Sri Lanka consistently losing the economic race – Dr. Dushni Weerakoon

By **Ishara Gamage** - October 27, 2022 2:20am

Sri Lanka's economic development will suffer a serious setback of many years, and other countries will overtake the country, as the real per capita GDP declines, a top Sri Lankan economist has warned.

Exchange rate management will be the biggest macroeconomic challenge, says Dr. Dushni Weerakoon, Executive Director of the Institute of Policy Studies (IPS) of Sri Lanka.

She was speaking at the launch of the State of the Economy 2022 report, which was launched on Tuesday (25) at IPS headquarters in Colombo.

In order to inspire policy action for economic and social stability, the State of the Economy 2022 report aims to prioritise and analyse current economic issues within the framework established by the Sustainable Development Goals (SDGs).

"Building up reserves for 3+ months of import cover will be a slow process. Regaining access to capital markets takes at least two years after a successful restructuring," Weerakoon predicted.

The local rupee is already under pressure due to the recent appreciation of American dollar.

"Sri Lanka must move as quickly as possible through the debt restructuring negotiations and establish credibility by stabilizing macroeconomic fundamentals. It is critical to keep output losses to a minimum. In the medium term, Sri Lanka must maintain greater macroeconomic flexibility without reversing its stabilisation efforts".

"Bridge financing for budgetary support will be available only if the Sri Lankan Government and creditors reach an agreement on debt restructuring", she said.

Her observations indicate that the recovery path from the point of immediate impact varies. The idea that a debt crisis leaves only temporary economic scars may not hold true for emerging market economies.

Sharp monetary policy tightening aims for high inflation, but it has limitations when inflation is primarily supply-driven.

This raises the question of whether monetary policy is too tight and whether there should be a trade-off on growth.

"There is no scope for trade-offs in
Sri Lanka's current elevated levels of inflation. Monetary policy is still accommodative for growth," IPS's Executive Director said.

Dr. Weerakoon also said that anchoring inflation expectations is important to help contain inflation at a lower economic cost.

"We need to watch for wage catch up in the context of the erosion of real wages, tax-related income cuts, and higher labour mobility. Bringing inflation under control is also critical to stabilising the exchange rate – persistent high inflation leads to immediate or anticipated currency depreciation", she said.

Bilateral lending has largely been exhausted and China is likely to reduce lending globally. Short-term capital inflow and outflow incentives for FDI (impacting tradable sector performance) are likely to have an impact on the Chinese economy.

Has the interest rate rise peaked?
Dr. Weerakoon queried.

Real interest rates have fallen into the negative zone. Monetary policy remains supportive of growth. Negative real rates that persist are regarded as a sign of financial instability. It favours consumption over investment. If inflation expectations remain high, markets may respond by raising interest rates. Monetary policy would typically support growth because monetary policy aims to restore price stability and anchor inflation expectations.

According to her observations, over the next two years, fiscal policy is not expected to be growth-friendly.

A primary surplus of 2.3% of GDP is expected by 2025, up from an estimated 4% deficit in 2022, and revenue collection will slow as growth slows. Spending freezes (salaries and wages) and cuts (capital expenditures) combined with high nominal GDP growth may help bridge the gap.

"We, as a Sri Lankan view, that a debt crisis leaves temporary, rather than permanent, economic scars, may not apply to emerging market economies." Because defaults are not random, quantifying their costs across widely varying episodes is difficult. The most severe and prolonged declines are associated with post-default restructurings. "When defaults are accompanied by banking and/or currency crises, the drop in output is especially severe," she said.

"Costs can encourage governments and creditors to engage in a 'shallow' restructuring, but it can also lead to repeat 'serial' defaults and restructuring. The pace of economic development will be years slower due to a decline in Sri Lanka's real per capita GDP. Other countries will overtake
Sri Lanka as the rate of economic growth declines."

The IPS Head warned that IMF programmes have a positive catalytic effect on private lenders, but over time, this may also raise the risk of sovereign default.

"If nations do experience financial difficulties, IMF conditions frequently prevent governments from requesting bailouts. IMF programmes have been found to significantly lower the likelihood of future sovereign defaults for countries that are already in default."

The IPS Head concluded that a gradual shift to a focus on growth is also required, along with an appropriate long-term policy framework.

By Ishara Gamage

Ishara Gamage

I WANT IN →

I've read and accept the Privacy Policy.