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Sri Lanka's macroeconomic polic Cohesion or confusion?

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The hike in policy interest rates by the Central Bank of Sri Lanka (CBSL) in August a shift from stimulus to exit strategies in the pandemic era. Such recalibrations gl focused on how to tackle the historically large debt-to-GDP ratios that the COVID pandemic leaves in its wake. At end 2020, advanced economies (AEs) on average h debt to the tune of 120% of their GDP with emerging markets economies (EMEs) t distance at 65% of GDP. As the spotlight moves, the full impacts of the macroecon measures, hitherto obscured by the urgency to deal with the health crisis, are now under greater scrutiny.

Sri Lanka's debt metrics make an orderly exit more difficult

Many countries, especially AEs, exercised their 'monetary sovereignty' to create a their own money to support stimulus efforts. They have done so through coordina monetary/fiscal policies – i.e. using monetary policy to keeping borrowing costs lo fiscal authorities provide back-stop assurance. Some are better positioned to mana inherent risks and conflicts of interest that are involved in this exercise. AEs have advantage as issuers of reserve currencies with global demand and historically low rates; EMEs with limited exposure to foreign currency-denominated debt and hold comfortable stockpiles of reserves are less exposed to disruptive tail events.

Such countries can bring down their debt ratios if they are able to maintain nomir growth persistently above the average interest rates that they pay on their debt – growth-corrected interest rate (r-g) whereby countries can run modest primary de still have a stable or falling debt-to-GDP ratio.

Sri Lanka is not similarly positioned. Its debt metrics point to high vulnerabilities debt-to-GDP ratio of 101% of GDP, large exposure to foreign currency-denominate a hefty foreign debt repayment schedule. Under these conditions, the threat from monetary sovereignty was always self-evident. A depreciating currency, notwithst distortionary controls on imports and capital flows, worsens the debt vulnerabiliti

Domestic and foreign debts are hardly similar. Given Sri Lanka's debt metrics and fundamental economic imbalances that have generated them, simple accounting i not always offer very plausible solutions. If the exchange rate depreciates, it adds value of outstanding debt, relative to the size of the economy, even if interest rate modest. Further, shocks like COVID-19 raise risk premia, and marginal borrowing rise suddenly and sharply, cutting countries abruptly out of financial markets.

Crucial to instill and retain macroeconomic policy credibility

Short of distortionary measures such as inflating debt away or maintaining an ove currency, a primary surplus is needed to stop the public debt-to-GDP ratio from ri even larger surplus is needed to reduce it. Improving the primary budget balance c increases or public spending cuts that are unpopular and have upfront costs. Give government's unwillingness to go down this path, households and firms will be re instead to bear the cost through higher interest rates affect their consumption and investments.

Higher interest rates in this instance will also not 'pul capital to firm up the exchange rate given the risk pre currency front as depreciating pressure deepens. With hand to cover barely two months of imports, the forex continue to face volatility and instability until a stead capital inflows, beyond short-term swaps, emerge. Un time, a depreciating domestic currency will increase t burden as calculated in that currency. If debt servicing interest rate costs are push persistently above the economic growth rate, Sri Lanka's debt burden will grow ste in the absence of new borrowing – a context sometimes called a 'debt spiral'.

Without a clearly spelt-out debt sustainability path, Sri Lanka seems to be placing on foreign direct investment (FDI) to ease external pressures and revive economic a successful outcome – i.e. productivity gains to drive long-term growth – the typ matters. The more desirable is efficiency-seeking FDI, but this is also harder to att now, a policy environment of import curbs and capital controls is more likely to se seeking infrastructure-led FDI. The latter runs the risk of switching resources to n sectors – reducing the availability of external financing over the longer term – and prospect of a short-lived growth burst as before in the post-war years. Crucially to reliance on FDI leaves Sri Lanka at the mercy of developments beyond its control.

Rather, efforts to attract FDI should be coupled with building effective policy strat instill and maintain credibility. Indeed, this is all the more important as Sri Lanka be firmly against an International Monetary Fund (IMF) bailout. IMF loan amount and it no longer has much sway on debt relief with much of EME foreign debt held institutional investors and China. An IMF programme is mostly useful in firming u credit ratings and reviving the sentiments of investors. But investor sentiments ca improve if governments put forward and implement credible policy strategies. By CBSL's policy rate adjustment to anchor expectations, for instance, will not stick i financing of fiscal spending is to continue under yield control measures. Instead, r convictions on the credibility of the policy mix will drive economic fundamentals. readies to transition out of pandemic-related emergency support, some notion of debt sustainability to anchor confidence should be the priority in Budget 2022 pre

* This blog is based on the comprehensive chapter on "Economic Performance and Managing the Crisis and Promoting Recovery" in IPS' forthcoming annual flagship

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