

STABILISATION ISSUES

by
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The experience of developing countries suggests that strong and sustainable growth is the obvious vehicle for improving the life of the poorest people. It is found that growth efforts aiming at the well being of people are hindered very often by prolonged and significant macro-economic imbalances. These imbalances are usually characterised by high and abrupt inflation and periodic balance of payments crises. The economic and social repercussions of these imbalances are well known. Inflation weakens the living standards of the masses and discourages savings. It also has the tendency to misallocate resources. Balance of payment deficits lead to fluctuations in economic activity and adversely affect long term growth.

In view of the above considerations, economic stabilization has been accepted as a pre-requisite to economic growth in developing countries. It is also recognised in recent times to have more credible stabilization policies so as to encourage the private sector to actively participate in economic activities. In general, stabilization means maintenance of a low inflation rate and sustainable balance of payments position.

The pressures on the general price level and balance of payments can be partly eased by reducing aggregate demand or total absorption level of the economy. Excessive absorption levels in developing countries are primarily linked to large government budget deficits. Therefore, fiscal policy has become a major absorption reducing instrument in

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these countries. This is supplemented by contractionary monetary policies. It may be noted however, that expenditure reducing strategies in most instances lead to slow down economic activity and lower growth rates. In addition to absorption reducing policies, economic stability can also be attained by switching expenditure to more productive sectors. Exchange rate policy is used as a main expenditure switching instrument in recent years.

TABLE 1

| FISCAL TARGETS, 1989 - 93 | (Rs. Millions) | | | | |
|--|----------------|--------|--------|--------|--------|
| | 1989 | 1990 | 1991 | 1992 | 1993 |
| 1. Revenue | 53.16 | 60.68 | 67.21 | 74.02 | 82.39 |
| 2. Current Expenditure | 57.80 | 64.54 | 70.93 | 75.08 | 79.65 |
| 3. Current a/c Surplus (+)/Deficit (-) | 4.64 | 3.86 | 3.72 | 1.06 | 2.74 |
| 4. Capital Expenditure & net lending of which Advance a/c net out payments | 26.60 | 25.60 | 24.60 | 26.45 | 32.96 |
| 5. Overall Surplus (+)/Deficit (-) | 31.24 | 29.46 | 28.32 | 27.51 | 30.22 |
| 6. Deficit Financing | | | | | |
| 6.1 Grants | 7.00 | 7.98 | 9.00 | 9.60 | 10.10 |
| 6.2 Net foreign borrowing | 8.27 | 9.89 | 7.93 | 3.93 | 5.25 |
| 6.3 Net domestic non-bank financing | 11.99 | 10.58 | 10.38 | 12.97 | 13.86 |
| 6.4 Administrative Borrowing | 0 | 0 | 0 | 0 | 0 |
| 6.5 Borrowing from monetary system | 3.98 | 1.01 | 1.01 | 1.01 | 1.01 |
| 7. GDP at Current Market Price | 250.20 | 283.50 | 315.40 | 352.60 | 392.40 |
| As Percentages of GDP (at Current Market Prices) | | | | | |
| 1. Revenue | 21.2 | 21.4 | 21.3 | 21.0 | 21.0 |
| 2. Current Expenditure | 23.1 | 22.8 | 22.5 | 21.3 | 20.3 |
| 3. Current a/c Surplus (+)/Deficit (-) | -1.9 | -1.4 | -1.2 | -0.3 | 0.7 |
| 4. Capital Expenditure & net lending of which Advance a/c net out payments | 10.6 | 9.0 | 7.8 | 7.5 | 8.4 |
| 5. Overall Surplus (+)/Deficit (-) | -12.5 | -10.4 | -9.0 | -7.8 | -7.7 |
| 6. Deficit Financing | | | | | |
| 6.1 Grants | 2.8 | 2.8 | 2.9 | 2.7 | 2.6 |
| 6.2 Net foreign borrowing | 3.3 | 3.5 | 2.5 | 1.1 | 1.3 |
| 6.3 Net domestic non-bank financing | 4.8 | 3.7 | 3.3 | 3.7 | 3.5 |
| 6.4 Administrative Borrowing | 0 | 0 | 0 | 0 | 0 |
| 6.5 Borrowing from monetary system | 1.6 | 0.4 | 0.3 | 0.3 | 0.3 |

Source: National Planning Department, Public Investment 1989 - 1993

AND THE 1990 BUDGET

TABLE 2

| | Budgetary Outturn | | | | |
|--------------------------|-------------------|--------|--------|--------|--------|
| | (Rs. Mn) | | | | |
| | 1986 | 1987 | 1988 | 1989 | 1990 |
| Revenue | 37237 | 42144 | 41748 | 52812 | 61162 |
| Expenditure | -51193 | -63894 | -76532 | -84381 | -89762 |
| Recurrent | -33966 | -39560 | -46132 | -56980 | -64490 |
| Capital | -23236 | -22816 | -22878 | -21034 | -20635 |
| Lending minus repayments | -1991 | -1518 | -7522 | -6367 | -4637 |
| Deficit Before Grants | -21956 | -21750 | -34784 | -31567 | -28600 |
| Financing | 21957 | 21749 | 34784 | 31569 | 28599 |
| Grants | 3754 | 4677 | 6588 | 6670 | 6800 |
| Deficit After Grants | -18203 | -17073 | -28196 | -24899 | -21800 |
| Financing | 16204 | 17072 | 28176 | 24899 | 21799 |
| Foreign | 9061 | 5716 | 7128 | 7800 | 10558 |
| Domestic | 9143 | 11356 | 21068 | 17099 | 11241 |
| Non-Bank | 6096 | 7815 | 10915 | 13099 | 10199 |
| Bank | 3047 | 3541 | 10153 | 4000 | 1042 |

We will examine the Budget presented in November 1989 in the light of the above stabilization issues. The budget states "..... macroeconomic stabilization remained high in the order of priorities of our economic policies in 1989. To this end the government had endeavoured to pursue appropriate financial and other policies. We expect as a result to achieve our twin objectives of internal and external viability by the end of the year."

The budgetary targets for 1990 are largely based on the medium term stabilization and structural adjustment programmes that are currently in operation in Sri Lanka. A gradual decline in recourse to domestic inflationary borrowing is envisaged in these programmes. Broad fiscal targets envisaged in these programmes are given in Table I. The underlying growth rate of Gross Domestic Product (GDP) over the period 1990-93 is 3.3 per cent per annum; the resulting Per Capita income growth will be about 1.6 per cent per year. In terms of these targets the overall budget defi-

cit will be reduced from 12.5 per cent of GDP in 1989 to about 8 per cent by 1993. This is expected to be achieved mainly by means of a reduction in aggregate expenditure of the government. The current expenditure will decline from 23 per cent of GDP in 1989 to about 20 per cent in 1993. The capital expenditure will be reduced from 10.6 per cent of GDP in 1989 to about 8 per cent in 1993. It is also expected to restructure public investments so as to give priority to more productive and employment oriented development projects. The revenue of the government will be maintained at 21 per cent of GDP throughout the medium term period.

The budgetary outturn for the year 1990 emerging from the above medium term framework is given in Table 2. A significant feature in this outturn is the effort to reduce the budgetary deficit. The overall deficit will be reduced to 10 per cent of GDP in 1990 from a peak level of 15.6 per cent in 1988 and 12.6 per cent in 1989. In absolute levels, the

budget deficit will be reduced to Rs. 28.6 billion in 1990 from the levels of Rs. 34.8 billion in 1988 and Rs. 31.6 billion in 1989. The major contributory factor for this development in 1990 is the anticipated decline in lending minus repayments. A marginal reduction in capital expenditure is also expected for 1990.

In an effort to mobilise more revenue in order to contain the budget deficit, several revenue proposals were presented in the budget. Accordingly, penalty provisions with respect to income tax were amended to avoid undue tax delays. Turnover tax rates for a number of luxury and semi-luxury items were raised. Steps were also taken to increase turnover tax rates for manufacturers and importers. Customs duties on certain imports and excise duties were increased. These revenue proposals are expected to generate an additional revenue of Rs. 3,085 million.

The reduced budget deficit will obviously help to ease the financing problems. Taking into account the outright grants from foreign sources, the financing gap of the budget is narrowed down to Rs. 21.8 billion or 7.7 per cent of GDP in 1990. In comparison, the financing gap was at a peak level of Rs. 28.2 billion (or 12.6 per cent of GDP) in 1988 and Rs. 24.9 billion (or 10 per cent of GDP) in 1989.

Thus the budget envisages a considerable improvement in the fiscal performances in 1990. As a result, domestic borrowings are expected to decline to about 4 per cent of GDP in 1990 in comparison with 9.5 per

Continued on page 11

Continued from page 7

cent in 1988 and 6.8 per cent in 1989. Recourse to inflationary bank borrowings will be reduced to 0.37 per cent of GDP in 1990. This is a significant achievement in considering the earlier extensive bank borrowings which amounted to the tune of 4.5 per cent of GDP in 1988 and 1.6 per cent in 1989.

Reduced recourse to bank borrowing in 1990 will supplement the policy measures that are already in operation to combat domestic inflation and external imbalance. Among these measures, Treasury Bills have been effectively used to mobilise resources from the non-bank sector. A wide range of maturities are of-

ferred for Treasury Bills. The Treasury Bills have become more market oriented and their rates are highly competitive. In the monetary sphere the Central Bank has intensified open market operations to mop up excess liquidity in the economy. In addition, the Central Bank has imposed a partial ceiling on bank credit and 100 per cent cash margins on Letters of Credit opened for non-essential imports.

It is expected that the fiscal programme outlined in the earlier sections and the current monetary measures will help to slow down domestic inflation and to achieve a sustainable external payments balance over the adjustment period.

As Percentages of GDP (at Current Market Prices)

| | | | | | |
|--------------------------|--------|--------|--------|--------|--------|
| Revenue | 20.74 | 21.42 | 18.72 | 21.12 | 21.57 |
| Expenditure | -32.97 | -32.48 | -34.32 | -33.75 | -32.66 |
| Recurrent | -12.94 | -20.11 | -20.69 | -22.79 | -22.75 |
| Capital | -12.94 | -11.60 | -10.26 | -8.41 | -7.28 |
| Lending minus repayments | -1.11 | -0.77 | -3.37 | -2.55 | -1.64 |
| Deficit Before Grants | -12.23 | -11.06 | -15.60 | -12.63 | -10.09 |
| Grants | 2.09 | 2.38 | 2.95 | 2.67 | 2.40 |
| Deficit After Grants | -10.14 | -8.68 | -12.64 | -9.96 | -7.69 |
| Financing | 10.14 | 8.68 | 12.64 | 9.9 | 7.69 |
| Foreign Loans | 5.05 | 2.91 | 3.20 | 3.12 | 3.72 |
| Domestic | 5.09 | 5.77 | 9.45 | 6.84 | 3.97 |
| Non-Bank | 3.40 | 3.97 | 4.89 | 5.24 | 3.60 |
| Bank | 1.70 | 1.80 | 4.55 | 1.60 | 0.37 |

Source: Central Bank of Sri Lanka.