Pathfinder Economic Flash

Public Concerns Grow Regarding the Economy

The latest LMD/Nielsen Business Confidence Survey shows that the percentage of people concerned about the economy more than doubled in 4th quarter 2012. The proportion of people indicating that the economy was their biggest or second biggest concern increased from 22% to 46 %. This sharp deterioration in public sentiment reflects the slowing down of the economy that has taken place following the implementation of the necessary stabilization measures that were introduced a year ago to address the overheating of the economy. That overheating was due to a combination of misaligned domestic macroeconomic policies in the wake of the euphoria associated with the war victory and adverse developments in the world economy.

The challenge now is to break out of the stop-go economic cycle that has characterized the Sri Lankan economy for many years. It tends to overheat whenever there is an acceleration in the growth rate, similar to that experienced in 2010 and 2011. However, other countries in Asia have been able to sustain accelerated growth rates for decades. In Sri Lanka, the combined effects of the structural budget and current account (BoP) deficits; low productivity/competitiveness; and uncertain investment climate mean that growth can only be pumped-up by artificially manipulating macroeconomic policy instruments. This is not sustainable as it leads inevitably to an overheating of the economy. The natural consequence of this is recourse to repeated cycles of stop-go policies. However, the dangers of continuing on this path has increased exponentially with the loss of access to foreign aid that has come with graduation to a lower-middle-income country. The risks associated with both the budget and balance of payments have risen with increasing dependence on foreign commercial borrowing—sovereign, state bank and corporate.

The shift in public sentiment reflected in the Nielsen survey is an indication of the need to address these fundamental issues. In this connection, the recent moves to adjust fuel and energy prices is very much a step in the right direction as they are designed to place public finances and the balance sheets of the state banks on a sounder footing.

However, increased energy prices will have a major impact on the competitiveness of domestic businesses, particularly industrial production. This will inevitably dampen economic activity at a time when growth impulses in the economy are already very subdued. Rising energy prices on top of high nominal interest rates and an overvalued real effective exchange rate will hollow-out productive capacity in the economy, particularly in the tradables sector.

In the past, the authorities have compensated for high nominal interest rates and an overvalued (uncompetitive) real effective exchange rate through tax and other concessions. However, the combined effects of a poor revenue performance and the ineligibility for foreign aid/much higher dependence on foreign commercial borrowings now mean that such an option is no longer viable without undermining fiscal stability and increasing the already elevated risks associated with the economy.

The challenge is to create conditions for improved economic fundamentals resulting in lower interest rates (that can be sustained in the medium term rather than a manipulated short-term temporary reduction); a competitive exchange rate and a conducive investment climate. Sri Lanka also needs to achieve higher productivity levels that not only increase competitiveness of the economy but can also support non-inflationary increases in income levels that can absorb the international price of oil.

All this serves to highlight the fact that a piecemeal approach tends to result in one set of problems while creating/exacerbating others. This reinforces Pathfinder Foundation's often espoused conclusion that the Sri Lankan economy cannot be placed on a higher growth path without a broad package of reforms. Of course, such reforms bring about pain in the short term, while the gains are only generated in the medium term. The timing and sequencing of such reforms, therefore, become important from a political perspective.

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