Pathfinder Foundation

**Pathfinder Economic Flash**

## Managing the Impending Economic Crisis: Policy Corrections, Privatisation, Elimination of Corruption

No sensible policy maker, economist or politician will deny the fact that Sri Lanka, at present, is on the verge of a major economic crisis. The looming economic disaster, if not prudently managed, will drive the country to a negative territory in the international ratings making it extremely difficult to attract foreign portfolio and direct investment. Of late, the gravity of the situation has been highlighted by many prominent and respected economists. The following headlines that appeared in the recent print and social media is a clear indication to this fact. *'Coming out of economic crisis: timing is running out for Sri Lanka,' 'Sri Lanka is on the doorstep of a public debt driven crisis,' 'The impact of the global financial crisis on Sri Lanka,' 'Financial crisis in Sri Lanka.'*

Although the political leadership of the country is unwilling to highlight the impending disaster for the fear of panic-driven consequences,we firmly believe that it is the duty of independent-minded responsible citizens, including think tanks, to bring to the notice of political authorities, policy makers as well as the general public the prevailing dangers and policy alternatives for avoiding an impending catastrophic disaster. Remaining silent and inactive about policy malpractices when we have a chance to make a difference is not cowardice, but may be considered a crime against ordinary people of the country. There are also a segment of academics and other intellectuals who tend to soft peddle in the criticism of the current regime or extending criticism to 'successive governments' without taking the 'bulls or buffalos by the horns'

Sri Lanka's present economic crisis has manifested itself in many ways such as the downward pressure on the Rupee, outflow of foreign exchange while the inflows are insufficient, domestic spending induced imports, public debt–both foreign and domestic is reaching uncontrollable levels. Furthermore, with the introduction of the so-called 100 day program to fulfill Presidential election promises, the government raised public sector salaries by RS.10,000, slashed petroleum prices locally and managed external reserves to maintain an artificially strong exchange rate etc. These manifestations are, of course, indications to the macroeconomic situation in the country.

The untold story in many public pronouncements, particularly by the political leaders is the worsening living standards of the people at large. For instance, a manufacturer of garments for the local market stated to the writer recently that his turnover for the month of January 2017 is exactly 10 times less than that of Jan 2016.

**Salient Features of the Crisis or Impending Disaster**

.Our foreign debt has increased from Rs. 3113 bn. in 2014 to Rs. 4,070 bn at end September 2016. During the same period, domestic debt too has increased from Rs.4, 278 bn. to Rs.4,959 bn. Pressure on the exchange rate in spite of the futile attempts to defend the Rupee is reflected from the depreciation of the Rupee from Rs. 132 in 2005 to the current Rs. 153. The strategy of the current government is to address the demand side of the equation. This is partly arising out of the understanding reached between the government and the International Monetary Fund (IMF). It appears that the IMF and the Government has agreed upon a set of macroeconomic targets such as budget deficit, government revenue, both from direct and indirect taxation, and non-debt official reserve build up etc. In spite of attempts to address revenue shortfalls through the increase of taxes, it appears that the desired results have not been achieved. Reserves have fallen drastically to USD 5.5 billion and the net official reserve figure has turned negative as short term liability stands at USD 6.5 billion. This means that for every dollar of payments the Central Bank has USD 0. 82 cents and is short of USD0.18 cents. Gross official figure is also without allowing a provision to settle USD 2.5 billion of swap arrangement with foreign and local banks. The correct official reserve figure, therefore, is around USD 3 billion. Substantial budgetary shortfalls have compelled the government to defer contractual payments. Central Bank holdings of Treasury bills have risen to around USD 250 billion

No Reducing of Govt Expenditure.

Due to short-term political considerations and strong opposition from the trade-unions, there seems to be no attempt at reducing the budget deficit through pruning the government expenditure. On the contrary, during the past two years the ‘good governance’ regime too has been expanding in many areas for example, the already over-bloated and inefficacious public service is continually being fed with thousands of unskilled workers. Similarly, overstaffed government institutions, such as ministries, departments, and other statutory bodies have continued to spread their wings in a hitherto unprecedented manner. The government has maintained unrealistic administered prices on petrol, diesel, electricity, water, etc. in spite of the fact that global oil prices have increased to USD 55/bbl and the exchange rate has depreciated from Rs 132 to 153/USD. Increased import of motor vehicles and petroleum products and increased use of high cost power generation mix have raised deficits in large state owned enterprises as well. Of course, everybody must be reminded of the promised petroleum pricing formula which has never been implemented. After implementing the so-called 100-day program, in 2015, it is unrealistic to expect the government to introduce drastic reductions in recurrent expenditure.

Country in Rock and the Hard Place

The current predicament entails being caught between a rock and a hard place. The most urgent need of the government is to restore fast eroding confidence on the Rupee and raising foreign exchange to ensure availability of sufficient funds for meeting the foreign debt repayment obligations. At the same time, the day-to-day foreign exchange requirement to meet import expenditure needs to be ensured. Without meeting the immediate requirement of foreign exchange, any discussion on short-term or medium-term adjustments or strategies becomes meaningless.

What is To be or Can Be Done?

The options available to the government need to be considered based on the time period available for implementation.

1. In the immediate run the most important requirement is to discontinue the Central Bank selling its foreign exchange reserves. The Central Bank had sold nearly USD 3 billion in 2015and a further USD 750 million in 2016. In January 2017, a further USD 500 million has been sold. All these attempts are defending the un-defendable, the writer has in many occasions even during the previous regime been critical of such market interventions of the Central Bank. Stop this now. Selling state enterprises and attracting foreign inflows make no sense if the Central Bank keeps selling its reserves. At the current scale of Central Bank interventions, even if Chinese pay USD 1.1 billion for the Hambantota port, that amount will be enough for the Central Bank only for 2 months and the country will be back again in the same crisis. So Bank has a primary responsibility to stop selling foreign reserves and unsustainable interventions. Let the market find its true rate as further delay is nothing but asking for much more drastic depreciation of the Rupee.

2. Similarly the Central Bank must refrain from Rupee market operations by not allowing to increase Central Bank holdings of treasury bills. The Central Bank and the Government must appreciate that there are no soft options for a middle income country's macro-economic problems. High interest rates, depreciated currency and corresponding domestic price adjustments are unavoidable in the short run. Price controls will never bring about the desired economic stability.

3. Provided that the above points are recognized and operationalized, in the immediate term the requirement is to generate at least $1 billion plus non-debt creating foreign exchange earnings to reduce the existing severe pressure on the balance of payments. Unless that immediate requirement is fulfilled the country will be forced to borrow from short-term bond markets at increasingly higher interest rates further entangling the country in the debt trap. Regrettably, the government has decided to raise USD 2.5 billion from international markets at a time global interest rates are on the rise and Sri Lankan market conditions are unstable.

4. Therefore, what is the only available means of generating the much needed foreign exchange reserves? The only way is to attract foreign direct investment to state-owned business enterprises leading to privatization or converting them to public-private partnerships. Privatization could take the form of direct sales, corporatization and

listing them in the share market or any other form of transactions which should result on full or partial transfer of ownership and management. The Pathfinder Foundation in the recent past has identified potential candidates for attracting FDI for state-owned business enterprises as indicated below;

| | Values in USD Million |
|---|---|
| 1. Hilton Hotel and Properties of HDL | 250 |
| 2. Hyatt Regency Complex | 100 |
| 3. Water’s Edge | 100 |
| 4. Grand Oriental Hotel | 75 |
| 5. UDA Rest Houses | 40 |
| 6. 50% Government Equity in LECO | 100 |
| 7. Lakdhanavi (Kerawalapitiya) 300 mw power plant | 300 |
| 8. Conversion of Debt into Equity of 900 mw Puttalam Coal power plant | 1,000 |
| 9. Public listing of Government/SOE equity in private companies (SLPA/Government equity in SAGT, CICT, NDB, Seylan) | 500 |
| 10. 30 percent Share issue of SLT | 300 |
| 11. Public Listing of Mobitel | 200 |
| 12. LITRO Gas | 250 |
| 13. Lanka Hospital | 250 |
| 14. 40 percent share issue of Sri Lanka Insurance | 250 |
| 15. 99 year leases for Plantation Companies | 200 |
| 16. Petroleum Retail Distribution | 150 |
| 17. Hambantota Airport/Port (40 percent equity with 10 year management) | 1500 |
| 18. BIA 40 percent equity and 10 year management contract) | 300 |
| **Potential income** | **5,865** |

5. This is one set of state businesses for privatization. The other is the domestic private assets and businesses taken over by successive governments since independence particularly through land reforms. Time has come to give these assets back to respective owners to recommence proper domestic investments in agriculture. 50 acre land ceiling is a major barrier for environment friendly agricultural investments in forestry, livestock, poultry, eco-tourism, grain, sugar, spices, fruits and vegetables etc. In the context of middle income country context, the prevailing land ceiling should be

raised at least for 500 acres for above mentioned investments by domestic entrepreneurs to regain their comparative strength.

6. In the medium and long-term, the government has to implement economic policies that will provide greater incentives to export oriented sectors, removing currently existing import substitution bias and restoring incentives for domestic producers instead of traders who are transferring funds abroad through over invoicing and transfer pricing. The elimination of constraints to foreign as well as local investments through the removal of regulatory and bureaucratic delays, practice of granting tax and import duty concessions to BOI projects is a necessary condition to substantially increase sustainable investment provided a level playing field is created. Policy consistency too needs to be ensured in the medium term, if the flow of FDI and exports of goods and services is to be sustained.

Irrespective of All These Measure Current Level of Corruption Image Will Destroy the Economy

No matter the implementation of the above mentioned policy actions the substantial flow of FDI will depend on the country's image of being a corruption free economy. It is a known fact that Sri Lanka's ranking in the Transparency International Corruption Index has further worsened during the 2015/2016 period. Adding insult to injury, according to the reputed Heritage Foundation Economic Freedom Index Sri Lanka has gone down hill mainly due to corruption. If bribery and corruption is a necessary condition to obtain project approvals, undertake construction, etc. and the perception is that from the highest levels to all the ministers, approval agencies and other related institutions seek 'oiling of the palm' no foreign investor will consider Sri Lanka as a destination to risk their legitimately earned money. Of course, a few investors with ill-gotten money may still consider Sri Lanka as a place for money laundering.

**Privatization of National Assets or Stolen Property: For and Against**

The privatization of state-owned business enterprises has been a subject of debate since the liberalization of the economy which was introduced in 1977/78. Most, if not all the arguments against privatization were based on ideological grounds while as of late on the basis of 'when we are in opposition we oppose anything the government in power does.' However, it must also be mentioned that some have opposed privatization on hypocritical grounds as there have been some corrupt deals, procedural lapses, under valuations, poor transaction design etc._

Nevertheless ideologically driven academics and intellectuals with the blessings of the opposing politicians base their arguments against privatization on the presumption that these state-owned enterprises are 'National Assets' and therefore, should not be offered to local or foreign private sector. But the history of state ownership of business enterprises in Sri Lanka goes back to the days of colonial rulers much before the 'so-called' socialist or nationalist ideologies supporting state ownership took root in the country. Therefore, it appears that modern parody of patriotism inadvertently defend the 'socialist actions' introduced by the colonialists. Other than the colonialism induced state-owned business enterprises, there are a large number of commercial ventures which were robbed in the name of socialism, but in practice sometimes it was for political victimization. From the mid-1950's several privately owned businesses were 'nationalized' including mass transportation, insurance, petroleum distribution, etc., creating an anti-private initiative environment except for selected crony national capitalists. During the period of 1970-77, an array of nationalization of private business enterprises (small, medium to relatively large) were introduced under the declared objective of driving Sri Lanka to socialism. At the end of this period this 'robbed property' included even an insignificant Biriyani Kade, Buhari Hotel. Of course, now giving them back to the private sector which created these enterprises to begin with is also argued as giving away of national assets. In the most recent assets that were forcibly taken from the original private owners are Waters Edge, Sri Lanka Insurance and Lanka Hospitals.

Other than nationalized business enterprises, there are also a set of projects created through foreign financing — among them are the Hambantota Port, Mattala International Airport and the Norchcholai Coal Power Plant. Many of the ideologues and opportunistic politicians who once deplored some of these ventures as white elephants are today debating for protection of these 'national assets'. Privatization of Norochcholai coal power plant and work on a power purchase agreement similar to AES Kelanitissa Power Station and other private power supply agreements will certainly be beneficial to CEB and the country, provided proper power purchase agreements are worked out based on past experience and with a legitimate regulatory framework put in place without government interference. The privatization of these enterprises will attract not only much needed investment, both foreign and local, but also enhance the efficiency of management, introduce cost efficient procurement systems, eliminate corruption and, in the final analysis will provide Sri Lankan consumers better choices. This process will increase the overall efficiency and competitiveness of the economy. The best example in this regard is the privatization of Sri Lanka Telecom inducing foreign capital, management and technology. The entire mobile telephone sector (except Mobitel) is currently owned and managed by foreign capital which has become a blessing to the successive government and customers. The sector contributes handsomely to the government revenues. However, we emphasize that bad experiences of certain privatizations should not be repeated as in the case of plantations, sugar, transport etc. In order to prevent corruption, malpractices or simply policy mistakes, an independent privatization task force with eminent professionals must be set up to undertake a fast track privatization.

**Conclusion**

Sri Lanka is currently facing an unprecedented challenge of rejuvenating the economy while maintaining measures for fiscal consolidation and stabilization of the economy and repayment of the foreign and local debts. In these efforts of privatization of a few enterprises, attracting much needed non-debt creating foreign capital is a necessary requisite. However, it is not a sufficient condition to maintain Sri Lanka at a higher growth trajectory. In order to ensure that the country maintains a solid and stable growth, privatization of state-owned business enterprises is a necessary condition, but may not be a means to an end. Prudent economic policies, consistency in maintaining such policies, uplifting our position in the World Bank Doing Business Index as well as further improvement of infrastructure has to be vigorously pursued in the medium term. Privatization devoid of these economic reforms and without day to day prudent economic management will not result in desired outcome.