HUMAN CAPITAL FORMATION: REVIVAL AND RESTORATION

It is an honor and a privilege to have been invited to deliver the 25th annual S R Kottegoda Memorial Oration. My gratitude to the family of Prof. S R Kottegoda and to the Sri Lanka Association for the Advancement of Science for this invitation.

Prof Sri Ramachandra Kottegoda was a gentleman of many and varied talents. He had an outstanding career as an academic. As a boy he was educated at Royal College, Colombo. He then read for a degree in the Faculty of Medicine at Colombo University. He obtained a Doctorate from Oxford University and was later a Research Fellow at Harvard University. He was awarded an Honorary FRCS by the Royal College of Surgeons and an Honorary DSC by the University of Colombo. He was a university Professor, and at one time Dean of the Faculty of Medicine.

Prof Kottegoda was a past general president of the Sri Lanka Association for the Advancement of Science. He had a special interest in, and commitment to, ethics. He was a member of several committees, and had numerous publications, in this area. He was highly influential in the development of ethical standards in the practice of Medicine in Sri Lanka, especially Medical Research. He was also a member of the WHO Expert Committee on Drug Evaluation, and a member of the Pharmacy and Therapeutic Committee of the National University Hospital, Singapore, while working there as a Visiting Professor and later as a Research Professor.

At a personal level he was a devoted husband and companion to his wife Damayanthi, and a loving father to his children, Indira, Mevan, Sepali and Ruwan. He was a photographer of a very high standard, winning several prizes at exhibitions throughout with accolades. He was also very cultured man with a keen interest in classical music, especially of opera; of fine writing and literature; and of sport, particularly cricket. He was an ardent wildlife enthusiast and had great interest in Archaeology.

Overall, he was a remarkable and talented person.

I now turn to the topic of this lecture, which would have interested Prof. Kottegoda greatly.

HUMAN CAPITAL FORMATION: MULTIPLE AND OVERLAPPING CRISES

The global economy, and particularly the developing world, are currently facing the most difficult circumstances since many of these developing countries attained their independence from colonial powers and became nation states. The COVID-19 pandemic caused more than 6 million deaths, with low-income countries (LICs) and middle-income countries (MICs) suffering the most as a proportion of their populations. Worldwide poverty had been steadily decreasing from the 1980s to the 2000s. After the COVID19 pandemic struck about 70 million people fell into extreme poverty. Also, global median income declined by around 4 percent, the first decrease since measurements of median income commenced in 1990.

About 70 percent of children in LICs and MICs are in learning poverty, defined as the share of 10 year old children who are unable to read or understand a basic text. COVID-19 worsened the global learning crisis, causing the largest shock to education and learning in recorded history. There are estimates that by the end of 2021 the impact of the COVID19 pandemic on human capital had caused a future loss of about 17 trillion US dollars in lost productivity and earnings. Further, fresh challenges have emerged on the demographic front: according to UN population projections, by 2030, more than 25 percent of primary-school-age children will live in Sub-Saharan Africa, the global region with the highest levels of learning poverty. This indicates the massive challenge confronting education systems and human capital production.

The LICs and MICs are encountering an extremely challenging short-term outlook. These are caused by high and rising energy, food and fertilizer prices, increasing interest rates and credit spreads, currency depreciation and devaluation, and outflows of capital. Under current policies, global energy production is likely to take years to diversify away from Russian output, prolonging the risk of stagflation. These shocks have struck development at a time when many LICs and MICs are also struggling in other areas, such as governance and the rule of law, debt sustainability, climate adaptation and mitigation; and constrained fiscal resources to counter the severe reversals in development from the COVID-19 pandemic, including in education and health and poverty reduction. The poor bear the major share of these negative shocks, especially women and girls, and various other disadvantaged groups, such as ethnic and religious groups, tribal and caste groups.

Macroeconomic Policy Challenges

At the heart of the macroeconomic crisis facing LICs and MICs is an enormous shift in fiscal, monetary, and financial regulatory policies in developed economies in recent years. Monetary policies over the last ten years or so have been inducing capital to flow into wealthy segments of the global economy: to developed country governments, large bond-issuing corporations, and high net worth individuals, at the expense of inclusive growth and broad-based development in LICs and MICs. Gross fixed capital formation in developing countries has stagnated while asset prices rose sharply in developed economies. Four factors stand out: firstly, the magnitude of the change in macroeconomic policy; secondly, the large size of the policies; thirdly, the impact on the global allocation of capital; and fourthly, the risk that these policies become permanent, impeding human capital and economic development.

Commencing in 2008, advanced economies adopted entirely new monetary policies to combat the global financial crisis. Central banks set interest rates at zero or lower and purchased bonds financed from their own accumulation of excess bank reserves. These crisis-focused activities helped cushion the effects of the financial melt-down. Years of zero or negative interest rates and the monumental expansion of the monetary base, controlled by credit regulation, created a new monetary regime. In effect, monetarism was replaced post-monetarism. The details of credit regulation and the central banks' choice of bond holdings assumed greater importance than the supply of money. The monetary base increased several times over the first decade of this new policy without inflation because regulatory policy contained money multiplication. This left developed country currencies relatively stable. However, inflation became vulnerable to supply chains and fiscal policy excesses.

One of the side effects of these new policies is that search for returns that support high prices on certain asset classes, such as real estate and bonds, assumed major importance. Over time these monetary policies cause the prices of these assets to diverge from their fundamental values. In some developing countries, this resulted in low government bond yields and high borrowing costs, drawing capital into unproductive projects. A second side effect reduced the incentives of corporations and firms to clean up their balance sheets and of governments to introduce structural reforms. Large-scale purchase programs promoted the creation of zombie banks and businesses, damaging the economy's development potential.

Fiscal policy has also been changing in the direction of greater national debts in economies. This has had major impacts on capital markets worldwide as available savings flowed into government securities. During the pandemic, governments borrowed heavily from savers around the world. Most of this extra spending and/or reduced taxes supported people with incomes well above the median. Demand grew faster than supply, an imbalance that became more apparent when supply chains began to diversify from China and when the post-COVID-19 recovery and restoration of the global economy commenced.

In the context of global economic development, the combination of large government spending, increasing government debt, and expansion of bond buying central banks, had the effect of allocating increasing amounts of global capital to a small economic group. The purchase and ownership of bonds by central banks re-allocates capital from small savers to well-capitalized sectors of developed economies. The regulation of banks has a bias towards debt of advanced country governments, as this is considered zero or low risk, while debt of LICs and MICs is treated as risky and requires equity capitalization of their banks.

A major challenge for development is whether global capital is now sufficient to fund the capital needs of the advanced country governments and leave enough to meet the investment needs of developing countries. Quantitative easing (QE) from *circa* 2008 helped to ease risk aversion globally and lowered borrowing costs for emerging markets. Large capital inflows from advanced economies flooded developing countries, especially MICs. The problem for some countries is that these capital inflows largely serviced government projects with low or negative returns, and not capital formation or foreign direct investment. Total public and private debt in developing countries rose by about 60 percent of GDP since 2010, while in most of them investment as a percentage of GDP declined. This combination is one of the most negative trends for global development prospects. High debt levels make developing countries vulnerable to exogenous shocks, and in particular to monetary policies in developed economies.

Global Economic Policies to Revive and Restore Human Capital

More investments in human development, in education, health and social safety nets, are urgently needed in both developed and developing nations to revive and restore human capital. LIC and MIC governments will need to invest their limited budgets in these sectors more efficiently, and

to target funds towards poorer households and other socially disadvantaged groups in the interest of equity, to generate the maximum economic and social benefits of their investments.

Clear policy communication that higher production is a policy goal is required to induce capital to flow to economic and human development. Conditions need to be created to enable the production and supply of goods and services, including in human capital formation, to increase in response to price increases. This is essential to combat high inflation and its debilitating effect on investment in human capital.

Fiscal needs in some countries can be helped with concrete action to broaden tax bases and increase tax revenues. However, the requirement of governments to increase revenues needs to be balanced against the effect of higher taxes on crowding out private investment and lowering personal incomes and economic welfare.

Debt relief from bilateral governments and commercial creditors can also play a central role in alleviating human capital conditions in highly indebted countries. This is most urgently needed in countries that have either defaulted on their debt or are on the verge of default. This is a vitally important requirement that can be facilitated through international cooperation, both at the level of multilateral institutions and at the level of individual countries.

Given the strong concern shown by Prof. Kottegoda for ethical behavior it is fitting to conclude this lecture by pointing out that there is a clear ethical case for restructuring global and national debt in favor of debtor nations, given the disproportionately high burden borne by the poor and vulnerable in these countries.

Thank you.

Harsha Aturupane