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TOWARDS A VIBRANT ECONOMY AND PROSPEROUS COUNTRY

Dr. GAMANI COREA MEMORIAL LECTURE
by Dr. Indrajit Coomaraswamy, Governor, Central Bank of Sri Lanka
on Monday, 6th November, 2017 at 5.00 p.m. at the BMICH

I. Introduction

The theme of my remarks this evening is going to be Towards a Vibrant Economy and Prosperous Country. I intend to begin by trying to make the case that this is probably the most favourable set of circumstances Sri Lanka has enjoyed for over five or six decades. I then propose to talk about key paradigm shifts which have changed the landscape for policy-making; the frameworks that have been put in place for macroeconomic policy making; the growth model; the policies to strengthen the growth framework; and some of the Government's major development programmes. These are embedded in the Government's Vision 2025 document.

II. Most favourable circumstances

Let me first seek to explain why I believe the current set of circumstances are the most favourable for 50 or 60 years. From the late-1950s, there was a secular decline in the terms of trade. The domestic economy was dependent on the export of tea, rubber and coconut sectors at that time. For almost 25 years, there was almost a continuous decline in the prices of these commodities. In fact, if you look at the World Development Report of the World Bank, the 1982 edition, there is a box citing Sri Lanka as a classic example of a country that had been buffeted by severe terms of trade decline. This was clearly a major drag on the development prospects of the country in those years. The challenges posed by this secular and continuous decline in the terms of trade were compounded by the fact that in the 50s, 60s and 70s there was a demographic surge. While surpluses in the economy were coming down, the number of people was increasing.

Clearly, these twin effects were a major challenge in terms of policy making. One could argue that the situation was further constrained by the fact that there were a set of inward looking, dirigiste policies which, with the benefit of hindsight, were clearly inappropriate for a country with Sri Lanka's endowments. Of course, the policies pursued were very much part of the mainstream thinking in many parts of the Third World at that time. This was an era when the general perception was that political sovereignty that came with decolonization had not been accompanied by economic sovereignty. It was argued that transformation was needed in that area as well. As the domestic private sector, the national bourgeoisie in Marxian terms, was not strong enough to pursue the objective of economic sovereignty, the state had to step in. Hence, it can be argued that it was probably a phase that we had to go through. However, clearly it did not give us good economic outcomes, particularly as over time the politicisation of institutions debilitated the capacity for prudent policy-making.

Then in the 80s, we had the conflict which lasted for almost 30 years. Now, when you look around there aren't any such major drags on the economic outlook of the country. Furthermore, we are located in Asia which is the most dynamic economic region in the world. So, one can plausibly make the case that these are probably the best set of circumstances that the country has had for several decades.

III. Three Paradigm Shifts

There are three types of mind set changes, or paradigm shifts, that need to be addressed, if we are to take advantage of this propitious set of circumstances. The first is the balance between social development and wealth creation. Have we got that balance right? Have we had it right in the past? As you are all aware, Sri Lanka has been an over-performer in terms of social development. If one looks at Sri Lanka's performance on the UNDP Human Development Index and its ranking in terms of per capita income, the gap has been the second largest of any country in the world. We have punched above our weight when it comes to social development. So, it is legitimate to ask why a paradigm shift or a mindset change is needed in the context of such accomplishments. The reason we need a mindset change to give greater weight to growth, to wealth creation, is the fact that despite all our social sector achievements we have had two youth insurrections and a separatist conflict in the country. Tens of thousands of our young people have lost their lives. While there is complex causality behind these episodes, arguably the most significant explanatory factor was the mismatch between expectations of and opportunities for our young people. We have not met their aspirations. So clearly, we have not done as well as we can in terms of growing the cake and providing productive livelihoods. The cake has to be distributed equitably but it is also important that the cake is grown.

We were second to Japan on almost all social indicators at the time of independence, in 1948, and we were above South Korea as late as in the mid-sixties. Singapore's per capita income was just a little bit higher than Sri Lanka at that time. It is now over USD 50,000 whereas ours is USD 3840. We have clearly fallen behind. Now, the focus must be not only on consolidating and building on our achievements in the social sector but also on looking for ways and means of pursuing growth and wealth creation. At same time, the quality of that growth has to be good. It has to be inclusive and regionally balanced. In addition, priority needs to be attached to employment generation which transmits the benefits of growth widely. It also needs to be sustainable. But the bottom line is we require 6% plus growth to meet the needs of an increasingly aspirational society.

It is encouraging that the recent household and income survey found that incomes had increased and the Gini Coefficient had improved. The median household income per month increased from Rs 30,814 in 2012/13 to Rs 43,511 in 2016. The Gini coefficient improved from 0.48 to 0.45 during the same period. Furthermore, the latest provincial GDP figures reveal a greater regional balance, with a reduction in the Western Province's share of total GDP. It has declined from 39.9% in 2015 to 39.7% in 2016.

The second paradigm shift is associated with the fact that we have now graduated to Lower- Middle -Income country status. For many years, as a Low-Income Country, we enjoyed extremely generous levels of ODA or foreign aid. Sri Lanka was treated very favourably because the traditional donors were very keen to demonstrate good development outcomes in a country, which since 1977-78 has had liberal economic policies as well as a relatively open polity. Sri Lanka was the second country after Chile, in 1974, to liberalise its traditional economy. Donors were keen that such a country should be successful in terms of development and they pumped in a lot of foreign aid. Not only did we receive a lot of foreign aid but about 2/3 of that came from the concessional windows of the World Bank and the Asian Development Bank. That money essentially had 10 years grace period, 40 to 50-year maturity and less than 1% administration charges. That was the kind of infusion of resources we were receiving to supplement domestic savings. It certainly helped in terms of our social development and some infrastructure improvement. However, it also meant that we got into the habit of living beyond our means and did not take some of the tough decisions that we had to make. In every year since 1987, recurrent expenditure has exceeded government revenue. This means that we have borrowed even for our recurrent expenditure each year. If a company or a household did that they would not have survived. We were able to survive because of the inflows of foreign aid.

Then we graduated to Lower Middle Income Country status, in 2010, and our access to concessional money began to dwindle. We were fortunate because at that very time the major Central Banks in the world were pumping in large amounts of liquidity into the global system in the aftermath of the global financial crisis. That money was looking for higher yields in emerging markets. Hence, plenty of money was available at relatively low rates. Furthermore, Sri Lanka had negligible amounts of commercial borrowing so it had the headroom to borrow. Consequently, there was a shift from foreign aid to foreign commercial borrowing. Now, the headroom has run out. Our fiscal deficit and debt dynamics are such that we can't keep borrowing commercially at an incremental rate. We have got to the stage where we are now borrowing to repay our debt. So, the mindset has to change.

There is a new Paradigm where we are now exposed to rating agencies and international capital markets. This imposes far more discipline and places a far higher premium on sound economic policy-making than we have ever experienced in the past. This is a major paradigm shift we need to understand. The IMF imposes conditions on its lending but rating agencies and international capital markets are far more unforgiving. We have seen in Greece and in a number of Latin American countries that access to markets can suddenly "stop". Extremely painful austerity is the inevitable consequence. It is imperative we have a shift in both mindset and actions in the light of this harsh reality. We need to understand the very high premium now placed on prudent and disciplined economic policy-making. We need to break out of the toxic combination of populist politics and a deeply entrenched entitlement culture among the people. This has been a mutually reinforcing non-virtuous cycle that has been a major drag on our development since independence. We have regressed from being second in Asia to Japan on most Socio Economic Indicators at the time of independence to a relative laggard today.

The third paradigm shift that I would like to draw your attention to is that we are unique in experiencing a demographic transition before our economic transformation. The population is ageing at a far earlier stage in our development process. This means Sri Lanka can no longer drive growth merely through labour augmentation. Instead, growth has to be driven to a greater extent by productivity improvement, by innovation, by research and an increase in total factor productivity. We are having to rely much more on productivity enhancement, at an earlier stage of our development process.

So, it is crucial we have a laser-like focus on improving productivity and shifting financial and human resources from lower to higher productivity economic activity. Agriculture, which has 27% of the labour force and accounts for 7% of GDP, the public service which accommodates 15% of the work force; and the SOE sector absorb significant amounts of human and financial resources yet yield low returns.

IV. The New Growth Model

Let me now address the importance of developing a new growth model which will give us 6-8% growth over 10 – 15 years i.e. the kind of economic transformation enjoyed by the successful countries of East and South-East Asia. In the years after the end of the conflict, the major growth impulses in the economy emanated from public investment in infrastructure which was largely financed by foreign commercial borrowing. Economic expansion was driven by non-tradable like construction, transport and retail/wholesale trade.

The previous growth model no longer has any headroom due to the country's budget deficit and public debt dynamics. Arguably the biggest indictment of the policy framework of the past decade was the combination of the sharp decline in exports and the rapid build-up in the commercial external debt burden. This has resulted in the potential transfer of an inter-generational time-bomb. The situation can be managed through prudent liability management provided there are disciplined macro economic policies. This is a necessary but not sufficient condition. The unsustainable debt burden can only be resolved through transformation of our export performance.

The new growth model has to be private sector driven, with exports and FDI as key pillars.

Why the ***private sector?*** Countries have achieved successful development outcomes with varying mixes of the public and private sector: China and Vietnam have been statist while others have had a much larger role for the private sector. In Sri Lanka's case, there isn't the fiscal space to have a statist development model. Hence, the emphasis on the private sector is not an ideological option. Instead, it is a pragmatic conclusion based on our fiscal deficit and public debt dynamics.

Why **exports?** With a domestic market of only 21 mn people and per capita income of USD 3,825 it is not possible to achieve sustained growth of 6-8% without a transformation in our export performance. Exports have fallen from 32% of GDP in 2000 to 12.7% in 2016. The corresponding figures for Malaysia, Thailand and Vietnam were 67.5%, 54.2% and 83.7% respectively in 2015. Sri Lanka's share of global exports fell from 0.09% to 0.06%. There is a lack of product (2/3 were apparel, tea and rubber products in 2016) and market (US and EU accounted for 58%) diversification. The share of external commercial borrowing has increased from 2% of GDP in 2007 to 13% in 2016. As mentioned above, this clearly is an unsustainable, and potentially dangerous set of circumstances. It can only be addressed by policy reforms which promote export transformation to generate non-debt creating earnings to both service the debt and support growth as well as employment generation. This places a high premium on getting the exchange rate; effective protection rates, particularly reducing paratariffs; trade policy, including trade agreements; and trade facilitation right. It is noteworthy that the success of the countries of East and South-East Asia has been based on transformation of their export performance – whether they are as large as China or as small as Singapore.

Why ***FDI?*** Evidence also confirms that FDI has played a major role in the economic transformation of the successful countries of East and South-East Asia. FDI not only infuses much needed capital to fill the savings/investment gap but it also brings in technology, know-how and market access. It also facilitates access to regional and global value chains which are the most dynamic aspect of the international trading system. Over half of global exports are accounted for by cross-border production sharing networks.

One may pose the question whether it is advisable to pursue a development strategy based on exports and FDI as key pillars in the context of the new normal for the world economy of relatively low growth and sluggish international trade. The response is that this is mitigated by Sri Lanka's strategic geographical location and excellent international relations, particularly with the capital surplus countries of East and South-East Asia. Sri Lanka is located twenty miles from India, the fastest growing large economy in the world. Access is particularly easy to the five fast growing South Indian states. In addition, we are at the Centre of China's Maritime Silk Route. Furthermore, countries like China, Japan, India, Singapore and South Korea have indicated their willingness to support Sri Lanka's development process. It is also important to factor in that geopolitics in the Indian Ocean has increased the potential for Sri Lanka to leverage its excellent location for its commercial advantage.

V. Strengthening the Growth Framework

(a) Framework for Macroeconomic Policy-making

Sri Lanka has historically been characterised by stop-go policies. The excess demand pumped into the system by unsustainable budget deficits has been the main source of instability in the system. We have tended to be a high budget deficit, high inflation, high nominal interest rate and over-valued currency economy. This caricaturisation is diametrically opposite to what the successful Asian economies have achieved. In order to address this and achieve sound macroeconomic fundamentals, the Government is putting in place clear frameworks for policy-making. This should serve to promote greater consistency and predictability in policies.

On ***fiscal policy,*** the Government has embarked upon a medium-term revenue enhancement based budgetary consolidation programme. It is designed to reduce the budget deficit to a sustainable 3.5% of GDP by 2020. The medium-term strategy is based on the premise of fiscal consolidation with the aim of increasing revenue, rationalising expenditure and reducing government debt to a sustainable level. The VAT reforms, the new Inland Revenue Act and measures to strengthen revenue administration and compliance are major achievements. The Government is considering institutionalising the fiscal consolidation process by introducing more binding targets to the Fiscal Management Responsibility Act.

On ***monetary policy***, the CBSL is making progress in introducing a flexible inflation targeting regime. This will create a framework for a data-driven, forward-looking and proactive monetary policy. For instance, the 25 basis point increase in the policy rates, in March 2017, was designed to anchor expectations at a time when there was a spike in headline inflation due to weather induced supply disruptions, tax adjustments and base effects rather than demand-side pressure. Legal and accountability frameworks are being formulated to institutionalise the flexible inflation targeting regime.

On ***exchange rate policy***, the framework being adopted is to adopt a competitive exchange rate. In this connection, one needs to adjust the nominal exchange rate gradually to bring the REER Index to 100. This is crucial for reducing the anti-export bias in the overall policy framework and increasing the competitiveness of the economy. This is an important prerequisite for transforming the country's export performance which is essential to overcome the onerous external debt burden and achieve sustained growth and employment generation.

A framework is also being established for ***liability management***. There is a peak in domestic debt repayments in 2018. As there are no maturities in the last five months of 2017, this has presented an opportunity to build up a buffer to manage the elevated domestic debt repayments next year. In addition, a Liability Management Act will be enacted to create the space to address the bunching of external debt from 2019. This will relax the ceiling on Government borrowing set out in the Appropriation Act to raise financing to extend the tenor and reduce the costs of external obligations. This will serve to reduce rollover risk. It is important to recognise that these measures serve to buy time by managing the cash flow. It must be reiterated that the solution to the problem lies in fiscal consolidation, export transformation and utilising the proceeds of the divestment of public assets to pay down debt.

On ***SOE reform***; the five major state enterprises [CPC, CEB, Sri Lanka Ports Authority, National Water Supply and Drainage Board (NWS & DB), Airport and Aviation Lanka Ltd] have signed Corporate Statements of Intent. For the first time, there will now be a framework against which the performance of these enterprises can be measured in terms of governance and financial performance. Furthermore, the Government is committed to introducing cost-reflective pricing through a formula for the CPC in March 2018 and the CEB in third quarter of 2018. This will go a long way towards putting these enterprises on a sounder financial footing. Most of their large accumulated losses have been due to part of the budget deficit being transferred to them. The subsidies built into their administered prices have not been compensated out of the Consolidated Fund. These losses were eventually reflected in the balance sheets of the state banks.

On ***factor market reform***, the Government will be introducing legislation establishing a **land** bank. This will address a major constraint in the business environment by identifying pre-cleared land which will be available for **private** investment projects. Land titling is another issue which is receiving attention. Other land-related issues include the removal of archaic laws and the need for a comprehensive review of land use/crop mix. **Labour Market** reforms include measures to increase female labour force participation from the current low level of 35.9%. There is a strong case for a concerted tripartite effort (Unions, business and Government) to modernize Sri Lanka's labour laws which are currently an impediment to investment and a constraint on improving overall labour standards in the country by incentivising informality and casual labour. On **capital market** reform, the Central Bank, SEC and the Insurance Board of Sri Lanka are all being supported by the World Bank and the Asian Development Bank to develop the government securities and share markets as well as the insurance sector.

(b) Boosting Investment

On the ***investment climate***, Task Forces have been established on eight pillars of the World Bank's Doing Business Index. Each of the Task Forces comprises all the Government entities involved in the respective pillars. Action Plans have been launched in May 2017, to deregulate by reducing the number of steps involved in each pillar; and technology is to be introduced where it can facilitate processes. These Action Plans must be implemented expeditiously. This will benefit domestic investors first.

On ***investment promotion***, the BOI has worked with the Centre for International Development (CID) at Harvard, to identify sub-sectors with potential for attracting FDI, which will enhance the complexity of the export basket and diversify export markets. Here again, effective implementation is the next step.

(c) Promoting Trade

There is a great deal that is being done in the area of ***trade policy***. The Government has developed a National Trade Policy Framework. An Anti-Dumping Bill is being presented to Parliament to protect domestic business from unfair competition. A trade adjustment package is being developed with the assistance of the World Bank and the EU/ International Trade Centre. It is designed to increase the competitiveness of local businesses exposed to increased competition as a result of trade liberalisation and to provide retraining for workers. There is also a medium-term plan to reduce paratariffs to create a more conducive environment for promoting linkages with regional and international value chains.

Arguably, the most significant trade policy measure is the negotiation of bilateral Partnership Agreements. The FTA in goods with India is being deepened and it is being broadened to include services, investment, technology and training. In addition, an "early harvest" is being pursued to address some of the shortcomings of the existing FTA, including some NTBs and quotas. Similar partnership agreements are being negotiated with China and Singapore. In addition, GSP plus has been restored providing preferential market access for 6000 items. If things proceed according to plan, it is possible the narrative will be that Sri Lanka has preferential access to a market of over 3 bn. people: China, EU, India, Pakistan and Singapore. In a world where over 190 countries are competing for FDI, this preferential market access can be a unique differentiator. It will greatly enhance our capacity to leverage the trade/ investment nexus to our advantage. Of course, the Partnership Agreements need to be negotiated vigorously with positive and negative lists; safeguard arrangements; and dispute resolution mechanisms which pursue national interests. Our trade negotiators are well aware of this.

On ***trade facilitation***, a single electronic window is scheduled to be operational in the Customs Department shortly. These measures are intended to reduce the transaction costs of the cross-border movement of goods thereby enhancing the trade competitiveness of the economy.

All these measures are intended to improve the investment climate and trading environment for both domestic and foreign investors.

(d) Education, Training and Skills Development

These are the opportunities that are out there. Two questions need to be addressed. One is can we implement? The other one of course is do we have the human resources, ie whether we have the skills to be able to absorb this kind of investment. Arguably, the biggest challenge is for us to move as quickly and as decisively as we can to align what we see as the emerging sectors having a comparative advantage with our labour market and the education, training and skills development systems. This is an axis we need to align quickly. We have not done it very well in the past.

It is often said that there is a scarcity of labour. The real problem is that there is too much labour in low productivity/low income livelihoods. At present, 27% of the workforce accounts for 7% of GDP in agriculture. The public service has 1.5 mn employees or 15% of the workforce [equivalent to Greece]. All these workers are responding rationally to distorted incentives (free water, fertilizer subsidy, guaranteed prices and non-contributory pensions). The incentive structure should be created to shift labour from low to higher productivity/income livelihoods.

(e) Facilitating R & D; Innovation and Entrepreneurship

A concerted effort is required to create an eco-system which promotes innovative thinking to create value in the market. Priority should also be given to lower risks and barriers associated with start-ups.

(f) Energy Security and Sustainability

The country's energy security needs to be established through a robust long-term energy generation plan based on credible demand forecasts. Priority is being given to LNG as the energy source of choice.

The increase in the frequency and intensity of extreme weather events highlights the need to mainstream sustainability into the planning and budget processes. Priority should be attached to mitigation and adaptive measures to address droughts and floods.

(g) Social Safety Net

It is important to shift from untargeted subsidies which benefit the non-poor disproportionately to a system of well -targeted cash transfers. In this respect, there is scope to reform the Samurdhi Scheme. The new bio-metric identity card can also serve to reduce leakages of scarce public resources.

The Budget 2018 is also expected to announce measures to address the acute challenges confronting debt-distressed families. There will be initially piloted in the North and North Central Province.

VI. Major Development Programmes

The Government is launching a number of major development programmes around the country along two economic corridors along major highways. This is intended to promote balanced regional growth. Japan is developing a Master Plan for the Kandy area. Given the religious and cultural importance of this area, the Japanese have been chosen as they are able to understand Buddhist sensitivities and priorities. It is expected that there will be a religious/cultural orientation to this development programme as well as an economic zone.

Then coming down, the Colombo/Kandy Highway that is being built, industrial zones are planned in the Kurunegala/Kuliyapitiya areas of the North-Western Province.

The Western Region Megapolis Plan covers the three districts of the Western Province. It is a USD 40 bn. programme over 15 years. It envisages elevated highways; a light railway; residential and commercial real estate, including affordable housing; a logistics hub, involving the Colombo Port and Bandaranaike International Airport, as well as a tech city.

The Port City Project, involving reclamation of 269 hectares, will have the Colombo International Financial Centre as its centrepiece. The intention is to develop a business area which has an investment climate which would rank in the top 10 in the World Bank's Ease of Doing Business Index.

An industrial zone is being established by a Thai company in Kalutara. Tourism developments and additional industrial zones are being planned along the Southern Coast. Further South, there is the major proposal to develop the Hambantota area. The long-lease of the port will not only generate much needed non-debt creating flows for liability management, which is essential to address the bunching of external debt repayments from 2019 onwards, but also assist in commercialising an asset which is currently a major loss-maker casting a heavy burden on the people through its impact on the Government budget. The leasing of the Port to China Merchant will also catalyse a plan which envisages investment in a refinery, LNG Plant, Cement factory, steel billet plant and a ship repair company. Subsequent phases are expected to involve development of industrial zones by Chinese companies on up to 15,000 acres of land.

In the 69 years since independence very little has been done for the people of Monaragala and Uva. The people of Hambantota have a number of assets, including a port and airport, which are very under-utilized at present while casting a heavy debt burden on the country. Chinese investment can transform the whole of that lagging region by generating thousands of employment opportunities at wages that are higher than the prevailing norms in the country. None of this is likely to happen unless a Chinese company has a long-term lease of the port; whose strategic location is a major part of the overall investment case. In assessing the Hambantota port deal, we need to ask ourselves is it right to stand in the way of developing a lagging region which has benefitted so little after seven decades of independence and has been the heartland for two youth insurrections (1971 and 1988/89) which led to the loss of thousands of lives.

Surbana Jurong, the Singaporean Consultancy, which developed the Western Region Megapolis Plan, is also preparing a Master Plan for the Trincomalee area. Tourism, real estate and industrial zones will be major features of this development. This development will yield benefits not only for the Eastern Province but also for the people of Rajarata. There are plans to develop the road and rail network in the North Central Province and the North to improve connectivity to the Trincomalee Port.

In the conflict-affected areas, Palaly airport and the Kankasanthurai port are being rehabilitated. There are also plans to improve road and rail connectivity. In addition, there will be a 200% upfront investment allowance for businesses locating in these areas.

There are also Master Plans for the development of the tourism and ICT sectors.

Given the lack of fiscal space, much of the investment for these major programmes will have to come from private investment, domestic and foreign. High priority is also being given to PPPs, particularly BOTs, and alternate financing instruments which are off the Government balance sheet.

VII. Conclusion

There are massive opportunities embedded in the plans in place. The jury is still out whether we will be able to rise to the challenge of executing effectively enough to take advantage of them. Even if we are able to execute 25 to 30% of all that I have mentioned, I think it will have a significant positive impact on the lives of the people of this country.

Thank you all very much■

Towards a Manufacturing Sector Development Strategy

Annual Report - 2016

Central Bank of Sri Lanka

Manufacturing to Drive Growth

Sri Lanka has achieved substantial economic and social progress since the economic liberalisation in 1978, in terms of national wealth and improved living standards. However, economic growth in the last few years has been constrained at around 3.0 to 5.0 per cent levels, while exports relative to GDP have declined. The contribution of the manufacturing sector to economic growth has remained low during the last two decades, due to the inability to remain competitive in both domestic and foreign markets, and evolve towards producing high value added products while increasing productivity. The accelerated development achieved by many other nations, through the implementation of strong industrialisation policies during the mid 20th century, demonstrates that the manufacturing sector of a country can play a major catalytic role in a country's economic and social transformation process. The development of the manufacturing sector can contribute to the eradication of poverty and regional disparity, create quality employment opportunities, increase export income, as well as develop technological capabilities and productive capacities of the economy to support growth. Therefore, at this juncture of Sri Lanka's growth path, where reliance on foreign aid and government welfare transfers cannot be sustained any longer, there is a crucial need to revitalise the manufacturing sector, for the economy to attain accelerated sustainable growth.

Table B 3.1
Sectoral Composition of GDP

%

Year	Agriculture	Industry	Services	Manufacturing (which is a part of industry)
1978	26	24	50	19
1980	24	24	52	18
1985	26	26	49	18
1990	23	27	50	17
1995	20	30	50	14
2000	19	28	53	16
2005	17	27	56	16
2010	12	29	59	17
2015 [1]	8	26	57	16
2016 [1]	7	27	56	15

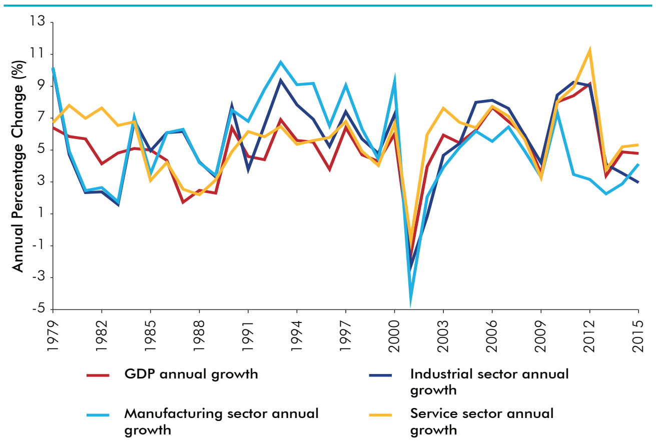
Sources: Department of Census and Statistics
Central Bank of Sri Lanka

In contrast to nations, which developed through industrialisation, Sri Lanka has leap-frogged from an agrarian society to a service-based economy. The sectoral composition of Sri Lanka's GDP evolved with the share of the agricultural sector declining, and the services sector and the non-manufacturing industrial sectors (i.e. construction, mining and quarrying, electricity, water and waste management) increasing substantially (Table B 3.1). The share

1. These percentages were calculated based on gross value added at basic price according to the System of National Accounts 2008 Standard. The sum of gross value added at basic price for agriculture, industries, services and taxes less subsidies on products equals gross domestic product at market price.

of the manufacturing sector in GDP remained low and stagnated since 1978 (Table B 3.1), while growth rates of the manufacturing sector remained below GDP growth rates throughout most of the last 15 years (Chart B 3.1). Consequently, the GDP growth rates that Sri Lanka recorded during the last few years emanated mainly from non-tradable services and construction, constraining growth to 3.0 to 5.0 per cent levels, which is inevitable given the limited size of the domestic economy.

Chart B 3.1
Growth Rates of GDP and Its Components



Sources: Department of Census and Statistics
Central Bank of Sri Lanka

Sri Lanka undertook numerous attempts, since economic liberalisation in 1978, to improve the manufacturing sector, through policy measures, such as the establishment of the Export Development Board in 1978 and export processing zones, privatisation of state industrial undertakings, setting up of the Industrialisation Commission in 1991 under the Industrial Promotion Act No. 46 of 1990, carrying out a "200 Garment Factories Programme" in the 1990s, announcement of an industrial policy statement in 1995, launching of the "Productivity Decade 1997-2006", and formulation of a National Framework for Small and Medium Enterprise Development in 2015. However, the impact of all such measures on Sri Lanka's factory industries in maintaining competitiveness in local and global markets has been low during recent years. Manufacturing activities have remained highly concentrated among apparel, food products and rubber products and other labour intensive industries producing goods of low technological intensity. GDP growth was less supported by growth in the manufacturing sector, especially after 2000 when Sri Lanka lost comparative advantage from cheap labour in apparel manufacturing to countries with even cheaper labour. The challenges were compounded by the end of the Multifibre Agreement (MFA) and the loss of the GSP+. During the boom of the apparel manufacturing era, Sri Lanka failed to effectively strategise on diversification into other product categories or for shifting manufacturing to more technologically intensive, high value-added and complex products. Sri Lanka's development pattern corresponds to a concept referred to as "premature deindustrialisation" in academic literature. This is shown to be caused by globalisation forces, which force growth in countries with open economies and a lack of a "head-start" in industrialisation, to be based on capital inflows, foreign aid, remittances and commodity price booms, making only moderate growth possible through a services-based economy.[2] This further highlights that Sri Lanka needs to undertake an urgent commitment to develop the manufacturing sector and integrate into global value chains even as a late-entrant, in order to accelerate growth.

International Experience

Many countries that shared a similar economic background to Sri Lanka during the 1950s, undertook government led policy measures to enhance the productive capacities of their manufacturing sectors aimed at increasing exports during the mid 20th century. It is widely stated that, countries in Asia followed a "flying geese pattern" (a tilted V-shape) in adopting government led industrialisation policies, with Japan in the lead, followed initially by South Korea, Hong Kong, Taiwan and Singapore ("the four tigers") and subsequently by many other nations including China, Indonesia, Malaysia and Thailand. The services sectors of these countries deepened later in the development process. Their Latin American

2. Rodrik, Dani. "Premature deindustrialization." Journal of Economic Growth 21.1 (2016): 1-33.

counterparts were Brazil, Chile, Peru and Mexico. All these countries have now surpassed Sri Lanka in GDP and social development.

The above countries adopted clearly stated "industrial policies" at the beginning of their development process. Most countries with subsistence farming simultaneously adopted policies to improve productivity in agriculture through land reforms and other farming techniques. Thus, larger-scale agricultural production evolved, releasing underemployed labour in agriculture to the manufacturing sector until the "Lewisian turning point"[3] of full absorption of surplus labour in the traditional sectors to the modernised manufacturing sector was reached. Most of these countries manufactured low value-added consumer goods, such as apparel, in the first phase of their development, but progressed on to complex products with technological skills gained from the previous phase. With the exception of Japan, the other countries adopted the strategy of obtaining direct investment from advanced nations to set up manufacturing plants within special economic zones in their countries. Meanwhile, domestic small scale enterprises were fostered as they grew into large enterprises and protected from dumping (competition through cheap imports). The technological development that took place in the manufacturing sector triggered transformation in other sectors, such as services and agri-business. The contribution of the manufacturing sector to GDP in these countries increased substantially and is much higher than Sri Lanka (Table B 3.2), while a greater percentage of merchandise exports are manufactured goods. At present, lower-middle income nations such as Vietnam and the Philippines are striving to follow a similar growth path through industrialisation. India, which has leap-frogged to services from agriculture has made a commitment to develop the manufacturing sector via a campaign named "Make in India" which commenced in 2014.

3. Lewis, W. Arthur. "Economic development with unlimited supplies of labour." The Manchester School of Economics and Social Studies 22.2 (1954): 139-191.

Table B 3.2

Percentage Contribution of the Manufacturing Sector to GDP of Selected Countries

%

	1975	1980	1985	1990	1995	2000	2005	2010	2013	2015
Sri Lanka	13.1	18.3	18.2	17.4	20.4	15.8	16.3	17.3	15.7[1]	154[1]
Japan	n/a	27.2	27.5	25.9	21.5	20.4	19.1	18.9	17.7	n/a
Rep. of Korea	20.3	22.8	25.2	25.0	25.3	29.0	28.3	30.7	31.0	29.5
Rep. of China (Taiwan)	n/a	n/a	35.1	31.2	25.6	25.7	27.9	29.0	28.6	29.9
People's Rep. of China	37.6	39.9	34.4	32.3	33.4	31.8	32.1	31.5	29.7	n/a
Thailand	18.7	21.5	21.9	27.2	26.5	28.6	29.8	31.1	27.7	26.9
Indonesia	10.3	14.0	16.4	22.3	24.1	27.7	27.4	22.0	21.0	20.8
Malaysia	18.7	21.9	19.7	24.2	26.6	30.9	27.5	23.4	22.8	22.8
Vietnam	n/a	n/a	20.5	12.3	15.0	17.1	18.8	12.9	13.3	13.7
The Philippines	25.7	25.7	25.2	24.8	23.0	24.5	24.1	21.4	20.4	20.1
India	15.2	16.2	16.0	16.2	17.3	15.3	15.4	17.5	16.5	16.2

Sources: World Development Indicators, World Bank
National Statistics, Rep. of China (Taiwan)
Department of Census and Statistics
Central Bank of Sri Lanka

Some of the above nations experienced difficulties at times in maintaining their industrial policies due to the failure of selected industries, inflation in consumer goods markets, macroeconomic volatility caused by reduction in global demand etc. but were successful in achieving rapid economic and social development in the long run because of their continuously evolving manufacturing bases. It is evident that focused and committed policy support from the government for the overall sector, including targeted infrastructure development, research and development, capacity building of human resources and broad fiscal incentives helped to increase the overall manufacturing output. This provides a development lesson for Sri Lanka regarding the importance of the manufacturing sector to development as well as the need for the state to support industrialisation through policy action.

Implementation of the Necessary Strategies

Successive Sri Lankan governments implemented various measures to increase industrial production. Recently, plans have been made to set up industrial zones in regional areas, along the new expressways, and around the Hambantota and Trincomalee Ports. These initiatives, together with all other plans to develop infrastructure, promote research and development, upgrade skills of the human resources, and establish new small and medium enterprises (SMEs), which are to be implemented by various government agencies, will help attract Foreign Direct Investment (FDI) and increase manufacturing. Meanwhile, having recognised the importance of policy support for development, the Government has also put in place an overall development strategy and is formulating trade and export related policies. However, there still remains a need for a comprehensive manufacturing sector development strategy, which aligns various government efforts to increase manufacturing activities with the government's overall development agenda, and provides due prominence to the whole manufacturing sector while addressing its structural issues.

Therefore, in order for Sri Lanka to effectively provide broad-based support to the manufacturing sector and address structural issues, the establishment of one practical manufacturing sector development strategy is necessary. Such a clearly stated policy, which is developed through a collaborative process with all stakeholders, will be a tool for the government to provide long term direction for local and foreign investors as well. This manufacturing sector strategy needs to be a part of Sri Lanka's overall development strategy. The trade policy and export strategies should be a part of the attempts to industrialise through a manufacturing sector development strategy such that the development process will spur international trade. This is essential for the country to achieve a higher trajectory of growth and development. Furthermore, this strategy must encompass the interplay between the manufacturing sector with the agriculture and service sectors as well. Importantly, productivity enhancement in the agriculture sector will not only transfer under-utilised labour to the manufacturing sector, but also reduce the share of income spent on food. The resultant increase in real income spendable on other goods will increase the demand within the economy for manufactured products.

The manufacturing sector development strategy should categorically address the needs of local investors as well as foreign investors. Similarly, the needs of large scale firms as well as micro, small and medium enterprises be addressed. FDI is crucial as domestic savings are low and fiscal space is constrained. FDI is also an avenue to address low technological know-how in Sri Lanka. FDI relating to technologically intensive and high value adding products, which Sri Lanka seeks to gain competence in, are generally manufactured via global value chains in which manufacturers base different stages of the production process in various locations, to harness advantages provided by each location for each production stage. Despite this global development, most of the FDI to Sri Lanka in the last ten years comprised investment into the tourism and real estate sectors and investors seeking the Sri Lankan market. Therefore, the future manufacturing sector development strategy must include measures to attract manufacturing based export focused FDI to Sri Lanka.

In order to attract FDI, the manufacturing sector development strategy should identify factors driving such flows and create an environment conducive for them. The FDI flows occur due to push and pull factors relating to the source country and the recipient country, respectively. In general, pull factors include low cost labour, raw material, access to markets, competitive exchange rates, low tax regimes, availability of land for setting up factories etc. Factors that create a conducive environment for FDI include political stability, consistent support by public institutions, sound macroeconomic and legal frameworks, efficient logistics, minimum trade barriers, agglomeration economies and low-cost and highly efficient human resources. Since global value chain producers need to transport product components from one location to another expeditiously and with low transaction costs, efficiency of road and sea transport, access to ports, speed of customs clearance, warehousing and the existence of minimum tariff and non-tariff barriers are critical. In the past, firms in advanced nations invested in developing nations seeking cheap labour and natural resources (North-South FDI). However, during the last decade, South-South FDI, which involve emerging market economies (EMEs) such as China, Malaysia, India and Russia, investing in similar economies has increased. Such countries are more focused on market access and raw materials and have different perceptions about the quality of institutions than firms of advanced nations. Therefore, Sri Lanka needs to cater to the requirements of different FDI sources.

The FDI alone cannot uplift the manufacturing base of the economy in the long-term, and development of the capabilities of local manufacturers is critical. Local firms need to provide support services required by the foreign investors and develop the capacity to absorb technology transfer from the foreign investors. Some Sri Lankan companies, particularly in the tea and apparel sectors, have been able to achieve global excellence standards, but most firms are stricken by low productivity and restrained growth. Data on capacity utilisation in factory industries compiled by the Central Bank of Sri Lanka indicate that not more than 83.0 per cent of installed capacity were utilised from 2011 to 2016. Meanwhile, economic value added in the industrial sector as well as the agricultural sector, in terms of the proportion of the labour force employed gradually declined from 1981 to 2016. This suggests that an increasing proportion of the workforce was used to generate a declining proportion of the total value added of the country. This indicates that labour productivity gradually declined in both the industrial and agricultural sectors. Meanwhile, total factor productivity of Sri Lankan manufacturing firms has also declined, as identified through academic research that studied firm performance between 1990 and 2010.[4] Therefore, the country's development strategy needs to identify means of allocating under-employed labour in less productive agriculture as well as service sector segments (such as petty trade, personal services and public service) to the manufacturing sector. Policies aimed at transforming small scale farming to larger scale agri-business is important (to transfer labour from the agricultural sector). Policies should also aim to improve total factor productivity in the manufacturing sector through worker skill enhancement, management practices, and removal of impediments to restructuring.

Meanwhile, there is a prevalence of a large number of small firms, which neither grow nor exit for a long period of time in Sri Lanka. This results in labour and other resources being locked in less productive activities, as suggested by a World Bank study.[5] Small enterprises that do not grow, do not contribute to long term productivity enhancement of the country, as they do not engage in product or process innovation or provide quality employment opportunities. This study estimates that firms with less than 19 workers make up 76.0 per cent of enterprises in Sri Lanka which is a much higher percentage compared to India, China, Bangladesh, Pakistan, Philippines and Vietnam. Further, firms aged 25 years or more are only 50.0 to 90.0 per cent larger than firms aged 5 years or less. Larger firms tend to be more productive due to economies of scale, access to finance, ability to attract better quality managers, maintenance of better networks of market access and better record-keeping etc. Therefore, it is important to remove barriers for small and medium scale enterprises to grow by improving access to finance, increasing project-feasibility based lending rather than physical collateral-based lending, modernising labour regulations that hinder termination of employment, upgrade poor accounting and record-keeping, rationalising taxes that deter firms from expanding operations etc. Strong collaboration needs to be built between research and development (R&D) institutions and SMEs such that product development needs of SMEs are identified by the R&D institutions, while their findings are

4. Chandrasiri, Sunil, and Nuwan Indika. "Industrial Productivity for Sustained Growth: The Case of Sri Lankan Manufacturing Industries". Way Forward For Sustained Growth. A D V de S Indrarathna, S Widanagama and A Wijesinghe. Colombo: Sri Lanka Economic Association, 2014. 139-164. Print.

5. Varela, Gonzalo, Antonio Martuscelli, and Apoorva Gupta. "Improving competitiveness is about raising productivity rather than keeping costs low". South Asia's Turn: Policies to Boost Competitiveness and Create the Next Export Powerhouse. Gladys Lopez-Acedevo, Denis Medvedev and Vincent Palmade. The World Bank, 2017. 17-35. Web. 28 Mar. 2017.

6. Altenburg, Tilman, and Wilfried Lütkenhorst. Industrial policy in developing countries: Failing markets, weak states. Edward Elgar Publishing, 2015.

used by the SMEs. R&D institutions need to explore avenues to utilise minerals, herbs and other natural resources in Sri Lanka to increase manufactured exports of domestic industrialists. At present, a lot of such resources are exported in raw or low value-added forms at present. Fostering small enterprises until they grow into large enterprises and protecting them from dumping (by cheap imports) are necessary to uplift domestic manufacturing and gear the sector towards exports. In this connection, the Anti-dumping Bill should be enacted into Law expeditiously. However, a healthy level of competition needs to be encouraged within industries, and bankruptcy and employment termination regulations need to allow efficient reallocation of resources from firms that restructure or exit to more productive uses. In addition, the proposed trade adjustment package is an important complement to the economic partnership agreements which are being negotiated. It should be well-designed to increase the competitiveness of domestic firms and provide retraining for workers affected by trade liberalisation.

The manufacturing sector development policy should promote cluster based industrial policies and enhance opportunities for agglomeration economies. This is achieved by encouraging similar manufacturers to locate geographically close to each other and their support service providers to cluster around them. In such a context, the government can provide the necessary infrastructure, fiscal incentives and facilities for employees in a more focused manner, while firms can gain through economies of scale in inputs, interaction with each-other, larger pools of employees and access to capital goods. The provision of large tracts of land enabling factories and their support service providers to cluster together is a main pull factor for FDI as well. By locating industrial zones in less urbanised areas, the government can spread the benefits of industrialisation to many regions of the country. The effective implementation of the new industrial zones that have been planned at present will contribute significantly in this regard.

Although the literacy rate and education level of the average factory worker is higher in Sri Lanka than competitor nations, their technical competencies and innovative capacities needed for the production of complex products are lower. Therefore, technical and vocational training, as well as qualifications in science and engineering, should be offered to more students at the secondary and tertiary education levels together with industry exposure. Further, the social stigma against factory employees and the undesirable incentives in society for youth to seek public sector employment and turn away from the manufacturing sector need to be corrected.

The manufacturing sector development strategy should not be confused with a strategy to pick a few industries to promote for producing export goods. Though countries like South Korea succeeded in "picking winners", most of the countries which did so had to continue with protection for a long period of time. Such an approach should be avoided, as governments lack the capacity to predict high performing industries in the medium to long-term in the global markets, as well as to avoid rent seeking behaviour by firms. Therefore, government attention should be focused on providing wide-ranging support to the whole sector and for all present and future stakeholders through providing clear, consistent and broad based policies while ensuring an enabling private-sector-friendly environment. The manufacturing sector development strategy needs to be holistic and encompass all impacting aspects. The success of this strategy will be determined by the timely execution of the actions proposed■

Financial Soundness Indicators to warrant financial system stability

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Importance of Financial Soundness Indicators (FSIs) for Financial System Stability

The global financial crisis has demonstrated the importance of early detection of problems in the finance sector to identify the possible future financial crisis in advance and take prompt regulatory actions to mitigate or avoid risks to the respective individual entities and the entire financial system as a whole in order to ensure the stability of the financial system and strengthen the resilience of the financial system to internal and external shocks. Accordingly, introduction of the FSIs as an early warning system and a vulnerability indicator facilitates to identify the potential risks in the financial system and to further strengthen the current supervisory mechanism with the objective of impeding the vulnerability of the financial system, enhancing the financial system stability and limiting the likelihood of failure of the financial system.

Hence, FSIs are a set of indicators which provide a broad indication of the soundness of the entire financial system for the assessment of vulnerability to protect against crisis.

According to the International Monetary Fund's "The Financial Soundness Indicators Compilation Guide", FSIs are indicators of the current financial health and soundness of the financial institutions in a country, and of their corporate and household counterparts. FSIs include both aggregated individual institution data and indicators that are representative of the markets in which the financial institutions operate.

The various selection criteria relevant for the soundness and risk exposure of financial institutions are used to develop FSIs that would be used to assess possible system-wide vulnerabilities and identify any threats to the financial system stability due to financial shocks. FSIs covers commonly used framework to assess the soundness of financial institutions named CAMELS framework, which involves the analysis of a wide range of indicators with respect of capital adequacy, asset quality, management soundness, earnings and profitability, liquidity, sensitivity to market risk.

Table 1.1. Financial Soundness Indicators: The Core and Encouraged Sets[1]

	Core Set
Deposit takers	
Capital adequacy	Regulatory capital to risk-weighted assets
	Regulatory Tier 1 capital to risk-weighted assets
	Nonperforming loans net of provisions to capital
Asset quality	Nonperforming loans to total gross loans
	Sectoral distribution of loans to total loans
Earnings and profitability	Return on assets
	Return on equity
	Interest margin to gross income
	Noninterest expenses to gross income
Liquidity	Liquid assets to total assets (liquid asset ratio)
	Liquid assets to short-term liabilities
Sensitivity to market risk	Net open position in foreign exchange to capital
	Encouraged Set
Deposit takers	Capital to assets
	Large exposures to capital
	Geographical distribution of loans to total loans
	Gross asset position in financial derivatives to capital
	Gross liability position in financial derivatives to capital
	Trading income to total income
	Personnel expenses to noninterest expenses
	Spread between reference lending and deposit rates
	Spread between highest and lowest interbank rate
	Customer deposits to total (noninterbank) loans
	Foreign-currency-denominated loans to total loans
	Foreign-currency-denominated liabilities to total liabilities
	Net open position in equities to capital
Other financial corporations	Assets to total financial system assets
	Assets to gross domestic product (GDP)
Nonfinancial corporations sector	Total debt to equity
	Return on equity
	Earnings to interest and principal expenses
	Net foreign exchange exposure to equity
	Number of applications for protection from creditors
Households	Household debt to GDP
	Household debt service and principal payments to income
Market liquidity	Average bid-ask spread in the securities market[2]
	Average daily turnover ratio in the securities market[2]
Real estate markets	Real estate prices
	Residential real estate loans to total loans
	Commercial real estate loans to total loans

[1] A summary of the guidance outlined in the *Guide* for each FSI is provided in Appendix II.
[2] Or in other markets that are most relevant to bank liquidity, such as foreign exchange markets.

(Source: IMF Guide)

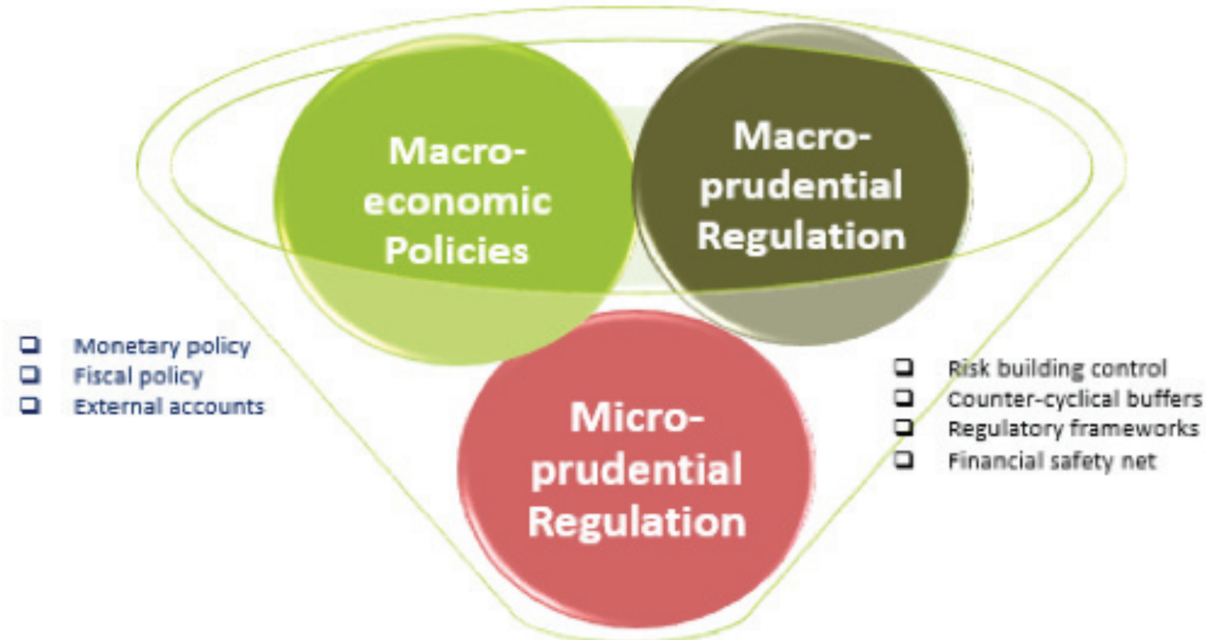
According to the FSI template developed by IMF there are two types of FSIs namely, Core FSIs and Encouraged FSIs based on various selection criteria as depicted in the following Table.

Use of Financial Soundness Indicators for Macroprudential Analysis

The global financial crisis has demonstrated the importance of implementing macro-prudential analysis focus on the health and stability of the financial systems whereas micro-prudential analysis deals with the condition of individual institutions. (IMF, 2001).

The CAMELS framework is commonly used supervisory framework to assess the soundness of individual institutions. The global financial crisis proved that the financial system stability cannot

Ingredients for financial system stability



be achieved purely through micro-prudential regulation which focused on assessing the safety and soundness of individual financial institutions due to systemic risk. Systemic risk refers to the risk of failure of the entire financial system leading to destabilize the real economy over time mainly due to spill-over effects that arise from direct and indirect linkages between institutions. Accordingly, the interconnectedness of financial institutions may transmit various shocks such as high losses in the banking sector due to excessive credit growth, across the entire financial system, thus impairing financial system stability. Instability in the financial system could destabilize the real economy and the whole economy over time through a variety of contagion mechanisms.

Hence, the implementation of a macro-prudential policy framework, with a view to identifying potential systemic risks in the financial system and reducing the vulnerability of the financial system to domestic and external shocks, is important. In macro-prudential regulation and supervision, it examines the overall functioning and stability of the entire financial system including all clearing systems, the Payments and Settlement System as well as exchanges and depositories for securities etc. This would help to reduce failures of financial institutions and improve the resilience of the entire financial system against shocks.

Hence, the financial stability framework provided in the Guide included the usage of FSIs for macroprudential analysis in the following manner:

(i). assess the vulnerability of the financial sector to shocks

(ii). assess the condition of nonfinancial sectors

(iii). monitor financial sector vulnerabilities arising from credit, liquidity, and market risk

(iv). assess the capacity of the financial sector to absorb losses, as measured by capital adequacy

Macroprudential tools

A variety of policy instruments have been identified as macro-prudential tools to identify the systemic risks in the financial system at an early stage. The macro-prudential tools that are commonly used are listed below:

(i). Capital regulation - minimum capital adequacy ratio (CAR), risk weights (RW), sectoral leverage ratio (LR), countercyclical buffer (CB), capital conservation buffer (CCB), systemic risk buffer (SRB)

(ii). Provisioning and loan classification – dynamic loan loss provisioning ratio (DPR), general loan loss provisioning ratio

(iii). Liquidity tools - average reserve requirements (RR), marginal reserve requirements (MRR), liquidity buffer requirements (LCR), net stable funding requirements (NSFR)

(iv). Eligibility requirements - loan-to-value ratio (LTV), debt service-to- income ratio (DSTI)

(v). Other regulation (including nonbank) - regulation of leasing/consumer finance companies, taxes on earnings, levies, systemically important financial institutions (SIFI) regulations

Further, the tools such as stress testing, assessment of compliance with Basel Core Principles, assessment of the robustness of financial system and payment system provide additional quantitative information to enhance the usefulness of FSIs on assessing the current health and soundness of the financial system.

Conclusion

FSIs play a vital role in monitoring the financial health and soundness of the financial sector as it facilitates to identify potential risks and vulnerabilities in the financial system in an early stage. However, it is important to improve the comparability of FSIs to consider as an effective early warning system. Hence, IMF has developed a compilation Guide for FSIs in 2006, which provides Guidance on the concepts and definitions, and sources and techniques for the compilation and dissemination of FSIs by member countries■

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