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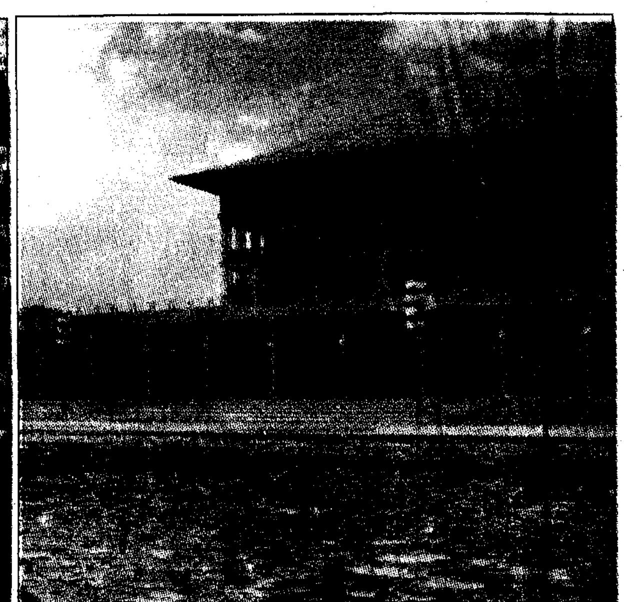
World Bank Global Economic Prospects 2011:

SL: Loose monetary policy, tight fiscal policy to contain inflation

- World Bank 'deeply concerned' about food prices, though 'not excessively alarmed'



A senior World Bank official said loose monetary policy and tight fiscal policy in Sri Lanka would fuel growth without putting pressure on inflation, while rising inflation is a major risk facing the South Asian region it belongs to.

"In general, it is often good for a country to loosen monetary policy while fiscal policy is tightened so as to manage inflation because aggregate demand can be sustained," World Bank Manager of Global Macroeconomics Andrew Burns told journalists via video linkup yesterday (14). Burns was speaking in Paris introducing the bank's Global Economic Prospects 2011.

Ms. Susan Razzaz, Senior Country Economist, World Bank Sri Lanka office said the bank was happy with the progress the government was making in fiscal consolidation. "Loose fiscal policy can make it difficult to maintain macroeconomic stability but we are happy with the progress Sri Lanka has made," she said.

On Tuesday (11), the Central Bank loosened monetary policy rates further on the grounds that tight fiscal policy was creating space to increase private sector credit without pressurising inflation, which is estimated to remain at single digit levels for the rest of the year.

Loose fiscal discipline in Sri Lanka has been the bane of macroeconomic stability in Sri Lanka with government contently and persistently overshooting budget deficit targets each year. Bridging higher budget deficits require more borrowings. Inflation and interest rates are under pressure and credit to the private sector, so vital for growth, is crowded out in the process.

With the conflict ending in 2009, Sri Lanka's macroeconomic fundamentals began to improve and inflation and interest rates were falling. In January 2010, the Central Bank cautioned that reckless government spending could threaten the low inflation and interest rate regime.

In 2009, the budget deficit ballooned to 9.9 percent of GDP, overshooting significantly from a 7 percent target. But the government is committed to containing the deficit, estimated to reach 8 percent for 2010 and reducing each year to reach 5.2 percent by 2012, which is also part of its commitments to the International Monetary Fund (IMF) in an ongoing US$ 2.6 billion standby facility arrangement.

The government deficit for ten months ending October 2010 has contracted by 2 percent to Rs. 376.8 billion from the previous year's Rs. 384.5 billion, latest Central Bank data showed.

Total revenue grew 12.60 percent to Rs. 671.9 billion from Rs. 596.7 billion a year ago, while total expenditure grew by 6.87 percent to Rs. 1,048.7 billion from Rs. 981.2 billion.

Tax revenue grew by 14.66 percent to Rs. 580.3 billion during the ten month period from Rs. 506.1 billion the previous year. Non tax revenue increased by 14.77 percent to Rs. 80 billion while grants declined by 44.76 percent to Rs. 11.6 billion. Total revenue and grants are estimated to reach Rs. 828.3 billion for 2010 and Rs. 986.1 billion in 2011.

Recurrent expenditure during the ten month period grew 3.07 percent to Rs. 787.4 billion from Rs. 763.9 billion a year ago while capital expenditure increased by 20.24 percent to Rs. 261.3 billion from Rs. 217.3 billion a year ago. Total expenditure is estimated to reach Rs. 1,275 billion this year and Rs. 1,419.9 billion in 2011.

Concluded a review mission in December, the IMF said the government had made significant fiscal reforms, but a lot more could be done.

While the Central Bank remains confident that inflation would remain around 4 to 6 percent this year on expected bumper harvests, inflation is a major concern in the global economy especially in South Asia.

"We are deeply concerned about rising (global) food prices, but not excessively alarmed because they are some way off from the peak levels reached in 2008," Burns said.

He said many of the food prices were quoted in dollars, which has depreciated, overstating prices.

"But globally, it is around 11 percent of the food produce that is being traded and many countries depend on domestic supplies. The problem is when domestic prices begin to mirror international prices and we are concerned about this," Burns said.

When food prices soared in 2008, around 100 million people were thrown in to poverty. Even today, a sixth of the World's population goes hungry every day.

In 2010, food contributed 72 percent to the rise of the official inflation index, the Colombo Consumers' Price Index, which ended the year at 6.9 percent higher than a year ago.

The World Bank's Global Economic Prospects 2011 says: " A major domestic challenge facing policy makers in the (South Asian) region is bringing inflation back down to the low levels observed in the pre-boom period, when regional inflation averaged 3.3 percent from 2000 to 2003 (Note- Sri Lanka's inflation averaged near 12 percent for the past thirty years). This challenge is complicated by the fact inflation has risen more or less steadily since 2000, contributing to rising inflation expectations, and because the process of (fiscal) deficit reduction poses real political challenges."

According to the World Bank South Asia's economy is set to grow at 8.7 percent in 2010, 7.7 percent in 2011 and 8.1 percent in 2012 but is the region with the highest fiscal deficits compared to other developing regions.

The Word Bank says tightening fiscal policy would be a challenge given the need to invest in infrastructure and social development.

However, according to the Treasury, in Sri Lanka all public investments including infrastructure is expected to remain constant, while revenue improves and recurrent expenditure controlled so that fiscal consolidation becomes possible leading to private sector led growth.