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EDITORIAL

Policy challenges in mitigating the economic fallout from COVID-19 pandemic in Sri Lanka

The outbreak of COVID-19 pandemic has severe consequences on the Sri Lankan economy, which had already encountered multiple economic setbacks including low economic growth, fiscal imbalance, balance of payments deficits and foreign debt burden even prior to the pandemic. Poor households who are mostly working in the informal sector with irregular income sources have become extremely vulnerable in the present crisis situation. Hence, the government has taken steps to provide pandemic-related relief measures to the affected households as well as to distressed enterprises. The expenditure incurred for such concessions is an additional burden on the government budget which is already under stress. Meanwhile, the government has imposed lockdowns, curfews, business restrictions, travel bans and various other precautionary measures from time to time, to tackle the health crisis relating to the pandemic, as per globally-accepted health guidelines. While such regulations have become inevitable to contain the spread of the virus and save lives, they encompass varying economic costs including production setbacks, job losses, livelihood disruptions, household income decline and low consumer demand. Hence, striking the right balance between health safety and economic sustainability is a formidable challenge faced by the government amidst the pandemic. The government, together with the Central Bank, has implemented a series of unprecedented relief measures and large-scale policy stimuli to help households and businesses adversely affected by the pandemic.

The government has introduced a range of fiscal measures to support businesses and individuals affected by the pandemic. Small and Medium-scale Enterprises (SMEs) have been granted several tax concessions. Import levy concessions have been provided for importation of certain health-related items. Maximum retail prices were imposed on several essential consumer goods. The government has also implemented novel welfare programmes to directly support the needy segments of the community affected by the pandemic. Accordingly, a cash allowance of Rs. 5,000 was granted to senior citizens, differently abled persons, kidney patients, farmers and displaced daily workers. Further, an interest-free advance of Rs. 10,000 was provided to Samurdhi beneficiaries during the lockdown period, while a one-month grace period was given to the general public for payment of utility bills. Further, the Agrahara insurance benefits were doubled for police officers, tri-forces and government employees and officials in the health sector who are engaged in COVID-19 preventive activities.

The relief measures provided by the Central Bank to the affected households and businesses too have been quite extensive. It has implemented a series of monetary easing measures including sequential reductions of the policy interest rates and Statutory Reserve Ratio (SRR), thereby injecting substantial liquidity into the market and lowering borrowing costs significantly. Concessional credit schemes were also introduced to facilitate the activities of (SMEs), alongside debt moratoria granted for businesses and individuals distressed by the pandemic. Further, the Central Bank has accommodated government finance requirements by directly purchasing Treasury Bills at primary auctions.

The Sri Lankan economy experienced negative Gross Domestic Product (GDP) growth rate of 1.6 percent (year on year basis) in the first quarter of 2020, largely reflecting the combined effects of local economic disruptions caused by lockdowns and curfews, and subdued global demand in the face of the pandemic. In the first quarter of 2020, the agriculture sector and industrial sector contracted by 5.6 percent and 7.8 percent, respectively, while the service sector reflected a moderate growth of 3.1 percent. The anticipated economic recovery in the second half of the year seems to be unlikely in view of the continuation of the pandemic. According to the official forecasts, GDP growth rate in 2020 would decline to around -2.0 percent, compared with 2.3 percent growth in 2019. The unemployment rate rose to 5.6 percent in the first quarter of 2020, compared with 4.8 percent in the corresponding period of 2019, as a consequence of the island-wide lockdown imposed from mid-March to mid-May 2020.

The fiscal sector deteriorated during the seven months ending July 2020, compared with the same period in 2019, due to the adverse impact of the pandemic on government revenue and expenditure. In view of the downfall of revenue mobilisation and higher expenditure outlays on pandemic-related relief measures, the budget deficit is projected to rise from 6.8 percent of GDP in 2019 to 9.1 percent in 2020.

The balance of payments has been adversely affected by significant declines in earnings from exports, tourism and worker remittances, owing to the pandemic. The negative effect of the pandemic on the balance of payments was contained to a certain extent by the import restrictions on non-essential consumer goods and vehicles imposed during the year. The emergence of COVID-19 clusters in several leading garment factories in the latter part of 2020 has been a severe blow to the export sector. In the circumstances, Sri Lanka may not be able to build up sufficient foreign reserves to withstand the COVID-19 shock in the backdrop of her already rising external debt burden and declining foreign exchange earnings.

Reflecting the substantial monetary easing measures adopted by the Central Bank to tackle the economic downfall amidst the pandemic, the money supply is expected to grow by around 21.0 percent in 2020, compared with 7.0 percent in 2019. Such excessive money growth inevitably causes demand pressures leading to inflationary repercussions. Annual inflation is projected to rise from 4.3 percent in 2019 to 4.7 percent in 2020.

In tackling the crisis, the short-term goal of macroeconomic policies should be crisis management by providing relief measures to avoid health care breakdowns, enterprise bankruptcies, mass layoffs, livelihood deterioration and output disruptions. The relief measures that could be adopted in the short run include increase in public healthcare expenditure, direct income support to vulnerable segments of the population and assistance to affected firms. In the medium and long run, policy focus needs to shift from crisis management to economic recovery by providing macroeconomic stimulus.

Developing countries, which have limited health care facilities, low output growth, large informal sectors, fragmented financial markets, weak export capacity, inadequate Research and Development (R&D), low productivity and acute fiscal imbalances, are more vulnerable to the pandemic, and they do not have much policy space to deal with the crisis, in comparison with developed countries.

In Sri Lanka, fiscal and monetary policies as well as credit policies have been used extensively thus far to achieve the above goals amidst the pandemic, as explained earlier. The success of this policy package will depend (a) on its continuity, and (b) revival of economic activity in response to the policy initiatives. First, it would be rather difficult to extend the package for a longer period in view of its burden on the government budget. While the cash transfers and other reliefs provided to the affected households entail expenditure hikes, the tax reliefs offered to the affected firms result in revenue losses. These are in addition to the tax revenue shortfalls resulting from low economic activity. Unless higher revenue mobilisation is made possible through revival of economic activity, continuation of fiscal relief would thus lead to widen the budget deficit and to aggravate the debt service problem. It would also be rather unviable to continue the monetary easing and credit concessions for longer periods due to their pressure impact on the aggregate demand, and in turn, on inflation thus making monetary policy less effective. In particular, such monetary easing severely constrains the capacity of the Central Bank to effectively implement its inflation, targeting monetary policy framework launched recently. Second, economic growth is likely to remain low due to factors such as frequent lockdowns, production constraints, travel restrictions, supply chain breakdowns, downturn in global demand and market failures amidst the pandemic.

Looking forward, COVID-19 has provided an opportunity to reorient macroeconomic policies towards achieving not only faster GDP growth but also creating a broader development process to share the benefits fairly by all segments across the society by way of "inclusive growth". This needs human capital development so as to provide opportunities for all to participate in economic activities without discrimination. Such development process will enable to distribute growth benefits equitably across different segments of the society. The adverse impact of income disparities is clearly evident during the pandemic, as the poor have become more susceptible to the crisis. Hence, equitable distribution of growth benefits is critically important.

The official medium-term macroeconomic framework indicates economic recovery over the next five years. The Sri Lankan economy would have been in a better position to tackle the economic fallout from the COVID-19 pandemic, had it achieved technology and innovation-driven growth by means of a knowledge economy, and thereby accelerating export-led growth. A successful knowledge economy is characterised by close links with science and technology, and high priority placed on innovation for economic growth as well as for export competitiveness. R&D is a key driver of knowledge economy. Whilst accelerating economic growth for the benefit of all along those lines, sufficient attention should also be given in post-pandemic economic policies to ensure macroeconomic stability so as to reduce the twin deficits in the fiscal sector and balance of payments.

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