



## **Pathfinder Economic Flash**

### **Don't take your Eyes off the Ball and Endanger the Economy**

The current government has attached high priority to the constitutional amendments, electoral reform and reconciliation. These are undoubtedly extremely important national issues which need to be addressed. However, it is important not to lose sight of the imperatives for urgent economic reform. The Pathfinder Foundation (PF) has constantly argued for the need to stabilize the economy through fiscal consolidation and to increase productivity/competitiveness through structural reforms.

It is unrealistic to expect major economic reforms just before the general elections. However, the authorities need to be vigilant about emerging macroeconomic pressures and the need to have a clear plan for structural reforms going forward. The following challenges require attention.

#### **Slowing growth momentum**

Growth is slowing down. The PF has previously pointed out that proxies for growth, such as electricity consumption, cement consumption (construction sector was a major source of growth); government revenue (indirect taxes constitute 80% of revenue and are closely correlated to the level of economic activity); imports; and private sector credit (there has been a pick-up in 2H 2014) have indicated that the official data was highly contestable. It is important, therefore, to recognise that growth is slowing down from a lower base than the 7.5% official figure. The balance of probability was that it has been in the 6% - 6.5% range.

Since the election, there has been a slowdown in public investment and the private sector is adopting a 'wait and see' attitude during the current uncertain political interregnum. In this connection, it is stated that efforts are being made to speed up public investment in recent days after it stalled due to disruptions associated with the change in government in a highly politicised system.

However, the major challenge is that Sri Lanka is currently caught between two growth models. Since the end of the conflict, the country has had a commercial external public borrowing financed infrastructure development led growth model. The debt dynamics are currently such that this model has now run out of headroom. The authorities have recognised that the country now needs to shift to a private investment, particularly a FDI, led growth model. This realisation needs to be acted upon urgently. This requires a package of reforms to

improve productivity/competitiveness of the economy. While the country is in the midst of this transition between the two growth models and in a longer period of inaction the rate of growth will decline, possibly sharply. Hence, the earlier the reforms are introduced the more quickly the economy will attain the 8% plus growth targeted by the government. An inordinate delay in such reforms will lead to a period of low growth.

### **The budget deficit and a worsening of debt dynamics**

The PF has already sounded a note of caution (Pathfinder Economic Flash 57: [www.pathfinderfoundation.org](http://www.pathfinderfoundation.org)) regarding the handouts contained in the Budget Speech (November 2014) and the Interim Budget (January 2015). There is also likely to be a shortfall in government revenue. The upshot will be an increase in the budget deficit and a worsening of the already fragile debt dynamics. Financing the increasing budget deficit will place upward pressure on interest rates. The government has also been forced to borrow from the Central Bank which will exert which will be highly inflationary if continued.

### **Balance of payments and vulnerability of the country**

Increased disposable incomes as a result of the reduction in electricity and fuel prices, as well as increased salaries, pensions and Samurdhi payments, is driving up consumption, with its high import component. This upward pressure on imports combined with a muted export performance, with Tea and Rubber in particular difficulty, is putting pressure on the balance of payments. Large external debt repayments are compounding the difficulties. The CBSL has been compelled to prop-up the exchange rate through a combination of intervention and moral suasion. Some foreign money has also flowed out of rupee securities. The overall outcome has been a sharp decline in reserves. This makes the country more vulnerable if there is an emerging/frontier market sell-off when the US Federal Reserve increases its policy rate (expected around Sept 2015).

### **Moving beyond politics: implementing economic reforms**

It is important for the country to get through its current preoccupation with political and constitutional issues as quickly as possible. Urgent measures are needed to stabilize the economy and strengthen its growth framework through a package of structural reforms, particularly to boost FDI and exports. In addition, the misdemeanours and malfeasance alleged to have found in State Owned Enterprises (SOEs) provide a good justification as to why reform of them should be given high priority. The authorities have the option of listing a minority share of underperforming SOEs, identifying strategic investors or outright sale. This would not only improve corporate governance and operational efficiency but also mobilise much needed budgetary resources.

Structural reforms would have been necessary whether or not there was a Presidential election and a change in government as the previous growth model had run out of steam. In addition, the measures introduced before and in the November 2014 budget would have necessitated some subsequent contractionary policies. However, the change of government in

our highly politicised system as well as 2015 interim budget has caused further disruptions. The current political uncertainty is also delaying the necessary reforms. The policy makers need to be ready to move very quickly after the elections. If it becomes necessary they would also need to consider a combination of interest rate, exchange rate and fiscal policy adjustments to maintain macroeconomic stability even before that, particularly if elections are delayed.

*This is the Sixty Fifth Economic Flash of Pathfinder Foundation. Readers' comments are welcome at [www.pathfinderfoundation.org](http://www.pathfinderfoundation.org)*