Spotlight: Econ Op-eds in Summary

Week ended 08th July '20

In Summary

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

1. SL's descent to lower middle income: Strategize to move up to high-income level
By: W.A. Wijewardena

- Sri Lanka was downgraded to a lower-middle income country just a year after being promoted to an upper-middle income country. This was a result of the fall in per capita GNI in the country due to the constitutional crisis in 2018 and the Easter Sunday bombing – both man-made shocks which could have been avoided.

- Despite these changes in GNI, the income disparity among citizens as well as across provinces had remained even when the country previously moved to the upper-middle income category, making the sustainability of the status questionable.

- However, reducing these disparities and sustainably moving towards being a high-income country is not impossible. For this, the economy should redirect resources towards investments, improve private participation in development and promote micro and meso enterprises, infuse them with technology and then manage them appropriately so that they would grow into SMEs and later into large corporates.

From upper middle-income to lower middle-income

The World Bank in its latest country classification by incomes, released last week, has downgraded Sri Lanka from upper middle income to lower middle income. This was just one year after Sri Lanka had been elevated to the status of an upper middle-income country in July 2019.

Sri Lanka's GNI per capita for 2018 stood at $ 4,060. Due to the non-growth of the economy in US dollar terms in 2019, GNI per capita in that year has fallen marginally to $ 4,020. This level was again marginally below the threshold of $ 4,046 fixed for an upper middle-income country valid for the period from July 2020 to June 2021. Hence the downgrading of Sri Lanka from upper middle-income to lower middle-income in the current year.

Man-made shocks causing GNI to fall

There had been two main negative shocks that had caused Sri Lanka's GNI to be stagnant in US dollar terms in 2019.

- One was the uncertainty created in the economic system in the first half of 2019 emanating from the constitutional crisis of October-December 2018. During this period, there was no government in Sri Lanka and hence, there was no proper budget approved by Parliament for 2019.

- The second was the Easter bomb attack on major hotels and Christian churches in April 2019 and the ensuing religious clashes in selected areas in the country. This shock had reduced the growth momentum of the country in the second half of 2019.

The final result was, according to the Department of Census and Statistics, the slowing-down of growth in GNI in 2019 to 2.2% in Rupee terms from previous year's growth of 3.2%. However, in US dollar terms, GNI fell by nearly 6% in that year. Both these negative shocks were man-made and could have been avoided or contained.

The elusive upper middle-income status

According to the World Bank data, Sri Lanka got promoted from low income to lower middle income in 1997. The annual economic growth at around 5% on average since then had helped Sri Lanka to pass the first barrier and be in the upper middle-income category in 2019, but that was after the lapse of some 22 years. Based on this performance, Sri Lanka had expected to cross the second barrier within the next 15 years and join the high-income country club by 2034. But the projected negative economic growth in 2020 and the very slow economic recovery in the next 4-5year period would make this goalpost move further away from Sri Lanka thereby lengthening the time period needed to become a high-income country.

Disparities in income distribution and provincial shares of GDP

Sri Lanka was jubilant when it was elevated to upper middle-income country status in July 2019. But due to two reasons, this was not an occasion for jubilation.

- One was the wide disparity in income distribution across citizens.
- The other was the disparity in the incomes earned by provinces.

In the case of the income disparity among citizens, the top 20% of the population normally bags a little over 50% of the total income of the country. In the opposite, the lowest 20% gets only 5% of the total income.

With regard to the income disparity among provinces, the lion's share of 37% was earned in the Western Province whereas the rest of the country had earned only the balance 63%. Accordingly, eight out of the nine provinces were below the minimum income threshold for an upper middle-income country. As such, from the welfare point of people, a large segment of Sri Lanka's population was not enjoying living standards attributable to those living in an upper middle-income country.

Still eight provinces are below the threshold level

The situation in Sri Lanka in 2020 remains the same. We now have the income distribution data for 2016 and those data too show the same pattern of income distribution. The Central Bank has now updated the provincial GDP numbers for 2018. According to these numbers, the Western Province has increased its share a little to 38% making the other eight provinces earn only the balance 62%.

Strategies for the future

But Sri Lanka should not remain here forever. It has the potential to come out of present low growth scenario and move up in the ladder to become a rich country. This requires the country to take a stock of its present state of the economy exacerbated by the economic fallout of COVID-19 pandemic. Using these assessments as the foundation, it has to plan out a credible economic reform program to place the country on a long-term economic growth path.

The perilous economy today

Sri Lanka's present economic conditions are not promising at all. The fallout of COVID-19 pandemic will worsen it. In 2020, the economy will shrink by about 5-10%. Economic recovery will be slow in the next four-year period mainly due to the restrained economic relationships dictated by health requirements. The government budget is in a precarious condition with a sharp decline in revenue, the undesired outcome of unsound tax reforms introduced in early 2020, and ballooned expenditure programs necessitated by the country's reconstruction needs. Consequently, the budget deficit will rise to about 10% in 2020 and will remain high in the next four years.

Due to constraints in borrowing, the government has got the Central Bank to finance its expenditure programmes by buying Treasury bills. During the first six months, these Treasury bill holdings have increased by about Rs. 300 bn. But this has not been reflected in printing of new money by the Central Bank due to a fall in its monetary base by about Rs. 68 bn – an unintended outcome of a fast decline in foreign reserves. What this means is that the Central Bank will have to pump new money into the system in the months to come to recoup the shortage of liquidity within the system. All these are not good signs for restraining inflation.

In the meantime, the rising foreign debt servicing, decline in foreign exchange earnings and untamed import bill will lead to deficits in the balance of payments. It will put pressure for the exchange rate to depreciate further.

Way-out: Stra.Tech.Man Approach

The way-out for Sri Lanka is to divert its resources from consumption to investments in physical capital, human capital and technology. They would create new openings for the private sector to actively participate in the country's development efforts. The development economist Charis Vlados in his 2019 book titled 'Strategy Technology Management: Theory and Concepts' has coined Stra.Tech.Man Approach for countries to follow for a quick economic recovery.

Inventions followed by innovations, diffusion and imitation. For growth to sustain, inventions should be made by engineers, scientists and management experts and they should be commercially adopted by entrepreneurs in a process known as innovation. Then, the knowledge about the new innovation should be spread across the economy in a process he named diffusion to facilitate other entrepreneurs to imitate the same.

The previous growth efforts in Sri Lanka have not delivered the desired results because they had disregarded this vital economic-biological process. What the policy authorities should do today is to look after and promote micro and meso enterprises, infuse them with technology and then manage them appropriately so that they would grow into SMEs and later into large corporates. When this happens on a large scale creating a critical pool of entrepreneurs, an economy would naturally move upward sustaining its growth achievements over the years.

This is how Sri Lanka should strategize today to move up from the lower middle-income status to upper middle-income and then to high-income level avoiding income disparities at citizens' level and production disparities at provincial levels.

For the full article - Refer Daily FT

2. Economic transformation of the COVID-19 battered MSME sector
By: Dr. Nimal A. Fernando

- The MSME sector makes up the backbone of many economies and in Sri Lanka, accounts for over 50% of GDP, and 45% of employment and a significant share of export earnings. They are also key for rural development and reduce dependence on welfare. Dismal growth projections for the global economy also has severe implications for the sector.

- Those particularly affected include microenterprises, young enterprises, women-owned and operated MSMEs, tourism related firms and SME's linked to global supply chains. However, the economic impact within the subsectors is uneven, and so, a substantial number of MSME's may recover in the next 6-9 months

- This uneven trend can also be seen in the finance gap within the sector. Nevertheless, it remains an issue, evidenced by the low productivity in the sector. The lack of detailed data on credit constraints remains a barrier to formulate reliable-evidence-based policies that can transform the sector so that it can contribute to economic growth and development.

Even before the pandemic hit the sector, governments in most countries have long-recognised that the MSME sector requires focused special policies and programs for its growth and sustainability. The pandemic made the case for such external support doubly stronger and more urgent.

The pandemic has crippled a massive number of MSMEs in virtually all developing nations and most of the developed nations. According to some analysts, it has "set in motion a downward spiral that can significantly impair the backbone of all economies".

Uneven impact

The pandemic affected some MSMEs more than others: microenterprises that were operating at the margin, young enterprises in all three categories (micro, small and medium), women-owned and operated MSMEs, firms strongly integrated in domestic value chains, firms engaged in tourism and related activities and food and beverage sector, for example, are particularly badly affected.

SMEs linked to global supply chains are another worse effected category because they are forced to take the brunt of the difficulties of large firms in the value chain.

The sector recovery is important for multiple reasons

Rapid and sustainable recovery of the pandemic affected MSME sector is critical for Sri Lanka for a multitude of reasons.

First, data indicate that MSMEs account for over 50% of GDP. Hence their economic revival is important for regaining growth.

Second, MSME sector account for over 45% of employment and an overwhelming proportion- about 87% of the firms in the country. ADB's Asia SME Finance Monitor 2014 put the number of microenterprises in the country at 880, 066 and SMEs at 132,483. And the total employment in MSME sector was over 2.09 million, accounting for approximately 70% of the total employment in all type of firms. Thus sustaining employment levels in the enterprise sector and preventing a worsening of socio-economic inequality depend to a large extent on their revival.

Third, SMEs contribute to some 20% of the total export earnings of the country and their revival is important for foreign exchange earnings.

Fourth, majority of MSMEs are located outside the Western province and in the rural sector. Therefore, they are important for regional economic development and reduction of regional socio-economic disparities and for rural development.

Fifth, because of their sheer number, failure to resuscitate MSMEs is likely to contribute to social unrest and generate greater demand for handouts from the government.

In terms of broader development objectives, the economic recovery of these firms essentially means preventing a vast number of people from falling into deeper poverty.

Pandemic damaged MSMEs through four channels

According to SME Finance Forum sponsored by the International Finance Corporation, the COVID-19 pandemic damaged MSMEs through four channels: falling demand; reduced input supplies; tightening of credit conditions and liquidity crunch; and rising uncertainty. Now that the recovery phase has begun across many countries, the severity of the effects of these seems to be declining though slowly in most cases and unevenly across and within countries.

The domestic demand for MSME products and services is beginning to improve from the pandemic affected levels. But a substantial pick-up in demand cannot be expected until the global economy improves and its spill-over effects are fully felt through multiple channels in the domestic economy.

Dismal economic growth projections

But the news is disturbing. According to the revised projections (24 June) of the IMF on global, regional and country-level growth and recovery, the global economy will shrink by 4.9% in 2020, much worse than the 3.0% shrink it projected in April.

The relative picture for Asia looks bit better: emerging and developing Asia economy will shrink but only by 0.8%.

The negative growth during the rest of the year and low growth scenario for 2021 coupled with high unemployment levels that would prevail in 2021 across countries do not provide any ground to be optimistic of the prospects of recovery of the MSMEs directly and indirectly linked to the tourist industry of Sri Lanka.

Similarly the MSMEs in wholesale and retail trade, accommodation and food services and personal services are likely to feel the economic brunt of the pandemic for a longer period even in the recovery phase despite numerous public support programs and targeted assistance.

Input supplies is likely to follow a similar pattern. MSMEs that depend on domestic sources for inputs are likely to overcome the bottleneck sooner than those that depend on overseas sources for their input supplies. Of the microenterprises, only about 25% were in manufacturing while 42% and 26% were in trade and services, respectively in 2013, according to Census and Statistics Department data.

If we assume that this distribution pattern reflects today's reality as well, it tends to suggest that a substantial proportion of microenterprises are likely to partially recover within about six to nine months when other sectors begin to operate at pre-pandemic levels. However, the SMEs that depend on inputs from overseas will have to bear the pain of supply shortages and probably higher prices for a longer time.

Finance gap in the sector is huge

Many commentators seem to assume that the most critical factor for the recovery of the MSME sector will be the flow of credit.

A joint study of the World Bank, IFC and SME Finance Forum, for example, estimated the formal sector MSME finance gap in developing and emerging market economies at $5.2 trillion in 2017. Microenterprises accounted for 14% (or $719 billion) of this total. SMEs accounted for 86% (or $4.5 trillion).

But all MSMEs are not credit constrained

However, the estimated colossal global (excluding rich countries) finance gap mask an interesting fact. That is not all MSMEs are financially constrained.

The same study estimated that in developing and emerging market economies 60% of the 141 million microenterprises and 56% of the 20.7 million SMEs are financially unconstrained while only 21% of the microenterprises and 30% of the SMEs are fully financially constrained. The total financing gap in South Asia was estimated at $337 billion: SMEs accounted for $290 billion (86%) and microenterprises accounted for $47 billion (14%) of this.

The estimated 4.48 million fully or partially credit constrained MSMEs in the region consisted of 3.91 million microenterprises (87%) and 570,000 SMEs (13%).

We must not overlook that the above numbers do not cover informal sector MSMEs. Although the study referred to earlier does not provide details on the informal sector, it puts the potential demand for finance in the global informal sector at $2.9 trillion.

But there is a serious lack of detailed data on the credit constraints of Sri Lanka's MSMEs. However, based on the above global and regional data it may be reasonable to assume that a substantial proportion of MSMEs in Sri Lanka also may not be facing a credit constraint although lack of access to finance has been a constraint on the overall growth of the sector. Perhaps this explains in part the uneven growth that we can observe in the MSME sector in the country. It is possible that SMEs keen to upgrade their technology face serious credit constraints. Same may be true for those aiming at using more advanced agricultural and information and communication technology.

It is also possible that many MSMEs in the country are not using the liquidity at their command in the best possible manner to increase productivity.

The generally low productivity level in the MSME sector and the questionable quality of most of the products and services coming out of the MSME sector tend to support this observation.

Conclusion

The MSME sector development is crucial for the overall growth and development of Sri Lanka. When compared with its potential, the current contribution of the sector is poor. Structural changes are long overdue in the sector.

However, a reliable data base and thorough analytical work are critical to identify the binding constraints in the sector and to design smart policies to address those constraints in a potentially effective manner.

We do not need just evidence-based policies for the sector; we need reliable-evidence-based policies to transform the low-productivity MSME sector characterised by short-termism and lacklustre growth into a dynamic sector that can contribute to the growth and development of the country on a sustainable basis in line with the requirements of the 21st century.

For the full article – refer the Daily FT