Pathfinder Economic Flash

Faltering Growth: Urgent Reforms or Stagnation?

The balance of probability is that growth will decelerate sharply by the fourth quarter of this year to about 5% (this was the average recorded during the 30 years of the conflict) and inflation will be at a double digit level. There is an urgent need for a mix of policies that not only curtail aggregate demand but also create the impetus for a robust supply response.

The slowdown in growth this year may be attributed to a combination of both external and internal factors. Global trends, particularly in Sri Lanka's major markets (the debt crisis in Europe and ailing growth in the US), are likely to result in a slowdown in export growth which amounted to 22% in 2011. The effects of the reduction in external demand will be compounded by a dampening of domestic demand in the wake of the necessary contractionary measures introduced to address the imbalances that emerged last year in the trade and current accounts of the balance of payments. The increased interest rates, the credit ceiling, the J-curve effects of exchange rate depreciation and the impact on disposable incomes of the sharp adjustments in tariffs and the administered prices of several goods will serve to exert both demand and supply side pressures on growth. Though the anticipated increase in remittances will mitigate these pressures it will not be sufficient to offset the overall dampening of growth impulses in the economy.

Unfortunately, the combination of adverse global economic trends and the policy induced imbalances in the balance of payments means that there are no easy options. The authorities need to persist with contractionary policies to stabilize the economy (i.e. to live within one's means). This will inevitably result in a slowdown in growth and productive employment. The twin problems of the deficits in the current account of the balance of payments and the budget mean that Sri Lanka has no macroeconomic policy ammunition to stimulate the economy (i.e. there is no scope for expansionary monetary policies or a fiscal stimulus). Furthermore, borrowing will merely postpone the problem while increasing the possibility of a full-blown economic crisis.

The challenge is to formulate a policy mix that would minimize the depth and duration of the downturn. This calls for a combination of stabilization measures and a package of growth enhancing structural reforms. This would not only bring about much needed efficiency gains to increase productivity and competitiveness but also provide a strong confidence-boosting signal to all economic agents, particularly domestic and foreign investors. Priority should be given, at this point, to reforms that can have an impact in the short-term. These include, inter alia, the following: an acceleration of the government's infrastructure development through recourse to an aggressive PPP program; development of a long-term debt market (corporate bonds); sale of parts of the equity of commercial SOE's in the stock market, with reservations for workers; and reinvigoration of the program to remove red tape (Ease of Doing Business), including restoration of the 'One Stop Shop'. These measures could be supported with longer-term action to strengthen the operations of the land and labour markets; enhance the capacity of regulatory agencies; and improve education, training and skills development through a pragmatic approach to public, private and mixed provision.

A proactive and pragmatic policy response is required both to stabilize the economy and to strengthen its growth prospects. Such a holistic approach would be mutually reinforcing and reduce the depth and duration of the economic downturn.

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