

A FRAMEWORK FOR ECONOMIC RECOVERY

Advocata Institute
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Colombo

Govt. to set MRP for rice, sugar from today

ESSENTIAL food items rice and sugar will come under the Maximum Retail Price (MRP) regime with effect from today, The announcement was made by Cooperative Services, Marketing Development and

Consumer Protection State Minister Lasantha Alagiyawanna as the Government wrestles with the shortage of and resultant spike in prices of these and other essential commodities.

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Govt. places fresh barrier on non-essential imports

- Monetary Board imposes 100% non-interest bearing cash margin deposit for import of 623 products
- Import of these products Jan-July have risen \$ 753.4 m as against \$ 871 m in full year of 2020 and \$ 1 b in 2019
- Banks told not to grant any advances to customers to meet minimum cash margin deposit requirement



Summary of non-essential/non-urgent imports subjected to 100% cash deposit margin requirements

Mayhem in markets!

CCPI-based inflation increased to 6% in August

THE headline inflation, as measured by the year-on-year (YOY) change in the Colombo Consumer Price Index (CCPI, 2013=100), increased to 6% in August from 5.7% in July.

"This was driven by monthly increases of prices of items in both food and non-food categories," the Central Bank said.

It said subsequently, food inflation (YOY)

Economic sentiment continues to shrink: Survey

Stock market dip persists amidst high turnover

Market merry

Global food commodity prices rebound in August

- Sugar, wheat and palm oil push up FAO Food Price Index

GLOBAL food commodity prices rebounded rapidly

in August after two consecutive months of decline, led by strong gains in the international price quotations for sugar, wheat and vegetable oils, the Food

and Agriculture Organization of the United Nations (FAO) reported yesterday. The FAO Food Price Index averaged 127.4 points in August, up 3.1% from July and

32.9% from the same month in 2020. The index tracks monthly changes in the international prices of commonly-traded food commodities.

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Government defends emergency regulations to deal with food crisis

- State Minister Alagiyawanna clears air on enforcement of emergency regulations, appointment of Commissioner General
- Says price controls essential, won't be long-term measure
- Admits controlled prices might impact importers and traders, but necessary to give relief to people Govt. to present



But with the import restrictions, 2020 that the government of Sri Lanka should restriction

Grip on imports further tightened to mitigate pressure on currency

- CB lists 623 products mandating 100% cash margin on imports
- All products fall under consumer category from fruits to chocolates to home appliances and mobile phones

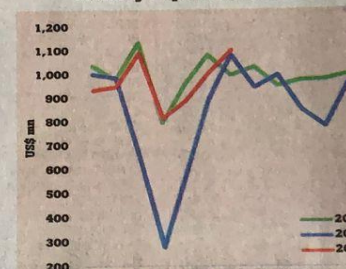
Summary of non-essential/non-urgent imports subjected to 100% cash deposit margin requirements

Product Description	No. of HS codes	Import Values (USD mn)		
		2019	2020	Jan-July 2021
Telecommunication devices (such as mobile telephones and fixed telephones)	5	247.3	268.4	250.0
Home appliances (such as fans, TVs, refrigerators, washing machines, digital cam eras, hair clips, heaters, lamps, ovens)	82	203.8	171.7	160.0
Clothing and accessories (such as babies' garments, babyary, jerseys, nightdresses and pyjamas)		152.6	129.9	

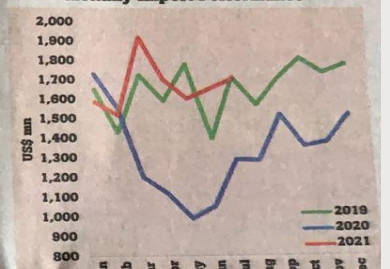
July trade deficit expands on surging imports; exports recover

- Trade deficit expands to US \$ 607mn, compared to a trade gap of US \$ 209mn in July 2020
- Cumulative trade deficit at US \$ 4.9bn, compared to US \$ 3.5bn in first 7 months of 2020
- Terms of trade continue to remain unfavourable to SL as increase in export prices continuously lags import prices
- Despite lower fuel import volumes, SL spends 28% more on such imports due to higher global prices

Monthly Export Performance



Monthly Import Performance



Macroeconomic Stability = Healthy Economy

Economy is **growing** steadily and in a sustainable manner.

Inflation is under control and the financial system is sound.

Economy is **resilient to shocks**.

Internal Balance

- Economy is producing goods and services in line with the resources in the economy.
- Inflation is low and stable.

Internal Imbalance

- Government spends too much
- Too much money in the economy
- Uncertainty

External Balance

- Current account can be financed in an orderly manner.

External Imbalance

- A combination of inflation and ex rate that makes imports more attractive and exports uncompetitive.
- Large CA requiring abrupt changes in the exchange rate, possibly financial assistance and in the extreme defaulting on payments to the rest of the world.

Relationship between the Fiscal Balance and the External Current Account Balance

National Income Identity: $Y = C+I+G+ (X-M) +Y_r+Tr$ (1)

External Current A/C Balance: $CAB = (X-M) +Y_r+Tr$ (2)

National Savings: $S= Y-C-G$ (3)

Combining (1) & (3) $S= I + CAB$ (4)

Private and Govt savings: $S= S_p + S_g$ (5)

Where $S_p =Y-T-C$ (6)

$$S_g =T-G \quad (7)$$

Substituting (6) & (5) in (4) $S= S_p+S_g= I+CAB$ (8)

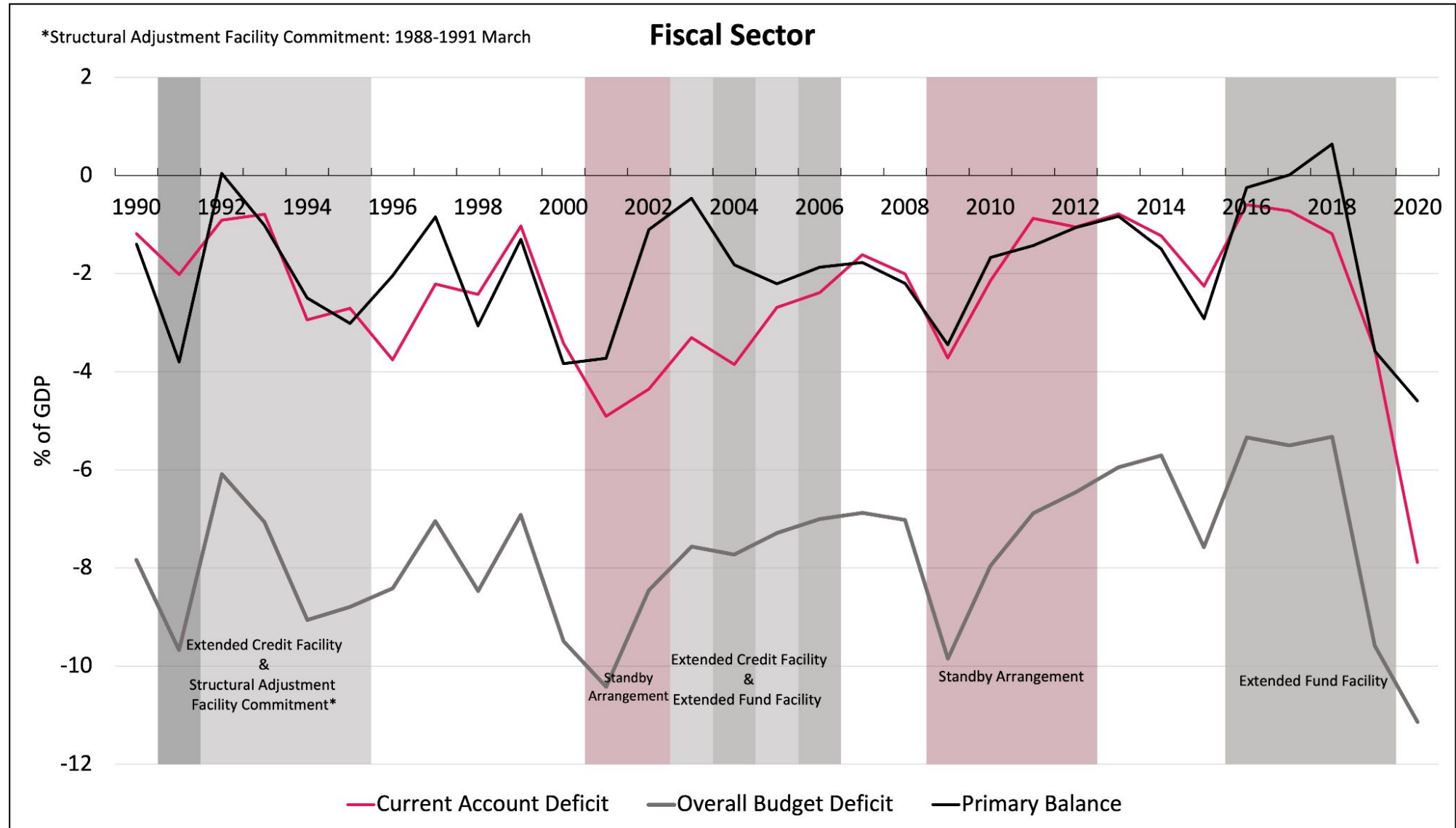
$$(Y-T-C)+(T-G)=I+CAB \quad (9)$$

$$S_p + (T-G) = I + CAB \quad (10)$$

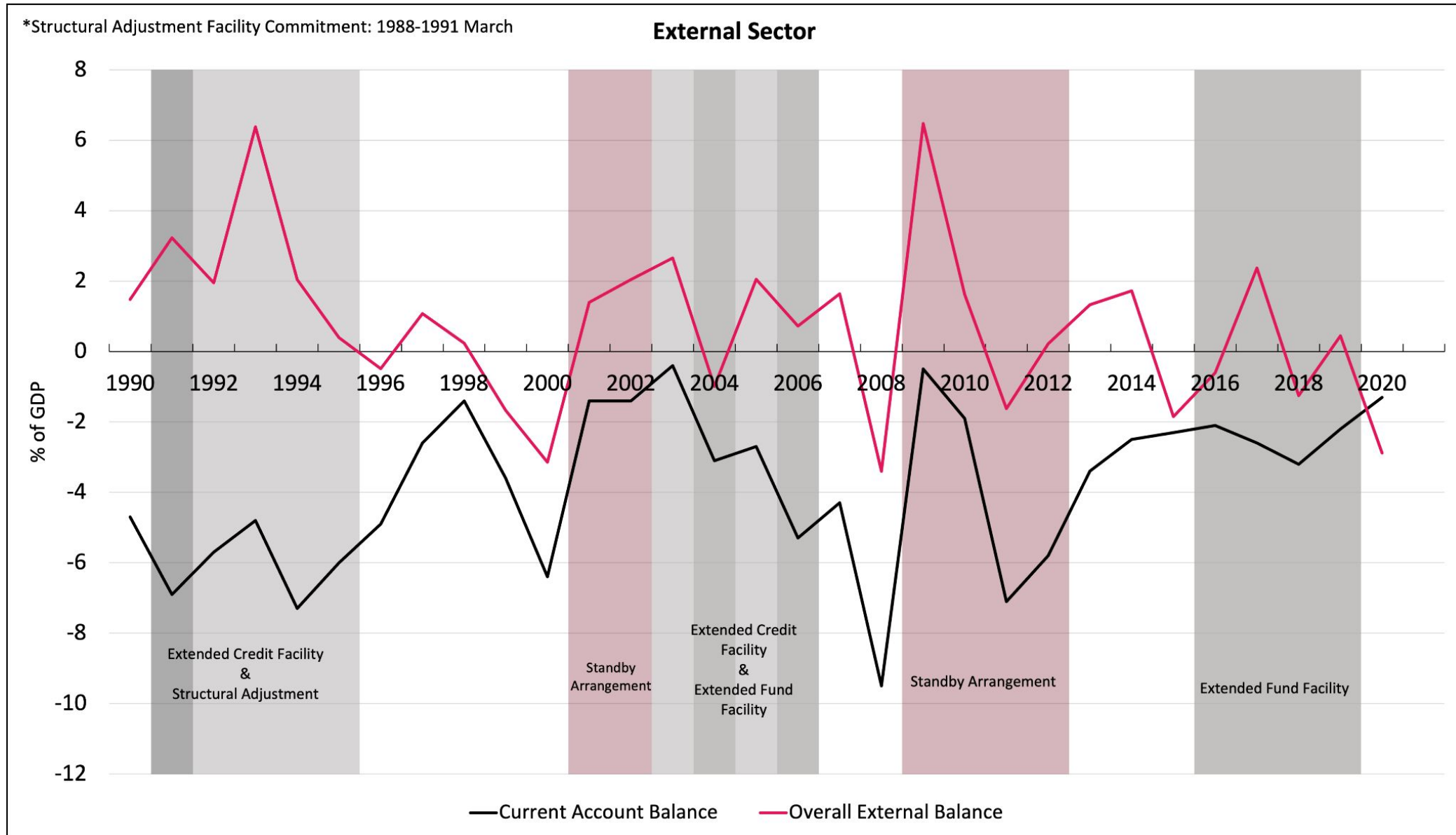
$$\begin{array}{rcccl} (S_p - I) & + & (T-G) & = & CAB \\ \text{Private savings} & & \text{Govt savings} & & \text{External Current account balance} \end{array}$$

Fiscal dominance has been the root cause for macroeconomic instability

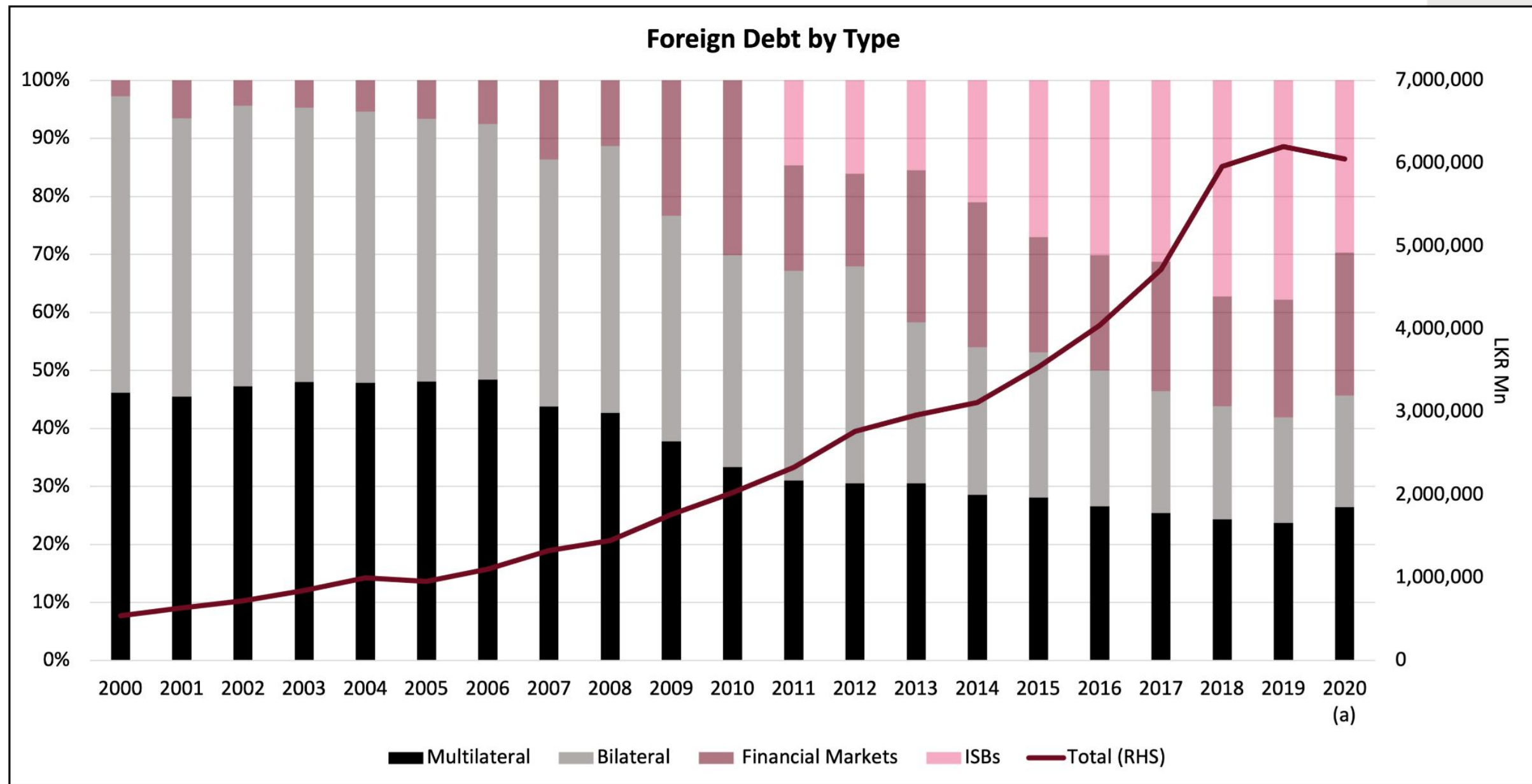
Periods in which SL was in an IMF programme are shown by the shaded areas



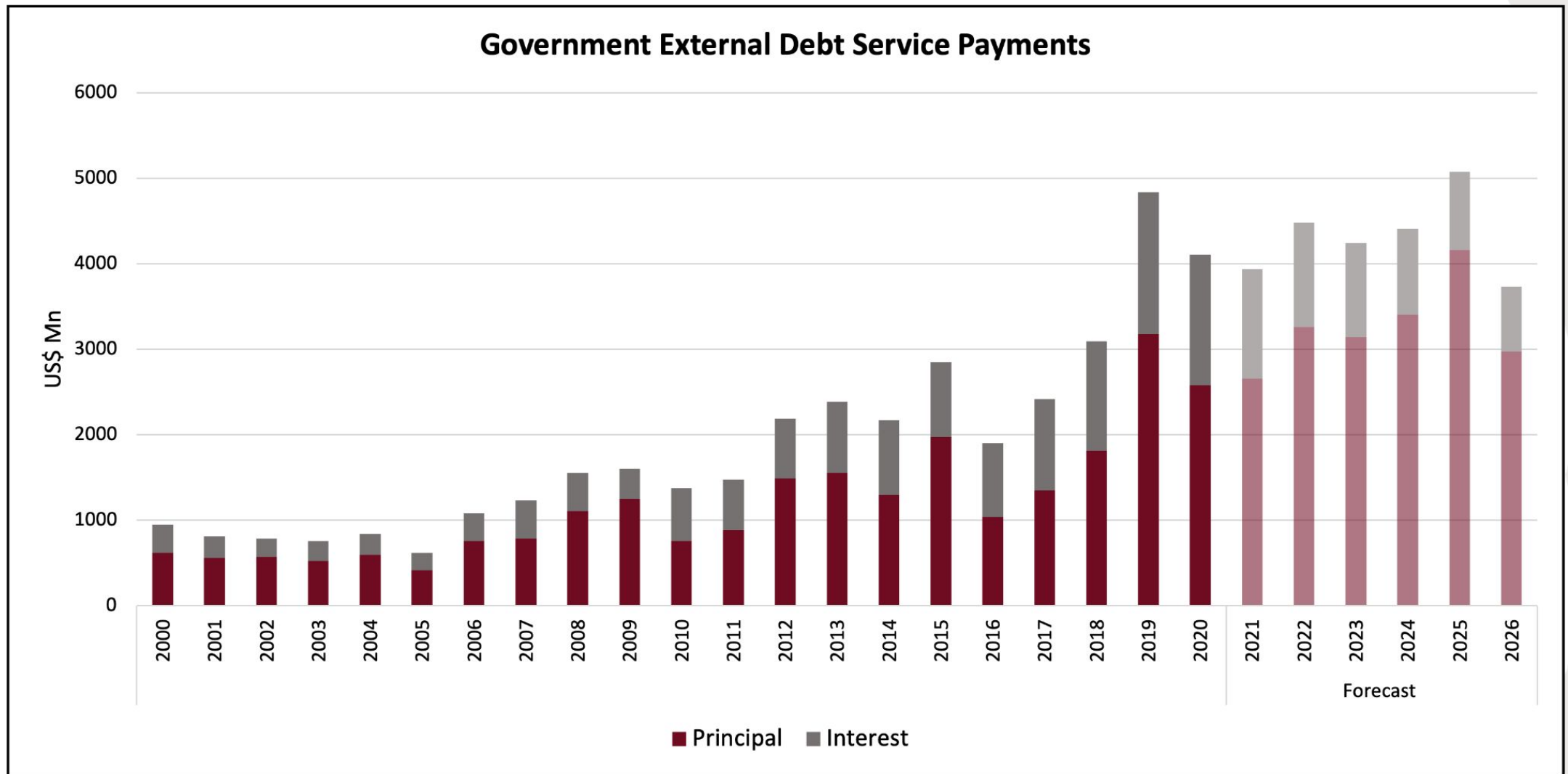
The fiscal deficit and external CA deficit have moved closely together over a long period



Shift to Non Concessional financing ...



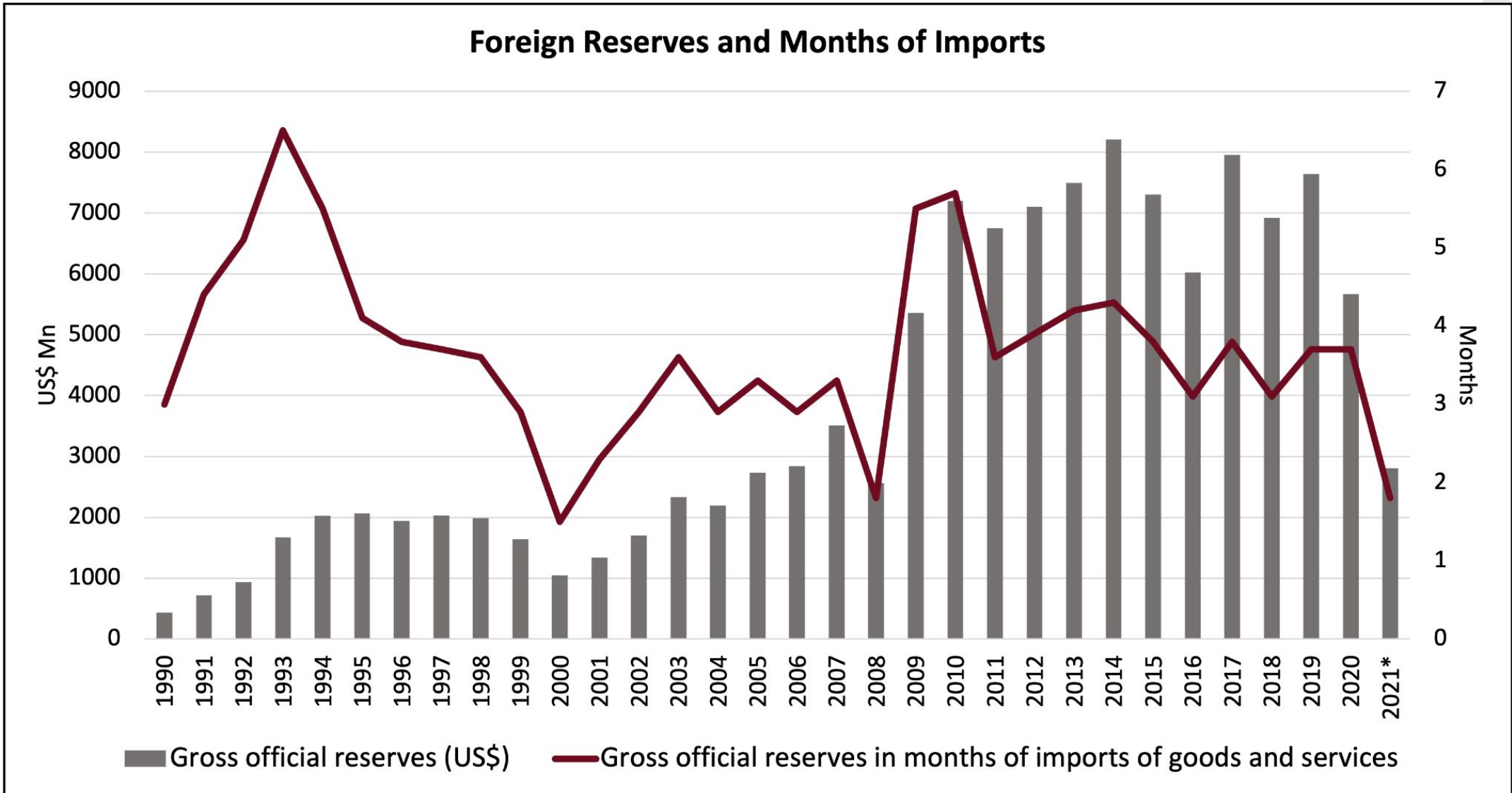
...leading to ballooning debt service payments.



Prior to **2010** the interest payment component is not broken down (Government, Central Bank and Private Sector Cooperations). Therefore the total is taken.

Prior to **2006**, both interest and principal payments are not broken down. Therefore the total is taken.

Declining foreign reserves



*Gross Official Reserves and Months of imports as of July 2021

I. ADDRESS MACROECONOMIC IMBALANCES

- correct the twin deficits

II. STRUCTURAL REFORMS FOR SUSTAINABLE AND INCLUSIVE GROWTH

- stimulate economic growth and improve competitiveness

III. BUILDING BUFFERS

- to strengthen resilience of the economy to internal and external shocks

I. ADDRESSING MACROECONOMIC IMBALANCES

- 1. Debt restructuring**
2. Revenue Centred Fiscal Consolidation
3. Public Finance Management and Public Sector Reform
4. State Owned Enterprise Reform
5. Enhancing Monetary Policy Effectiveness and Maintaining Exchange Rate Flexibility
6. Supporting Trade and Investment to Strengthen External Sustainability

1. DEBT RESTRUCTURING - IMMEDIATE

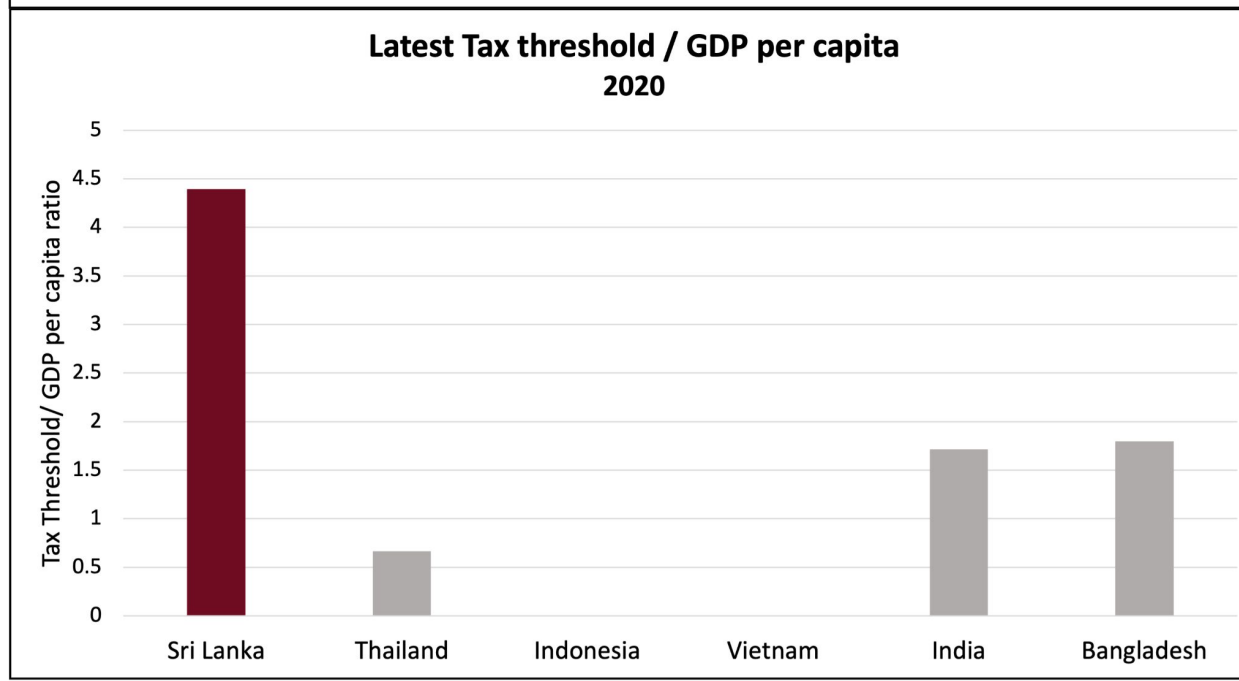
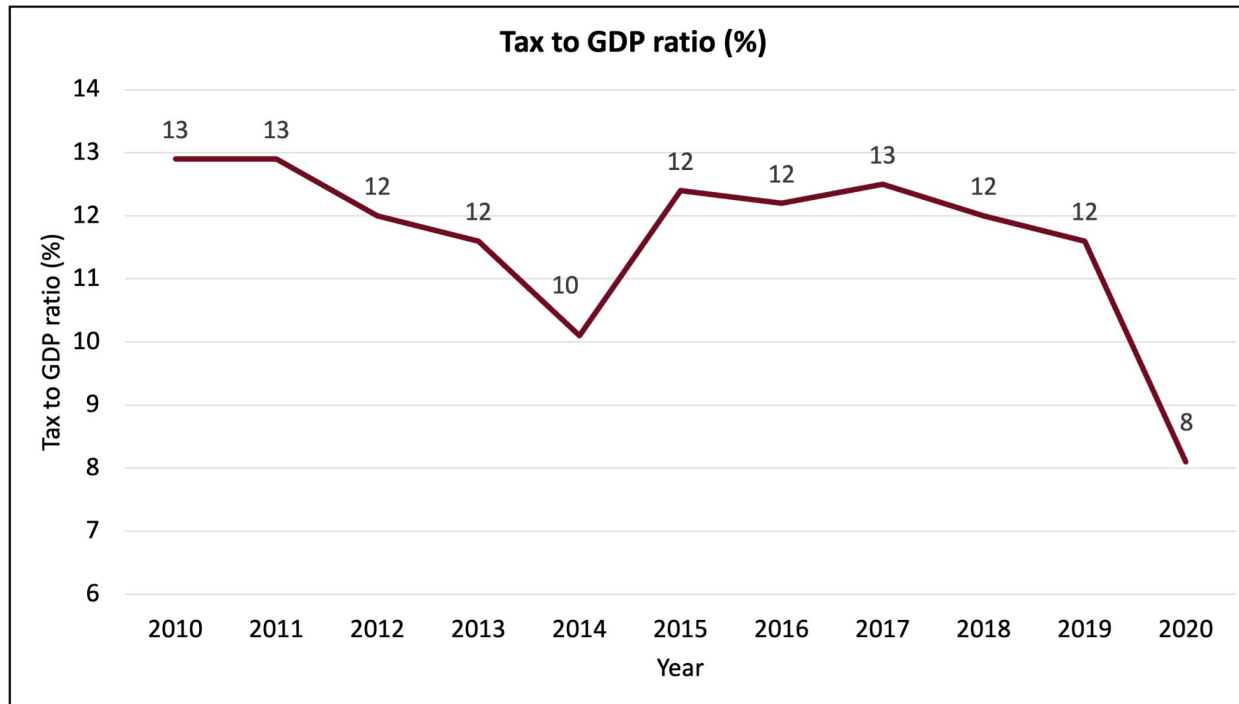
- Do nothing
- Default
- Debt monetisation
- Financial repression
- Debt conversion
- Debt restructuring

I. ADDRESSING MACROECONOMIC IMBALANCES

1. Debt restructuring
2. **Revenue Centred Fiscal Consolidation**
3. Public Finance Management and Public Sector Reform
4. State Owned Enterprise Reform
5. Enhancing Monetary Policy Effectiveness and Maintaining Exchange Rate Flexibility
6. Supporting Trade and Investment to Strengthen External Sustainability

2. REVENUE CENTRED FISCAL CONSOLIDATION

- **Reducing the tax threshold and widening the tax base -**
income tax threshold in Sri Lanka is more than 4 times its per capita GDP
- **Reducing excessive reliance on indirect taxes -**
80% of tax revenue collected in 2020 was from indirect taxes, increasing the regressivity of the tax system
- **Rationalising tax incentives**
- **Strengthening tax administration**
 - facilitate compliance
 - effective monitoring

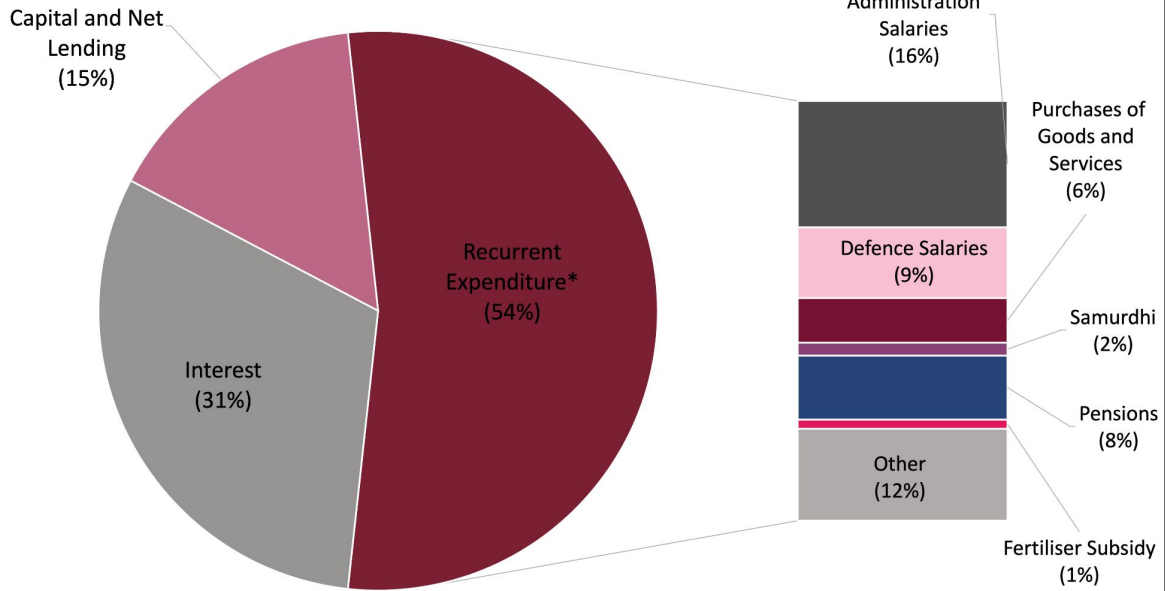


3. PUBLIC FINANCE MANAGEMENT

MEDIUM TERM EXPENDITURE FRAMEWORK AND PUBLIC SECTOR REFORM

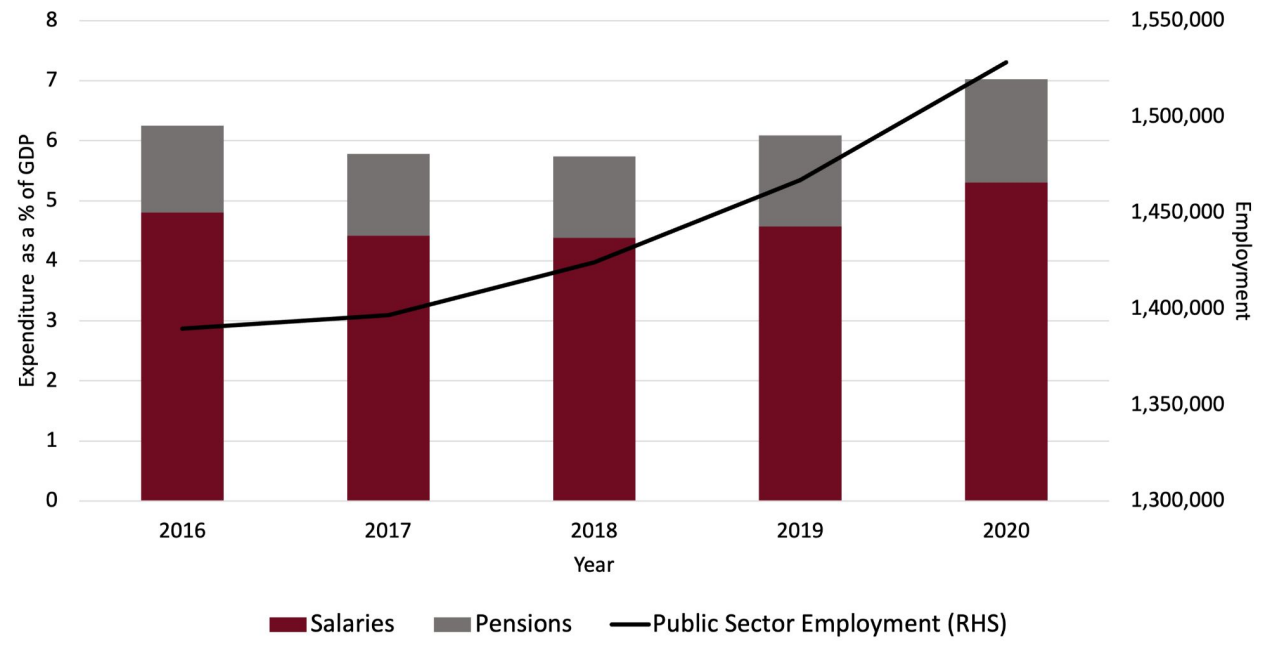
- **Strict oversight and control of government expenditure -**
increase in recurrent expenditure has come at the cost of capital expenditure
- **Rationalising the public sector**
- **Improving the targeting of subsidies and transfers**
- **Strengthening fiscal rules to constrain discretionary spending**
- **Strengthening budgetary institutions -**
They should be well financed, have individuals with the necessary expertise, be transparent, independent and held accountable.

Composition of Expenditure - 2020



*Excluding adjustment for arrears as per the Ministry of Finance

Salaries and Pensions - Public Sector



4. STATE OWNED ENTERPRISE REFORM

- **Strengthening governance**

- Measures to improve corporate governance mechanisms must be implemented
- key performance indicators must be highlighted

- **Improving transparency**

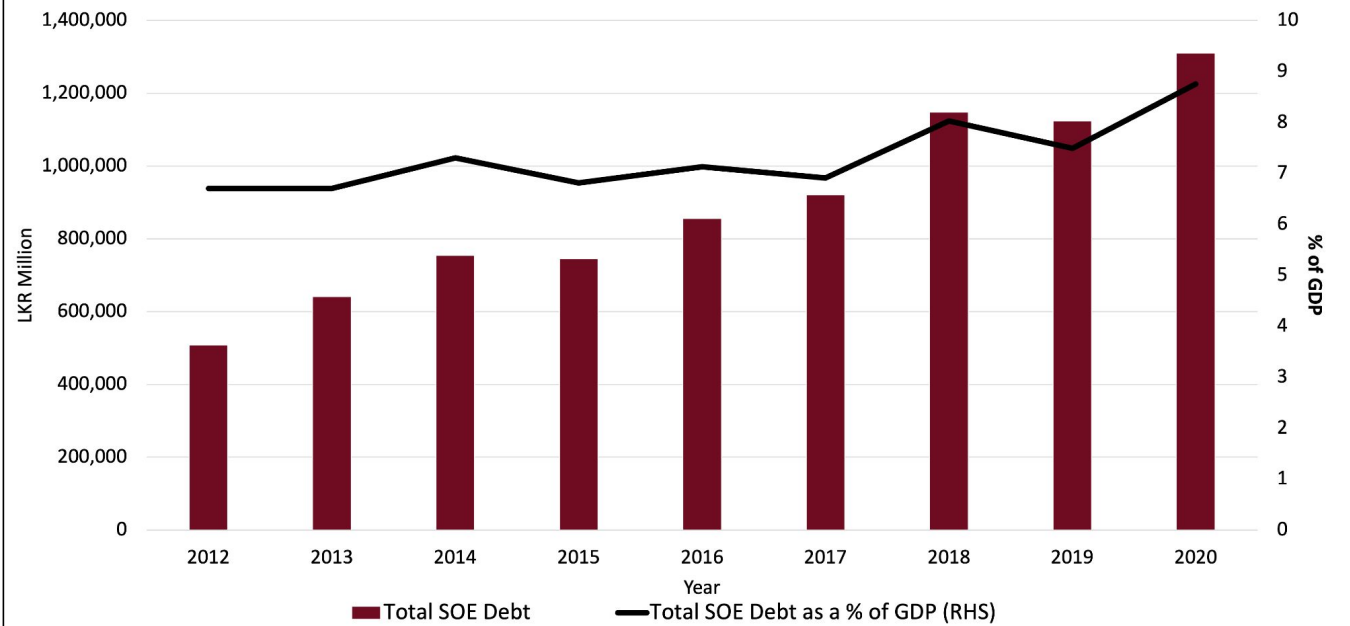
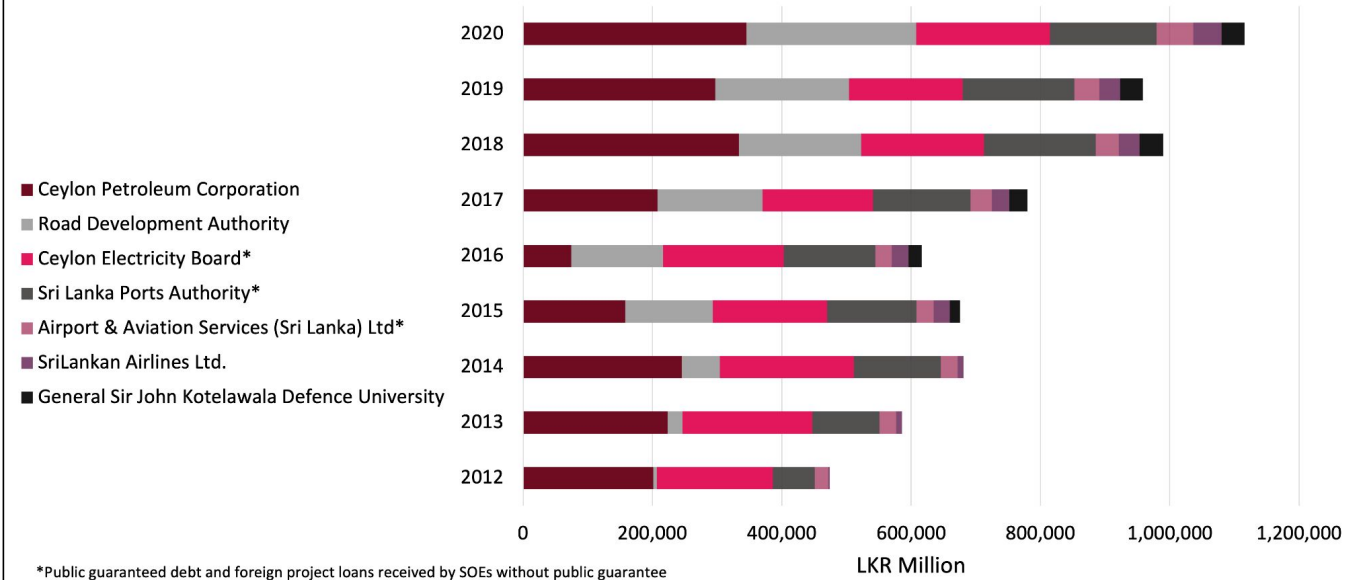
- transparency of subsidies should be improved

- **Cost-reflective pricing**

- **Restructuring and divestment**

- needs to be undertaken within a strong institutional framework and with an overall objective of improving competition.

SOE Debt



Note: Total SOE debt includes only non financial public corporations

5. ENHANCING MONETARY POLICY EFFECTIVENESS

- **Inflation Target -**

recent increase in inflation and emerging risks should reinforce the focus of monetary policy on keeping a lid on inflation

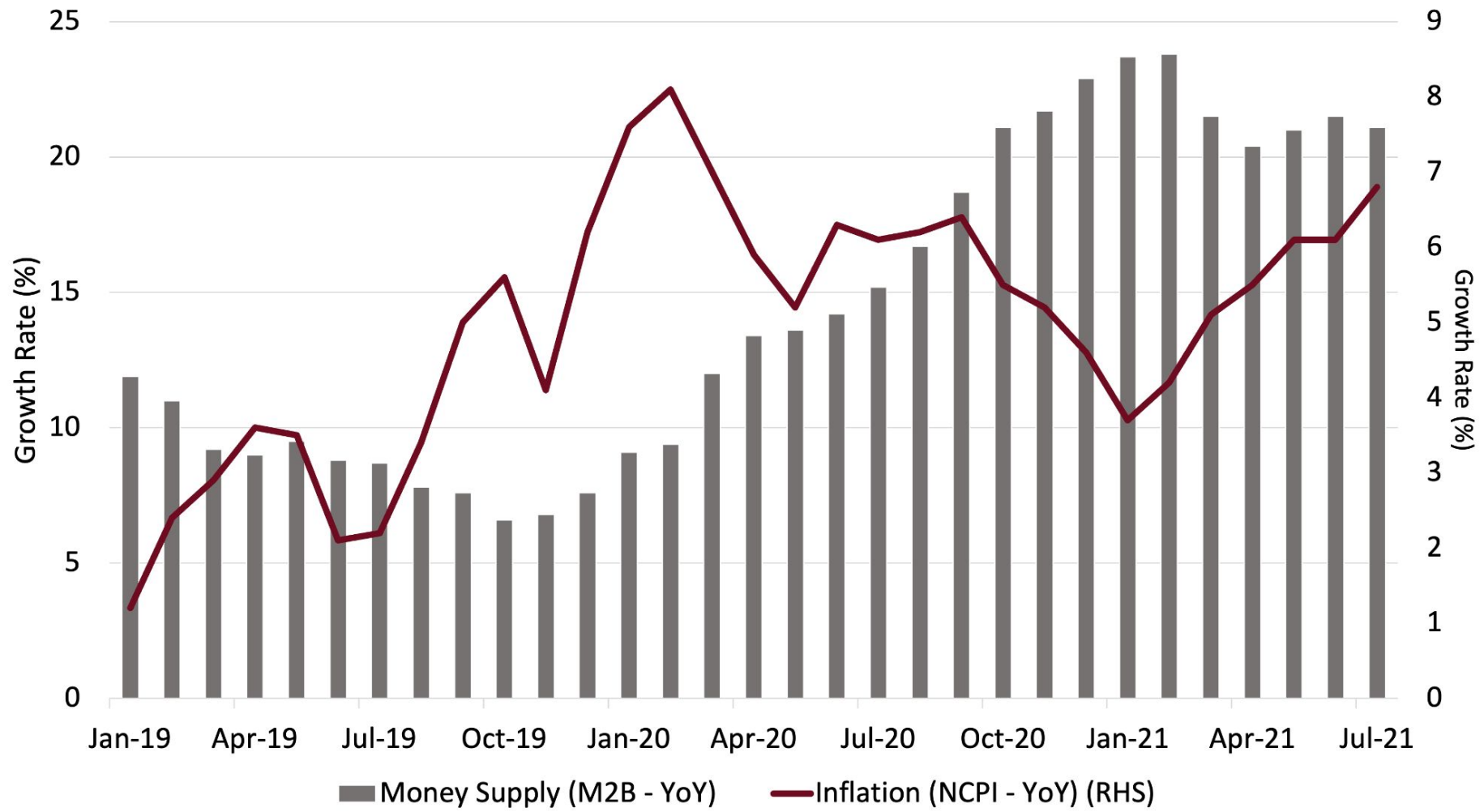
- **Independent central bank -**

However monetary independence without fiscal discipline is untenable

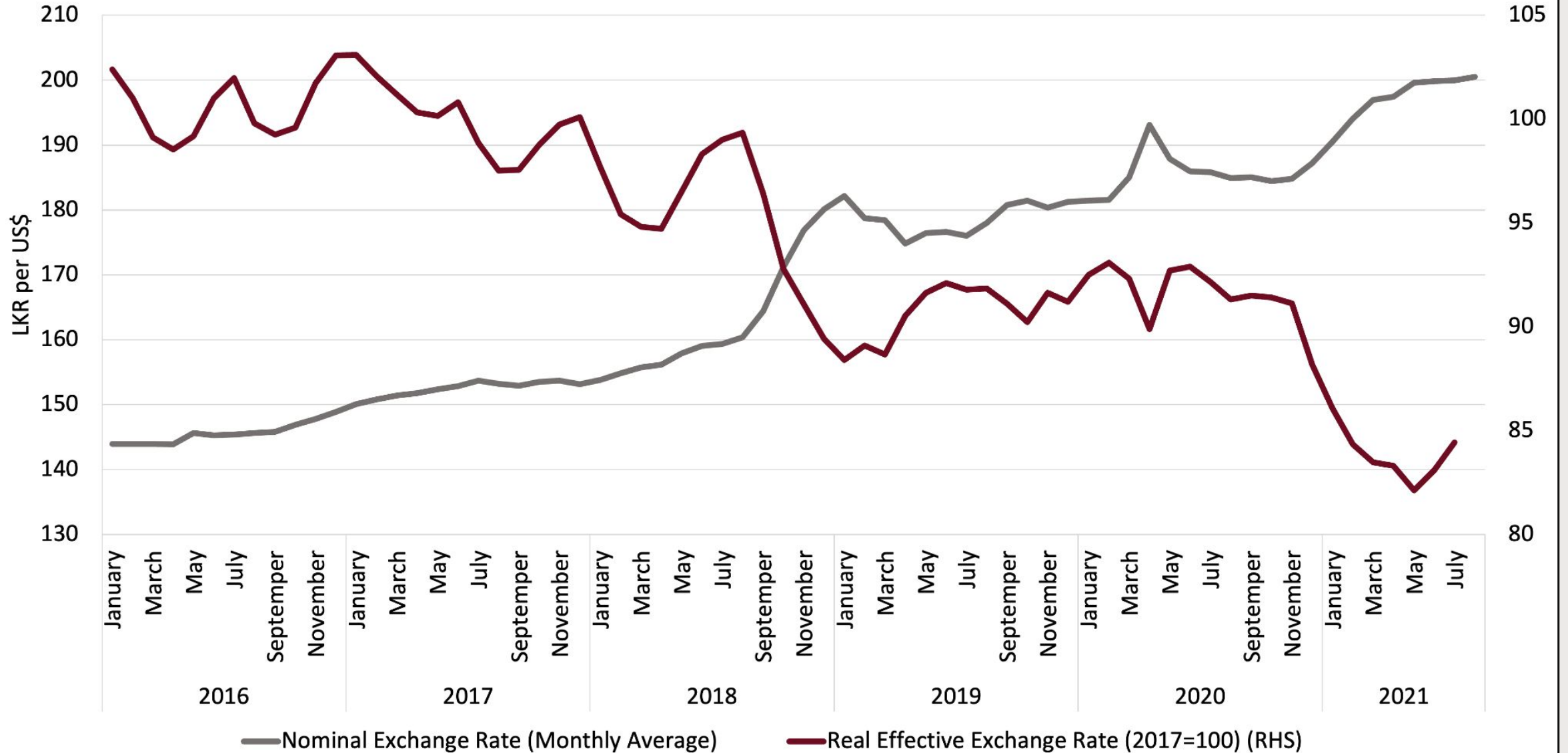
- **Financial sector stability -**

worsening of these conditions can pave the way for a full blown banking sector crisis, with serious consequences for the country

Monetary Growth Rate vs Inflation Rate



Exchange Rate in Sri Lanka



6. SUPPORTING TRADE AND INVESTMENT

TO STRENGTHEN EXTERNAL SUSTAINABILITY

- **Global Production Networks**

- **Trade reform: Reducing para-tariffs -**

High protection on imports leads to more domestic resources being diverted to sectors that are not competitive and also induce a bias against exports.

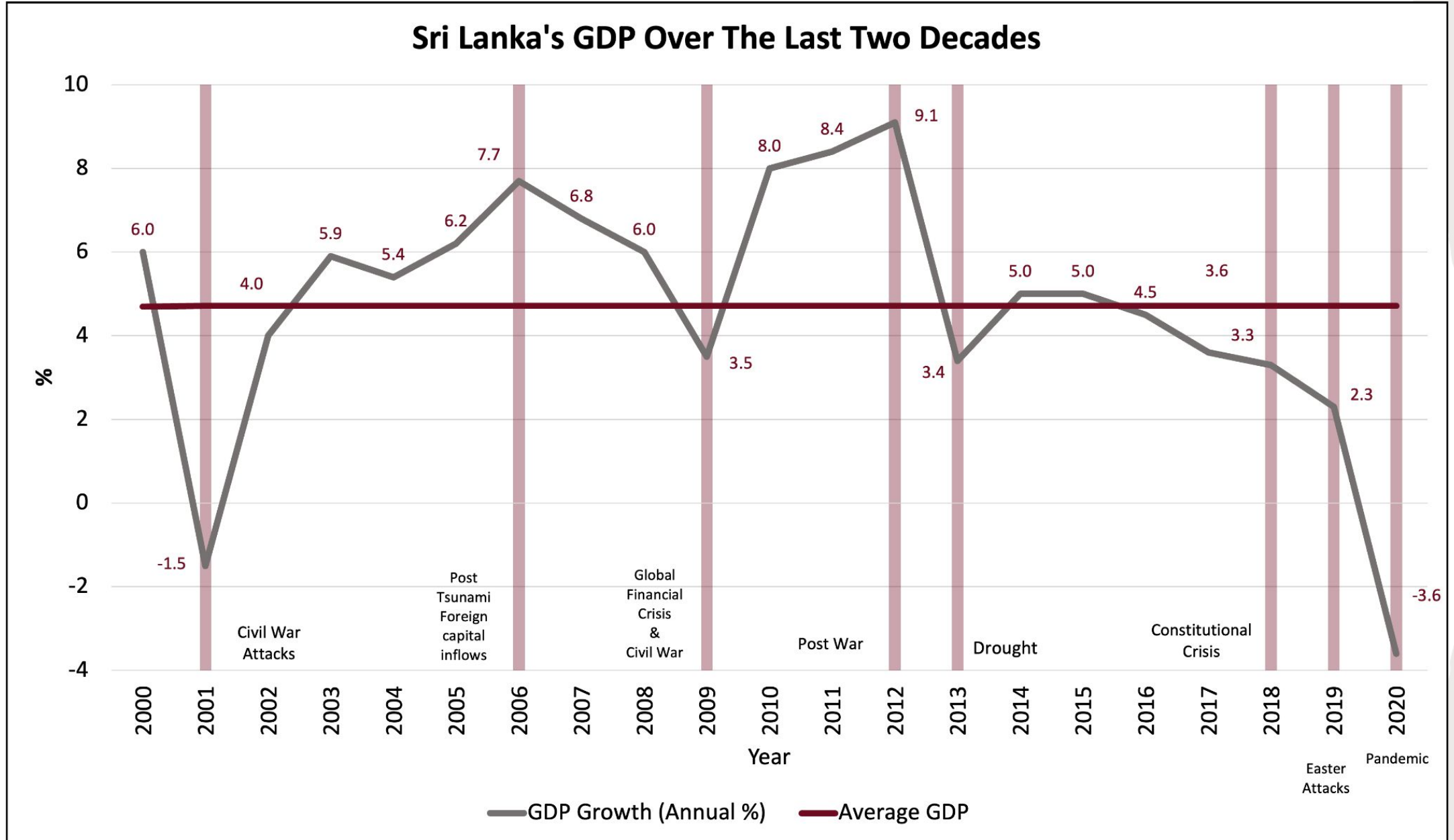
- **Trade facilitation –**

Improving trade facilitation which reduces the cost of exporting and importing is equivalent to a tax cut without the loss of revenue to the Treasury

- **Foreign Direct Investment -**

FDI flows to Sri Lanka have remained below 2% , significantly lower than to its neighbouring countries

Highly volatile economic growth rates ...



II. STRUCTURAL REFORMS FOR SUSTAINABLE AND INCLUSIVE GROWTH

IMPROVING PRODUCTIVITY AND COMPETITIVENESS OF THE ECONOMY

Improving the doing business environment

Unlocking land supply

Creating flexible labour markets & raising female labour force participation

Building human capital

Bridging the infrastructure gap

IMF Program	Stand By Arrangement 2001 -2003	Extended Credit Facility 2003- 2006	Stand By Arrangement 2009-12	Extended Fund Facility (EFF) 2016-19
Amount	SDR 200 mn (US\$ 253 mn)	SDR 260 mm (US\$ 368 mm)	SDR 1.6 bn (US\$2.6 bn)	SDR 1.1 bn US \$ 1.5 bn)
Fiscal Sector:	<p>Reduce fiscal deficit from 9.8% of GDP in 2000 to 8.5% (and to 5% in the medium term)</p> <p>Increase tax revenue by 1 ¾ percentage points to 16 ¼ percent of GDP.</p> <p>Tax concessions to be consolidated in the IRA</p> <p>Bring GST under the coverage of the large taxpayers unit (LTU)</p> <p>Freeze on government sector salaries and hiring freeze</p> <p>Temporary targeted transfers to the poor</p> <p>Increase capital spending by 0.75%</p> <p>Reduce domestic debt by privatization proceeds</p>	<p>Enhance fiscal consolidation, and aim to reduce the deficit by about 1¼ percent of GDP per year.</p> <p>Establishing a unified revenue authority.</p> <p>Continuation of policies to broaden the government's revenue base.</p> <p>Establishing a medium-term expenditure framework (MTEF) by mid-2003.</p>	<p>Reduce fiscal deficit to 5% of GDP by 2011.</p> <p>Submission of tax commission report by Oct 2009 and proposals to broaden tax base in budget 2010</p>	<p>Fiscal deficit to 3.5% of GDP by 2020 (primary surplus of 1%)</p> <p>Revenue mobilization (broaden base of income taxes and VAT, IT systems for domestic tax and customs admin)</p> <p>Submit new IRA simplifying and broad basing income tax</p> <p>Suspend BOI's capacity to grant tax exemptions, holidays and special rates</p> <p>Time bound strategy to reduce or eliminate tax expenditures.</p> <p>Revise expenditure ceilings for govt ministries and depts in line with overall budget deficit target</p> <p>Conduct diagnostic review of VAT</p> <p>Public financial management reform (ITMIS, fiscal risk & reporting)</p>

<p>Monetary Policy & Exchange rate:</p>	<p>Shift to flexible exchange rate regime (completed on 23 Jan 2001)</p> <p>Tight monetary policy to bring inflation down to single digits</p>	<p>Continue adoption of a flexible exchange rate arrangement.</p>	<p>Strengthening the country's international reserve position and restoring external viability. Allowing greater exchange rate flexibility is also needed to facilitate external adjustment and ensure export competitiveness.</p>	<p>Transition to flexible inflation targeting under a flexible exchange rate regime</p>
<p>State Owned Enterprises</p>	<p>Increase administrative prices of energy and transport fares aimed at eliminating operational losses</p> <p>Adopt automatic petroleum pricing method to ensure timely passthrough of input costs that would prevent nonoccurrence of operating losses of CPC.</p>	<p>Speed up the general privatization program</p>	<p>Develop a plan to address outstanding dues of SOEs to the banking sector</p>	<p>Comprehensive database of outstanding arrears of the govt and obligations of SOEs State enterprise reform (resolution strategy for SLA,</p> <p>Record fiscal cost of non-commercial obligations.</p> <p>Sign and publish a statement of corporate intent for 6 largest SOEs.</p> <p>introduce automatic pricing mechanisms for CPC and CEB.</p>

Trade & Investment	Phase out limits on inward FDI	Eliminate the import surcharge.		Reforms in trade and investment (greater integration into regional and global supply chains, reduce protectionism to enhance competitiveness)
Banking sector	Restructuring plan for BOC and PB	Continue to restructure the two state-owned banks	Continue to restructure the two state-owned banks	
	Improve financial sector supervision by CBSL.	Improve the mechanism to resolve NPLs	Revised Banking Act (resolution framework etc)	

Summary of IMF Programs

Facility	Date of Arrangement	Expiration Date	Amount Agreed (SDR)	Amount Drawn	Amount Outstanding
Extended Fund Facility	Jun 3, 2016	Jun 2, 2020	1,070,780	715,230	715,230
Standby Arrangement	Jul 24, 2009	Jul 23, 2012	1,653,600	1,653,600	0
Extended Credit Facility	Apr 18, 2003	Apr 17, 2006	269,000	38,390	0
Extended Credit Facility	Apr 18, 2003	Apr 17, 2006	269,000	38,390	0
Standby Arrangement	Apr 20, 2001	Sep 19, 2002	200,000	200,000	0
Extended Credit Facility	Sep 13, 1991	Jul 31, 1995	336,000	280,000	0
Structural Adjustment Facility Commitment	Mar 9, 1988	Mar 8, 1991	156,170	156,170	0
Standby Arrangement	Sep 14, 1983	Jul 31, 1984	100,000	50,000	0
Extended Fund Facility	January 01, 1979	December 31, 1981	260,300	260,300	0
Standby Arrangement	Dec 2, 1977	Dec 1, 1978	93,000	93,000	0
Standby Arrangement	Apr 30, 1974	Apr 29, 1975	24,500	7,000	0
Standby Arrangement	Mar 18, 1971	Mar 17, 1972	24,500	24,500	0
Standby Arrangement	Aug 12, 1969	Aug 11, 1970	19,500	19,500	0
Standby Arrangement	May 06, 1968	May 05, 1969	19,500	19,500	0
Standby Arrangement	Jun 15, 1966	Jun 14, 1967	25,000	25,000	0
Standby Arrangement	Jun 15, 1965	Jun 14, 1966	30,000	22,500	0
Total			4,426,250	3,585,360	715,230

Source: IMF