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Sri Lanka's economic development would be set back for years: IPS

By Raj Moorthy

While Sri Lanka's real per capita GDP stood close to Rs. 60,000 in 2021, this could decline to below Rs. 50,000 in the years 2023 and 2024. As global inflation has reached its highest point, other countries will be scrambling ahead of Sri Lanka as the country's real per capita GDP keeps declining.

This was stated by Dr. Dushni Weerakoon, Executive Director of Institute of Policy Studies (IPS) in her presentation on 'Economic Crisis and Policy Adjustments for Stabilisation' during the release of 'Sri Lanka: State of the Economy 2022 Report' by IPS this week in Colombo.

Dr. Weerakoon said, "Sri Lanka's economic development will be set back by years. Other countries will be scrambling ahead of us as Sri Lanka's real per capita GDP declines." Costs can encourage government and creditors to engage in a shallow restructuring, but it can lead to repeat serial defaults and restructuring, she added.

The report 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, there is no scope for trade-offs. Anchoring inflation expectations is important to help contain inflation at a lower economic cost. There is a need to watch the wage catch up in the context of erosion of real wages and tax related income cuts and higher labour mobility."

Dr. Weerakoon stressed that managing the exchange rate will continue to be the biggest macro policy challenge in the next few months. "Building up reserves for more than three months imports will be a slow process. On average, regaining access to capital markets will take at least two years from a successful restructuring. Bridging financing on budgetary support will materialise only on agreement between the government and creditors on debt restructuring."

Elaborating on whether interest rates have peaked, Dr. Weerakoon stated, "Real interest rates have moved into negative territory. Monetary policy is still accommodative for growth. High and sustained negative real rates are viewed as sign of financial instability that encourages consumption over investment."

She pointed out that spending freezes on salaries and wages and cuts on capital expenditures alongside high nominal GDP growth may help to bridge ratios. Fiscal policy is not expected to be growth friendly over the next two years. There was limited consensus on economic impact, ranging from sharp and/or persistent recession after defaults to little or no impact. Defaults are not random or not created alike, making it difficult to quantify their costs across widely varying episodes.

Commenting on important ramifications for Sri Lanka she said, "Suggestion that a debt crisis 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 is particularly large when defaults are accompanied by banking or currency crisis. Defaults harm the traded sector via a current account reversal," she noted.

IMF programmes have a 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, IMF programmes were found to significantly reduce likelihood of subsequent sovereign defaults, she added.

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