Verité insights

The post-war growth bump has hit the ceiling

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Gross Domestic Product (GDP) is the most common measure of a country's prosperity. Can Sri Lanka expect higher sustained GDP growth post war? The first two years after the war were positive, but the data suggests it was unsustainable, and the signs are that the post-war bump-up is over for the time-being.

GDP is a measure of the value of all the goods and services produced "in the country". So, Sri Lankans working abroad don't count for GDP while non-Sri Lankans working within the country do.

The war ended in 2009. In the years prior to that, from 2003 to2008, GDP growth averaged 6.34%. After the war in 2010 and 2011 recorded GDP growth surged to 8.02% and 8.25%. But in 2012 it came down to 6.41%, in short, back to the pre-war average. The question is, what is the prognosis for the future, and how is it to be deduced?

Figure 1 analyses how much different categories of economic activity contributed in absolute terms to GDP growth in 2012 and to GDP growth in 2010-11, in contrast to the 2003-2008 period. If the growth in a category contributed more post-war (that is, if they became a driver of post-war growth) then the bars extend right in the positive direction, and vice-versa.

If the two sets of bars have a very similar pattern it would imply that growth drivers in 2012 were not fundamentally different to those in 2010-11. However, they don't, implying that the growth drivers were different. And it is these differences that provide the deductive clues to the sustainability question.

2010-11 Growth by ballooning the trade deficit

The post war bump 2010-11 has come primarily from three sectors: (1) Import Trade, (2) Transport, and (3) Construction. The first two alone added an extra 0.75% to post-war GDP (That is close to half of the post-war bump).

Import Trade refers to the additional economic value created by the selling in Sri Lanka goods that have been imported. Since the goods themselves are produced overseas, the purchasing value of the item is not counted in Sri Lanka's GDP. The transport category can also be boosted, independently, by high levels of imports. Therefore, growth in both these categories is driven by the growth of imports.

Indeed short term reductions in import taxes, and post-war consumer confidence, and a Central Bank controlled exchange rate, saw a huge boom in imports, which grew by 32%, and then again by 51%, in 2010 and 2011. With export growth lagging this meant that Sri Lanka's trade deficit (the difference between imports and exports) ballooned to a record high of 16.4% of GDP in 2011.

Import led growth is not sustainable

The ballooning trade deficit put pressure on the Central Bank's ability to maintain the exchange rate and forced sudden depreciations of the rupee in the third quarter of 2011 and the first quarter of 2012.

Hasty adjustments in taxes and regulations to keep the trade deficit from ballooning further, began to take effect in 2012. Imports fell by 11%, and, as would be expected by 2012, there was a drastic reversal in the contribution of Import Trade and Transport to growth (from being a driver that added 0.75% to post-war GDP growth to being an impeder contributing 0.68% less to GDP growth than in the 2003-08 period)

In short, growth by ballooning the trade deficit reached its limit very quickly. It is not sustainable in theory and proved so in practice as well.

2012 Growth by pressuring the fiscal deficit

The third driver of post-war growth is construction (see figure 1). It added an extra 0.33% to post-war GDP (That is close to one-fifth of the post-war bump).

In 2012, the decline in contribution by Import Trade and Transport was mostly compensated for by a huge increase in the recorded GDP contribution from construction. As a post-war driver of growth, it leapt-up, tripling its significance and adding an extra 1.07% to GDP growth in 2012.

The problem is that the main driver of construction in Sri Lanka is government financed expenditure on infrastructure.

Government expenditure led growth will also not sustain

With the government's revenue share of GDP lagging, increasing expenditure does two things. Firstly, it pressurises the fiscal deficit, and secondly, it increases debt. Both have ramifications for external confidence in the economy, which is a key factor in attracting foreign direct investment.

It is possible to underestimate the fiscal deficit for one year by postponing payments. But the trick can't be repeated; so it exerts real pressure on the next year, and in 2013 the government seems to be under such pressure. This could explain the several drastic and unpopular and inflationary steps to curb the fiscal deficit, including increasing electricity tariffs, and extending VAT to supermarket sales.

This secondary strategy of growth by pressurising the fiscal deficit will also reach its limit, even if it has not done so yet. The debt to GDP ratio, which declined post-war in 2010-11, has begun to rise in 2012; and foreign direct investment has not been forthcoming (low and stagnating below USD 1 billion a year). In short, if the public investments undertaken are not significantly productive, this strategy of growth through government spending is also unsustainable.

Prognosis for the future

Increasing GDP growth in a sustainable manner requires serious administrative and policy reforms involving the public sector, in education, in regulation, through technology improvements and by solving efficiency blocks in economic interactions. Shortcuts are short-lived. The trade-deficit based short-cut has expired, and the fiscal-deficit based short-cut could run a little longer.

It is, therefore, in Sri Lanka's best interests to undertake the serious reforms before the short-cuts have run out.

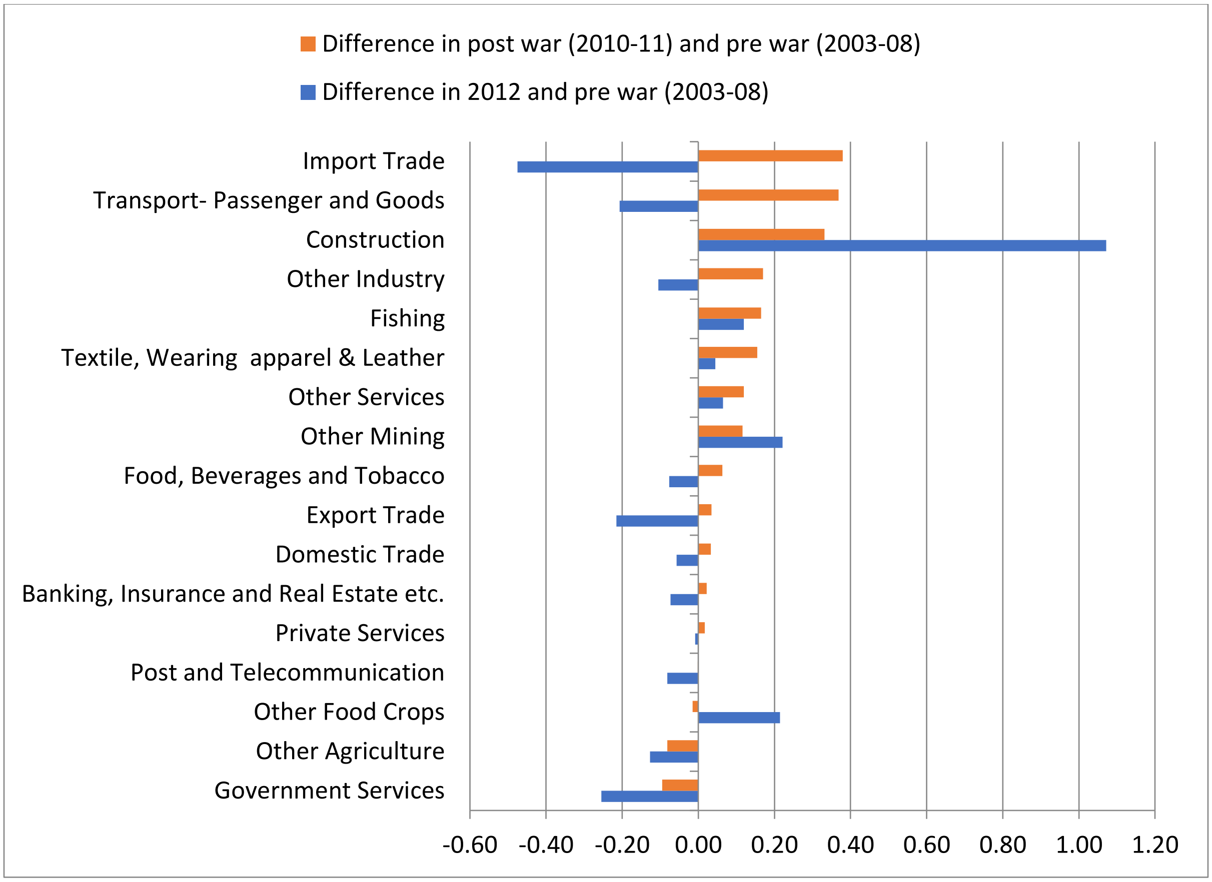

Figure 1: post war drivers of growth 2010-11; vs 2012

(Verité Research is an independent think-tank based in Colombo that provides strategic analysis to high level decision-makers in economics, law, politics and media. Comments are welcome. Email publications@veriteresearch.org)