Pathfinder Economic Alert

Sri Lanka Cannot Afford an Auction of Non-Existent Resources

The government has called for submissions from all stakeholders as part of the preparatory process for its Budget. This has elicited responses from a variety of quarters, including political parties, trade unions, businesses and other interest groups. Some of the wish-lists which have emerged in the media bring to mind a comment made by Lee Kuan Yew some years back. He said that Sri Lankan democracy was a periodic auction of non-existent resources. This comment has even greater resonance today now that Sri Lanka is a lower-middle-income country exposed to the discipline imposed by rating agencies and international capital markets in a manner it was not when Mr. Lee made this remark. It is important to explore why this is so. There are fundamental problems at three levels which need to be considered: revenue, expenditure and debt dynamics. Failure to take these into account will undermine the commendable progress that has been made towards a more stable macroeconomic framework largely as a result of the fiscal consolidation achieved during the 2009 – 13 period.

Revenue Shortfall.

Government revenue is at historically low levels at 12% - 13% of GDP. One would expect it to be in the 18% - 20% of GDP range in a lower-middle-income country like Sri Lanka. The challenge is to widen the tax base and strengthen tax administration. However, reform is constrained by difficult political consequences and strong vested interests. The budgetary submissions need to be realistic about the current revenue performance. Spending non-existing money fuels inflation, increases interest rates (to maintain positive real rates), exerts depreciation pressure on the currency (to compensate for the loss in competitiveness arising from the increased inflation differential between Sri Lanka and its competitors and trading partners) and worsens debt dynamics.

Expenditure Needs to be Aligned with Macroeconomic Stability.

At present, all government revenue is absorbed by debt servicing. As a result, all other public expenditure must be financed out of borrowed resources – domestic and foreign. This means that outlays on health, education, the social safety net and development projects are all de facto funded out of borrowed money. The need to balance the competing expenditure claims on the government Budget, in a low-revenue environment, while maintaining a stable fiscal framework, has already led to a reduction in outlays on education and health as a percentage of GDP. This is clearly a negative outcome at a time when human resources could well be the binding constraint holding back the government's five hubs + tourism strategy. This is the overall landscape within which the various requests for salary increases, subsidies and tax relief should be considered.

Those, who put forward these requests, should also specify how they can be funded out of increased revenue, expenditure cuts or a combination of the two. Reversing the commendable progress made in lowering the budget deficit from 9.9% of GDP in 2009 to 5.9% last year (this year's target is 5.2% of GDP) would be highly counterproductive. It is this fiscal consolidation that has enabled inflation to remain in single digits for 60 months and currently to be running below 5%. It is this that can also serve to anchor inflationary expectations and transform Sri Lanka into a low-interest rate and stable/competitive exchange rate economy. The opposite has been the case for the last four decades. Sustained accelerated growth will not be possible without a continued commitment to fiscal discipline. In this respect, it is noteworthy that the perception regarding macroeconomic conditions was one of the main reasons given for the decline in the country's most recent ranking on the World Economic Forum's Global Competitiveness Index from 65 to 73 out of 144 countries. Weakening fiscal discipline would clearly be highly imprudent at this juncture. The cost of such short-term political expedience would be much higher now that Sri Lanka is exposed to international capital markets in a way it has not been at the time of previous elections.

It is also important to remember that an unsustainable budget deficit would fuel inflation by pumping excess demand into the system. The upshot would be that inflation would erode the benefits from any salary increases, subsidies etc. as well as ultimately undermining growth and productive employment creation. It is also important to highlight that inflation is an implicit tax on the poor. While the rich own assets that gain value through inflation the poor do not own any assets which can act as such a hedge.

Taking on More Debt: The Negative Consequences.

As mentioned above, a loosening of fiscal discipline would inevitably lead to higher borrowing. Increased domestic borrowing would trigger negative consequences through the following channels as a result of upward pressure on interest rates. Business investment would be deterred with a negative impact on growth, employment and incomes. Debt servicing of households would be elevated with an adverse impact on domestic demand, resulting in a less opportune business environment. This will, however, be balanced by increased incomes for savers.

While funding fiscal indiscipline by increasing domestic borrowing would have a negative impact on inflation, interest rates, the exchange rate, economic activity and productive employment, resorting to excessive external borrowing would be even more dangerous. Sri Lanka's external debt dynamics are already in the 'amber' light zone. External debt has increased from 6% to 45% of total public debt. The external debt service ratio is trending towards 20% of foreign receipts (including remittances). The general rule of thumb is that there is cause for concern once the external debt service ratio reaches 20%. Furthermore, the External Vulnerability Index (EVI) remains above 100%. The country's external creditworthiness has also been impacted by the sharp build-up in the external borrowings of state-owned and other corporates, particularly the banks. The headroom for additional external borrowing to fund consumption-oriented public expenditure is, therefore, constrained.

The New Paradigm.

An increasing clamour for fiscally irresponsible populist measures is an inevitable part of the build-up to major elections in competitive polities. The current call for salary increases are understandable as public sector salaries have declined in real terms (have not kept up with inflation) in recent years. However, in considering this and other requests, it is important to factor in that Sri Lanka is now operating in a new paradigm in relation to fiscal management. In the past, governments invariably indulged in highly in-disciplined fiscal pump-priming prior to elections. However, this time around it would be the first time that elections will be held with Sri Lanka being exposed to the discipline imposed by rating agencies and international capital markets.

In the past the adverse effects of pre-election fiscal profligacy was cushioned by the fact that Sri Lanka, as a low-income country, was eligible for highly concessional external borrowing. We used to be able to live beyond our means and then be bailed out with concessional financing without too much pain. About 2/3 of our foreign borrowing tended to come from the concessional windows of the World Bank and Asian Development Bank. Typically, these loans had grace periods of up to 10 years, maturity of 30 + years and an administrative charge below 1%. The rest came from bilateral donors at interest rates below 2 ½ %. Sri Lanka was also eligible for concessional borrowing from the IMF. As a lower-middle-income country, Sri Lanka now borrows at commercial interest rates, currently over 5.5%. Additionally, maturities are 10 years at best. One may conclude that though the improved macroeconomic conditions resulting from fiscal consolidation (2009-13) and accommodative global liquidity have led to improved borrowing conditions for Sri Lanka, they are still much tighter than those prevailing when this country was eligible for foreign aid.

In assessing the implications of this new paradigm associated with Sri Lanka's lower-middle-income country status, it is important to recognize that rating agencies and other analysts have focused particularly on fiscal performance and debt dynamics when evaluating Sri Lanka's creditworthiness. In recent times, they have responded favourably to the fiscal consolidation achieved by the authorities, while signalling that the external debt dynamics are in 'amber' light territory. If fiscal performance is allowed to deteriorate and the debt profile worsens, a rating downgrade could well be the outcome. This would result in a decline in Sri Lanka's creditworthiness at the very time there is a general consensus that the US Federal Reserve (and the Bank of England) are likely to increase interest rates in 1H 2015. This would tighten global liquidity and raise yields in international capital markets. It would, therefore, be very dangerous to be fiscally irresponsible and risk a rating downgrade at a time when risk appetites in international capital markets are likely to be recalibrated in the context of rising rates in key advanced country markets.

The consequences of fiscal ill-discipline

This would involve much more painful austerity than in the past as Sri Lanka can no longer be bailed out with concessional foreign aid. The pain would be most severe for the poor and vulnerable.

The overall message is that a lower-middle-income country exposed to international capital markets can no longer indulge in auctions with non existent resources as it has done in the past whenever elections loomed up on the horizon. This is a message to be understood and internalized by politicians, policy-makers, trade unions and the general public.

Lies, Damn Lies and Election Promises.

We Sri Lankans are extremely familiar with the election promises of notoriety. A few examples of such infamous and un-kept promises in the past 40 years include 'we will get rice from the moon and give you two measures free', 'I will give you eight pounds of pulses' and 'I will continue to give you a loaf of bread at Rs. 3.50'. After being proved many a time that parties in opposition or in power do not honour their election pledges, it is hard to imagine a highly politically literate population will believe unrealisable promises of wage increases and price reductions.

Under these circumstances, the PF wonders why the major political parties should worry about unrealistic and absolutely unbelievable pledges/demands made by trade unionists, other pressure groups and insignificant political elements.

This is the Sixty second Economic Alert published by the Pathfinder Foundation.
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