



Pathfinder Economic Flash

Politics is Dominating Economics: A recipe for a hard-landing

Sri Lanka is once again allowing politics to suppress and postpone urgently needed economic policy reforms. Since independence, time and again political opportunism and short-term political expediency have undermined sound economic policy-making. Politicians have been able to get away with this partly due to the low level of economic awareness among the population. While Sri Lankans are knowledgeable and engaged on political issues, their interest in economic issues is governed by an entitlement culture, which has been fostered by politicians from all parties.

The Case for Consensual Action

There is a danger that yet again politics is proving to be an unhealthy distraction at the present time. There is gridlock in parliament while the economy trends towards a hard landing. The costs to the people of Sri Lanka of parliamentary politics and economic management continuing to be dysfunctional will be extremely high. No country should allow drastic deterioration of the economy due to political gridlock or opportunism. Sri Lanka has got to a point where it has no option but to undertake painful stabilization measures and structural reforms. Such unpopular measures are easier to implement if there is a consensus which cuts across the major political parties. There is no tradition in Sri Lanka's highly adversarial politics of acting in the national interest along these lines. It is important, therefore, that the President and Prime Minister work together to build such a consensus around a package of reforms on an urgent basis. The choice is to implement reforms in a timely manner or have them imposed upon the people of Sri Lanka far more painfully in the wake of an economic crisis.

Risks of delay and inaction

At present, there is inaction on the part of the government and the opposition with regard to urgently needed economic policy reforms while their attention is focused on the impending parliamentary elections. There is no justification for such negligence when the country is in danger of severe economic deterioration, or a hard landing, which will have highly damaging consequences for the poor and the middle class. The rich and the political elite have the means to get by even during an economic crisis. The 100-day Program, with its highly populist Interim Budget, anticipated the dissolution of parliament around 23rd April to be followed by elections. The expectation was that there would then be a government, which had the legitimacy and political strength to correct past policy mistakes and introduce a package of economic reforms. The case for such sequencing is based on the fact that the necessary measures entail pain in the short-term, with the benefits materializing only in the medium to long-term. Hence, it is argued no government can be expected to embark upon painful but necessary reforms in a context where elections are looming on the horizon. However, the

current impasse in parliament and government inaction is seriously endangering the economic situation of the country. Sri Lanka cannot afford to allow the economy to drift without clear direction in terms of a medium-term strategy.

Avoiding a hard landing through reforms

Why is there an urgent need for economic reform? The Pathfinder Foundation (PF) has repeatedly pointed out since the end of war that Sri Lanka faces three major challenges:

- Macroeconomic stabilization is necessary. The current mix of fiscal slippage, accommodating monetary policy and defending the indefensible exchange rate is not sustainable even if the recent dollar – bond issues and the RBI SWAP arrangement have bought some time. The pressures on the balance of payments front could well come to a head by the end of the year, particularly if the US Federal Reserve increases its policy rate by that time as currently anticipated. This could trigger an acceleration of outflows from countries with fiscal and balance payments weakness. This would make Sri Lanka potentially vulnerable to such destabilizing outflows from foreign holdings of Rupee securities (currently about \$3.3 billion) and the stock market. The PF will be issuing another ‘Economic Alert,’ which will elaborate on these issues. The anticipated release of the UNHRC Report is likely to further compound the uncertainties.
- The country no longer has a growth model. The previous external borrowing financed infrastructure development led growth model has run out of headroom due to the fragile external debt environment. In addition, the positive effects of bringing on stream underutilized capacity with the end of the conflict have also now waned. There is urgent need to shift to a private sector driven export-led growth model. There has to be a major role for FDI in this due to the lack of domestic savings; as well as the benefits of access to technology, markets and know-how. Without structural reforms to promote this transition, economic growth will lose momentum from levels, which have been less than indicated by the official figures since 2012.
- Sri Lanka is in a situation where it cannot leverage low wages to compete with low-income countries. Nor does it have the human resources/productivity to compete with middle-income countries. It has difficulty in competing with both the Bangladeshes and the Thailand. High priority must, therefore, be attached to strengthening human resources, improving the eco-system for innovation and increasing the capacity for technology management (adoption & adaptation).

Reforms Necessary for Social Stability

The country’s recent history also adds further urgency to address the economic challenges. It is necessary to reverse stalling growth and arrest the slide towards an economic crisis, which could undermine social and political stability. Sri Lanka has fault lines based on ethnicity, religion, class and caste. It has also become an aspirational society impatient for material advancement. The mismatch between expectations and opportunities has already been one of the primary causes of two youth insurrections in the South and a separatist conflict in the North and East with the loss of thousands of lives. Improving the country’s economic prospects and avoiding a crisis are therefore, crucial for maintaining social and political stability.

Compulsions of a New Paradigm

There is another compelling concern why politics should not be allowed to be a distraction yet again. Sri Lanka is now in the midst of a new paradigm. It is a lower-middle-income country, which makes it far more vulnerable to painfully disruptive crises, which affect not only the poor and vulnerable but also the middle class. This is because there is no longer access to concessional resources (foreign aid) to bail us out. Instead, the country is now much more exposed to the fickle and harsh sentiments of rating agencies and international capital markets.

The Leaders should lead

The choices are clear. The best option is to have politics, which puts the national interest first and results in expeditious and wide-ranging economic reforms. This requires a new brand of consensual politics together with greater awareness among the people. At this point, there is no option but to implement a package of stabilization measures (some combination of fiscal consolidation, tighter monetary policy and a more market determined [depreciated] exchange rate) and structural reforms. This places an important responsibility on the President and Prime Minister to drive through reforms. This is not the time to sacrifice long-term growth and development for the sake of opportunism and short-term political expediency.

It was a combination of the lack of consensus on necessary economic reforms and weak political leadership which were the main causes of the severe austerity programs seen in Europe recently, most notably in Greece. Decisive action is needed to avoid a similar fate for the Sri Lankan people.

A final point to be made is that maintaining good relations with friendly countries will not only help to buy some time but it can also sweeten the blend between adjustment and financing. More financing means less painful adjustment which reduces the burden on the people. However, there is a limit to how far one can kick the can down the road. Economic reforms are urgently needed through constructive consensual politics. This is not only in the national interest but it has the advantage of spreading the political risks more widely.

This is the Sixty Sixth Economic Flash of Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org