 141 countries (Global Competitiveness Report, 2019). Since most of the lots are not owned, the farmers find it difficult to access bank loans and to invest in expansion of cultivation or on value addition to production to earn better prices.

Fragmentation of the land is so heavy that 45% of the lots were less than ¼ acre in extent (out of a total of 3.3 million land parcels, according to the Census of Agriculture, 2002. (It may be worse now). This is mostly subsistence farming and mixed cropping; this is one of the reasons for low productivity in rural agriculture; the use of machinery on small scattered irregular plots requires long journeys and therefore is costly. In addition, as small quantities are being produced, it is infeasible to undertake further processing and provide for export.

As fragmentation of holdings becomes worse with each generation and incomes decline, some of the youth especially the educated leave the land in droves due to poor returns/low wages and migrate to the already crowded urban areas, or go abroad legally or illegally to work under harsh conditions, leaving the children and the elderly behind creating a severe social problem. Thus, consolidation of the small lots by way of land reform is essential for increasing output and reducing unit costs (or for improving productivity/value added per person) to improve incomes.

Undeveloped value chain

The situation is further worsened by the fact that little attention is being paid to strengthening the value chain for agricultural produce that should consist of the supply of quality planting material, well-maintained irrigation works, secured warehouses (with or without freezing facilities for villages to enable farmers to store farm produce and prevent elephants breaking into houses where harvested food products are usually stored), paved rural roads, marketing and research institutions, etc.; the research programs and extension services being undertaken appear to be ineffective in controlling disease, pest attacks, for increasing yields and for indicating the remunerative crops/products.

Low and unstable rural incomes

Worse still, the price the small subsistence farmer gets from the market for his produce does not compensate him adequately and so most farmers are frequently in debt; consumers too are affected unfavourably as the transporters/traders in particular demand high prices to compensate especially for high wastage (30-40%) in transit; heavy imports have to take place to make up for shortages, leading to a worsening of the trade balance. Agricultural prices also fluctuate because of weather conditions and natural disasters; incomes of farmers therefore do not remain stable; the average monthly income of a household (of about 4 persons) among the poorest 20% of households was Rs. 14,843, (Department of Census and Statistics, 2016).

The overall result of all this is the severe abuse of the natural environment and reducing the primary forest cover of SL to 2.6 % of the total extent of land, (FAO, 2010), which is the 'sponge' that stores the rain water received by the island of SL.

Current solutions create additional problems

The usual solution resorted to by the authorities has been to set up at central and provincial government level numerous 'top-down', under-funded, poorly coordinated, inefficient and mostly corrupt public institutions to service the sector with underpaid and de-motivated officials; through these institutions samurdhi payments and guaranteed prices at enormous expense have been thrown in indiscriminately; other subsidies like low priced fertiliser, planting material and disaster relief often get diverted, are of low quality and are not delivered on time.

Enhancement of productivity

It should now be clear that nothing much has happened so far to improve the wellbeing of some 18 million people who depend directly or indirectly on rural agriculture. Why? One of the reasons could be the fact that the wellbeing of the farmer and consumer, was not uppermost in the minds of politicians who sought only short-term political gain.

In order to increase farmer earnings, it may be necessary first to study the land reform movements adopted successfully in Japan, China, Taiwan and South Korea. One of the methods of improving productivity adopted in these countries has been the grant of ownership of larger holdings mainly by consolidation of the small unprofitable/subsistence farms. The small farmers who did not receive any land were given jobs in manufacturing undertakings. The success of these land/agrarian reform programs in terms of speed of implementation and the higher incomes earned by the farmers was ensured by state led planning and implementation.

The significant rise in the net incomes of the rural population, (as earnings increase with production increases, while unit costs decrease as costs are spread over a large area of output) enabled even the farmers in Japan, China, South Korea and Taiwan to invest in industries and services and undertake the education of their children to produce the technical and soft skills for such activities because of the rise in their incomes.

Problems and solutions of ownership

Next, SL has to study the social and economic consequences if ownership of the land is given to farmers. One of the problems that would be created would be the inclination on the part of some farmers to sell their land; if the land is sold to owners of larger holdings, it would not create much of a problem as it would lead to the improvement of productivity. If these farmers sell their land to outsiders, however, it might even lead to the breakup of the existing rural social fabric.

The best solution (as productivity and value addition are ensured) is the prohibition of selling the land and setting up of joint-stock companies of small farmers (or corporatisation). In such a case the farmer is in control of the management of production, further processing as well as marketing and could recruit the skilled people required like any other commercial enterprise or handover the management to specialised companies.

Urban/industrial clusters and infrastructure facilities

In addition, each large-scale cropping area (selected on the basis of best returns) could accommodate a well-located urban cluster/industrial area consisting of manufacturing and service-oriented enterprises to absorb the excess employment and the landless in the area as done in Israel.

The planning, policies, location and the provision of infrastructure facilities such as roads, water and electricity in the clusters and in the area around them is the responsibility of the state or the provincial authorities; the private sector could be incentivised to undertake the rest of the work such as setting up of the factories and the services required; businesses might readily do so when the primary inputs would be made available by the farmers on a large scale.

Conclusion

It has been a long disastrous journey with subsistence farming and heavy subsidies as well as protection where rural agricultural policies and operations in SL are concerned; it has failed to reduce rural poverty. The way out appears to be to find solutions particularly for improvement of the productivity of land and developing manufacturing, especially further processing of primary agricultural produce, mainly for export, to create better paid employment opportunities for those leaving farming and not to resort to simplistic solutions like increasing the extent of cultivated land which would lead to the destruction of the natural environment as well.

Therefore, a new land policy to replace it is timely. The consolidated versions of rural farming with urban clusters proposed here may not need much Government support like the Guaranteed Price Schemes from the state. It may also be noted that such farms could definitely contribute to higher increases in rural productivity. They could in addition generate additional investment due to higher earnings and discourage people especially women from going abroad for menial employment.

Such operations would also enable an increase in food production at lower prices that could reduce hunger, malnutrition, anaemia and sickness among rural people, while protecting the precious natural environment; more earnings could be made from exporting the surpluses. Higher rural incomes would increase the demand for various industrial goods and services from the rest of the country and speed up economic growth in the entire economy. This then is a dynamic model of development that could complement the slower, less dynamic 'trickle down' process often resorted to currently.

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