# Budget - 2009: Challenges in the Midst of Global Financial Crisis[1]


## K.M. Mahinda Siriwardana

*Deputy Director,*
*Economic Research Department,*
*Central Bank of Sri Lanka.*


**Introduction**

The Budget 2009 was presented in an environment where unprecedented events were taking place in both domestic and external fronts. Domestically, the government was in the midst of decisive humanitarian operations to liberate the Northern Province and to end the protracted civil conflict. Externally, the global financial crisis was unfolding towards an unforeseen end with a rapid slide of the global economy into a recession. Many global financial giants in the advanced countries were bailed out by respective governments or went bankrupt. Confidence in global financial institutions and markets has been badly shaken and threats to systemic stability became manifest in September (2008) with the collapse or near-collapse of several key institutions[2]. In addition, the financial system has been severely weakened by mounting losses on impaired and illiquid assets, uncertainty regarding the availability and cost of funding, and further deterioration of loan portfolios as global economic growth slows[3]. Consequently, the international credit markets gradually dried up leading to very tight liquidity conditions. Many central banks around the world responded by cutting down their policy interest rates to exceptionally low levels, while introducing various other measures to increase the availability of liquidity in the markets to revive economic activities. Nevertheless, economic activities slowed down due to the demand destruction thereby crippling the world economy. The layoffs became a common feature in many countries. Many governments announced fiscal stimulus packages as well to boost their economies with a view of combating the slowdown[4]. On the contrary, the decelerated economic activities and the subsequent recessionary situation resulted in a drop in the international commodity prices including oil.

**Expectations**

The Budget 2009 was presented with the view of continuing the increasing trend in the revenue collection, containing recurrent expenditure further while maintaining public investment at a desired level to stimulate private sector economic activities. Accordingly, total revenue is expected to increase to 16.3% of gross domestic product (GDP) while maintaining the total expenditure and net lending at 22.8% of GDP (Table 1). Consequently, the budget deficit is expected to reduce further to 6.5% of GDP from estimated 7.0% in 2008. The outstanding debt to GDP ratio is expected to decline further to 75.6% in 2009 from estimated 78.2% in 2008. In achieving these targets, the government expects to continue with new revenue enhancing measures introduced in Budget 2009 while taking further measures to improve tax administration. On the expenditure side, implementation of the infrastructure development projects, with the emphasis on mega projects, is expected to address infrastructure deficiencies in the country. The broader objective of these policies is creation of employment opportunities to increase income levels of the general public to reduce poverty on a sustainable basis.

**Table 1: Revised Medium Term Macro Fiscal Framework (2007- 2011)**
As a per cent of GDP

| Item | 2007 Prov. | Projections | | | |
|---|---|---|---|---|---|
| | | 2008 | 2009 | 2010 | 2011 |
| Revenue | 15.8 | 16.1 | 16.3 | 17.0 | 17.5 |
| Expenditure | 23.5 | 23.0 | 22.8 | 22.7 | 22.4 |
| Current Account Deficit(-)/Surplus(+) | -1.6 | -0.8 | 0.2 | 1.5 | 2.5 |
| Overall Budget Deficit | -7.7 | -7.0 | -6.5 | -5.8 | -5.0 |
| Government Debt | 85.8 | 78.2 | 75.6 | 73.4 | 70.5 |

*Source: Fiscal Management Report - 2009, Ministry of Finance and Planning*

**Potential Impact of the Crisis**

The projections by many international organisations reveal that the impact of the financial crisis on the world economy could be much bigger than initial expectations. According to the latest forecasts by the International Monetary Fund (IMF), *world growth is projected to fall to ½% in 2009, its lowest rate since World War II and despite wide-ranging policy actions, financial strains remain acute, pulling down the real economy (IMF, 2009)*[5]. The IMF has also projected that *"output in the advanced countries will contract by 2% in 2009, which would be the first annual contraction during the post-war period"*. This situation would have some impact on Sri Lanka's economic growth prospects due to lower external demand that could arise due to slowing down of the world economy. Nevertheless, it appears that Sri Lanka's economic growth increasingly depends upon domestic demand as well. Hence, the integration of the Eastern Province with rest of the country would provide some impetus to the economic growth. The liberation of Northern Province would also have favourable impact on the growth with the commencement of economic activities in the liberated areas. Therefore, the rate of slowdown in the economic activities in 2009 would mainly depend on the net impact of these developments.

The direct impact of the international financial crisis on Sri Lanka was minimal as the country's capital account is not fully liberalised and that many local banks did not trade in collateralised debt instruments. Nevertheless, it appears that the Sri

Lankan economy is also experiencing the impact gradually, since the latter part of 2008. As an immediate response to the financial crisis, there was a significant outflow of foreign investments in Treasury bills and Treasury bonds, particularly since mid September 2008, which was subsequently stabilised to a large extent. Since then, the Sri Lankan economy is also felt the impact of severe shortage of liquidity in the international capital market. This was manifested by not receiving the foreign commercial borrowings, which were expected to raise by the government during the latter part of 2008. Furthermore, the export sector, particularly the agriculture and manufacturing sectors, including garments, tea, rubber and cinnamon, has also hit mainly by the lower prices and the declined international demand. In addition to the above developments, there are several areas, which need to take into account in analysing the potential budgetary performance in 2009. The increasing layoffs in many countries and the accompanying slowdown in income- earning capacity of foreigners would lead to cut their expenses on leisure activities thereby considerably lowering the number of tourists coming to Sri Lanka, mainly from the Euro area. The lower economic growth in the countries that employ Sri Lankan employees would slowdown the expected growth in worker remittances to some extent. Nevertheless, the decline in commodity prices, including oil, and the decline in the import demand would have a favourable overall impact on the external accounts.

**Challenges in Achieving Targets in Budget 2009**

The difficulties that the entire world face due to the ongoing financial crisis has resulted in the governments to introduce various policies to better face the challenges associated with it. In that sense, this will be a testing time, not only to Sri Lanka but also to the entire world.

A major implication of the ongoing global financial crisis on the government budget would be on the ability to achieve the revenue target in Budget 2009. Sri Lanka's government revenue consists of about 90% of tax revenue and about 10% non tax revenue. Of the tax revenue, about 80% comes from indirect taxes. Value Added Tax (VAT) and excise duties are among the major sources of revenue, which amounts to about 56% of the total indirect taxes. Any deceleration of domestic economic activities would have adverse impact on the indirect tax revenue collection, particularly from VAT and excise duties. In addition, the decline in international prices of many imported commodities and the possible slowdown in imports would make the generation of expected revenue from the import duties also a challenging task. Furthermore, if the domestic economic activities are slowed down further during the course of the year, it will tend to reduce the income of the persons and the profitability of the corporate sector, resulting in lowering the expected increase in the revenue from the direct taxes; i.e. personal and corporate income taxes, as well. These developments would necessitate the government to re-think about its strategy for enhancing revenue and introduce new measures to achieve the revenue targets to the maximum possible extent.

On the recurrent expenditure front, the declining oil prices in the international market would give the government a breathing space in contrast to the periods where Sri Lanka had to face adverse implications of higher international oil prices. The decline in the prices of other commodities in the international market will also have a favourable impact. As a result, the declining trend observed in the inflation is expected to continue throughout 2009. In particular, the year-on-year inflation has already declined to 7.6% in February 2009 which will settle down at a single digit level at end 2009. This favourable trend will result in a decline in the market interest rates for government securities, thereby containing the interest cost of the government.

The global financial crisis has necessitated the government of Sri Lanka, as many governments in the world, to intervene in supporting certain economic sectors directly, which will have additional burden on the Budget. Accordingly, the government will have to incur additional recurrent expenditure, particularly in respect of the measures introduced towards making the Sri Lankan economy withstand in the wake of international financial turmoil. The first such policy measure, the Economic Stimulus Package, was introduced by the government on 30 December 2008. This package is expected to assist production sectors which are facing various difficulties through provision of working capital requirement, payment of subsidies, suspending the recovery of loans for a specified period and providing various other concessions. The total cost to implement this package in 2009 is estimated at Rs. 16 billion (Ministry of Finance and Planning)[6]. The impact of this fiscal stimulus to resuscitate the economic growth depends on many factors including its ability to boost consumer, business, and investor confidence. In any case, the cost of this package will have to be accounted as an additional expenditure in the government budget. In addition, the resettlement and rehabilitation activities may require a higher than expected amount of resources once the Northern Province is also liberated completely. Meanwhile, the defence expenditure may not exceed the target as the need for new defence machinery may not arise given the progress of the humanitarian operations in the Northern Province.

In the wake of increasing per capita income of the country, the reliance on commercial financing would naturally increase as the access to concessional financing will decline gradually over the years. However, the non-receipt of the expected foreign commercial financing flows during the latter part of 2008 signals that obtaining foreign commercial financing would be difficult and challenging at least in the first half of 2009 as well due to tight global liquidity situation. In fact, financial market conditions have remained extremely difficult for a longer period than envisaged earlier[7].

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Hence, any decline in foreign inflows due to these reasons would affect the *planned* public investments of the government, which will lead to the prioritisation of the development projects particularly to continue with mega infrastructure development projects unabated. In addition, the disbursement of concessional financing could also be slowed down in 2009 if there are difficulties in providing necessary counterpart funds by the government.

The difficulties in obtaining foreign commercial financing point to the necessity of introducing alternative financing methods to face the challenges during a historically difficult period of time. Accordingly, the government and the Central Bank of Sri Lanka have introduced alternative financing mechanisms to better face this emerging challenge. The opening up of the government securities market for Sri Lankan Diaspora and the working community overseas is one such activity that has been introduced with a view of obtaining new sources for invest in government securities.

## The Way Forward

Sri Lanka, being a small open economy, seems to be impacting from the ongoing global financial crisis slowly. In the meantime, the humanitarian operations are nearing completion requiring a huge amount of funds to resettle people and, rehabilitate and reconstruct the infrastructure in the conflict-affected areas. At this critical juncture, the country needs to handle the emerging issues cautiously with a better understanding about the potential risks. Hence, a concerted effort by all stakeholders is necessary to face the challenges particularly emanating from the global financial crisis, in which the success of the implementation of Budget 2009 would mainly depend.

### *References*

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### *Footnotes*

[1] *The views expressed in this article are those of the author and are not those of the Central Bank of Sri Lanka.*

[2] *IMF, October 2008*

[3] *IMF, October 2008.*

[4] *The use of 'fiscal stimulus' as a counter cyclical or stabilisation measure has gained momentum in order to offset declines in economic activity of the private sector in the midst of adverse economic developments.*

[5] *The IMF has also indicated that "a sustained economic recovery will not be possible until the financial sector's functionality is restored and credit markets are unclogged. For this purpose, new policy initiatives are needed to produce credible loan loss recognition; sort financial companies according to their medium-run viability; and provide public support to viable institutions by injecting capital and carving out bad assets. Monetary and fiscal policies need to become even more supportive of aggregate demand and sustain this stance over the foreseeable future, while developing strategies to ensure long-term fiscal sustainability".*

[6] *This amount includes the provision of a concession of Rs. 20 per litre for the petrol for three wheeler owners with a view of giving the ultimate benefit of this measure to the passengers who use three wheelers as their mode of transport.*

[7] *IMF, 28 January 2009.*

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