Pathfinder Economic Flash

To: **H.E. the President** **From: Pathfinder Foundation**

Hon. Prime Minister

Economic Situation Analysis and need for Urgent Policy Actions

The Pathfinder Foundation (PF) at the outset wishes to emphasise the need for the government (the President, the Prime Minister, his Cabinet as well as heads of institutions dealing with key economic sectors) to operate in a well-coordinated and consistent manner. The new government, which, has committed to operate in a consensual spirit (*sammuthi vaadi*), needs to speak with one voice on necessary and urgent economic reforms. There have been some discordant and inconsistent voices which are a cause for concern. From the beginning, the new leadership needs to send consistent messages to business, especially local and foreign investors.

The new government is expected to begin functioning with the swearing-in of the Cabinet on 4th September. It will have to hit the ground running as there are a number of major issues which require urgent attention. These include important issues, such as responding to the UNHRC Report and Constitutional Reform. However, it is arguable that the most difficult and pressing challenges relate to the economy. These include containing short-term dangers and measures to promote long-term inclusive growth and development.

Short-term dangers

At present, the economy is confronted with the unusual combination of below potential growth and pressure on the external account (the current account of the balance of payments, the currency and reserves). The present strategy of borrowing (including the Indian swap arrangements) and defending the exchange rate by depleting resources is unsustainable.

Balance of Payments pressure is usually associated with an overheating economy (high and unsustainable growth) not one with an output gap. The muted inflationary pressure also reinforces the fact that the economy is growing below potential (though imported deflation is also an important explanatory factor). The low growth may be attributed to a lack of structural reform after the stabilization package in 2012; an uncertain business environment with inconsistent and unpredictable policies; and the political uncertainty over the last 9 months.

The combination of low growth and external account pressure can occur when there is a major exogenous shock, such as a sharp rise in oil prices and /or a collapse of key export production/markets. While tea and rubber exports have been experiencing difficulties, this has been easily offset by the substantial foreign exchange savings generated by low oil prices. This means that the current combination of low growth and external account pressure cannot be attributed to an exogenous shock.

So, why is there pressure on the external account when growth is low? The answer lies in the massive boost to consumption given by the non-productivity linked giveaways in the Budget (Nov 2014) and the Interim Budget (Jan 2015). Consumers have used their higher disposable incomes to increase their purchases of imported items (particularly motor vehicles). At the same time, nothing has happened to earn or save more foreign exchange. In fact, exports have declined in 1H 2015. The result is inevitable pressure on the external account.

The policy challenge posed by this combination of low growth and pressure on the external account is being greatly compounded by elevated risks in global markets due to the anticipated US Federal Reserve interest rate increase and the economic slowdown and market uncertainty in China.

In the current context, fiscal austerity in the short-term will depress already low growth (though the structural budget deficit needs to be addressed in the medium-term). Tightening monetary policy and/or exchange rate depreciation is likely to accelerate the outflow of foreign funds from Rupee securities and the stock market. There is a global trend of money flowing out of emerging markets, especially Asia. Countries, like Sri Lanka, with fiscal and current account of the balance of payments deficits are particularly vulnerable. Consequently, aggressive monetary or exchange rate adjustment, at this point, can be counterproductive by triggering outflows thereby exerting even more pressure on the balance of payments, the currency and external reserves.

Measures for urgent attention

The macroeconomic policy-making landscape is complex and difficult. This may be attributed to adverse trends in global markets as well as electorally motivated and irrationally over-exuberant fiscal measures. In this context, the policy-makers may wish to consider, inter alia, the following measures.

- Demonstrate a firm commitment to tackling the structural fiscal deficit by announcing a credible back-loaded medium-term fiscal consolidation framework (back-loading the adjustment would avoid further dampening growth in the short-term while the investment climate is improved.)

- Some combination of monetary tightening and exchange rate depreciation. It would be a political call as to how the burden of adjustment is distributed between these two macroeconomic policy instruments. Greater reliance on the exchange rate is more growth – friendly (despite the J-curve effects). The current low-inflation environment and higher disposable incomes offer room to manoeuvre.
- The combination of a deteriorating balance of payments and defence of the Rupee with external borrowing, including swap arrangements, is unsustainable. This needs to be addressed with some stabilization measures, especially in the current uncertain global environment.
- An early IMF arrangement would provide financing to reduce the burden of short-term stabilization and also boost sentiment in global markets at a time when Sri Lanka is vulnerable. The IMF today is different. It is no longer overly preoccupied with austerity measures. It has a greater focus on growth and distributional issues.
- Boost growth through a laser-like focus on improving the investment climate. This is the low hanging fruit with little financial, legislative and political costs.
- Urgent action to take forward foreign and local investment projects which have been temporarily suspended or delayed due to reviews during the 100-day programme in order to transmit the right signals to domestic and foreign investors.

The medium-term challenges

Sri Lanka needs structural reforms to achieve sustained high and inclusive growth. The economy needs to be transformed from one which is characterised by low productivity agriculture/low-technology manufacturing and traditional services (retail/wholesale trade, transport and public administration) into a modern economy based on higher productivity agriculture/ higher technology manufacturing and modern services, (such as shipping, aviation, ICT/BPO/KPO, financial services and health and education).

The new political cycle, and the formation of a national government, presents an opportunity to forge consensus on the tough reforms necessary to transform the economy. It provides an opportunity to break out of the repeating cycle of stop-go policies which have characterised the last four decades. A key lesson to be learnt from the 2012-2014 period is that stabilization measures alone are not enough to achieve sustained growth that touches the lives of the people. Stabilization measures are a necessary but not sufficient condition to strengthen the growth framework in the medium and long – term. They need to be complemented by structural reforms which boost productivity/competitiveness. This is the recipe for achieving sustained increases in people's incomes. Not hand-outs and subsidies, which are not linked to productivity, and are unsustainable.

The Prime Minister and his economic team have recognised the importance of a private sector – led export – driven growth model with a major role for FDI. They have also stressed the importance of linking with global and regional supply chains. The PM has also spoken of the need for a new generation of reforms, including the factor markets (land, labour and capital). The challenge is to transform these good intentions into action. In this connection, the PF suggests the following.

- Maintaining sound macroeconomic fundamentals. Especially fiscal consolidation. In this connection, boosting revenue should receive the highest priority.
- Improving the investment climate, including a concerted focus on improving performance on the World Bank's Doing Business Index.
- Reforming factor markets. The state owns 80% of the land and current policies are a major obstacle to expanding commercial activities. The current labour laws do not serve the interests of workers or businesses. The capacity of financial and capital markets to serve a modernizing economy also needs to be strengthened.
- The lacklustre export and FDI performance needs to be addressed urgently. The decline in the openness of the economy should be reserved. (A recent World Bank study found that the Sri Lankan economy in 2014 was as closed as it was in 1970).
- Commercial advantage should be taken of the government's 360 degree foreign policy.
- A coherent and well-coordinated SME development program is necessary to boost the growth framework of the economy and to achieve balanced development. High priority should be attached to create the enabling conditions for SMEs to be linked to domestic and/or external supply chains.
- Agricultural productivity should be increased through reform of policies which currently trap a large share of the population in low productivity/low income activities. This is a major causal factor explaining why 25% of the population lives below $2.50 (Rs. 338) per day. The new leases for the plantation companies, which are due to be renewed, should be more flexible in relation to issues like ownership, duration and land use.
- Empowering people to participate in the benefits of a modernizing economy by strengthening education, training and skills development. This is an important means of achieving inclusive growth.
- Reforming public enterprises (options include privatisation, strategic investment, listing of minority stakes on the stock market and privatising management). Singapore's Temasek model has been mentioned. This requires highly professional management.
- Improving public service delivery is essential to meet the requirements of a modernizing and more complex economy and increase the rate of return on the financial and human resources deployed.
- Develop a well-designed and targeted social protection scheme based on income transfers rather than on distortionary and wasteful subsidies. Analysis has shown that a disproportionate share of subsidies benefit the better – off. Consideration should also be given to extending social protection to workers who are adversely affected by the structural changes associated with a modernizing economy.

Greater elaboration of these reforms can be seen in the Pathfinder Foundations Charting the Way Forward: Prosperity for All at www.pathfinderfoundation.org

Conclusion

The government would need to calibrate the speed and sequencing of the reforms. The overall thrust should be shift to from a culture of entitlements to one which unleashes the capabilities of Sri Lankan's, especially the young, through their empowerment based on increased opportunities for human resource development on the one hand and productive employment on the other. Countries like Greece have faced crises as they were not able to transition from an entitlement culture to a greater focus on productivity/competitiveness.

Sri Lankans are now aspirational and impatient. Governments will be judged by their capacity to deliver improving living standards. The old stop-go policies of deceiving people with hand-outs and then imposing burdens on them are unlikely to be politically and socially tenable in the future. The country needs a new paradigm of economic policy-making which breaks away from the short-term political expedience of the past.

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