Pathfinder Economic Flash

Bitter Pill Now or Intensive Care Treatment Later?

With the end of the war, there was a desire throughout the country for a peace dividend. Over the 30 years of the conflict, pent-up demand had built up both for consumption and investment expenditure. The authorities were under intense political pressure to create an environment that was conducive to finance imports of consumption goods, as well as intermediate and capital goods to boost investment and business activity.

They were able to create a policy environment which enabled the people of Sri Lanka to realize their desire for a release of the pent-up demand. This was achieved through the combined effects of an overvalued exchange rate and expansionary monetary policy based on an aggressive reduction in interest rates and an encouragement of credit growth. The understandable wish for a peace dividend in terms of an improvement in the standards of living of the people was achieved through higher imports, including a sharp increase in motor vehicle imports~~.~~ However, the economic activity, which was boosted by the policy framework that existed before February 2012 (i.e. by living beyond one's means), was clearly unsustainable. This was reflected in the doubling of the trade deficit from $5 billion to $10 billion despite a 22% increase in exports in 2011. Furthermore, the current account of the balance of payments declined sharply despite 25% increase in remittances and a 70% rise in earnings from tourism.

As reiterated on several occasions by the Pathfinder Foundation (PF), the authorities have taken bold action to address the fundamental misalignment in the policy framework. They have moved from a rigid to a flexible exchange rate; monetary policy has been tightened through higher interest rates and a credit ceiling; and taxes have been increased to discourage non- essential imports. These measures are commendable.

It is, however, important and prudent for the political leadership and the technocrats to draw lessons from the policy mistakes made in the past that led to the sharp deterioration of the country's external situation in the second half of last year. The failure to lean such lessons is likely to be punished harshly by rating agencies and international capital markets. This will have painful repercussions for the people of this country. The key lesson is that it is not possible to both maintain an overvalued exchange rate and reduced interest rates once the current account of the balance of payments begins to deteriorate. A repeat of such a policy mix, would inevitably result in another episode of the hemorrhaging of the country's external reserves, thereby once again wasting hard earned dollars. Another lesson that needs to be drawn is that the external account of the country cannot be put on a sustainable footing through further foreign borrowing (by the government or banks). Reserves need to be built up through increased revenue from exports of goods and services, higher levels of remittances and non-debt creating capital flows (FDI & portfolio flows into the stock market).

The stabilization measures introduced in February/March of this year will inevitably dampen investment, growth and employment in the short-run. There is no option but to pay for last year's import binge and artificially boosted growth in this manner. Furthermore, the deteriorating globally situation, especially in the West, will aggravate the domestic imbalances created, in large measure, by the past policy mistakes. At the same time, there is likely to be pressure both from some politicians and businessmen to reverse the stabilization measures before the economy has regained balance of payments stability. Caving in to such pressures would be similar to abandoning a course of medical treatment before a patient has been cured. A deterioration in the condition of the economy (or the patient) would be inevitable. Furthermore, as the economy (patient) has already been weakened the next time around the consequences are likely to be more severe. The remedial measures that would become necessary would be even more painful than the current round of stabilization measures and the political costs would also be correspondingly higher.

The overall message is that the painful stabilization needs to be worked through. However, it needs to be supplemented by a package of reforms which strengthens the investment and growth frameworks in the economy. Such a package would need to include, inter alia, an acceleration and deepening of the measures that have been initiated to improve the investment climate; urgent revamping of loss-making state enterprises through restructuring or partnering with new investors; reform of factor markets (land, labour and capital); strengthening of education, training and skills development; supporting research and development as well as improving technology management; and continuation of fiscal consolidation through tax reform and a rigorous public expenditure review. Arguably the most effective means of boosting growth in the short-run is to accelerate the government's infrastructure development program. Given the fiscal constraints this can best be achieved through an aggressive public/private partnership program. Such a program would also have the added benefit of attracting foreign investment, which would also constitute a non-debt creating avenue of addressing the balance of payments problem.

In the current global and local contexts there can be no economic gains without short-term pains.

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