Spotlight: Econ Op-eds in Summary

Week ended 17th November '21

In Summary

The underneath contains summaries of the articles given above, including key extracts from these articles.

1. Budget 2022: Daunting task of achieving financial stability
By Nimal Sanderatne

- The budget for the year 2022 was presented to the parliament last week amidst deteriorating economic conditions coupled with social and political upheavals in the country. However, the possibilities of achieving financial stability through the budget seems to be narrow.

- The present budget face multiple limitations, among them are not being able to provide relief to losses for farmers, increase expenditure, inadequate allocation for education and health.

- Considering the possibility of the fiscal deficit being almost 15% of the GDP in 2021. government's expectation of bring it down to 4.5-5% by the end of next year, would be a daunting task for the state taking the current condition of the economy.

Incentives can be introduced to stimulate domestic savings and promote greater participation in economic activity by the corporate sector. It has been appropriately described as one of the trickiest budgets in Sri Lankan history.

Little prospect

The central objective of the Budget should be to rein in the large fiscal deficits of recent years. This is a Herculean task. There is little prospect of the budget proposals achieving financial stability and fostering an economic recovery.

Economic conditions

Economic conditions could hardly be more difficult.

- Unemployment and poverty are increasing.
- Food security of a large proportion of people is threatened.
- The trade deficit is widening and,
- foreign reserves are perilously low at about US$ 2 Bn, inadequate to meet essential import expenditure.

Social and political upheavals

The country is in the midst of a multitude of social and political upheavals that have been brought about by the

- Deteriorating economic conditions,
- Ill-advised economic policies,
- The mismanagement of the economy and
- The unscientific and impractical policy of suddenly switching to organic agriculture.

These problems are likely to intensify in the next 2 months and in 2022. They pose insurmountable economic and fiscal problems.

Aggravated problems

While the economic difficulties, especially the severe foreign currency difficulties, are underlying reasons for the shortages and price hikes of food and essentials.

The mismanagement of the economy by inappropriate and faulty monetary, fiscal, trade and exchange rate management policies have aggravated the severity of the problems.

Organic agriculture

The sudden switch to organic fertilisers has threatened crop production and livelihoods of farmers and caused mass protests country-wide. The inevitable reduction in crop production would strain the external finances further owing to increased imports of food and reduced tea and rubber exports. This is especially so as international prices of food, fuel and raw materials are increasing

Limits of budget

Sri Lanka's 2022 budget will not be able to provide reliefs to the public due to the shaky nature of the economy and woeful lack of fiscal space. It will not be able to provide reliefs to the public given the lack of financial resources.

Furthermore, there are increased expenditures that are not justifiable in a context when prudence in expenditure is vital. For example, the already large defense expenditure has been increased by 21% in 2022.

In contrast, expenditure on education and health is inadequate. The prioritisation of expenditure should be towards the country's developmental needs.

Budgetary expenditure

The appropriation bill has reduced total government expenditure by Rs 20 Bn to Rs 4 Tn in 2022. This reduction has been achieved by reducing capital expenditure in most ministries.

The expenditure on

- Health has been increased by 7 Mn,
- Education has been reduced by Rs 6 Mn.
- Public (expenditure) is being contained by a reduction of capital (expenditure), except for the development of rural infrastructure.

Fiscal deficits

In 2020 the fiscal deficit reached 14% of GDP, though by the manipulation of figures it was reduced to 11% of GDP. This year's fiscal deficit is likely to exceed 15% of GDP.

Crucial issue

The fundamental problem that must be addressed by this budget is the bringing down of the high fiscal deficits of recent years. Bringing down the fiscal deficit to even 7% of GDP is a challenging task owing to the rigid structure of expenditure and the current state of the economy that makes increased revenue collection difficult.

Fiscal objective

However key officials have made statements that the 2022 Budget will aim at reducing the fiscal deficit to 5% of GDP. This would be a huge achievement. They have said that the budget will make a 'significant reduction' in the country's runaway fiscal deficit in 2022.

They have described it as a 'non-traditional budget,' The transformation is expected to be an increasing revenue collection. Treasury Secretary, Dr. S. R. Attygalle said "We are planning to reduce the budget deficit by a significant level. Maintaining a higher budget deficit is against the state's fiscal policy."

Dr. Attygalle said the Budget will curtail non-priority spending while maintaining funds for the Government's development projects will remain unhindered.

"The Government's policy is to reduce the budget deficit to 4.5-5 % of the GDP. We are getting into that path of reducing the budget deficit by a significant portion while maintaining the government expenditure and development activities," Dr. Attygalle said.

Revenue enhancement

The 2022 Budget is expected to achieve this fiscal consolidation by a revenue enhancing strategy rather than by expenditure cuts. We will have to wait to see what these revenue enhancing proposals are and how realistic they are in enhancing revenue and reducing the fiscal deficit.

Conclusion

Unless the fundamental problem of fiscal consolidation is addressed, the economy will continue to be highly unstable. An economic programme that curtails wasteful and productive expenditure and finds ways and means of increasing revenue is imperative.

For the full article – Refer The Sunday Times

2. The economy of Sri Lanka Is there a way out
By Arusha Cooray

- Sri Lanka is facing a severe economic crisis. Foreign exchange reserves are just sufficient to cover two months of imports and current debt to GDP ratio stands at 101%. Sri Lanka has imposed capital controls and businesses relying on imports are struggling with payments. Essential food item prices have risen due to hoarding and black markets.

- To get out of this situation, the government should look at measures such as fiscal consolidation, enhancing the monetary policy, reducing the burden on the banking sector, enhancing the external sector and economic growth, and skill development.

- Apart from these measures, it is important that the government maintains policy consistency in order to improve the local and foreign investor confidence. Incentives can be introduced to stimulate domestic savings and promote greater participation in economic activity by the corporate sector.

Sri Lanka is currently facing an unprecedented set of economic challenges:

- large and increasing public debt
- rising fiscal and current account deficits
- foreign exchange shortages

- declining investor confidence
- collapse of tourist revenues and remittances due to the pandemic

Sri Lanka's foreign exchange reserves are at an all-time low, currently sufficient to cover two months of imports. As a rule of thumb, a country's foreign exchange reserves should be sufficient for at least three months of imports. The fall in foreign exchange reserves has led to a depreciation of the rupee against the US Dollar, making it more difficult to service the debt denominated in foreign currency. Sri Lanka's debt to GDP ratio currently stands at 101%.

Businesses relying on imports are struggling to make foreign currency payments. Prices of essential food items have risen, leading to hoarding and black markets. The Government's ban on the use of chemical fertilizer for farming and the printing of money by the Central Bank have intensified the situation.

Sri Lanka has responded to these challenges hereto by imposing capital controls, restricting imports and engaging in currency swaps. Import controls have led to a shortage of essential goods. Currency swaps and capital controls are short-term measures. There is no strong evidence to show that import and capital controls succeed during a foreign exchange crisis.

Is there a way out? It is imperative that the Government undertakes a reform plan that addresses key priority areas to salvage the economy.

Fiscal consolidation

One is fiscal consolidation. Sri Lanka's Government finances are dominated by expenditure on public wages and Government transfers, subsidies, and interest payments on rising debt. Greater effort needs to be made in curtailing current expenditure and channeling these expenditures into more productive use. Cutting down on public sector spending will reduce the large and persistent budget deficits. Continuing budget deficits can undermine investor confidence and crowd out private sector investment.

A concerted effort also needs to be made to reduce the size of the public sector. Sri Lanka's inflated public sector is in serious need of restructuring. Re-assessment and reform of the number of ministries and Government agencies will reduce the wasteful and inefficient use of Government funds and increase productivity.

On the tax front, Sri Lanka needs to address structural weaknesses in the tax system. Sri Lanka's tax burden as % of GDP is 12.6%. The low tax revenue to GDP ratio has meant that Sri Lanka has faced difficulties in meeting its expenditures which have consistently exceeded tax revenues. A large proportion of Government revenue has been generated through indirect taxes which are regressive. Tax evasion, moreover, is high. Rather than introduce new taxes which will further burden low-income groups and undermine economic growth, tax management and collection can be improved by focusing on reducing loopholes for tax avoidance and evasion.

Monetary policy

The success of monetary policy in achieving goals has been severely constrained by to the Government's policy of deficit financing. To the degree that the Government is induced to run debt financed fiscal deficits, the main function of the money market would be to engage in the sale of Government securities to finance the servicing requirements of the Government debt.

Fiscal consolidation would help raise public savings, contain price rises and enhance the effectiveness of monetary policy. There are concerns further about the Central Bank's lack of independence. Increasing Central Bank autonomy will assist in insulating monetary policy from the pressures created by the Government to finance budget deficits.

Banking sector

The continued dependence of the Government on the State-owned commercial banks has not only inhibited their efficient functioning, but also constrained the competition and efficiency of the entire banking system.

Political pressures to finance unviable projects and limited incentives for screening and monitoring projects has led to a rising volume of non-performing loans by these banks. Therefore, the Government should reduce reliance on these two banks for funding.

External sector and GDP growth

Higher GDP growth can be promoted by diversifying export markets and export sectors and encouraging Foreign Direct Investment (FDI), all of which will help relieve Sri Lanka's foreign exchange position and rising debt levels.

Sri Lanka attracts disproportionately very little FDI compared to its South Asian counterparts. Increased FDI inflows and trade will generate new employment opportunities and increase the tax base. Economic policy, therefore, should focus on developing comparative advantage in a broader range of sectors, rather than relying on a few areas. Entering into trade agreements with countries will also help.

Skill development

Policy aimed at promoting investment in infrastructure, research and development, learning, competencies and skill development through education and on-the job training will encourage FDI in high-skill industries. This would give local firms the capacity to absorb the technologies and skills that come with FDI.

A large proportion of jobs created by FDI in Sri Lanka, are in low paid, low skilled areas. Sri Lanka possess a highly literate population. It has however, not succeeded in harnessing this stock of human capital to foster comparative advantages.

Policy consistency and domestic savings

The sustainability of economic policies will reduce not only private sector concerns about policy reversals and the lack of policy consistency, but also that of foreign investors. Incentives can be introduced to stimulate domestic savings and promote greater participation in economic activity by the corporate sector.

Getting the economy out of this state will not be easy. Sri Lanka possesses several underlying strengths such as a well-developed stock of human capital and resources, which can be built upon, but have not been harnessed to their full potential to foster comparative advantage.

Unless policymakers make a concerted effort to ensure macroeconomic stability through a sustainable and coherent reform plan that addresses structural shortcomings in the economy, Sri Lanka will be trapped in a vicious cycle out of which it will find difficult to get out.

For the full article – Refer Daily FT