Daily FT – June 7, 2017

Sri Lanka's economic prospects amidst challenges

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By Federation of Chambers of Commerce and Industry of Sri Lanka

Business sentiments and prospects

Sri Lanka's growth forecast for 2017, as given by the World Bank, projects an economic growth below the threshold 5% level for the third year running, and even more worrisome, economic growth appears to be on a downward spiral.

Rising costs and dampened domestic demand, possibly due to falling purchasing power, have been hitting the SMEs dearly. With key economic fundamentals, such as inflation, nominal interest rates, the VAT levies, and exchange rate remaining unfavorable to the SME growth and new investments, looming cost pressures due to drought-affected food sector, in particular rice, and a possible upswing in world oil prices, and their combined pressure on energy costs are real worries.

The macroeconomic challenges arising from an already-ballooned fiscal sector and a seemingly-volatile balance of payment situation against the IMF austerity targets would result in decision-making becoming even more challenging to the SMEs. Making matters worse has been the absence of coherent long-term economic policy making and strategy.

Against this prevailing backdrop, the FCCISL welcomes the measures been taken by the Government to project a turnaround in the medium-term. Amongst the most tangible recent policy and strategic moves has been the regaining of the GSP Plus extended by the EU, and previously the lifting of the ban on fish exports. The FCCISL commends the swift and persevering actions of the Government to regain duty free access to the largest market in the world.

The granting of the GSP Plus outcome signifies a sign of the confidence placed by the EU in the Government and should augur well for broader attention of the potential location of FDIs in Sri Lanka. As an immediate outcome, it will be a boost to the struggling apparel industry and several other export sectors.

The FCCISL also welcomes the Government's much-publicised recent vision and commitment, as articulated at a national symposium in Colombo in April this year, to a private sector-led, export- and FDI-led development strategy. The SME community, while welcoming the broadly spelled out vision, awaits a clear commitment to a policy framework and a consistent strategy that is well-supported by the coalition political establishment.

Moreover, the local SME sector, comprising thousands of medium to micro production and service units, is badly in need of a business-friendly enabling environment that promotes SME business development as a bedrock development strategy. In this regard, well-sustained policies and strategies to ease the escalating cost pressures and reverse the negative economic sentiments are most fundamental if the SMEs are to make any headway.

Moreover, a holistic policy and strategic framework and action hold the key to any prospects of creating a competitive SME sector and national competitive advantage in general. Without creating Sri Lanka's competitiveness directed at a sustained export drive, and also supporting import competing local industrial and service SMEs, front-end actions of promoting FDI and FTAs alone will yield little positive outcomes, and in a worse scenario, even adverse outcomes.

Economic growth forecasts

The Sri Lankan Central Bank Governor recently predicted that the forecast economic growth would be 5-6.0% in 2017, while the Minister of Finance projected an even more optimistic 5.7-6.0%. However, the business community in general is less convinced.

As reported in a local web-based business journal, local private business and policy forecasters predict a growth of 4.5% in 2017 while a Singapore-based investment forecast a figure as low as 3.5% citing prevalent tight fiscal and monetary stances as a "drag" on growth.

The growth forecast released by the World Bank for South Asia places Sri Lanka's economic growth for 2017 at an estimated 4.7%, a marginal rise from its provisional growth estimate of 4.4% in 2016. This growth forecast, in perspective, appears a low-end performance when South Asia is forecast to achieve 6.8% in 2017, sustaining its 6.7% achieved in the previous year.

Clearly, against a promising South Asian growth forecast, Sri Lanka cuts a sorry picture with growth estimates. Even more concerning is that, while the forecast growth is well outside highly optimistic official growth forecasts, it is placed at the sixth place in the ranking of South Asian countries, just ahead of the Maldives and Afghanistan.

This predicted growth performance, even if one assumes to be a plausible estimate, does not augur well for the country, the people and the business community. Last year's economic growth, having been revised down several times, ended up at 4.5%, worse than growth of 4.6% in 2015. Ironically, Sri Lanka seems to have failed to capitalise on exceptionally favourable costs on oil and other commodities seen in 2015, and a very favourable domestic political climate with the induction of a new regime on a good-governance platform.

The very toxic, politically-motivated, and unprecedented fiscal excesses in the 100-day Budget derailed the most sought-after sustained economic growth prospects that would have been realised through a better-managed economic strategy and political establishment. With business sentiments running subdued and the political establishment seemingly under duress while social pressures are mounting, there clearly seems little room for policy manoeuvring.

Fiscal sector and growth

Recent statements by the World Bank and the IMF about the prospects of fiscal improvement commended Government efforts taken so far to consolidate the budgetary position, especially revenue and deficit targets. While this outturn should augur well for some kind of improvement of the Government's fiscal scorecard, it remains to be seen how the increased revenue measures impact upon SMEs, and on growth prospects in general.

If the improvements could enable the Government to ease its grip on revenue collection through VAT and other indirect taxes it tightly holds now, the possible outcome should contribute positively to catch up some domestic demand and hence the production. However, with the Government having no choice over its maligned policy of raising salaries of the 1.2 million-strong public sector, which adds an estimated Rs. 12 billion of extra expenditure every month, and several other populist measures granted though the past budgets, any prospects of easing the Government's tight grip on VAT collections in this year will be almost unrealistic. It appears that the perceived Government fiscal position could only come about at the expense of economic growth prospects.

Inflation beckoning on the horizon

Annual inflation, which was measured in CCPI (2013 base year), was estimated at exceeding 8%, according to March 2017 estimates released a few days ago. Such a scenario has added a further concern to the SMEs which are reeling from poor economic growth outturn.

Inflation will turn a major worry soon, as it affects a wide range of economic inputs across the board and adds a further premium on escalating costs. It may however be recalled that, until the first half of 2015, inflation measured by the CCPI and its core inflation index measures, fell to a historical lowest of 1%, and moreover, showed signs that inflation was stabilising within a 'no worry' zone.

It's most unfortunate however that Sri Lankan inflation had turned around from its downward trajectory when in fact global inflation has remained dampened and when that could have been exploited to make gains to push for growth, in particular manufacturers, and notably trade competing sectors.

Inflation expectations, which provide a barometer of inflation to come, were at low level at the beginning of 2015 with cost-push pressures at bay, as oil prices, which usually has been a main culprit of inflation cost pressures, hitting rock bottom. Contrary to the early-held low inflation expectations, rising cost pressures have been eating into the profitability of SMEs. Simultaneously, inflationary expectations have been eroding the purchasing power of workers giving rise to predictable wage pressures in the immediate and the short-medium term.

The SMEs also fear that the Government, under pressure for populist policies, will de-facto remain a passive spectator or even pressurise the private sector to comply with wage pressures for short-term political gains as provincial elections loom large on the horizon. These concerns are not quite unfounded given the basis of policy actions taken in the last two years. Adding insult to injury, rising exchange rate depreciation pressures and signs of upward movement in oil and global commodity prices will only lead to more inflationary outcomes in the months ahead.

With inflation comes pressure on interest rates and exchange rates

Besides the broad concerns on the inflationary front, the sudden jump in interest rates has been real and growing concern to the SMEs. Over the last several months, escalating costs of finance has severely eroded the ability of the SMEs to remain afloat as going concerns, leave alone the prospects of being profitable.

The spikes in interest rates at most unexpected times, in particular when the SMEs were gearing for a lower interest regime, was most destructive to all the SME sectors and their subsectors. It severely dents business confidence for medium- and long-term investments, essential replacement and new capital outlay efforts. Those who had such plans in the pipelines in 2015 and 2016 were hit by a severe blow. Some have been trapped in business propositions where they have no easy way out should they wish to minimise the effects of the economic fallout.

As the interest rate rise registered an unprecedented jump of over 500 basis points, equivalent of over 5% rise, since the first quarter 2015, the SMEs were affected by both the absolute real time costs and downward revisions of profitability forecasts. It's our informed understanding that many SMEs are struggling with a heavy burden of debt with survival as a day-today business strategy. Last but not least, the heavy shift towards increased VAT had created a major dampener on consumer confidence.

With the Government increasingly under a debt burden cloud, especially domestic short-term debt, which was evidently was self-inflicted since its populist Robin Hood style budget in 2015, the expectations that the policy environment will calm the situation down has turned bleak. As the Government is running out of viable options, having exploited all short-term exit routes, including the much controversial printing of money which has become the norm over the last several months, the prospects of turnaround any time soon remains a horizon too far. Adding further to the economic misery have been the inconsistent policy positions within the Government, including the political gaps within the coalition that are now conspicuous in the public domain.

Looming over the horizon, as concerns recently expressed by the Governor of the Central Bank, is a rising property bubble that was apparently triggered by monies pouring into property which provide lucrative returns when other sectors were underperforming. Excessive money creation through the Central Bank while holding interest rates down is likely to have created a toxic mix of optimism towards property investment and shift towards import financing. Both outcomes are loaded heavily against true real economic sectors and the SMEs.

Economy on the SMEs

If the current economic trends provide a yardstick of future economic scenario, the predicted snail's pace of the economy will have a lasting negative impact on SMEs in particular (which contribute nearly 60% to the country's GDP), and which are already hit with a double whammy of rising costs and dwindling sales.

With regard to the immediate short-term, the situation looks even bleaker. As a recent study stated, this year's Avurudu sales, which usually provide some respite to an otherwise below-expected performance, has been down by as much as over 40% compared to last year. While the prevailed drought provides a partial explanation, the persistently-falling purchasing power of people and dwindling business sentiments remain among the main underlying factors. The SMEs, which are usually cash-strapped and are commonly heavily-geared, when faced with a prolonged downturn take a serious hit on cash flow and jeopardises their very continuity as a business enterprise.

Way for the medium and long-term

Perennial productivity issue: Sri Lanka's inherent issue has been the lack of efficiency and productivity which directly affect exports and eventually the GDP of the country. Industrial sectors across the board are faced with acute productivity issues that make our products uncompetitive in the world market. While there are micro-level or firm-level issues of productivity, much of the issues are beyond firms and industry levels.

Broad macroeconomic policies, including fiscal policies, provide no encouragement; firms are grappling with excessive costs wrought on them due to wrong policy measures and the lack of an institutional framework that promotes productivity and competitiveness. It's the widespread opinion of the SME community that, without adequate measures to address productivity and competitiveness issues, Sri Lanka's attempts to enter into Free Trade Agreements with countries such as Singapore and Korea which maintain very high productivity levels across their industries could make the situation worse. However, we note that despite these mixed sentiments, the country needs to enter into FTAs selectively and appropriately to enable local firms to gain more business opportunities.

It's inevitable that FTAs would result in restructuring of local industries and some may even have to be closed down if they fail to meet the new challenges posed. Yet, it should enable more opportunities for firms to adjust to competition and reap the benefits. Hence, the Government also needs to create the right business environment for SMES to adjust and adapt.

It is also noteworthy to mention that Sri Lanka has still not been able to reap expected benefits from the FTAs signed so far, and in reality, many SMEs face extinction. Low-priced, often substandard imports from the Indian sub-continent have flooded the Sri Lankan market, when Sri Lankan exports to Indian sub-continent have faced non-tariff barriers and other trade obstacles.

Back to development banking

In the least the SMEs expect policy consistency and management of the present economic challenges to avoid them turning into catastrophic proportions. In this regard, it's important to pay attention to contemporary economic discourse on a Sri Lankan strategy. In a speech at a recent seminar in Colombo Prof. Howard Nicholas lamented the foolhardiness of Sri Lankans to have converted the only two development banks into commercial banks and underscored the fundamental necessity to provide funds at low cost with adequate risk cover to local investments to create a competitive economic environment.

Sri Lanka to plug into exports through value chain

Dr. Nicholas further stated that the global economic is heading for a recession in 2017-19, and countries like Sri Lanka should gear to reap the best in a worst scenario. For that it's imperative that we get out of these economic uncertainties sooner and concentrate on creating the mood for competitiveness and promote SMEs to launch into exports and import competing manufacture.

The global recession would create opportunities as the Asian economies that enjoyed sustained growth momentum over the last decades look to relocate their businesses into yet-unexplored locations like Sri Lanka. This provides openings for SMEs to partner with such relocating businesses. This will enable an export drive and technology sharing for a sustained manufacture-based export growth.

A vision for the future – A lesson from Singapore

Given below is an extract of Singapore's experience and strategy to reach the level as the top most position of the World Competitiveness Index Back. With the right vision, and commitment to a well implemented strategy it reached its goal. What Sri Lanka needs is a leaf from Singapore success. We share the relevant extracts below as the FCCISL believes that Sri Lanka needs to believe in itself its people and put together a set of policy framework supported by the political establishment with meticulous planning and commitment to achieving them with a definite time frame. We have missed the bus many a times in the history. It's not too late yet that we learn from the mistakes and move forward to creating the promise of South Asia

Singapore story

In 2010, the Economic Strategies Committee (ESC) reporting to the Prime Minister was tasked with making Singapore more competitive and getting Singapore to the top of the World Competitiveness Index. They put together a team of 1,000 people from the Government, universities, private sector, think-tanks, etc. After forming and working on their plan, they achieved second place in the World Competitiveness Index for six years in a row, from fifth position in 2007-08.

Singapore's ESC 2017 plan

Singapore's ESC 2017 plans to achieve an average GDP growth of 2-3% per year over the next decade. This can be achieved through the seven mutually-reinforcing strategies it proposed:

1. Deepen and diversify Singapore's international connections
- **Press on with trade and investment cooperation**
- **Set up a Global Innovation Alliance**
- **Deepen knowledge of Singapore's markets**

2. Acquire and utilise deep skills
- **Facilitate acquisition of deeper skills**
- **Strengthen nexus between acquisition and utilisation of skills**

3. Strengthen enterprise capabilities to innovate and scale up
- **Strengthen Singapore's innovative ecosystem**
- **Support enterprises to scale up**
- **Catalyse the private sector to provide more growth capital**

4. Build strong digital capabilities
- **Help SMEs adopt digital technologies**
- **Build deep capabilities in analytics and cybersecurity**
- **Leverage data as an asset**

5. Develop a vibrant and connected city of opportunity
- **Invest in Singapore's external connectivity**
- **Continue to plan boldly for growth and city rejuvenation**
- **Build partnerships for a vibrant city**

- **Develop exportable capabilities**

6. Develop and implement Industry Transformation Maps (ITMs)

- **Tailor ITMs for each industry**
- **Take an open, cluster approach to maximise synergies across industries**

7. Partner each other to enable innovation and growth

- **A greater role for Trade Associations and Chambers (TACs) and unions**
- **Create a regulatory environment to support innovation and risk-taking**
- **Use lead demand to support the development of promising industries**
- **Review and reshape Singapore's tax system**
- **Create a sustainable environment**

- See more at: http://www.ft.lk/article/620385/Sri-Lanka-s-economic-prospects-amidst-challenges#sthash.gmH1QbWH.dpuf