**Pathfinder Economic Flash**

# Good Economics is Good Politics in the Medium and Long Term.

## Two Key Questions

The Budget Speech 2015 was a very well formulated document which provided benefits for important segments of the population and allocated resources/provided concessions to priority sectors of the economy. It was certainly a good political document in the run-up to the anticipated Presidential election in January 2015. In pluralist polities all over the world it is usual to have some parting of the ways between good politics and good economics in pre-election budgets.

In this connection, it is important to examine whether the Budget Speech delivered last week falls into this category.

In order to this, one may pose two questions:

- Does the Budget have a negative impact on the benign macroeconomic conditions which have been achieved?
- Does the Budget serve to advance the economic transformation envisaged in the government's own five hubs + tourism strategy, which is designed to achieve a $7,000 plus per capita income economy by 2020?

## Implications for Inflation and the Balance of Payments

### *The Success Story*

The two key indicators of the stability of an economy are inflation (domestic) and the current account of the balance of payments (external). Since February/March 2012, when a major stabilisation package was implemented, significant progress has been made in containing inflation and improving the current account deficit. Inflation has been brought down below 5% and the current account deficit has declined below 3%. These are historically excellent outcomes for Sri Lanka (though a number of our competitors in South East Asia have lower inflation and current account surpluses). Sri Lanka's significant improvement on the stabilization front has been due in no small measure to the authorities' steadfast commitment to fiscal consolidation. There has been a sustained reduction in the budget deficit since 2010. As the budget deficit has been the main source of instability for the last three decades, it is not surprising that the country has been able to achieve benign macroeconomic conditions. One must also recognize that there has been sound fiscal/monetary coordination, with an accommodative monetary policy compensating for the contractionary fiscal stance in an effort to create space for growth in the economy.

### *Upward Pressure on Prices*

In order to address the first question posed above it would be useful to explore the effects of the budgetary measures on inflation and the balance of payments.

Expansionary measures such as the increase in the pubic servants' emoluments (Rs. 120 billion) and subsidies (Rs. 60 billion) will increase aggregate demand. As these are not linked to productivity improvements, there will be an upward pressure on prices. However, there are a couple of mitigating factors which are likely to temper these price pressures created by an increase in aggregate demand. First, the economy has been operating below capacity. This would mean that the scope exists to meet some of the additional demand through increased capacity utilization. To what extent this will happen remains to be seen. Secondly, the deflationary impact of low international commodity prices (e.g. oil and wheat) will also moderate the upward pressure on the price level. Given these opposing effects, it is difficult to come to any firm conclusion at this point regarding how the upward pressure on prices, induced by the increased aggregate demand generated by the salary increases and subsidies, would play out. The authorities would need to be vigilant to determine whether their hard-earned price stability is being undermined by the impact of some of the budgetary measures.

Other measures such as the increase in the guaranteed price of rice, the introduction of guaranteed prices for milk and sugar, high para tariffs to generate revenue, the increase in EPF contributions and the lowering of the VAT threshold for retailers will all exert upward pressure on prices. A number of these measures are intended to boost domestic production. However, if the local cost of production is higher than import costs, the consumer will be faced with higher prices. It is also possible that these measures will divert resources (financial and human) away from the sectors which the government has identified as the drivers of growth in the economy (five hubs + tourism).

### Containing the Deficit

Another question which needs to be addressed is whether the budget deficit can be maintained at the targeted level so as to contain borrowing (domestic and external) and/or recourse to high powered money (Central Bank printing money to finance part of the budget deficit ). In this regard, it is important to note that there seems to be some uncertainty about the revenue numbers (e.g. Rs.40 billion out of the Rs.65 billion of additional revenue is to be collected out of arrears of taxes and EPF payments through a refinancing scheme). Underperformance on the revenue front has been a recurring phenomenon in recent years. Despite this, the authorities have been disciplined in their compliance with their budget deficit targets through a combination of underspending on the budgeted allocations; arrears in payments due from the Consolidated Fund; and parking of losses incurred by SOEs due to subsidies on the balance sheets of the state banks. The uncertainties on the revenue side could result in a similar scenario being repeated this year.

In this regard, it is important that the highly commendable increases in the allocations for education and health are realized in full rather than subject to cuts as part of a mid-course fiscal correction program. Human resource development is the best means of addressing the 18% youth unemployment problem. Another important point is that the increased resources made available to a range of government institutions should be linked to institutional strengthening and quality/productivity improvements.

**Pressure on the Balance of Payments**

Domestic consumption has a high import component in Sri Lanka, as in all small countries. This means that the increase in aggregate demand generated by the budget is likely to exert some pressure on the balance of payments. The reduction in tariffs on motor vehicles to generate additional government revenue will also have a negative impact on the external position of the country. Here again, there are some mitigating factors. The sharp decline in oil prices; low prices of other imported commodities due to global disinflation; and the positive impact of the US recovery on Sri Lankan exports, particularly apparel; and the high external reserves taken together provide a cushion on the external front.

**Early and Decisive Course Corrections**

From the perspective of macroeconomic policy-making, the challenge will be to exercise vigilance about any build-up of inflationary or balance of payments pressures. If there is an upturn in prices, it is important that monetary policy is tightened early given the transmission lags. A combination of a more restrictive monetary policy stance and exchange rate depreciation can be used to counter any deterioration in the current account of the balance of payments. The option is also available to counter the emergence of any excess demand, if it materializes, through tightening fiscal policy via additional revenue measures; expenditure cuts; or a combination of the two. The overall message is that the budget has, as is typical of pre-election budgets here and abroad, included measures which will increase aggregate demand. However, there are some mitigating factors to cushion the effects on the internal (inflation) and/or external (balance of payments) stability of the economy. If however, prices and the current account come under pressure, transparent and decisive remedial macroeconomic measures should be implemented using all the policy instruments available to the authorities.

In this connection, it is important to recognize that this is the first pre-election budget which has been presented after Sri Lanka’s exposure to rating agencies and international capital markets became a significant factor. This means there is careful external attention paid to trends in the country’s twin (budget and current account) deficits and debt dynamics. The discipline imposed by this new paradigm has been one of the contributory factors encouraging the Sri Lankan authorities to implement sound macroeconomic policies. The prospect of any significant deviation from the government’s own inflation and current account deficit targets should trigger early corrective action.

**Does the Budget Incentivise Transformation?**

There are a number of budgetary measures which will promote economic transformation. However, an unintended consequence of the budget is to keep financial and human resources in low productivity economic activity. For instance, the generous additional support offered even to low productivity agricultural activities and the public service is clearly politically desirable at this time. However, it deters the economic transformation the government seeks through its 2020 vision and five hubs + tourism strategy. There are, therefore, high opportunity costs involved in some of these measures. Once elections are over, progress should be made towards greater consistency between budgetary measures and the overall objective of the economic transformation necessary to meet the aspirations of the Sri Lankan people.

**A Post-Election Perspective**

There is a strong consensus that good politics has been served by the pre-election budget. As one would expect in any competitive polity, there have been a number of measures which fuel aggregate demand in the economy. However, there are some mitigating factors, such as spare capacity in the economy and disinflationary commodity import prices, particularly oil, which will serve to temper inflationary and balance of payment pressure. However, vigilance will be necessary to implement corrective macroeconomic policy action, if it becomes necessary. This should not include underspending in key areas such as education and health because human resources are likely to be the binding constraint as Sri Lanka seeks to move to the next level of development. In this connection, it is important to reiterate that the additional resources allocated to government ministries and departments should be linked to institutional strengthening and quality/productivity improvements.

Above all, it is important to create a conducive environment for the economic transformation envisaged in the government’s five hubs + tourism strategy which is a working-in- progress. Financial and human resources need to be shifted from low to these higher productivity economic activities. The challenge after the elections is to embark upon the politically difficult reforms which will incentivise further economic transformation and accelerate the country’s growth and development trajectory.

The Budget is well formulated, of course very well crafted too, in seeking to influence voters in the elections anticipated in 2015. However, Sri Lanka is now a highly aspirational society. In the longer run, people are likely to have a low threshold of tolerance for policies which constrain their material advancement. After the elections good economics would become good politics.

***This is the Fifty Fifth Economic Flash published by the Pathfinder Foundation. Readers’ comments are welcome at www.pathfinderfoundation.org***