The Pathfinder Economic Alert

Macroeconomic Road Map for 2013

The Pathfinder Foundation which has been promoting research and advocacy for economic reforms to increase the welfare of people of Sri Lanka wishes to extend its best wishes to all readers for 2013. We sincerely hope that during the new year the political leadership and the policy makers will undertake implementation of more prudent economic reforms and development projects.

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A Delicate Balancing Act

The policy-makers face a challenging balancing act with difficult trade-offs in formulating the Macroeconomic Road Map for 2013. They need to address the following objectives: the structural deficit in the budget and the trade deficits; the slowdown in growth currently well below the 8% target; and contain inflation which is currently above the desired mid-single digit level at 9.5%. In this context; it is necessary to: exercise caution regarding the relaxation of the macroeconomic policies too early; and initiate action to prevent the growth deficit from becoming too large. If policy is loosened too early, the twin deficits in the budget and the current account will be exacerbated and inflationary pressures will be elevated. The room for manoeuvre has been circumscribed even more following the recent Fitch assessment regarding the financial risks associated with the economy. On the other hand, if policy is too tight, growth and employment creating impulses in the economy will be squeezed.

Tackling the Twin Deficits

The **external account** continues to require policy attention. The necessary stabilization measures, introduced in Feb/March 2012, have contributed to curtailing imports. However, exports have also declined, due to a combination of global developments and the anti-export bias in the overall policy framework that has persisted for many years. The upshot is that imports will continue to be about double exports, leading to an estimated trade deficit of US$ 9.5 billion this year ($10 billion in 2011). This is being offset by favourable developments in non-debt creating inflows such as remittances, tourism receipts and portfolio flows to the stock market. As a result, there have been some improvements in both the current account and the overall balance of payments. However, it has not been sufficient to allay concerns regarding the current unhealthy reliance on "borrowed" rather than "earned" reserves. Net reserves remain negative and gross reserves amount to 85% of the total obligations due over the next 12 months (100% is the comfort level). In such a context, ad hoc cash flow management should be complemented by measures that reform an overall macroeconomic policy environment that has contributed to: tradables as a percentage of GDP declining significantly; exports as a percentage of GDP falling sharply; and Sri Lanka's share of global exports declining.

Remedial action requires attention to the real effective exchange rate, trade policy (tariff structure) and structural reforms that improve productivity and, therefore, the competitiveness of the economy. As the Pathfinder Foundation signalled over 6 months ago, the **budgetary framework** has come under considerable pressure largely due to the contributory factors identified at that time: the reduction in revenue arising from the economic slowdown, increased debt servicing; and drought relief. The authorities have responded robustly to the worsening budgetary outcome by: re-phasing expenditure, especially investment; and delaying payments for goods and services delivered this year to 2013. These cash flow management measures are likely to contain the budget deficit at a level that is not too far above the 6.2% of GDP target. However, they do little to address the structural imbalances in the budget. The current account has not been in surplus since 1988. Revenue collection continues to be a problem and the current expenditure is very sticky downwards as 90% is accounted for by interest payments (35%), public service emoluments (32%) and subsidies/transfers (21%). In addition, the 6.1% of GDP allocation for public investment has proved unsustainable. As in the case of the balance of payments, cash flow management needs to be supplemented by structural reforms. These include: continued tax reforms including widening of the VAT collection from retail traders; improved tax administration; a rigorous review of public expenditure; and greater recourse to PPPs in order to maintain the momentum of infrastructure development.

Addressing the Slowdown in Growth

The 8% and 8.3% growth recorded in 2010 and 2011 were achieved on the back of an unsustainable macroeconomic policy stance. While these policies delivered a much-needed peace dividend, the restrictive measures introduced subsequently, in Feb/March 2012, became necessary to deal with the inevitable over-heating of the economy. As a result, growth slowed down from 7.9% in 1Q 2012 to 6.5% in the 2^{nd} quarter. The easing of the growth rate would have continued in 2H 2012 as the effects of the credit ceiling kicked-in and public capital expenditure was curtailed. It is likely, therefore, that it will be a struggle to reach even 5.5% growth in the current quarter (4Q 2012). Despite this, it is necessary to be very cautious about relaxing the restrictive macroeconomic policy stance too early to avoid a repetition of the stop-go policies that have been a major drag on Sri Lanka's development for many years. Instead, the economy now needs to be boosted by a package of structural reforms. The PF has written extensively about the types of reform that are necessary. Such reforms are even more necessary as there is likely to be upward pressure on interest rates through: inflation (see below); and increased domestic non-bank borrowing due to the decision for the government not to undertake foreign commercial borrowing in 2013. In a context where both monetary and fiscal policies should continue to be restrictive (the Fitch assessment reinforces this), a high premium has to be attached to structural reforms that boost growth and productive employment.

Containing Inflation

It is unlikely that inflation will recede from its current level (9.5%) in the coming months. It will become increasingly difficult to avoid cost-reflective pricing for fuel and electricity. The massive losses being incurred by the CPC and CEB undermine the balance sheets of the State Banks and constitute contingent liabilities of the government. As a result, price adjustments are going to be necessary to maintain financial stability in the economy. These necessary price increases are going to make it very difficult to bring inflation down to the targeted mid-single digit level in 2013. As mentioned above , this also makes interest rate reductions more problematic. Negative real interest rates have serious adverse impacts on

the economy. (It is a matter of concern that savings declined from 19% of GDP in2010 to 15% in 2011. This can mean that real interest rates were negative for at large parts of last year).

Broad Contours of the Road Map

The Road Map 2013 would need to simultaneously: reduce the budget and current account deficits to address the elevated financial risks associated with the economy; boost growth; and contain inflation, while balancing the trade-offs involved. A possible scenario is to target 15% nominal growth for 2013 comprising real growth of 6% - 6.5% and inflation of 8.5%- 9% The prospects of achieving these targets for next year and then moving on to the government's 8% growth and mid-single digit inflation targets in the medium term would depend on pursuing prudent macroeconomic policies complemented by a robust package of structural reforms. Above all, Sri Lanka needs to move from ad hoc measures focused on cash flow management to a more strategic approach that yields consistent and predictable policies which are both growth and export friendly.

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