The need for economy

BY R.M.B SENANAYAKE

We have been running deficits in the current or so-called recurrent account of our Balance of Payments for several years, almost continuously from 1977 with the opening of the economy. In 2015 the deficit in the current account was Rs 10,605 million. Fortunately the Terms of Trade have been improving in our favor and in 2013 it was 4.6% in our favor; in 2014 it was 4.2% and in 2015 it went down to 2.3%. This meant that the prices of our exports have done better than the prices of our imports and this provides us an unforeseen gain in welfare.

But we cannot expect such a favorable situation to last forever. World prices of commodities and industrial goods keep changing and sometimes the prices of primary commodities rise more than the prices of industrial goods. We export primary goods like tea, rubber and a few coconut products like desiccated coconut. Our current account in the balance of payments is sustained largely by the remittances received from our migrant workers abroad who remit their incomes to the country.

In 2016 such private transfers amounted to Rs 6,167 million. In addition the government obtains official transfers by way of foreign aid although such official transfers have come down with the country reaching middle income status and hence losing the privilege of concessional aid at low rates of interest. We have been living on the remittances of our migrant workers to sustain our high standard of living which includes much imported goods relative to the consumption of domestically produced goods. This is not a healthy factor in the long run although a strict balance in imports and exports is not necessary.

It is not sustainable in the long run and we must increase the consumption of domestically produced goods. True, there was a reaction against the policy of import substitution because our domestically produced goods were too expensive compared to the imported equivalents. So it is necessary to keep prices if domestically produced goods down. This requires wage restraint which is assisted by low inflation for workers demand wage increases to compensate for increases in the cost of living.

Our solution has been to depreciate the rupee periodically to make the imported goods more costly and thereby reduce their consumption. But this has not worked and several rounds of depreciation of the rupee have been followed by increases in the government budget deficit and financing it from bank financings which is tantamount to the creation of new money. Although successive Ministers of Finance have promised to eliminate bank borrowings and borrow only from the people's savings they have failed to do so. So some amount of money creation has figured in every realized financial statement of the government.

Deficit financing is recommended by economists only for special unusual economic circumstances. But our profligate governments have not been able to even balance the current or so-called Recurrent Account of the budget. Borrowings must be restricted only for capital expenditure in the nature of investments which produce a return greater than the cost. We still don't seem to have prior evaluation of costs and benefits before including new items of expenditure in the Annual Budget. The Department of National Planning is expected to evaluate projects and approve them before they are included in the Annual Budget. This is standard modern practice in other countries. The Planning Department should publish their evaluations for the benefit of the public.

> "Inflation may be internally or externally induced. It is internally induced when there is money creation by the government through deficit financing funded through bank borrowings which is tantamount to money creation. The government should refrain from bank borrowings except for a temporary shortfall in cash management. There should be no net increase in bank borrowings at the end of the financial year and preferably a reduction of such bank borrowings until their total elimination and replacement with borrowings only from the people."

True that the techniques available for the Planning Department are limited particularly in forecasting future benefits which have to be discounted for their present values but this is essential economic practice.

Our failure to follow sound economic practices have perhaps led to over-borrowing and the common criticism nowadays is that we are too much in debt particularly foreign debt. Unlike in the case of domestic debt in rupees, foreign debt has to be repaid in foreign currency and if we continue to run current account deficits in the balance of payments we cannot hold the exchange rate steady. If the exchange rate depreciates due to market forces, the foreign debt burden increases and the original rationale for the foreign borrowing for particular projects may be invalidated. The official transfers on foreign borrowings by the government in 2015 were US $ 27 million. We are living on foreign borrowings to maintain our standard of living consuming an unsustainable amount of foreign goods and services on top of the migrant transfers from our workers abroad.

Our external debt to foreigners has been rising with the continuous dependence on foreign aid. The total external debt a few years ago was 54% of our Gross Domestic Product. This prima facie is not high when we compare it with the foreign debt levels of the Latin American countries in the mid 1980s which exceeded 100% of their GDP. But these Latin American countries got into debt crises and had to be bailed out by the world community; so also Russia in 1994.

We cannot afford to go borrowing more and more from external sources except for concessional loans from the IMF and the World Bank. The IMF provides support only to tide over a temporary balance of payments crisis and not for general purposes of development. So it is necessary for the people to be more realistic and substitute domestic products for imported goods. The usual objection to that is that our domestic products are too expensive relative to the imported products. We have failed to exercise wage restraint. What the workers say is that they want compensation for increases in the cost of living. Fair enough. Hence the primary obligation for the government is to prevent inflation.

Inflation may be internally or externally induced. It is internally induced when there is money creation by the government through deficit financing funded through bank borrowings which is tantamount to money creation. The government should refrain from bank borrowings except for a temporary shortfall in cash management. There should be no net increase in bank borrowings at the end of the financial year and preferably a reduction of such bank borrowings until their total elimination and replacement with borrowings only from the people.

We also should reduce our consumption of imported goods and substitute them with domestic products. It is true that the prices of domestically produced goods are often higher than the comparable imported prices. It is not desirable to impose import controls and hence the government will have to depend on fiscal and monetary controls to keep down imports. The rupee has been allowed to float in accordance with market forces which will help to maintain its true economic value vis a vis the market. Unlike the private sector the government is not responsive to prices and the discipline of the market. In the case of the private sector consumers look for and substitute alternatives when the prices of the goods they use go up in price. But the government is oblivious to an upward change in prices and departments continue to buy at higher market prices rather than look for alternatives.

There should be stricter budget control so that the budgeted amounts paid by the treasury are not allowed to increase. In the past such controls did exist although it led to severe criticism of the Treasury. But that is the essential role of the Treasury and in the UK the Treasury Board is headed by the Prime Minister himself who takes the responsibility for the refusals of the Treasury. We should not make the openness of the economy a fetish. Yes the economy particularly for a small country should be open to get the benefits of world trade and payments. But economics dictate that the comparative supply costs of our exports will be lower to nearby countries than to more distant countries.

India is a large market we can take advantage of. Are we doing so? We are too scared about Indian domination than we don't like to have closer economic relations with India. But isn't India the natural economic choice when it comes to trade and foreign investment? The Indians are said to be seeking to reduce distances and costs of supply to Sri Lanka. But Indian attempts to do so are looked upon with fear. It is time we accept the need for closer economic relations with India, which includes freer trade and investment although it does not mean we surrender our sovereignty in political or even in economic matters.

The whole process should be based on mutual cooperation and arrived at through discussion and negotiation. Are our government negotiators in the Ministry of Commerce doing so? Perhaps they do although there is not much publicity. There is no free lunch in economic matters and economic bargaining involves give and take. The Prime Minster appreciates the situation and can be expected to guide the policy on the correct tracks.

We can make many economies but they must be preceded by study and their rationale must be explained to the people. Often the government doesn't provide the public with adequate information about its plans and programs and the extremists are able to capitalize on such failure by spreading lies or exaggerations of purported disadvantages while ignoring the benefits.