

Ajith Nivard Cabraal: The role of productivity improvement in achieving economic prosperity

Keynote address by Mr Ajith Nivard Cabraal, Governor of the Central Bank of Sri Lanka, at the Annual General Meeting 2007/08 of the International Chamber of Commerce Sri Lanka, Colombo, 17 September 2008.

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Mr. Chairman, Distinguished Invitees, Ladies and Gentlemen,

I consider it a unique honour to be invited to deliver the Key Note Address at this Annual General Meeting of International Chamber of Commerce Sri Lanka (ICC Sri Lanka). I also consider it a great privilege to share my thoughts and views on **a very timely topic, “The Role of Productivity Improvement in achieving Economic Prosperity” since productivity improvement is essential from both a micro and macro perspective.** Therefore, at the outset, I wish to thank the ICC Sri Lanka for inviting me to deliver the keynote address on a vital theme at this important forum and giving me an opportunity to plant a few seeds in your distinguished minds so that such seeds may be nurtured by you in your future endeavours positioning the country at a higher level in the global environment.

As we all agree, as individuals, our main objective is to experience a better life and we think, act and react aiming to achieve this. At the same time, the main objective of economic management is to enhance standard of living of the people. Hence, relevant stakeholders in the country formulate, implement, revise and re-implement economic and other policies to achieve such goals. **Whatever the policy we formulate and pursue, the ultimate aim is to raise living standards of the nation.**

At the same time, we are all aware that it is compulsory to have higher economic growth and fair distribution of benefits of growth for achieving higher standards of living. The issue is, **how can we achieve higher rates of economic growth?**

Theory will say savings, investments, diversification, technology, hard work, attitudes and perceptions. Yes. All these are important and they have certain importance in a country's overall performance. However, in a highly competitive, globalized environment with a limited resource endowment all of these factors would be second to productivity. **For sustained prosperity, productivity is the key.**

Why is the productivity so important? Economists agree that, **in the long-run, productivity growth is the principal means of improving living standards.** The rate of productivity growth influences the economy in important ways, even in the short run, by affecting key variables such as output growth, employment growth, and the rate of inflation. So, as a first step, let us examine the need of productivity improvements in the current global and domestic economic context and the lessons of success by emphasizing on productivity, so that we could deal with this topic in a wider perspective.

In my view, **our economy should focus on productivity due to two important reasons.** First, limits in expanding agriculture and industry sectors and the resultant hindrance of economic expansion. Second, in the current economic context, a greater emphasis has to be placed in not only expanding the services sector, but also improving its productivity in order to achieve higher economic growth. Let me elaborate on these two reasons in a broader manner.

The economic history of countries clearly shows that **there is a set pattern of the transformation of the structure of economies, typically from agriculture to industry and then to services.** It happens due to two major reasons. First, in the first stage, the economic value was entirely created by agriculture, which is called the pre-industrial era. Thereafter, the source of a country's economic value shifted to industry with fast

industrialization. However, **the value creation through agriculture and industry was constrained at a certain point as the performance in both the agriculture and industry naturally depends mainly on the natural resource endowment.** Therefore, when the natural resource endowment of countries limits further expansion of agriculture or industry, a greater need for improving productivity arises.

Second, **when growth is limited due to constraints in agriculture and industry, the vacuum has to be filled with some other more efficient economic activity.** Otherwise, the economy would be stagnant. Hence, **the existence of an efficient and vibrant services sector has become a necessity for further growth of the economy as a whole and the agriculture and industry sector in particular.** Although the services sector was often criticized as a sector that does not create real wealth, both the theory and evidence prove that the wide-spread development and also the saturation of agriculture and industry has led to the creation of a new source of wealth through a more dynamic growth sector in the form of services.

The services sector is currently the largest and fastest growing economic activity in most of the developed and developing world. The World Bank estimates that the share of services in the Gross Domestic Product of developed countries is typically between 60 and 70 percent. While these figures are generally lower in emerging and least developed countries, they have steadily been increasing over the years. However, it is equally accepted that existence of expanded services sector alone cannot generate wealth. It has to be dynamic, vibrant and it should add high values to the economy. **The services sector should be more productive and efficient.** Today's customer not only demands services, but demands more productive, efficient and reasonably priced services.

Let's take a closer look at Sri Lanka now

Undoubtedly, Sri Lanka's agriculture sector has made its greatest contribution to create wealth and employment in the past. As we all are aware, we have been self sufficient in rice production over the millenniums. We have been producing and exporting agriculture commodities for centuries. At the time of independence, the agriculture sector was dominating with a share of 47 per cent of GDP. However, **keeping with the global and domestic economic trends, the relative importance of the agriculture sector has been shrinking.** Accordingly, the share in agriculture reduced to about 12 per cent of GDP by end 2007. What has been the impact? **It has not been able to create sufficient value or wealth with the reduced share of sectoral importance.**

While recognizing the historic importance of the agriculture sector we should recognize the fact that it has a limitation in the form of low contribution to the national output and low productivity in the current context. Notably, as about one third of the labour force is engaged in agriculture, its total output is distributed among a large number of workers. According to the World Development Report 2006 of the World Bank, the agricultural value added per agricultural worker in Sri Lanka, measured in 2000 US dollars, has been US dollars 696 for the period of 1989-91. This has increased only marginally to US dollars 737 in 2001-03. However, the comparable figures for other countries, even in emerging countries, have been much higher than these figures. What is the result? **As a result, the income of agricultural workers in Sri Lanka has been very low, keeping them below the poverty line.**

At the same time, **underemployment has been the natural consequence since employment in agriculture is seasonal and there is a higher concentration of a large farm-based work-force on limited extents of cultivable land.** Even disastrously, the under-employment in agriculture in Sri Lanka is not only the highest but also on the increase. According to the Consumer Finances and Socio-economic Survey of the Central Bank, the underemployment in the agriculture sector in 1996/97 stood at 31 per cent of the employed and it rose to 36 per cent by 2003/04. In contrast, the underemployment in the services

sector fell from 20 per cent to 18 per cent between the two reference periods and that in the industry remained unchanged at 20 per cent.

This has to be seen as both a weakness and an opportunity. We know that food prices have recorded an unprecedented increase in recent times. Hence, there are immense opportunities arising from increased prices and resultant increase in production. At the same time, food security has to be ensured in order to avoid adverse consequences of increased food prices and also undue declines in stocks. **Given these limitations, the obvious strategy is to increase productivity.** Accordingly, attempts need to be made to concentrate on land, water, agricultural methods, seeds, harvesting, credit to agriculture, transport, harvesting storage, stable prices, value addition etc. to raise productivity in agriculture.

If the growth is constrained by limited expansion in agriculture, can't we focus more on the industry sector? Of course, we can. Unlike the agriculture, which is constrained with limited land availability, industry does not have capacity or demand limitations. Even the non-availability of raw materials or essential inputs or the domestic demand for the output no longer does inhibit industrial growth in view of globalization of trade and services and the advancements in information and communication technology. **Although the importance of the agriculture sector in Sri Lanka is reducing, the share of industry has been improving.** By end 2007, the share of industry remained at around 30 per cent of GDP compared to 20 per cent in 1950.

However, **there are still risks and weaknesses in industry sector as well.** The higher reliance of imported raw material, increased cost of economic infrastructure, higher wages per unit of output, overall increase in cost structure, intense global competition and possible abolition of various concessions certainly tells us there is an urgent need to improve productivity in the industry sector as well. The demand for the country's industrial goods will always depend on its comparative and competitive advantages. This requires **local industries to raise productivity and efficiency in production so as to successfully compete with the rival producers in other parts of the world.**

Since Sri Lanka does not have an unlimited natural resource base it would be difficult to enhance growth through industry or agriculture alone. As mentioned above, services sector is important for both industry and agriculture sector performance. Hence, **we need to focus more on services sector.**

However, **the focus should be placed on a "more productive" services sector.** Although we always stress the importance of improving productivity in agriculture and industry sectors, a similar significance should be assigned to the services sector as well. Despite the growing weight in services in economies, productivity growth in services has been slow in many countries and the share of the working-age population employed in services remains low in many countries. If we wish to strengthen economic growth and improve the foundations for the future performance of our economy, the services sector will need to do better. But strengthening growth performance is not the only challenge that we are facing. We are also confronted with the growing globalization of services and with rapid technological change posing the huge challenge of keeping the momentum in the services sector. Addressing such challenges and strengthening the potential of services to foster employment would be definitely through increased productivity and innovation. Certainly **a productive services sector would deliver more benefits in a highly competitive environment.** Sri Lanka's telecommunication sector is a good example.

In which areas have we been below par? Although Sri Lanka has a huge potential in services such as education, health and tourism, we haven't done enough. So, also, has it been in the case of ports, financial services, including banking. We have not been able to reduce prices and charges through increased productivity.

We may need to open domestic services markets to create new job opportunities and foster innovation and productivity. Further regulatory reform of services markets will create fresh opportunities for firms to develop new services, meet emerging global demands and increase

employment. It will also increase the incentives for companies to innovate and improve productivity growth. **With all these, country would reach higher level of economic growth.**

Before I conclude, I would like to **address three broader issues based on three important macroeconomic fundamentals.** First, unemployment; second, exchange rate and the third is inflation.

What will unemployment reduction do? **The declining trend in unemployment to its lowest recorded level in Sri Lanka brings to focus the need for more efficient use of labour through productivity improvements.** Precisely, lower unemployment indicates a potential hindrance to future higher growth prospects unless labour productivity is improved substantially. It has been encouraging to observe the continuous improvements in labour productivity over the years, especially in the industry and services sectors, which have contributed well to higher economic growth. However, an increasing mismatch in labour supply and demand is reflected by the high rate of youth unemployment, including graduates, and their desire to join the already expanded public service, while certain sectors in the private sector are finding it difficult to recruit necessary skilled labour. This together with declining labour force available for agriculture employment indicates the need of improving productivity as a prerequisite to achieve the envisaged higher growth targets and a more balanced regional development.

What will the Exchange Rate do? Under the floating exchange rate regime, the Sri Lankan currency can no longer be regarded as a steadily and continuously depreciating currency. With the maturing domestic foreign exchange market, the exchange rate is now more responsive to, and determined through, market forces of supply and demand, while the intervention by the Central Bank is limited to mitigate excessive volatility in the market and to build up official external reserves. **The stabilization of the Sri Lanka rupee utmost underlines the need for the export and import competing sectors to focus more on productivity improvements and market access in order to maintain external competitiveness.** Instead of waiting for the exchange rate to depreciate and then for our businesses to become competitive, it is time for all of us to improve our productivity in whatever manner we can. The garment sector, I hear is trying to gain from higher productivity and also through cost efficiencies.

How does inflation and productivity affect each other? **Increased productivity is an important prerequisite to achieve low and stable inflation levels in the long-run.** The lower productivity allows cost increases that flow through to product prices and thereby raises inflation. Therefore, the lower productivity growth thus represents a negative supply shock that generates inflationary pressures. In such context, it is necessary to pay due attention to improving the productivity in order to prevent potential inflationary pressure associated with high income arising from faster nominal growth and cost-push factors that raise the cost of production. The long run containment in inflation necessarily relies on containment of monetary expansion and increase in production in the country, particularly by improving productivity.

As the Central Bank, what we can do? Obviously we cannot produce goods or services for the consumption of the economy, but certainly we can create the right conducive environment enabling the country's economic performance.

Why should the Central Bank be interested in productivity? Our role is to maintain economic and price stability and financial system stability. We also provide necessary payments and settlement infrastructure. We advise the government in economic affairs and policy making, and we provide important agency services such as exchange control, public debt management, provident fund management and regional development activity. In all these functions, our Mission is to "contribute to Sri Lanka's prosperity". At the same time, the Central Bank widely pronounces the theme of "success through productivity".

But, obviously this cannot be done by ourselves... **The success through productivity needs a consolidated national effort.** That is why we all have to push ourselves to a greater productivity level. We have to,

- **work smarter,**
- **combine better,**
- **deliver results,**
- **get it right.**

It should be noted that **the private sector has continued to make commendable efforts in order to improve productivity** in the country. What can the ICC Sri Lanka do? ICC Sri Lanka too can play a prominent and essential role. Since your organization establishes the business stance on broad issues of trade and investment policy as well as on vital technical or sectoral subjects including financial services, information technology, telecommunication, marketing, environment, transportation and etc., a vital role can be played in articulating the need for improving productivity.

Do it now. This will be a major contribution that you make to our country.