Minimising output losses in the short term:

“Conclude debt restructuring negotiations as soon as possible”

Wednesday, October 26, 2022 - 01:00

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The combined effects of the economic stabilization process will lead to sharp output contractions and the recovery path from the immediate impact may vary, Institute of Policy Studies of Sri Lanka (IPS)- Executive Director Dr. Dushni Weerakoon said.

Emphasizing the need to minimize output losses in the short term Dr. Weerakoon explained the need to conclude debt restricting negotiations as soon as possible whilst establishing credibility by stabilizing macroeconomic fundamentals.

In the medium-term Weerakoon said that it is essential to have more macroeconomic flexibility without throwing stabilizing efforts into reverse, ensuring a al shift to an emphasis of growth, aligned to an appropriate long-term policy framework.


Dr. Dushni Weerakoon

Dr. Weerakoon made these observations, marking the release of 'Sri Lanka: State of the Economy 2022' report, held at IPS yesterday (25). Speaking further Dr. Weerakoon stated that the primary surplus target of 2.3% of GDP by 2025 from the estimated 4% deficit in 2022 will slow growth and revenue collection.

"This would lead to freeze spending such as salaries, wages, and capital expenditure cuts. Fiscal policy is not expected to be growth-friendly over the next two years. Even if we look at the revenue side, increases in personal income tax and corporate income taxes are not growth friendly taxes."

Speaking on the IMF role for Sri Lanka, Dr. Weerakoon said IMF programmes have positive catalytic effect 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. For countries in default, Dr. Weerakoon said IMF programs found to significantly reduce likelihood of subsequent sovereign defaults.

Meanwhile, as per Sri Lanka's inflation trajectory announced over the last 12 months, she said food and fuel are the key drivers of inflation. Going forward, Dr. Weerakoon said attention must be given on curtailing inflation expectations. If the central bank has credibility and the public investors believe that adequate policy action is being taken , Dr. Weerakoon said that inflation can be curtailed at a lower economic cost.

"As Sri Lanka makes transition from supply driven to demand driven inflation, anchoring inflation expectations becomes more critical."

In the context of tight labour, Dr. Weerakoon pointed out the need to watch for wage catch up in the context of erosion of real wages, tax related income cuts and higher labour mobility.

"If this continues many Sri Lankans will be compelled to leave the country."

Noting that monetary policy has been tightened given the current economic situation, Dr. Weerakoon noted that it raises questions whether monetary policy is too tight and should there be a trade-off on growth.

"At Sri Lanka's current elevated levels of inflation, we have to make sure that there is no scope for trade-offs.

Noting that the exchange rate has stabilized to a certain extent in recent months due to depreciation of the US dollar, Dr. Weerakoon said currencies across the world are coming under enormous pressure and LKR is no exception.

"We need to build up reserves of at least for three months import cover which will be a slow process."

Dr. Weerakoon also added that on average, regaining access to capital will take at least 2 years from a successful debt restructuring.

"Bridge financing on budgetary support will also materialize only on agreement between GOSL and creditors on debt restructuring. We are more or less exhausted by bi-lateral lending options. Even beyond this immediate crisis and going forward, China is likely to revisit its role as a large scale lenders to developing countries." Dr. Weerakoon added.

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