Effective measures needed to minimise output losses from crisis: IPS

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- **Swift conclusion of debt restructuring negotiations and establishing credibility by stabilising macroeconomic fundamentals are key**
- **Govt. needs to ensure more macroeconomic flexibility without throwing stabilisation efforts into reverse**
- **Opines a debt crisis that leaves temporary, not permanent, economic scars may not hold for emerging market economies**
- **Post-default restructurings are associated with the most severe and protracted declines**
- **Fall in output particularly large when defaults are accompanied by banking and/or currency crises and defaults harm traded sector via a current account reversal**
- **Managing exchange rate will continue to be biggest macro policy challenge**
- **Bringing inflation under control critical to stabilise exchange rate**
- **Anchoring inflation expectations critical to help contain inflation at lower economic cost**

The Institute of Policy Studies of Sri Lanka (IPS) Executive Director Dr. Dushni Weerakoon on Tuesday called for effective measures to minimise output losses owing to the current challenging macroeconomic conditions. Speaking at the launch of IPS' State of the Economy 2022 report, Weerakoon said to ensure minimisation of output losses given the current challenges, in the short-term, the Government needs to conclude debt restructuring negotiations as swiftly as possible and establish credibility by stabilising macroeconomic fundamentals.

Institute of Policy Studies of Sri Lanka Executive Director Dr. Dushni Weerakoon

In the medium-term, the Government needs to ensure more macroeconomic flexibility without throwing stabilisation efforts into reverse and embark on a gradual shift to an emphasis on growth, aligned with an appropriate long-term policy framework.

She noted that ongoing stabilisation measures on fiscal policy (income cuts), monetary policy (demand squeeze) and exchange rate devaluation (higher prices) are meant to reduce aggregate demand in the economy. She added that sharp monetary policy tightening targets high inflation, although limits when inflation is mostly supply-driven, with food and fuel rates acting as key drivers of inflation in recent months.

"This raises questions whether monetary policy is too tight and should there be a trade-off on growth," she queried at the event where CBSL Governor Dr. Nandalal Weerasinghe and Treasury Secretary Mahinda Siriwardene were also present.

Weerakoon said that at Sri Lanka's current elevated levels of inflation, there is no scope for trade-offs and anchoring inflation expectations is critical to help contain inflation at a lower economic cost. The importance of being concerned about wage catch-up in the context of the erosion of real wages/tax-related income cuts and higher labour mobility was also stressed.

"Bringing inflation under control is also critical to stabilise the exchange rate," IPS Executive Director stressed, pointing out that persistently high inflation leads to immediate or anticipated currency depreciation. "The rupee is already under pressure from appreciating dollar in recent months," she added.

In that context, Weerakoon flagged that managing the exchange rate will continue to be the biggest macro policy challenge.

She was of the view that building up reserves for over three months' import cover will be a slow process, and on average, regaining access to capital markets is at least two years from a successful restructuring. It was observed that 'bridge financing' on budgetary support will materialise only on an agreement between Government and creditors on debt restructuring.

Furthermore, bilateral lending is more or less exhausted, she said, adding that China is likely to scale back lending globally as well. Therefore, the need to incentivise short-term capital inflows and outflow of FDI which impact tradable sector performance, was stressed.

Focusing on interest rates, Weerakoon said real interest rates have moved into negative territory with monetary policy still accommodative for growth. “High/sustained negative real rates are viewed as a sign of financial instability and encourage consumption over investment. If inflation expectations stay high, markets might react by pushing up interest rates,” she added.

It was stressed that as monetary policy aims at restoring price stability and anchoring inflation expectations, fiscal policy would typically support growth.

Commenting on the IMF program’s envisaged primary surplus target of 2.3% of GDP by 2025 from an estimated 4% deficit in 2022, Weerakoon said that as growth slows, so too will revenue collection.

She pointed out that spending freezes (salaries and wages) and cuts (capital expenditures) alongside high nominal GDP growth may help to bridge ratios. She also opined that fiscal policy is not expected to be growth-friendly over the next two years.

Weerakoon noted that the combined impact of stabilisation is output loss and the recovery path from the point of immediate impact varies.

It was revealed that there was limited consensus on economic impact, ranging from sharp and/or persistent recession after defaults to little or no impact. Additionally, defaults are not random and not created alike, making it difficult to quantify their costs across widely varying episodes. Given these conditions, Weerakoon focused on significant ramifications for Sri Lanka.

“The suggestion that a debt crisis leaves temporary, not permanent, economic scars may not hold for emerging market economies,” she said, adding that post-default restructurings are associated with the most severe and protracted declines.

“Fall in output is particularly large when defaults are accompanied by banking and/or currency crises and defaults harm the traded sector via a current account reversal,” she noted, adding costs can encourage Government/creditors to engage in a ‘shallow’ restructuring, but it can lead to repeat ‘serial’ defaults and restructuring.

Focusing on the role of the IMF, IPS Executive Director said IMF programs have positive catalytic effects on private lenders, but this can also increase sovereign default risks in the long run.

“If countries do run into trouble, IMF conditionalities often tend to delay governments from availing themselves of bailouts,” she said, emphasising that for countries in default, IMF programs are found to reduce the likelihood of subsequent sovereign defaults significantly.

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