Pathfinder Economic Flash

Do Not Do Too Little Too Slowly to Boost Growth

Achievements So Far

The authorities have achieved significant success in reducing the budget deficit from 9.8% of GDP in 2009 to 6.8% in 2011. The bold measures introduced in February/March 2012 to increase fuel and electricity prices, passing on higher global costs, have gone a long way towards reducing the off-balance sheet losses of 2% of GDP incurred by state-owned enterprises, especially CPC and CEB.

Currency depreciation and increased interest rates were prudent actions necessary to address serious balance of payments pressures and a haemorrhaging of international reserves. However, the trajectory of fiscal consolidation envisaged by the Government now faces significant challenges. The targets of an overall budget deficit of 6.2% of GDP and a current account deficit of 0.5% are now under considerable pressure on both the revenue and expenditure fronts.

The Challenge

The revenue target in the budget is being undermined by the slowing growth. This has an adverse impact on tax receipts. In addition, there is pressure on recurrent expenditure through the higher than anticipated rupee depreciation (13%) and increased interest rates (the benchmark one-year Treasury Bill rate has increased by 600 basis points from the trough a year ago and about 350 basis points year- to- date). In addition, debt service payments will be increased by the effects of both depreciation and interest rate rises. Unanticipated supplementary expenditures, such as drought relief, will also have an adverse impact on the overall deficit. Some measures have already been introduced to curtail public expenditure. However, these are likely to prove inadequate.

Policy Options

The authorities have a mix of policy options open to them. They could introduce austerity measures which include any combination of tax increases, cuts in recurrent expenditure and scaling back of capital expenditure. Such a course of action would further dampen growth. Another option is to introduce reforms to strengthen the framework for local and foreign private sector-driven growth. Increased economic activity would increase tax revenue and reduce the need for austerity measures. Previous Pathfinder Foundation Economic Flashes and Economic Alerts have set out reforms which would yield not only efficiency/productivity gains but also provide a much-needed boost to business confidence. These include among others:

1. an acceleration of infrastructure development through a Public Private Partnership (PPP) program
2. development of a long-term debt market (corporate bonds)
3. broad base ownership of commercial SOE’s through sale of a part of their equity in the stock market with a reservation for workers

4. speed up measures to improve the 'Ease of Doing Business' and ranking in the Global Logistics Performances Index

The authorities should be applauded for considerably improving Sri Lanka's ranking in World Bank Indexes in a relatively short period of time. However, there is no reason to be complacent as our competitor countries too continue to improve

Be Pragmatic, Speedy and Comprehensive

It is important not to ***"do too little too slowly to boost growth."*** It is important to learn lessons from the response to the macroeconomic pressures which emerged in 2H 2011.

There is a strong case for proactive policy-making to maintain the fiscal consolidation and revive the growth momentum in the economy. To achieve this, it is important to focus on the nexus between fiscal stability and accelerated growth. Fiscal consolidation is essential to create the low inflation, stable and competitive exchange rate and reduced interest rate environment necessary for sustaining accelerated growth. Equally, growth is necessary to generate sufficient non-debt creating revenues to meet priority expenditures related to social cohesion and infrastructure development. . This requires proactive and pragmatic policy-making

This is the Fourteenth Economic Flash published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org

Economic Alert, Economic Flash & Economic Dialogue articles can be viewed at www.pathfinderfoundation.org you can also find us on facebook and follow us on twitter.