Pathfinder Economic Flash

Economics of the 100 day program: Word of caution on populist measures.

Welcome governance reforms

The Pathfinder Foundation (PF) congratulates H. E. Maithripala Sirisena on his assumption of duties as the sixth President of Sri Lanka. It is encouraging that momentum seems to be building up in support of the important constitutional and governance reforms contained in his 100-Day Program. Every effort should be made to consolidate the consensus which seems to be emerging on these issues. Reform of the Executive Presidential system; the establishment of the Constitutional Council and independent commissions; the strengthening of the Parliamentary Oversight System of Committees; new electoral laws; the Right to Information Act; the National Drugs Policy; and the National Audit Bill are all measures which are very much in the national interest. The proposal to form a National Government of all parties represented in Parliament to govern for two years after the General Elections, in April, is also commendable as a measure to overcome the negative effects of the highly adversarial political system which has served to constrain the reforms necessary to address some of the major challenges which have confronted the country for decades.

Though the PF is primarily focused upon economic issues and policy reforms, it recognises that good governance is required to create the enabling conditions for promoting sustained growth and development. **It is also important that the current welcome emphasis on Governance reforms should not result in a diversion of attention from the equally important economic agenda. It is worth quoting President Bill Clinton, 'It is the economy stupid'.**

A word of caution: Please avoid another auction of non-existent of resources

However, it is also important to convey a word of caution. **The PF's previous Economic Alert (No: 67), titled 'The Election Manifestos: An Auction of Non Existent Resources,' pointed out that the manifestos of both the main candidates were essentially populist on economic issues.** They did not display a commitment to sound fiscal management which is crucial for macroeconomic stability. In this connection, it is important to be cautious about implementing the commitments in the 100 day program to increase salaries and reduce taxes/tariffs on 'necessary goods and services'. A Vote on Account is to be introduced in Parliament on 29th January. It is important to explore the implications of implementing some of the populist measures that have been promised.

The proposed relief measures: No such thing as a free lunch

The populist measures, which have been promised, have either revenue or expenditure implications for the government's budget. If all the populist measures in the manifesto of the Common Opposition Candidate are implemented, a back of the envelope calculation seems to indicate that it could cost close to Rs. 200 billion. In the absence of mitigating revenue measures, this would increase the budget deficit to 8% or more of GDP. If one focuses only on the commitments in the 100-Day Program, the removal of taxes on fuel (loss of Rs. 40 billion per year in revenue) and the reduction of tariffs on essential items would result in a significant decline in government revenue when it has already fallen to about 11% of GDP. This figure tends to be close to 20% of GDP in countries in our peer group. In addition, the proposal to increase public servants' salaries is likely to add about Rs. 17 billion to Government recurrent expenditure. This combination of reduced revenue and increased expenditure will inevitably result in an increase in the budget deficit, unless the Vote on Account includes new revenue measures. In the absence of this, there would have to be additional borrowing in a context where the country's debt dynamics are already in amber light territory. It is also important to point out that the prospects for increased foreign borrowing will be affected by the greater volatility in international capital markets expected when the US Federal Reserve raises interest rates after April 2015. While the ECB and the Bank of Japan pursue Quantitative Easing (bond buying programs). If there is fiscal slippage, the terms and conditions of borrowing available to Sri Lanka will also automatically harden. In the event of greater recourse to domestic borrowing, there will be upward pressure on interest rates and a crowding out of the private sector.

A repeating vicious cycle: Hand-outs to austerity

It is important to recognise that Sri Lanka has been afflicted by repeating cycles of stop-go measures over several decades due to populist policies which undermine fiscal discipline. These have inevitably generated excess aggregate demand which has resulted in an over-heating of the economy (i.e. increased inflation and balance of payment pressure). When this happens, the inevitable consequences were stabilization (austerity) measures: tax increases, expenditure cuts (often including a reduction in the real incomes of public servants and cuts in public investment), increased interest rates and depreciation of the currency. The upshot has been that the hand-outs given to the people have had to be taken away / eroded subsequently through such austerity measures. The PF urges the new Government to avoid repeating the non-virtuous cycle which has characterized economic policy-making over the last four decades.

The non-productivity linked salary increases promised to the public servants in the 100-Day Program will fuel demand-pull inflation. As the PF has already noted Sri Lanka's over bloated public service has nearly 1.7 million employees. These price pressures will be exacerbated as there is likely to be agitation for similar salary increases in the private sector as well. Inflationary forces are also likely to be compounded by the cost-push pressures arising from the promised increases in the guaranteed price of key food commodities, particularly paddy.

Greater exposure to externally induced risks

Today, it has become even more important to avoid making the same mistakes yet again because Sri Lanka is now in a new paradigm. Unlike in the past, as a lower-middle-income-country Sri Lanka is no longer eligible to be bailed out with concessional financing. It is now exposed to rating agencies and the fickle sentiments of international capital markets.

One should not forget that the fiscal deficit has been the main source of instability in the system for four decades. As a result, Sri Lanka has tended to experience elevated inflation and high interest rates, with an exchange rate which was under constant downward pressure. Given this legacy, it is important to recognise that rating agencies and other market participants monitor Sri Lanka's fiscal performance very carefully as a key indicator of the economy's health. Significant slippage on the fiscal front is likely to raise concerns in international markets at a time when there is likely to be increasing volatility for the reasons given above.

Damage control

If political compulsions, at this moment, are such that fiscal loosening is unavoidable, then it would be necessary to consider some mitigating measures. One option would be to phase in the promised measures more gradually than currently envisaged. Another is to tighten monetary policy through increases in interest rates and/or the reserve requirement ratio. This means high priority should be attached to sound fiscal / monetary coordination, keeping in mind that early and timely action reduces the adjustment costs in terms of lower growth, employment and income. These policy options are not mutually exclusive.

In considering the appropriate mix of fiscal and monetary policies, it is important to understand the downside risks associated with a loose macroeconomic policy-setting which creates excess demand leading to an overheating economy. The consequences will be increased inflation; tighter monetary policy; balance of payments instability and pressure on the currency; downward pressure on Sri Lanka's rating; outflow of foreign portfolio flows from bond, especially Rupee securities, and stock markets; a negative impact on investor (domestic and foreign) confidence; and ultimately lower growth, employment and incomes. This is clearly a scenario which needs to be avoided.

Does the political leadership want to impose burdens on ordinary people?

One should also recognize that an overheating economy and the resulting macroeconomic instability have the most painful consequences for the ordinary people of this country. Elevated inflation is equivalent to a highly regressive tax. The rich own assets which act as a hedge against inflation. (The value of their assets also appreciates with the increase in prices). The poor are much more directly exposed and vulnerable to the ravages of rising prices on their living standards. A depreciating currency associated with increased balance of payments pressure (the other consequence of overheating) serves to reinforce these price pressures.

Treating the cause rather than the symptoms

In the medium/long term relief for the people cannot be provided through populist measures. They are short- term palliatives (quick fixes) which cannot be sustained. It is important, therefore, to address the causes rather than the symptoms of the problem. The underlying cause is low productivity, which severely curtails the prospects for non-inflationary increases in salaries. This can only be addressed, on a sustained basis, through increased investment, both domestic and foreign, which creates higher productivity employment. The PF has constantly emphasised that structural reforms are necessary to achieve this. Above all, it is important to remember that populist giveaways have to be paid for eventually through higher inflation and increased taxes. The burden is invariably borne disproportionately by the ordinary people. In addition, a repeat of stop-go policies would elevate uncertainty and have a negative impact on investor confidence in a context where poor investment performance has been the most disappointing aspect of the post-conflict years.

Good governance and sound economic management are the twin pillars of the path to sustained prosperity. Ignoring one usually leads to the undermining of the potential benefits delivered by the other as well. Political leaders in Sri Lanka would well know that history teaches us that sudden and sharp decline in economic circumstances can create the conditions for the rise of populist, even fascist, movements.

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