

Is the Sri Lankan Economy in Crisis?

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Economic Growth in 2006

- 7.4 % in 2006, an increase from 5.4 % in 2004 and 6.0 % in 2005.
- Fairly broad based growth. Agr. – 4.7% (11% contribution to growth), Ind. – 7.2% (27%), Serv. – 8.3% (63%).
- Agr – favourable weather/ tea & rubber performed well. Ind – EU GSP+ supported garment exports to show 18.4% growth to EU market and overall garment export growth of 6.4 %. Construction grew at 8 per cent mainly as a result of Tsunami reconstruction. Serv. grew by expansion of telecom, banking, etc.

How the Growth was Achieved

- Private sector factoring in uncertainty.
- US \$ 1.2 bn foreign capital was available for the government and aid utilization increased from 17% in 2005 to 21 % in 2006.
- FDI increased to record US \$ 604 mn.
- Remittances increased to US \$ 2.3 bn.
- Share market attracted a record US \$ 355 mn.
- Fiscal stimulus supported by low interest rate policy.
- Overall buoyancy of the Asian region spilling over to SL

Growth Reflected in:

- Number of new infrastructure projects that have kicked-off such as Upper-Kotmale.
- Increase in credit expansion to the private sector.
- Unemployment reduced to 6.3 per cent; 8.2 million in the labour force.
- Per capita income US \$ 1335 – middle income country.

Policy Shift

| Pre 2004 | Post 2005 |
|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| <ul style="list-style-type: none"> ○ Recruitment/ Wage increase, Freeze. ○ Privatization. ○ Compression of development spending and phasing out of welfare expenditure. | <ul style="list-style-type: none"> ○ Flexible wage policy with the long standing correction in salary anomaly. ○ Policy on Management Improvements. ○ Increased Public Investments. ○ Increased Targeted Welfare/subsidy Expenditure <ul style="list-style-type: none"> (1) Nutritional meal Programme, Free School Uniforms, Text books and season tickets (2) Bursaries & Scholarships (3) Samurdhi (4) Fertilizer Subsidy (paddy & small holding agriculture) (5) Street Lighting. |
| <ul style="list-style-type: none"> ○ Peace in N/E by appeasement | <ul style="list-style-type: none"> ○ Peace in N/E from a position of strength |

Macroeconomic Instability

- Expenditure far exceeding government revenue
- Demand far exceeding the supply capacity of the economy
- Huge budget deficit of 8.5 % GDP in 2006
- Government resorted to high domestic borrowing and part of it was from the banking system.
- 5 % current account deficit in the BOP

Manifestation of the Instability

- Commodity Market: Inflation at two digit level at 17%
- Forex Market: Pressure on the exchange rate to move up (or depreciate to cut imports)
- Money Market: Pressure on the interest rate to move up (to cut expenditure)

Major Concerns

Economic growth of 7.4 % has not been well supported by economic stability and restructuring to boost the supply side of the economy

- Macroeconomic Instability
- Slow Movement of Economic Restructuring

The economic problem in a nutshell

- Growth was achieved by disturbing the stability in the macroeconomic environment in 2006,
- Growth was achieved by maintaining the status quo of many SOEs, agriculture, education, and other areas without implementing restructuring.
- We know that this growth cannot be sustained for long unless some stability is brought in the macroeconomy and restructuring implemented to boost the supply side.

Measures Taken to Restore Macro Stability

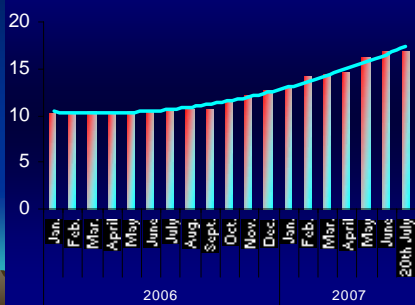
Monetary Policy

- Increases in interest rates (IR) since mid-2006 till 1Q of 2007. IRs above 17% now.
- Monetary Policy Road map put into operation in early 2007

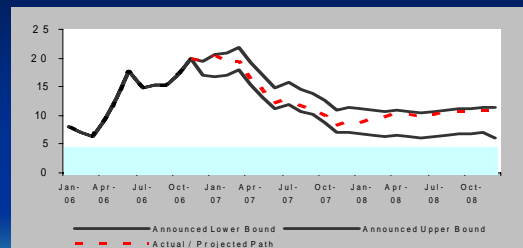
Fiscal Policy

- Reductions in transfers to some SOEs due to price revisions
- Reductions in targeted capital expenditure
- Increasing and broad-basing taxation

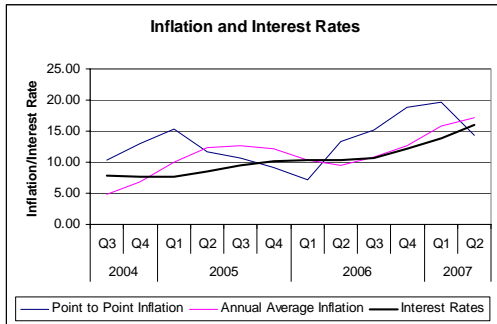
Treasury Bill Yield Rate (%)



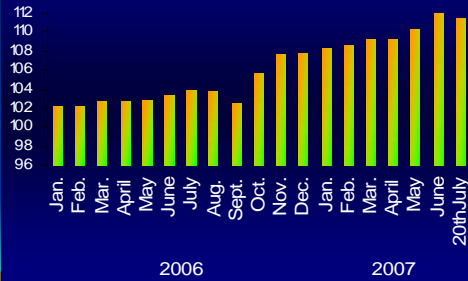
CBSL is expecting the Inflation to come down as indicated



Interest Rate behaviour



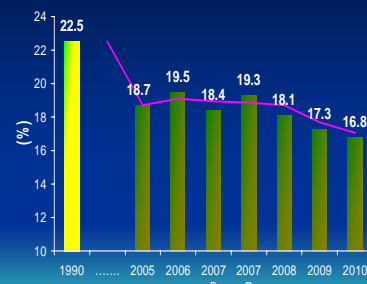
Exchange Rate (US \$) Middle Rate



What is Happening ?

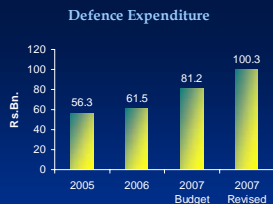
- $Y = C + I + G + (X - M)$
- $Y = A + (X - M)$
- $Y - A = X - M$
- If interest rates does not cut absorption in the economy to maintain the *ex-post* balance, then exchange rate will depreciate to cut imports to restore the balance

Current Expenditure / GDP (%)

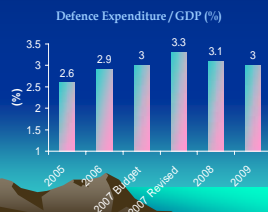


Cost of providing Security

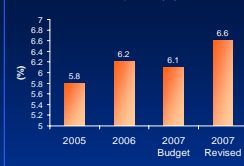
One off-up front cost on neglected areas (Air defence, Naval surveillance, etc)



Additional staff for security in liberated areas



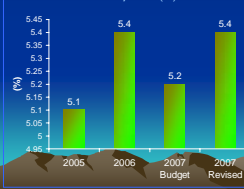
Salaries / GDP (%)



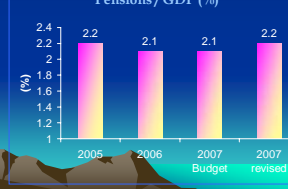
Other Operational Expenses

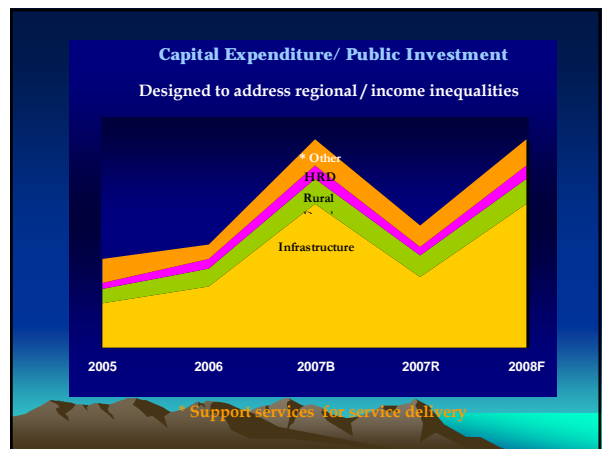
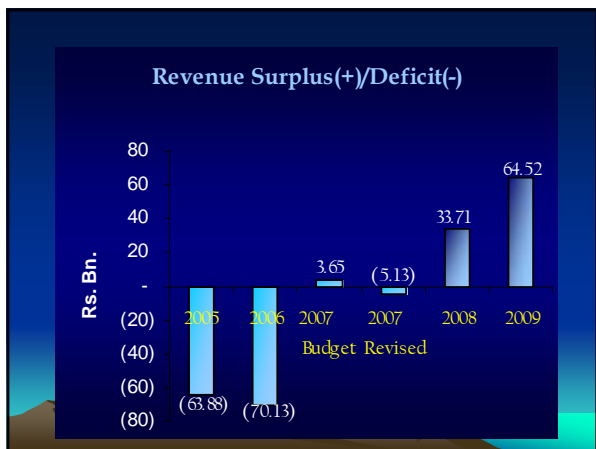
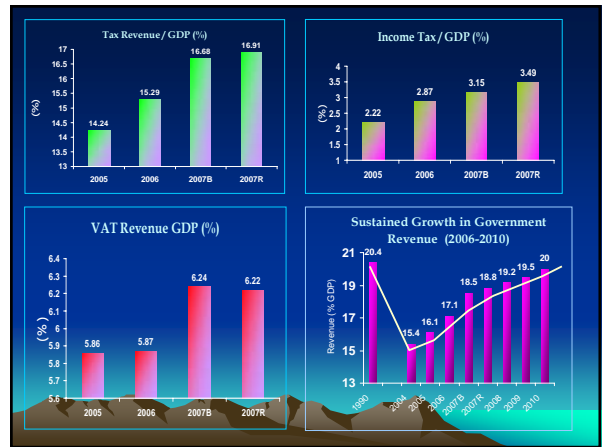
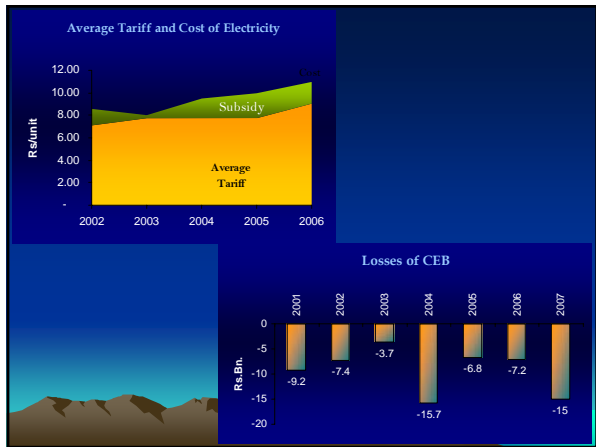
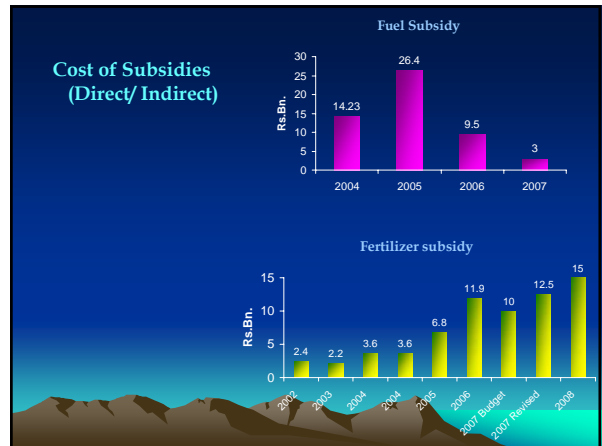
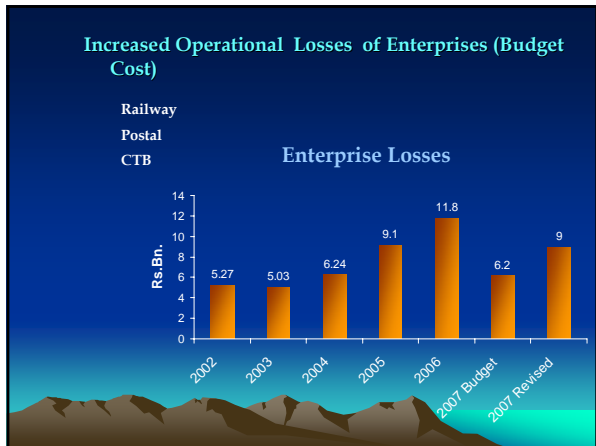


Interest / GDP (%)

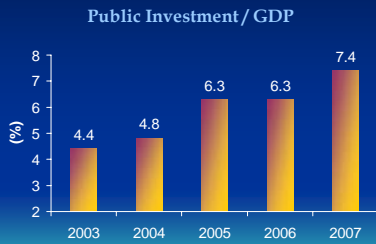


Pensions / GDP (%)

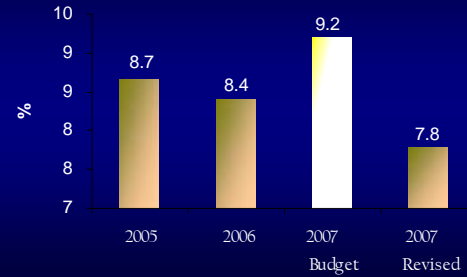




Capital Expenditure



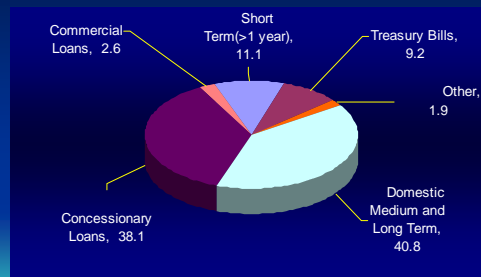
Budget Deficit/GDP (%)



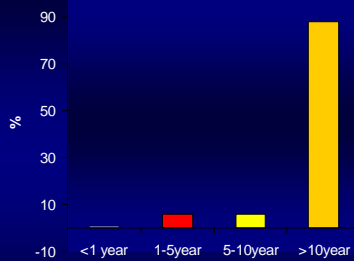
Demand Situation

- Monetary Policy will gradually achieve its objective.
- Some fiscal stability has been achieved by reduction in capital expenditure.
- But has the underlying demand pressures been curtailed ?
- Not fully, pressure on ER reflects this. US \$ 500 loan can curtail the pressure

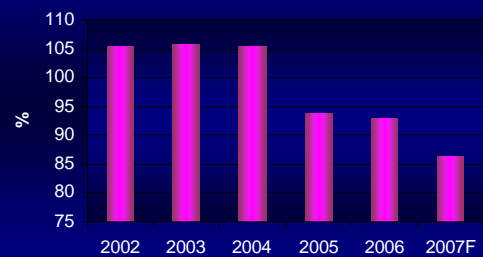
Total Outstanding Debt / GDP (%) - 2006



External Debt Maturity



Public Debt on a declining path



Macro stability ?

- Macro Stability should be restored by curtailing current expenditures and here other than in the case of tariff revisions for oil and electricity there has not been much progress in other areas
- Revenue has improved by better tax collection
- Economic reforms should be implemented not only to reduce the demand pressure but also to boost the supply side
- Need to restore confidence in the economy and attract more investment, especially for infrastructure projects

Economic Restructuring

- Restructuring is urgently needed in the loss making State-Owned Enterprises (SOEs), like CEB, CRD, etc. CEB total accumulated debt around US \$ 800 mn. Transfers to SOEs 3-4 % GDP.
- Restructuring have taken place in certain areas: automatic pricing system in petroleum (July), electricity tariff increases, but these measures have been inadequate to reduce the burden of these enterprises on the government budget.

Restructuring : Needs Acceleration

- Restructuring confined only to price adjustment are inadequate. Cost reduction and productivity improvement will come only if private sector participation is permitted in these agencies.
- Restructuring in Education, agriculture, and other areas need to move in parallel.
- Communication with the public on the need for economic restructuring is important.
- Managing the economic restructuring /change process is equally important.

Economic Restructuring support Fiscal Management

- With economic restructuring in the SOEs the govt. can save and redirect 3-4 % GDP to investment on infrastructure and other productive investment.
- Government can reduce expenditure and bring down the budget deficit and inflation thereby reducing pressure on interest rates and exchange rates.

Private Public Partnerships (PPP) in Infrastructure

- The private investor will finance, construct, operate and maintain the assets in order to deliver the products/services
- The private sector is “generally” regarded as more efficient than the Public Sector in Service delivery

PPP Framework Required

- SEMA models on PPP for SOE restructuring should immediately be put in place
- Public Utilities Commission (PUC) setting the tariff structure to look after the interests of both the investor and the consumer. Already CPC, CEB and the NWSDB are gazetted under the PUC.
- The new Acts should also soon come into effect to move PPPs

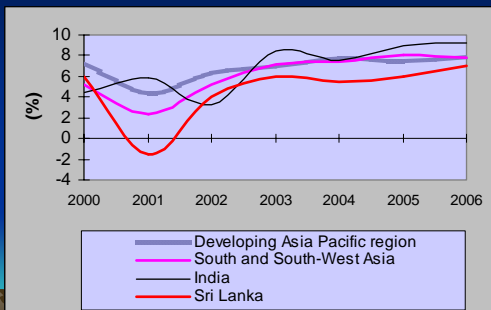
Real Economy

- Private sector factoring in the uncertainty,
- Remittances on the increase, exports on the increase,
- FDI flows stable,
- Aid utilization rate further improved
- Asian buoyancy
- Growth about 6.5 %

Open Economy and global Environment supporting the Real economy

- Despite the slow movement of economic reforms in loss-making SOEs, agriculture and education sectors (Supply-side constraints) and despite overheating of the economy due to excess demand, the real economy has responded to market forces and showing growth. For sustenance of this growth the demand and supply side problems should be continuously addressed.

Sri Lankan Growth of Asian Region Rate of Economic Growth 2000-2006



Answer: Is the Economy in Crisis?

- No, there is no major crisis for the economy to fall apart and show negative growth
- but stability in the macroeconomy has to be restored especially by curtailing current expenditure.
- Supply side needs a boost by economic reforms – implementation has been too slow.
- B+ grading clearly reflects this.