28/05/00 Island

The economy needs discipline and austerity

By Analyst

The economy is said to have grown by 4.3% in 1999. Inflation is said to be down to 4.7% from the previous year's figure of 9.4%. This growth is due primarily to the improvement in agricultural production, particularly paddy. Value added in paddy production increased by 7.0%, recording the highest yield in recent years. Yet we had to import 214,000 metric tons of rice during the year.

The Central Bank is crowing about the reduction in inflation as if it was brought about by the bank. Reduced inflation goes along with deflationary tendencies in the economy, caused by the slackening of the export growth. Export prices of apparels declined by 9% although production increased by 8%. Tea prices also declined and export earnings decreased by 13%. Industrial production grew by 4.4%.

How accurate the statistics are is difficult to say. It is usual to compare other statistics like the output of electricity to see whether they confirm the growth in GDP, since it is a good proxy for production. The statistics of electricity consumption by industrial consumers show a growth of less than 2% according to the Annual Report. This is despite an increase in the number of industrial consumers by 6%.

The increase in the broad money supply is 13-15%. In spite of this expansion in money supply, inflation has come down to 4.4% from 8.4% the previous year. The stock market has collapsed and asset prices of both shares and even property are stagnant. It is difficult to square up all this with the figures published by the Central Bank.

The annual reports of the quoted companies show both a decline in turnover as well as profits, both gross as well as net profits before and after tax. They show clearly that there is a slackening of demand for products sold in the domestic markets. This is in spite of fiscal expansion by the government.

The budgetary deficit will invariably exceed the budgeted figures firstly because the practice in budgeting is to always understate the projected deficit. The actual figure is said to be 7.6% of GDP. As the Bank report says, the overall deficit has been considerably higher than the average in developing countries which is 2.8% while for the period 1992-96. The Sri Lankan average was 10.1%.

It is not only the costs of financing the war that boosts the fiscal deficit. It is due also to wasteful welfare expenditure like the Rs. 8-9 billion for Samurdhi benefits. Throwing money to political supporters in the name of poverty alleviation is economically damaging.

Uncompetitive banking

The Seylan Bank's annual report records the low return on assets obtained by the commercial banks in Sri Lanka. The industry average according to this report is only about 0.45%. The return on assets in banks like Britain's Hongkong & Shanghai Banking Corporation is 1.62% (in 1995). Then there are the non-performing loans, bad debts to the ordinary layman, which are as high as 17-18%.

The non-performing loans in the state owned banks must be much more. Do the banks make adequate provisions for bad (non-performing) loans? Only the Central Bank could know. The interest yield is also low and would be even lower if all interest in suspense is not treated as earned income.

If there is competition among the banks, which is prevented by the special position of the two state banks with their implicit guarantee of deposits by the government, the yield would be even lower. The strength of the trade union among bank employees ensures that the public are fleeced by the banks and they get adequate earnings from every little service they provide. These employees are able to obtain salaries and perks far in excess of what they could command if the labour market was free.

It is the banking public that is paying the price, not the owners of the banks. But the government sees no reason to liberalize the labour market, the most important requirement to promote competition and thereby economic growth. If there is one thing that economists are fully convinced about, it is the power of incentives in determining favourable responses. If we wish to stimulate economic growth we have to permit incentives to operate.

Economists have studied how people choose marriage partners, decide on family size, on polygamy, levels of religious activity etc. and all such studies have borne out the importance of incentives. As long as murderers can be deterred, capital punishment can be a deterrent. How can this be? Are not many murders, crimes of passion, carried out in the heat of the moment?

But people engaged in such crimes also respond to incentives. The probability of punishment affects him even in the heat of the moment when he raises his hand to hash his wife. If he thinks the probability of capital punishment is even 15-20% he may still be affected although not every would be murderer would be deterred. But some would surely be. So, if we want to promote some activity or a particular type of behaviour we should see to it that there are incentives to such behaviour.

Incentives needed

If we want enterprises to safeguard the environment we should see to it that it is in their financial interest to do so. If we want to reduce traffic congestion, we cannot permit free parking by anyone; not by the three wheelers or school vans. It is misplaced sympathy that has prevented the government from cost recovery. But unless there is cost recovery which includes social costs, there will be no solution to the problems we encounter.

It is free markets and competitively determined prices that ensure that the private interests of the economic actor - be he a producer, consumer, financier or whatever - promotes the public interest. Monopolies are not in the public interest and the state should ensure free competition. Predatory pricing, price discrimination are not competitive practices.

The state itself is unwittingly supporting uncompetitive markets. Consider the regulation of fees of medical specialists. It helps only the doctors. It is better for the state to keep clear of such regulation. Similarly, the state is through regulation preventing free entry into professions.

Should the supply of doctors be limited by banning private medical colleges? Who benefits? Not the public who are patients. Should government doctors be permitted private practice? If there is a shortage of medical consultants it would be better to engage those from the private sector rather than allow the government medical specialists to engage in private practice as well.

There are similar barriers placed on entry to the accounting and auditing professions to keep the earnings of these professions high. It doesn't benefit the public. Long ago Adam Smith noted that "people of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."

But there is a problem. Even if all the producers agree to restrict their production to keep prices high as OPEC does, it pays an individual producer to cheat by exceeding his quota while the others abide by the agreement. Eventually the cartel crumbles unless there is an enforcement mechanism. Such enforcement mechanism is often through the state. When such an enforcement mechanism exists, any group of competitors will attempt to collude.

The professionals have cleverly involved the state in limiting entry ostensibly to maintain professional standards but really to keep their earnings high. The state bureaucrats should understand this instead of being guided purely by the professional bodies in determining conditions of entry to the professions.

The economy is in a crisis situation. Hitherto, the businesses, whether in industry like garment manufacture or in the services like tourism and hotels, or in the tea and rubber estates could afford to pay higher wages whenever the trade unions strike and then look to the government to depreciate the rupee to make up the losses. But globalization has made things much more difficult.

Our workers now compete with those in Bangladesh or Vietnam or other low wage countries for their jobs. The footloose enterprises in manufacturing like the apparel industry can pack up and go elsewhere in search of lower labour costs. It is therefore not prudent to increase wage unless there is a compensating increase in productivity which will keep unit labour costs of production unchanged.

This applies not only in the export industries but even in the tea plantations or services, both in the public and private sectors. Our workers and their trade union leaders are not sophisticated enough to understand the effects of globalization or even the changed situation in the country with the open economy which inherits the ups and downs characteristic of capitalist economies.

So they will strike for higher wages in good times as well as bad, in booms as well as in depressions or recessions. But increases in productivity are severely inhibited by macro constraints like the excessive paid holidays due to government policy and the lack of flexibility in the labour market. If we want to increase productivity we must produce incentives to the workers to increase productivity by working harder, doing an honest day's work and working more efficiently.

Paying every worker the same wage irrespective of whether he is a shirker or a hard conscientious worker is no way to increase productivity. Economists say that the individual firm will hire labour up to the point that his marginal product equals his wage. But such principles cannot be applied where workers cannot be reduced without paying costly compensation; where shirkers and idlers cannot be disciplined or got rid of without much cost and trouble.

During the early 20th century in China goods were transported by barges and each barge was drawn by six men. If the barge arrived on time the men were rewarded handsomely. Each man soon

See page 23