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The laborious pains of rectifying Sri Lanka's historic economic errors

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- Economists at IPS' annual 'State of the Economy' report launch highlight need for proper, timely decisions towards economic recovery

BY Sumudu Chamara

Although Sri Lanka's economic recovery is proving to be a painful process, the reforms that make it so painful are absolutely necessary to ensure this recovery. If the country resorts to unsustainable short-term measures for temporary comfort, the country will only face a more difficult situation moving forward.

These are the prerequisites for the country's economic revival, as explained by economic experts during a seminar titled "Driving Policy Action from Crisis to Recovery" which had been organised to launch the Institute of Policy Studies' (IPS) annual report, "Sri Lanka: State of the Economy 2022 Report".

Recovery amidst inflation, debt, and uncertainty

During the event, experts underscored that while Sri Lanka's economic growth would be an extremely difficult process, if the necessary decisions are taken on time and in the proper manner, the country can expect to recover within a few years. It was also noted that the prevailing economic situation is also an opportunity to identify and rectify some mistakes Sri Lanka has made.

IPS Executive Director Dr. Dushni Weerakoon expressed concerns as to whether Sri Lanka's existing monetary policy is too tight, and whether there should be a trade off on economic

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growth. She noted however, that at the current, elevated levels of inflation, there is no scope for tradeoffs.

"In light of the high inflation, the monetary policy has been tightened sharply. But, in a context where inflation is driven by supply side factors, there are obvious limits to the monetary policy. If you look at Sri Lanka's inflation trajectory over the last 12 months, it is quite clear that food and fuel are the key drivers of inflation.

"As we make that transition from supply-driven inflation to demand-driven inflation, anchoring inflation expectations becomes even more critical for wage-related catch-up. Most of us are seeing an erosion of real incomes and also cuts to wages as income taxes. In a context where there is higher labour mobility, while many Sri Lankans are leaving the country, many more will probably leave."

She stressed that the fiscal policy is not expected to be growth-friendly over the next two years.

She also pointed out that anchoring inflation expectations is important in order to help contain inflation at a lower economic cost. "If the Central Bank of Sri Lanka (CBSL) has credibility and the public, investors and other relevant parties believe that adequate policy related action is being taken, inflation can be contained at a lower economic cost. Another reason why anchoring inflation expectations is critical is because the country needs to stabilise exchange rates. Persistent high inflation leads to immediate or anticipated currency depreciation. If inflation expectations stay high, markets might react by pushing up interest rates."

Dr. Weerakoon also noted that managing the exchange rate will continue to be the biggest macro-policy challenge, and that building up reserves to cover imports for more than three months will be a slow process.

She added that research evidence shows that once a country has defaulted and successfully concluded debt restructuring, it will get at least another two years before it can comfortably return to capital markets in the expectation of borrowing at reasonable rates, and that borrowing and bridge financing will also not materialise until Sri Lanka has concluded debt restructuring negotiations. Adding that Sri Lanka's bilateral lending has more or less exhausted, she added that China is likely to scale back lending globally.

"We need to be watchful because when exchange control restrictions are lifted, we might see an outflow of foreign direct investments (FDIs), given that business operating costs have gone up substantially," she cautioned, adding that there may be an inclination on the part of businesses to relocate overseas or expand their operations overseas rather than in Sri Lanka.

"The bottom line is, Sri Lanka's economic development will be set back by years. Other countries will be scrambling ahead of us in terms of the per-capita income growth whereas we will be falling behind. In the path of recovery, the best case scenario is that after the initial impact, we will see a further contraction for two years, and then, real per-capita income will start to revive. But, if there is uncertainty in terms of when debt restructuring talks will be concluded, the crisis would be protracted. As a result, the real per capita will continue up to five years before it starts to reverse."

She further said: "Given these costs related to the uncertainty of debt restructuring and the decline in the real output, there is an incentive for the Government and creditors to engage in the 'shallow' restructuring of debts. The Government wants to quickly tie up all the loose ends and a deal on the table, while the creditors would rather recover their investments as early as possible. Research evidence shows that countries that do shallow restructuring default within two years."

With regard to the ramifications that the country is likely to face, Dr. Weerakoon said that post-default restructurings are associated with the most severe and protracted declines, and that the fall in output is particularly large when defaults are accompanied by banking and/or currency crisis.

Adding that minimising output losses is essential, she proposed concluding debt restructuring negotiations as swiftly as possible, and establishing credibility by stabilising macroeconomic



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fundamentals as short-term measures, and ensuring more macroeconomic flexibility without throwing stabilisation efforts into reverse, and gradually shifting to an emphasis on growth, aligned with an appropriate long-term policy framework, as long-term measures.

Meanwhile, CBSL Governor Dr. Nandalal Weerasinghe opined that the most important question before Sri Lanka, is how long the country would take to recover and regain the losses it has suffered. He added that it depends on how successfully the country implements important reforms and policies.

"I am optimistic about recovery, because with the crisis comes an opportunity for the people of the country and the authorities to realise the importance of implementing long-term growth enhancement reforms," he said, adding that amidst debts and a balance of payment crisis, this time, Sri Lanka would not get a second opportunity to stabilise the economy and that all necessary reforms need to be implemented at once.

In addition, Dr. Weerasinghe noted that there needs to be a broader public debate for people to understand the economy related mistakes that were made in the past, and that the difficult economy rebuilding process needs public support. While also acknowledging criticisms with regard to the state of the economy and the economic reforms process, he stressed that without public support, no reform can be sustained.

Key priority areas

Meanwhile, IPS Research Director Dr. Nisha Arunatilake shed some light on priority goals and objectives that were identified during the formation of the said Report.

Ensuring macroeconomic stability is one of the priority goals, which she said is essential in order to reach sustainable growth and to ensure that the most vulnerable groups are not affected adversely in the economic crisis.

Social inclusion and social protection are another key priority area. Adding that it is needed not only because it is a human rights related matter but also because it is essential to ensure sustainable growth, Dr. Arunatilake noted that its absence would be a hindrance to economic growth. In terms of objectives related to this priority area, she said that in a context where food inflation has risen, ensuring food security is crucial.

"Looking into social protection is crucial. A lot of people have lost jobs, and the number of people in poverty has increased in the country. Recovery in countries where you have wider social protection and adequate social protection is faster. We need improved access to social services. The poor are the most affected when public services, education and health are undermined," she added.

Another priority area is improved governance, regarding which she stressed that the vulnerability of not having proper governance, and how it affects the economy has been exposed in the past year. The importance of transparency and accountability of institutions was also noted in this connection.

In regard to sustainability, another key priority area that was identified. Regarding this, Dr. Arunatilake said: "We are talking about sustainability in a broader sense. We mostly talk about sustainable development and sustainability in terms of climatic change. But, taking into account that we are a small, open economy which is linked to the rest of the world, we need to move forward with the rest of the world. We need to move with and adapt to the changes including technology that are taking place."

She also raised the importance of ensuring that Sri Lanka's growth does not compromise national resources such as water, land, forests, and the ocean.

Several speakers pointed out food inflation and the lack of food security as key issues that require urgent action. In order to address food related issues, IPS Research Fellow Dr. Manoj Thibbotuwawa presented a number of strategies.

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Developing the domestic agriculture sector in order to increase the local production of a diverse group of nutritious foods is one key strategy. As part of this endeavour, he proposed to promote the adoption of cost-effective production systems and precision farming, and site specific applications for maximum productivity and farm income, and also to diversify agriculture with crops, aquaculture, and animal husbandry, while promoting research and development with regard to the agriculture sector and modern extension approaches.

Among other strategies he proposed were, promoting technologies and infrastructure in transportation, storage, and processing, in order to reduce post-harvest losses, introducing and implementing technologies and strengthening regulatory mechanisms and value addition along with the value chain, to improve the quality and safety of food, integrating smallholders with dynamic supply chains, developing effective institutional mechanisms with information and communication technology for moderating food system planning and monitoring, strengthening the storage capacity and to maintain a buffer stock of essential food items through a national food bank with key points at the Provincial Council level, and maintaining climate change adaptation in national development policies.

Increasing the adaptive capacity of the affected sectors and communities, was another strategy that he proposed. As part of this measure, he pointed out the development of resistant varieties/cultivars/breeds/strains, the introduction of resource efficient farming methods, and the development of climate smart technologies and climate information systems.

In addition, in regard to climate-related challenges, he proposed to reduce the vulnerabilities of communities, the economic sector and ecosystems, build the capacity for surveillance and monitoring, and to increase preparedness through disaster planning and management.