

PUBLIC LECTURE ON
ECONOMIC REFORMS IN EMERGING ECONOMIES
BY PROF. JEFFREY SACHS

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INTRODUCTION

We are greatly honoured by the presence of Prof. Jeffrey D. Sachs who is going to talk to us today on ECONOMIC REFORMS IN EMERGING ECONOMIES.

To introduce him of course is almost trite and superfluous but as his record is so exciting, I thought I would make some references to important aspects of the brilliant career of Prof. Sachs.

He is currently the Director of the EARTH INSTITUTE and Professor of Sustainable Development at Columbia University and a Research Associate of the National Bureau of Economic Research. He was formerly the Director of the Harvard Institute for International Development (HIID) and Professor of International Trade at Harvard University. In January 2002, Prof. Sachs was appointed by the Secretary General of the United Nations, Kofi Annan, as his Special Advisor to the United Nations on the Millennium Development Goals Program. During 2000/2001 he was the Chairman of the Commission on Macroeconomics and Health of the World Health Organisation. And from September 1999 to March 2000 he served as a Member of the International Financial Institutions Advisory Commission established by US Congress. He served as Economic Advisor to several Governments in the past and now advises governments in Latin America, Eastern Europe, the former Soviet Union, Asia and Africa. I just read somewhere that he was one of the people who advised Bolivia when Bolivia had an inflation rate of 40% per year and within about a year it was down to 10%. He is also the Co-Chairman of the Advisory Board of the Global Competitiveness Report and has been Consultant to the IMF, the World Bank, OECD and the United Nations Development Program.

In February 2002 'Nature' magazine stated that Prof. Sachs had revitalised public health thinking since he brought his financial mind to it. He was cited in the New

York Times Magazine as probably the Most Important Economist in the World. And that sounds very much like the famous advertisement for Carlsberg Beer which says "Probably the Best Beer in the World". His syndicated newspaper column appears in more than 50 countries and he frequently contributes to such major publications as the New York Times, the Financial Times, and The Economist.

Prof. Sachs is the recipient of many Awards and Honours including Membership of the American Academy of Arts & Sciences, Harvard Society of Fellows and The Fellows of the World Economics Society. He has been conferred so many honorary degrees that it will take a long time for me to complete that list.

Prof. Sachs' research interests include the links between health and development, economic geography, globalisation, transition to market economies, international financial markets, macroeconomic policy coordination, economic development and growth, global competitiveness and macroeconomic policies in countries like ours. He is now directing a major research programme on global public health and economic development as Chairman of the WHO Commission on Macroeconomics and Health.

Prof. Sachs has published more than 200 scholarly articles and has authored or edited many books. His NBER Volume, 'Economics of Worldwide Stagflation', co-authored with Michael Bruno was published in 1985 and his book "Global Linkages: Macro Economic Interdependence and Cooperation in the World Economy", co-authored with Warwick McKibbin. 'Peru's Path to Recovery', co-authored with Carlos Paredes, was published by the Brookings Institution in 1991. His textbook on Macroeconomics in the Global Economy co-authored with Felipe Larrain was first published in 1993 and has appeared in German, Spanish, Russian, Chinese, Japanese and Portuguese.

He was born in Detroit, Michigan in 1954, received his BA summa cum laude from Harvard in 1976, MA in 1978, and Ph.D. from the same University in 1980. He was 26 years old at that time. He joined Harvard Faculty as an Assistant Professor in 1980 and was promoted to Full Professor in 1983, at the age of 29 years. He began his career in Columbia University, last year.

That's a very short edited version of a long story. I hope you will have a wonderful evening today listening to Prof. Sachs. He is in Sri Lanka for a brief visit at the invitation of the Government and the Central Bank. I have great pleasure in introducing Prof. Sachs to you.

PROF. SACHS LECTURE

Thank you so much for that very warm introduction and thank you very much for the opportunity to be here. This is my first visit to this beautiful country. I have been enjoying my first day enormously. I have been here only for 8 hours, so I cannot call myself an expert yet, but I already know that this is a very beautiful country with extraordinarily warm hospitality for which I am very very grateful.

I will be here a couple of days to discuss the general economic situation, the growth and development strategy of the country, and issues of health and macroeconomics that have been taken up by the Ministry of Health and Ministry of Finance and other departments of the government.

My main message today is how issues such as health, climate, environment and traditional issues of macroeconomic management have to be seen in an integrated fashion to understand the prospects and challenges of economic development. When seen in this integrated fashion, it is possible to envision for this country a quite dramatic rate of economic growth in the coming years.

The basic question of what emerging markets should do to achieve economic development has been studied in a serious scientific manner for about 226 years and probably much longer. One can date this debate to Adam Smith who wrote the Wealth of Nations in 1776 when he studied the question of what accounts for economic success or failure, what accounts for economic growth or stagnation, or in his terms Wealth or Poverty. He gave some pretty good answers that are still referred to. He didn't get everything right but given that he was sitting in Scotland and did not have a laptop or a worldwide database, he did a lot that was pretty good and a lot of what he pointed out remains true today.

That debate has continued for generations, and is indeed roaring as furiously as ever.

About 20 years ago, there was a proposal on what was to be a consensus, which had the unfortunate name of the 'Washington Consensus.' That was a checklist story to poor countries that were aiming to achieve economic growth. In some ways it was implemented at least in parts under the directions of the Washington-based Bretton Woods Institutions (the IMF and the World Bank) in what became known as the Structural Adjustment Period. As I came into town today I noticed an editorial on this topic in one of today's newspapers just to assure me that the debate is very much alive.

Well, 20 years of what I experienced goes to prove that there is no consensus. There is still a need to formulate strategy and a need for each country to find its way among quite wide diverse views. Even in Sri Lanka today, I can read from the press, there are anti-globalisers, pro-globalisers, those who are fairly mainstream orthodox structural adjustment promoters and those who regard structural adjustment as the kiss of death for development. So there is a great diversity of debate and views.

I want to try to shed some light on why the debate hasn't settled down by trying to point out areas in which it has been too limited for us to understand properly what is really happening. Here I will broaden out the prospects in the agenda that we cannot understand much better. The situations of countries in different parts of the world differ. Hopefully, I can understand a little bit of the situation faced by this country in its challenge to stimulating economic growth. The period of some moderate growth during the last quarter century was far from what might have been hoped for and from what other countries in the region achieved.

First on globalisation: What is the experience of developing countries on globalisation? There are the anti-globalisers and there are the globalisers and they are both wrong on general principles. We are not going to find a simple story line

that is going to explain the great divergence of economic performance in various parts of the world in the era of globalisation.

As Special Advisor to the UN Secretary General Kofi Annan, I have during the last couple of years been looking at the question of how poverty is faring under the forces of globalisation. What I have concluded is something like the following:

First, there are parts of the developing world, both poor and middle-income, that have achieved spectacular success in progress against poverty and in achieving overall economic development. There is certainly no case for saying that globalisation is in principle adverse to economic development of poor and middle-income countries. And this scenario is controversial here because many of your neighbours in Southeast Asia and in East Asia, even taking into account the crisis of 1997 and 1998, which by now has been largely overcome, have experienced sustained and very significant improvements in overall economic development and serious reductions in poverty during the last quarter century. China is probably the greatest example, because they are a country of 1.3 billion people that has been able to achieve at least doubling of per capita income every decade for the last 2½ decades, since the onset of economic reform and globalisation in 1978 under the leadership of Deng Xiaoping. China is not only the example in development economics of a successful government, but also clearly one of the world's globalisation successes. If you look at the real underlying force of China's economic improvement, there is no doubt that it is concentrated in the coastal provinces of China. There is no doubt, at least in my mind, that this coastal development strategy was to resort to export-oriented growth which was made possible by globalisation and by the decisions of the Chinese leadership 25 years ago to engage actively in globalisation. In a nutshell, what was achieved in terms of globalisation was that China's exports rose from about 20 billion dollars a year in 1980 to almost 300 billion dollars a year, last year (about a fifteen-fold increase). That is a great force that brings up the entire country's living standards. Since almost all the growth was export-related, right on the coast, the benefits of development in China have been highest in the coastal provinces and least in the western provinces, because growth has been driven not from the interior but from the coast itself through the globalisation process. Of course the rest of East Asia had absolutely

remarkable successes during the past quarter century. Again, in my opinion, clearly and quite obviously, success was achieved through exports and engagement with the world economy with coastal integration in ways that I am going to describe to you in a few minutes.

So that's the great success story. You can balance that against all other parts of the world that had not only failed to benefit from globalisation but also experienced significant retrogression during the last 25 years. No question about it. The most dramatic example of retrogression in the world is the starkest and direst humanitarian crisis in the world in sub Saharan Africa where 600 million people, broadly speaking, have experienced, on average, a decline in per capita income over the last 25 years. And Africa has been, at the same time, over-run by 3 massive endemic diseases: AIDS, tuberculosis and resurgent malaria. The combination of disease and malnourishment has meant that almost the entire continent has been hit again and again by chronic deepening economic crises during close upon a quarter century. There are small exceptions, but the general proposition fits.

Well those are the two extremes and there is a lot to fill in the middle. In the Americas, Mexico and the Caribbean have had experiences of economic growth during the globalisation period but not dramatic. South America has moved from crisis to recovery and back to crisis. The Andean region - the mountain belt on the west coast of South America through Central America - has been in fairly constant crisis for the last 15 or 20 years. And most of those countries are in a lot of difficulties, turmoil even, facing chronic economic difficulties.

Central Asia is another region of crisis. Afghanistan is not the only place in Central Asia in terrible difficulties. Most parts of Central Asia, not even touched by globalisation, are experiencing tremendous difficulties unless they have enough oil, so that somehow oil can save them from poverty.

And where does South Asia fit into this picture? South Asia as a whole has not done badly, but not spectacularly either. But with increasing success, it achieved moderate economic growth during the past 25 years. And the 1990s have been better than the 1980s. Your economic crisis last year may seem to belie that, but if

you look beyond the fluctuation from year to year, to periods of 5 to 10 years, the 1990s was a period of at least moderate growth in most of the region. It was pretty good in Sri Lanka from what the data tell us. And quite respectable growth as well, compared to India, your giant neighbour to the north, where after economic reforms and the globalisation process initiated in June of 1991, what had been an unstable growth rate of 3 or 4% for a couple of decades has now turned into a fairly reliable growth of about 6% in the last half decade. I am quite confident that growth rate is likely to continue with at least 6% per year.

Sri Lanka had good growth, but it wasn't spectacular. I was amazed when I arrived yesterday. A country that was considered by many as hopeless 25 years ago, has not only proven itself able to make significant progress in social indicators but also to achieve pretty good economic growth in recent years, on the order of 4% to 6% per year with a lot of strength coming from globalisation.

So when I step back, the first thing I see is a fairly complicated story. No simple lesson that globalisation is a disaster because it has been a great life saver for a significant part of the world; but no lesson that globalisation has been a panacea either because globalisation has either bypassed some places or has seen to render them unable to continue the growth they achieved earlier.

So I spend quite a bit of time trying to analyse how to account for these differences in economic performance. And indeed in that sense, it follows the tradition of Adam Smith because he really asked those percipient questions more than 2 centuries ago and I think they remain the most interesting questions for economists who try to understand the ultimate and deepest sources of success and failures in economic development.

Well, one answer that was attempted 20 years ago, which I have already mentioned was to deal with the basic strategy. It had one list of 10 elements, and said, "Follow the magic of 10 elements and you reach economic nirvana, economic development on a sustained basis." Unfortunately, that kind of diagnosis proved to be insufficient.. The diagnosis essentially said that what a country had to do was implement a few basic economic reform measures (macroeconomic stabilization,

trade liberalization, privatisation), and that these measures would reliably sustain economic growth. A lot of the world one way or another tried to do that. And at times, it seems to trigger spectacular results and other times not so spectacular. That suggests that it is a limited, partial prescription based on a very limited and very partial diagnosis. Then what are the underlying factors in development?

As I tried to fill out the picture, I have tried to summarize a more complete framework in the following ways, and if you will bear with me, I will try to lay it out and explain why I think this fuller framework helps to account for this variability that you see around the world and gives some ideas about what individual countries should pursue.

This is an oversimplification, but one not quite as dramatic as the Washington Consensus. In my way of thinking, I see four interlocking circles that interact to produce economic results whether favourable or unfavourable. And those four are the BUSINESS ENVIRONMENT, the SOCIAL ENVIRONMENT, the ECOLOGICAL ENVIRONMENT and the country's STRATEGY OR LACK OF STRATEGY WITH REGARD TO SCIENCE & TECHNOLOGY. Countries have to address these four different broad areas of concerns in an integrated manner. They have to promote a sound macroeconomic environment, like the Washington Consensus said, but with a few differences and emphases that I will underline. But that's not enough by any means. Countries also need clearly a strategy for investing in people. Sri Lanka is a country that understood since independence that the country needed investment particularly in the health and education of the population, especially in children but also in parents. The third component is that the strategy must be compatible and well-integrated with the ecological challenge and geographical challenges that the country faces. So the physical environment is quite central and a country's ecological and environmental strategy is as much a part of the economic developmental strategy as are the macroeconomic parameters. The fourth area of concern is Science & Technology. At the core of economic development in the long term, without doubt, is technological advance. The reason that countries are able to achieve economic development and the reason for the whole remarkable experience of modern economic growth that really began only around 1800 is the advancement of technology. That doesn't simply come from the sky or from market forces alone.

Just as countries need a strategy for investment, health and education, countries need a strategy for building the scientific and technological capacity of the population.

As I look around the world and try to understand why some regions flourish and others don't, having those four different dimensions in mind has been immensely helpful. Countries that fail in one or two out of those four dimensions can fall into a major crisis in overall economic development. Sri Lanka, in many ways, pioneered investment in human capital. But it did not create the business environment that is as important for development as is the environment, health and education. Many developing countries achieve good results, when all four concerns were addressed simultaneously.

Moreover, in development you cannot forget the strategy for Science and Technology. That's how I explain to myself (and others) why countries like Argentina have had such severe difficulties. Although the conventional view at present is to fault the government's macroeconomic role, I think that's much too simplistic. Argentina's government is in a crisis because it could not raise the productivity of the economy having failed to invest in science and technology. And that, in my view, is the deeper reason why the macroeconomics credo went wrong.

So how do these four pieces interact? What do they mean? We will start from the proposition that globalisation is potentially a necessary if not sufficient basis for economic development. In this sense, for a country like China or Bangladesh or Sri Lanka, there is no reliable course of economic development other than through integration with the world economy. Why do I believe that? Because fundamentally the thing that this country needs to achieve high-income levels is a marked improvement in labour productivity. That will come through harnessing and being able to take advantage of modern technologies. Those two routes can really be gained reliably only through economic integration. Why? Because most of the technologies that any country needs for development are not going to be invented internally. They will come through the import of capital goods. They are going to come through the global flow of ideas. These may not be right off the shelf, but in most of the technologies that stand between Sri Lanka's 1000 dollars per capita

income and its target of 25,000 dollars per capita income are technologies that exist in world markets now. Those technologies need to be incorporated into the economic management of the economy. They would be incorporated by buying capital goods, they would be incorporated by having multi-national companies engaged in international production, and they would be incorporated through an intensified flow of ideas and information.

So the first step, in my view, is indeed a process of integrating the production structures in the economic environment with the global economy in order to be able to absorb rapidly the improved technologies and capital goods, which form the basis of very rapid increases in income. Has Sri Lanka done that? Clearly not. Sri Lanka has not been able to attract foreign direct investment. Probably, the major reason for that has been the continuing violence in the country. Foreign investors do not like to come into circumstances of civil strife. My interpretation would be that this country has so much economic potential that even in the middle of war it has been able to grow 5% per year. Imagine what it could do with peace.

With peace, the extent of economic integration should rise dramatically. In information technology sectors, obviously in continued growth of textiles/apparel, in tourism, and I would guess in many other sectors there could be rapid increase in productivity through economic integration with India, the border nation.

In most developing countries that I worked with, it is actually the second dimension, which is the hardest: the social dimension. Here I have relatively little to add because for students of Sri Lanka there is no need to point out the success in this dimension.

Most developing countries, at the income level of Sri Lanka, have a life expectancy of perhaps 60–65 years, at best. Some even lower. In this country, thanks to early attention to health and education, life expectancy is 72 years (some estimate 73) and another estimate for women goes all the way up to 75 or 76 years. That is a tremendous achievement in the social sphere in literacy and in health and the critical result of that is the reduced fertility rate. High population growth is one of the

major challenges that a large part of the developing world still faces and this country surely does not.

So of those four areas, investment in the social sector has proved to be the greatest success. There is a huge challenge ahead. I have to add, however, that Sri Lanka's success in education and its current levels are not going to be sufficient when looking forward. Everywhere in the world, secondary school completion is becoming the minimum necessary to achieve high levels of economic development. Completing tertiary education (university level education or technical education) is becoming a pre-requisite for achieving income levels above 5,000 dollars per capita, for example.

So the big challenge looking ahead is to preserve the good outcomes on health and raise achievements in education by expanding dramatically the proportion of students that are able to go to tertiary education.

The third circle that I mentioned is the ecological dimension. And again for Sri Lanka, the situation, I would say, is of mixed character. Geography plays a huge role and the physical environment plays a large role in the economic outcome, much more than we generally recognize. Countries that are deeply burdened by chronic drought, by huge instabilities of climate, by very poor soils, by remoteness from ports such as the Central Asian countries or the Andean countries or the west of China as opposed to the coast of China, find it extremely difficult to achieve economic development.

Comparing internationally, Sri Lanka is in a pretty good situation, I would say. There is no intrinsic geographical barrier to Sri Lanka's economic development as there is for Afghanistan, for example, or Mongolia or Bolivia or the Central African Republic. For those places the burdens of geography are so great and the burdens of ecology are so great that nobody truly has a strategy for achieving economic development. We know that for Sri Lanka, however, that cannot be true, because it has been the island economies of the Indian Ocean and the Pacific basin that have been the most successful countries in the whole world in economic development. If Singapore can reach \$30,000 per capita income as it has, sitting astride the great trade lanes of

Europe and Asia, well so does Sri Lanka. And what Hong Kong achieved as the entry port for China, in principle Sri Lanka can achieve as the entry port for the Indian sub-continent as well. So the deep waters ports, and the plentiful rainfall over so much of the island are all fundamental bases of strength. There are of course significant ecological risks as well, especially as my colleague of the Earth Institute that is working with scientists in Sri Lanka has advised me. We know that parts of the island are subject to repeated episodes of drought. Fluctuations in rainfall, which we already saw, did great damage to the economy in 1996, and again in 2001. We know that soils are under threat because of non-optimal soil and agronomic management practices; we know that the coastlines are under threat of massive pollution coming from inland industries. There is a major ecological challenge here but I would say that it is of manageable proportions compared to many other parts of the world.

The fourth area that I mentioned is the upgrading of science and technology. One thing that I am sure of is that no country in Sri Lanka's position has been able to achieve a significant level of economic development without considerable investment in upgrading the scientific and technological capacity of the whole population. That includes the development of a significant scientific and technological base of engineers and researchers within the economy. This is a dimension that was completely forgotten by the IMF and the World Bank, for example, during the structural adjustment era. Technology was not even on the radar screen as something countries needed to worry about. Nobody was talking about how important higher education is, no one was saying how important it is to invest in technological upgrading a national effort, private business investment in research development and international partnerships. But what we know is that without technological capacity, it would not be possible to attract the kinds of foreign direct investment that this island needs; it would not be possible to address the ecological challenges; it would not be possible to address many of the other challenges of social development. So a special strategy needs to be formulated.

I am happy in just the first few hours that I have been here to hear from a number of government officials of the efforts of expanding higher education in the country and of the efforts to expand the information and communications technology

backbone. This island still is relatively undeveloped in being able to access information technology. Broadband has not really come yet to the island, as I understand it. And without that, without the penetration of computers in schools, without the access and utilization of information technology, the country will lose in two ways. One, the industrial base will remain small. The kinds of achievements of your near neighbours in Chennai, in Hyderabad, and in Bangalore of developing information technology which is creating a tremendous boom in Southern India, will continue to bypass this island unless that is focused on properly. Secondly, the ability to identify, address and solve the other kinds of ecological challenges will be unfulfilled.

Now, none of these problems is really too tough for this country to solve. There are many places in the world; I already mentioned a few, where I defied anybody to come up with a realistic strategy that is going to get all of that done. For more than a decade now, I have occasionally advised Mongolia, for example. I'm yet to have a good idea. That country is 1500 km away from a port; it is very hard to get industries developed in those circumstances. We are probably a kilometre from the port here. There is no problem in this country of that sort, there are no barriers to overcoming major disease burdens, and there is no barrier to economic integration. This is not an island out in the South Pacific: this is an island right smack in the middle of one of the world's largest and most economically important sea lanes. I think it probably is the most important sea-lane. It made Singapore rich and can make you rich. So what are the problems? That is what I am trying to understand. As I said, this country, despite a lot of difficulties politically, and with all of the violence of the last 20 years, has still achieved a rate of growth that is among the highest in the world. That should tell you how close you are to being able to really take off. Because you have done that in a way without really trying, I would say. Now if you put your minds to it, and put the peace process to it, what cannot be achieved? Well, there is no doubt first of all, that a number of key industries could be developed quite rapidly with the tremendous inflow of foreign direct investment.

Firstly, your port services themselves should be much bigger moneymakers and a much more dynamic source of income than they are today, unless someone explains to me why that is not the case. But what I see is that ports have not been viewed

as the strategic elements of economic development, so that India tranships three-fourths of its shipment through Singapore, rather than through Sri Lanka. Why is that? Because your ports do not work as effectively, because the turn around time of a big berth ship off-loading and on-loading containers is probably not four hours here, as it is in the port of Singapore. The information technology services that are needed to maintain and support a major world-class port are probably not in place right now. For all I know there are strikes or labour unrest or other difficulties in labour relations. I do not know that for a fact but I worry about it aloud. So the simplest thing that comes to mind is a major deep-water port on the world's leading trade lane, one that somehow this country has not been able to develop adequately. And that is a matter of doing some straightforward things, including close relations with India and a lot of investments through the private sector in upgrading the technological capacity of the ports.

Secondly, where is the information and communications technology in this country? As far as I know it barely exist now. I know that there are a few firms with dedicated satellite lines. You are on the path of the major Indian Ocean fibre optic cable lines. It turns out that the Sri Lanka Telecom still has a monopoly and I guess, access to the fibre optics cable. That is a good way to kill an industry, by the way. You can't develop the IT sector on the basis of satellite hook-up because it is too expensive. You can't even develop a call-answering centre, data transcription services and so forth on the basis of satellite hook-ups. But you have the fibre optic cables. In Africa, there is not a single fibre optic cable right now around the African Continent. Everything has to be done by satellite, but not for you.

Well, where are you going to get the expertise? To be sure, it will come from your universities, from the domestic engineers and from your near neighbour. You have the Indian states that are the dramatic pioneers in using long distance IT-enabled industries as a basic development strategy. My colleague Dr. Nirupam Bajpai and I have visited Hyderabad, Chennai, and Bangalore on numerous occasions. They are booming on the basis of the IT sector. As Dr. Bajpai said to me on the way over here, they are also incredibly crowded, have high rent, and are looking for infrastructure. I can tell you by the way and I hope I am not insulting my Indian friends, but this place is a lot more beautiful, a nicer place to be in, and a good place

for business location. So you could definitely attract a lot of the business that's going to your next-door neighbour in this sector. And with the huge Tamil-language-based IT systems that are being developed, this is obviously a tremendous direct link for the Tamil-speaking population here as well with all of the Tamil-enabled software and internet capacities that have been developed in Tamil Nadu over the last 10 years by the Indian Institute of Technology in Chennai and by other units. So that's another industry that could really flourish here.

Besides port services and information/communication technology, a third industry that could expand dramatically is tourism. Many people have said to me today something a little bit unusual, which I don't agree with, "Oh yes, tourism, that would be good for a quick start," as if that is somehow a small and not very desirable or useful sector for the long term but something quick for the short term. That is actually not correct. International tourism is a highly sophisticated information technology enabled sector; it brings tremendous linkages with the rest of the world. It was not possible to develop tourism during the war period. It is a sector that could expand enormously now and with some foresight and planning, it would not only grow, but could grow in an ecologically sound manner as well. Indiscriminate tourist development is not to your advantage either in this beautiful island.

I have been told that a lot of the most beautiful tourist areas are in places where there was war or that are economically depressed. Tourism is a major way to get economic development and desirable rebuilding. It is going to be shared between both communities in the island. So that seems to be self-evidently another major area that could get a lot of economic development going.

My guess, and again my colleague and I were discussing it, is that if you focused on ports and related services and the financing of international trade and business office operations which grow around the major port like in Singapore and Hong Kong, if you focused on the IT sector, if you really went after tourism and you did the other things right, it is hard to believe that you would not get 6%, 7% or 8% economic growth fairly reliably. So that alone would make a huge change.

Rather than take a few tens of millions of dollars a year from foreign directed investment, you should aim for billions of dollars a year. Singapore with four million people probably takes in around ten billion dollars a year in foreign direct investment right now. Sri Lanka has been running with maybe 50 million dollars a year in recent years. It is not possible to achieve economic development with such a small number. Economic integration is also wonderful in that there are undoubtedly fifty other sectors that I don't even know about or haven't thought about that could also take off. Trade relations with India would no doubt be promising as it is Southern India that is the fastest growing part of India. That is a big market for you, that is a real opportunity for processed food, cultural goods, all sorts of things including new kinds of industrial production, expanded production of pharmaceutical products... the sky can become the limit. It is going to require inflow of capital and an open base for international production.

So what is standing in the way of all that-- that is what I would like to talk about during discussion. I don't see fundamental obstacles; I think that consolidation of peace, of course, is the number one issue for the country economically.

Secondly, we need a broad political consensus in the country not only between the fighting communities but also between the competing political parties. The politics should be allowed to simmer and not be on a hot burn all the time, so that there is time for economic development to take hold.

Thirdly, I would say we need good labour relations with flexibility in the labour markets. The basic social deal in the country would be labour relations and flexibility of labour markets on one hand and deeper investments in the social sphere on the other hand, thus leaving no one out. The way of inclusion would be jobs and investments in health and education. That should be the social package for the country: jobs, health, education and with good labour relations behind it so that Sri Lanka could put itself forward as the place to attract international business.

Business will not necessarily run to you, you are going to have to coax it here because there are about 50 other places in the world that are at least as eager to get the business, also with good deep water ports. You are in a better position, I can

tell you, and I visited most of them. They are not as beautiful, they are not on the main sea-lanes, they are not as well located to major markets, so I think that you have some advantages but you are going to have to work at it. And labour and management is going to have to be able to say together that they want international business because they agree that is the way forward for economic development.

So let me conclude by saying that this seems one of the easier cases. Thank you for doing the hard work. You invested for forty years in health and education, stable populations, you chose a beautiful place to live in and you are making peace. And I want to wish you the very best in that and to say how honoured I am to be invited to this country and hope that some of us can make at least a tiny contribution for your efforts. Thank you.

Thank you very much Professor Sachs.

And you must kindly agree to answer a few questions from the audience and I would thank the audience if the questions could be limited to three sentences.

DISCUSSION

Q. 1 Professor, I was wondering what importance you would advise on legal reform, in the light of the traditional advice of the IMF for legal transplanting. Is that something that you think that Sri Lanka needs to focus on?

A. Let me make a general observation about the priorities for reform.

I think the big problem with the IMF and the World Bank advice is, more than anything else, that it is too much directed towards a narrow path that I talked about. Almost all the emphasis is put on macroeconomics, privatisation, and the new infrastructure of an economic environment. What is wrong with that is that it takes away attention from strategies and tactics for building up new sectors of the economy. Notice that I am advocating not the planning model of industrial policy but a practical and strategic model of industrial policy where one gives a lot more attention and weight not to that checklist of things that needs to be done but rather to the question of how we are going to get certain industries developed in the country. And when you think about it like this: how are we going to get the port sector expanded tremendously? How are we going to get the tourism industry growing in a significant way? How do we get the IT sector growing? I find that it leads to different kind of questions or a different kind of focus than the questions on the standard checklist of measures. So a lot of what I find wrong with the usual advice is that I think it is too narrowly circumscribed. Again in other countries, it is even more dramatically the case because it often left out major dimensions of the ecology, environment and health, although they were very important in the economy strategy. So the problem with the legal transplantation, as you call it, is that what you need to do is often taken in a

very abstract way rather than in a practical way of finding reasons for making those changes.

Legal reform out of the blue without a strong motivator does not really appeal to me. You might say, "Yes we need to reform labour laws because otherwise we are not going to be able to attract foreign investment in the following sectors", and that appeals to me a lot. Pure legal reform does not really appeal to me. The IMF got that wrong when they argued for capital market liberalisation, because that was under the checklist but it was not a very sensible strategy in terms of timing. If legal reform says we need to change the law relating to land holdings so that we can have a housing mortgage market, now that appeals to me. So what I like is a much more concrete and targeted set of recommendations. The IMF never met a state enterprise that it did not want to privatise. Well you know that may or may not be right but it is not a very strategic in view. I find for instance in Africa where there is AIDS or there is war, the IMF is spending most of its time trying to privatise sugar mills and that is just a lack of focus on priorities. So I am not against legal reform, I am not against privatisation and in fact I am generally in favour of it. But I am for focusing on real problems and real places and trying to solve them and to think much more practically and pragmatically about what to do in this regard.

Now what I am suggesting is that there should be an organisation asking the principal question: What it is going to take to get foreign direct investment in Sri Lanka above a billion dollars a year soon. That is pretty strategic. How is that going to work? What is missing? Well, you listen to businesses and they will tell you, maybe, that electric power is too unreliable, maybe they feel that there are other real needs to be solved. If there is a power failure every time there is a drought, then that is not great for industrial development, much less the convenience and safety of households. So maybe that problem needs to be solved. I could go on, but the point is to try to focus on these issues not in the abstract but in more practical ways that address the specific problems facing the country.

Q. 2 Professor, on the question of education and health, which had been provided in Sri Lanka by the government. There is a progressive reduction in government revenue. Direct taxation has been largely reduced, tariff revenue has been reduced and with privatisation, government income generating enterprises have also been reduced. So in this context the money going into education and health is diminishing and with that there is going to be a deterioration of the social backup that you stressed. How should it be tackled?

A. I think it is very important for the government to set out a medium-term fiscal scenario soon – one that addresses the next 5 years or so and that addresses the questions that you are asking. How is the budget going to find room for adequate levels of public expenditure in health and education? Where can there be legitimate savings and where there cannot be more saving? Let us not forget the donor world – what can they do to help the country particularly during the next 5 years when there is a peace process that is extremely important? The peace process is not a six months deal, where the donors give something for 6 months, reconstruct some roads and infrastructure and then go home. A reconstruction of society is needed here and what the donors need to do is to be prepared to stand with the country at least for 5 years (possibly more), to help achieve growth so that it becomes self-financing.

Right now, there is no money for some of this and that is where the international help, in my view, has to supplement what can be done domestically. Over time if growth is at 7% or 8% per year, then you are going to find added space for this, I personally would shudder at the idea of the government abandoning the free universal access at least to the core services (I don't think they have the intention of abandoning it). I know that the government is going to have to spend more for that, not less, over time because health costs are rising in this global economy and that is going to impact the cost of health care in Sri Lanka as well. And the government surely is going to have to spend more on education. An education on that mixed model of private universities and state universities makes sense to me. I am less enamoured personally of the mixed model of private health and public health because I think the public provision of essential health services

makes a great deal of sense. So on education, there is going to be an increase in spending too. Now all of this is a context where the budget deficit is already very large. It would be a huge mistake though to begin this phase of history with deep austerity in cutting social spending or infrastructure, and that is why, I think, the donors really need to pay attention and give adequate help, so that this peace will be reliable and robust, and for that donor assistance is going to be filling the gap for a number of years.

In truth you ought to be able to achieve a doubling of per capita income in about a decade; at 8% growth and 1% population growth, thus 7% per capita growth, income would double in a decade. As that happens, the capacity to support these endeavours will rise. So it is going to be, in the end, growth that will accomplish this, but that process should not start with an austerity program that cuts into the bone of the social sector, definitely not.

Q. 3 I am very touched and impressed by the support you have given us by using the term focus. You have also looked at transport, which Abraham Lincoln and Henry Kerry did in the United States of America. The phenomenal growth of United States of America was created by a focus on railways. So there is a historical element in what you have brought up and I think the message is a very wise and astute one for our future. I say that not with my eyes closed. Joseph Stiglitz speaking of reforms in the former USSR claimed that those reforms did not lay the foundation of a market economy. And he points to the success of China as a country, which did not follow those policies. The previous policy was one causing a lack of focus, to cause the private sector to attack the government sector and by that token to cause the private sector to loose facilities. That was the past. You have been learning on the job and we hope very much that you will be on the other side of the tennis court with us focusing on practical means of supporting industries with which we could go forward. Thank you.

A. I am not sure whom you meant when you said "YOU" all the time. I am not from IMF, by the way. I was a consultant 21 years ago for six months in 1982. Just to be clear, let me say a word about China and my dear colleague Joseph Stiglitz because we teach together and we like each other very much. China did not follow all the rules, to be sure, and I am stressing that those rules are not necessarily the right rules. But what China did, without question, was to globalise. The essence of what China did was to get export-oriented coastal industry working even in an economy where the rest of the rules of the game were very opaque and very difficult. And that was the basis of the export boom (which is all private sector growth, there is not a single state enterprise). Now, China is pulling in about forty billion dollars a year of foreign direct investment, and that is about the right proportion that I am advocating for you as well. A billion a year for you would be roughly a 40th of what China is pulling in and your population is about a 40th of the Chinese population (maybe a little less). But what they did which was very important was to enable both Chinese and international private business to operate. They did it by setting up special economic zones, by setting up industrial parks, and by making Shanghai a premier centre for foreign direct investments by building the massive Fudong Development Site. In other words, they figured out how to get the infrastructure, administrative and the tax holidays, and other things that were needed to make China a very attractive place for export-oriented foreign direct investment. That is what I am urging Sri Lanka to do as well and I think it is in the spirit of your comment. I just want to point out that what China did was globalisation that was private sector led, was very practical and very successful.

Q. 4 Sir, I believe that you advised Russia and Poland on transitional economies and I like to ask you two questions: one is about a private foreign exchange market. Now, in this country, we are supposed to be liberalised. But we have a system of banks that have authorised foreign exchange dealers. Private residents are not allowed to buy, sell, hold, accumulate foreign exchange or deal with foreign residents to come here or take it across. Could you advocate a foreign exchange market?

And the second question I want to ask you is about the market-determined rate of interest. Now market determined rates of interest are what has been proclaimed time again but I find that in the government debt security market for treasury bills and treasury bonds, the central bank is subscribing in the primary market. I cannot understand how you can have market-determined rates of interest and such intervention in the primary market apart from the question, of course, of the increase in money supply. I would like to have your answer.

- A.** On the foreign exchange issue, there are different degrees of market liberalisation. The minimum degree that I advocate is what you call the free convertibility under current account. That is the right of any private citizen or business to buy foreign exchange or sell foreign exchange at a unified rate for current transactions, meaning imports, servicing of capital, payments of dividends, going abroad for tourism, remittances to students and so forth. The rationing of foreign exchange for current transactions has a lot of detrimental features. Then comes the question about freedom of transaction on capital account. To what extent should the capital market be open? Now that means that everybody has the right to buy and sell foreign exchange without any restrictions. The ability to buy foreign exchange is to invest abroad, to hold stock market assets or invest in international mutual funds or to borrow from abroad. There are actually a lot of problems in moving to full capital account convertibility, as it is called, the right to buy and sell foreign exchange for capital or asset transactions. In general, I am completely with you here – I believe that the movement of capital for investing in business should be as liberal as possible. Certainly, inflows and the rights of the foreign investors to repatriate should be open. I also believe in general that fairly free mobility of foreign investors who invest in the domestic portfolio market is OK.

When tremendous problems came up in the last 10 years, there was the ability to move short-term capital in and out of the country in an unregulated way. And where the real problems came up was not the right to hold foreign assets but the right to borrow from abroad. That turned out to be a real

killer. What they did in the early 1990's, for instance, in Bangkok after establishing a Bangkok International Banking Facility was to allow financial houses to borrow from abroad without restrictions because, after all, they said it was an open foreign exchange market so if we want to borrow abroad and someone abroad wants to lend to us, why not? And that is what allowed a rapid build up of foreign short-term debt. And when the exchange rate was mismanaged in Thailand in 1996 and 1997 and speculation about the *baht* took place, all that short-term debt that it had been built up was quickly called and the money fled the country. The banks became illiquid because they borrowed short-term, lent long-term and the short-term liabilities were called in by the foreign investors. So there is a real unsolved problem in the international capital markets relating to short-term capital movements. And if Sri Lanka keeps restrictions on short-term capital flows, from my point of view, fine. If the right of a Sri Lankan individual, household or business to own foreign assets is limited, I think that should be gradually liberalised. But the ability of firms here to borrow short-term from abroad, I think should continue to be limited. You should try to turn over the investment coming from abroad from short-term loans to long-term investments. You would get a lot of long-term investments in this country if peace and good economic policies were to prevail. As I say you will get a tremendous boost to GNP coming in with foreign direct investments, a rise in several percentage points in GNP that will be enough to handle the capital needs of the country to allow a significant expansion of investment. So my answer is: absolutely open for current transactions, open for long-term capital transactions to a large extent and pretty strongly regulated short-term capital transactions for the time being. That, by the way, is especially necessary since the budget deficit remains large right now and the temptation of the government to borrow heavily short-term from abroad might be present and that would be a very bad idea. It would be dangerous for the country to build up a lot of short-term foreign debt. So keeping limits on short-term indebtedness, I think, is desirable. That means that certain kind of capital account restrictions will be there. Gradually, they can be removed but I would keep them on until the regulatory environment is strong, until the banks are strong, until the State

Banks are privatised and reformed and until the budget deficit is much reduced.

Q. 5 Thank you Professor Sachs for your enlightening speech this evening. I must say that I am very enamoured with it. But I think I should ask a little thing to clarify my mind. The four globes that you drew up are familiar but I feel that I miss something. There is a political aspect to this and I do not know to what extent you have given emphasis to this particular thing: When you look at the successful stories in Asia or South Asia or any part of the world today, the government plays an important role in driving countries to development, and Asia is not an exception. I do not want to go into details but if you look at the success of any country, governments and their strategies have played a very major role. So if you ask me what is the difference between that country and this, I could say to some extent politics has played a role. Thank you.

A. I think there is something true about one strand of political science that calls the East Asian states developmentalist states. Because I do think that politics was not entirely but heavily subordinated to the development imperative in a lot of East Asia for a long time. Whether a government was democratic or authoritarian was not the issue as much as whether it was developmentalist or predatory on the society. What I think is first needed in political terms is a developmental philosophy. That means that major political parties subscribe to the philosophy that it is more important to support economic development than to tear down your opposition. That means putting politics on a simmer rather than boil, as I said. And I think that is really important here because politics can get pretty inflamed. Now your politics gets inflamed in party terms and in communal terms and both of those need to be put back and the communal violence ended because that is absolutely destructive to the development agenda. And inter-communal peace in Southeast Asia was really critical. You had problems between the minority Chinese population and the majority local population throughout Southeast Asia, and when that became violent then development stopped. When that was peaceful then development continued. And that is a major lesson to this country, obviously.

I do not think that there is a simple set of political institutions that guarantee any of this; rather I would say that there is a mode of social behaviour. Responsible politics, peace and basic social responsibility, especially in an ethnically divided country, needs to take hold. That is the important thing for politics here. Then the parties calm down and stop throwing each other out over petty provocations. It is important to see this from the outside. My eyes see the following: here is a place that can have remarkable economic growth, no question about it. I know because I go to many parts of the world every year, and I know how many places in the world are begging for foreign investments and for this kind of development. These firms will not be coming to demand a way into your country. You've got to make the case. Violence is a big showstopper and political instability is a big showstopper and that is why it is so important to make the case that Sri Lanka is open for business now for development. That is the goal for the next 20 years, not settling scores or anything else and that is the basic politics that is needed. There are also many other things. Corruption is everywhere but keeping corruption fairly low is important. So whether it is the 5% to 10% variety and not the 50% to 100% variety is really an important part of the story. I was going to mention one other thing; South Asia is also famous for having one of the world's most refined bureaucracies. It is quite amazing. Maybe Egypt rivals because the Egyptians claim that they have 5000 years of practice. No doubt you have 5000 years of practice also but it is pretty deep and pretty inclusive. For economic liberalisation, the bureaucrats need to be supportive and they need to step back more than they are accustomed to. We are finding in India that this is a real challenge and it is happening only very gradually; it could happen a bit faster here, no question.

The last question please because time's almost up.

Q. 6 It is evident that you have been here for 11 hours, because in spite of your comments on our communal problems and our peace process you put your foot firmly in when you talked of the bright prospects for the Tamil language IT sector. Now I think that I am in a better position than many others to

make that statement, but having said that I think we and I am not saying you, it is we who have to do it. We have to retool our education system to produce the person for the new age. I am proud of our education system, our mainstream education system, but I think that we have to use the resources we are putting into that to produce some individuals suitable for the new age and we need the support of the international community. The main task is ours but then we need support for it and I think people like you can emphasise that aspect very much. Thank you.

- A.** Thank you very much. Let me tell you that this country needs an IT strategy. I was happy that when I was with the Minister of Economic Reforms, Science and Technology that it loomed very large in his thinking right now and that is very important. Once you have the IT strategy you are going to find that you have all sorts of capacities to draw from the international community.