Pathfinder Economic Flash

Restraint and Prudence: An Amber Light for the Economy.

Global and domestic economic developments call for vigilant and cautious policy-making at this time. The Eurozone crisis; the fragile recovery in the US; the economic slowdown in China; the twin deficits (budget and current account) and a lack of economic reform in India; the political turmoil in the Arab world; and sanctions against Iran mean that the external economic environment is characterized by elevated uncertainty and risks. These negative factors are mitigated to some extent by a softening of oil prices as a result of a slowing of global economic activity. However, policy-making needs to take cognizance of the very real risk of the slow-down in Sri Lanka's key export and tourism markets outweighing the benefits of lower oil prices. Consequently, the authorities' forecasts of a trade deficit of $9.2 billion and an overall balance of payments surplus of $1.2 billion this year could well come under considerable pressure. It is also important to recognize that it is highly risky to count on borrowing oneself out of trouble.

While the adverse external environment is likely to have a negative impact on the balance of payments, the necessary, bold and courageous stabilization measures introduced recently are likely to exert pressure on the government's growth forecast of 7.2% for 2012. Higher interest rates and the credit squeeze will curtail investment and the combination of tighter monetary policy and price rises will curb consumption. The consequential reduction in aggregate demand will reduce economic activity, thereby depressing the growth rate below its current target. The J-Curve effect associated with exchange rate depreciation will further dampen growth and the generation of productive employment in the short-term.

Lower than anticipated growth will also have a negative impact on government revenue. In addition, as the full impact of the austerity measures introduced in February 2012 take hold, there is likely to be pressure for relief/salary increases from affected social groups (especially the poor and those on fixed incomes) and businesses. This context of declining revenue and pressure for supplementary expenditure will put pressure on the government's fiscal consolidation program.

The authorities have made significant progress in reducing the budget deficit from 9.8% of GDP in 2009 to 6.8% in 2011, though last year's performance was marred by the losses of Rs. 150 billion (2% of GDP) incurred off the government's balance sheet by three state-ownedenterprises (CEB, CPC & Sri Lankan Airlines). However, as a large proportion of these losses were due to the subsidies on fuel and energy, they need to be considered a part of the government's fiscal operations.

Over the last 35 years, the unsustainable budget deficit has been the main source of instability in the system. It has led to high inflation which has, in turn, resulted in elevated interest rates and an overvalued exchange rate. This is diametrically opposite to the experience of the successful countries of East and South East Asia which achieved robust fiscal performance, low interest rates and undervalued/stable exchange rates.

Sri Lanka cannot achieve its growth target of 8% over a sustained period without meeting its fiscal consolidation targets. The highest priority, therefore, needs to be attached to continue strengthening the tax base and improving tax administration. Even more importantly, there needs to be a line-by-line review of public expenditure. Waste and mismanagement need to be minimized and a concerted effort should be made to ensure the quality of public investment. Adopting a zero-budgeting approach may not be too radical an option at this time.

Emerging international and domestic trends call for vigilant, proactive and prudent economic policies to stabilize the economy and strengthen its growth framework. The time is right for the necessary austerity measures to be complemented by a package of growth and productive employment oriented structural reforms (see Pathfinder Foundation Economic Alert 27).

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