Macro economic problems of sri lanka and maldives

Introduction

Human needs and wants can be fulfilled through production of goods and services. Production can take place with the help of factors of production, which are inputs into the production, such as land, labor and capital. So production and distribution of goods and services, in order to fulfill human needs and wants directly and indirectly, is known as economy. According to Barro (2008), economy is divided into micro economic environment and macroeconomic environment. Micro economy is about economic behavior of specific individual, firms and the distribution of production among individual industries. Macro economy is mostly focused on total production, productivity, rate of employment, consumer prices, incomes of households and net import and export of a country.

In this project we will focus mainly on macro economic problems such as inflation, income, unemployment, etc and trends over ten years of economic growth experienced by Sri Lanka and Maldives. And moreover the policies used by government of both countries throughout these ten years to sustain their economic growth at a favorable level. Economic growth shows the changes in real gross domestic product over time.

The business Cycle

Constant economic growth is not experienced by any country. For each and every country, if we observe the path of economic activity, it can be seen that there are deviation or fluctuations. At times these fluctuations will lead the economy into a more favourable position while during other times it could lead to a more devastating situation. These fluctuations in the economy are known as business cycle, and consist of periods of contraction, trough, expansion and peak. The fluctuations in the economy are usually measured in real GDP and other macroeconomic variables (Delong & Olney, 2006).

Source: www. imf. org

Figure – Business Cycle

Diagram 1 above shows the business cycle for Maldives and Sri Lanka for the years starting from 1998 to 2008 measured in GDP at constant prices. As can be seen in diagram 1, both the economies of Maldives and Sri Lanka were experiencing a period of contraction from the years 1998 to 2001. After reaching to its lowest in 2001, the economy of both nations started to recover and was flourishing until the natural disaster, tsunami, left a huge impact on the economy of Maldives. However with the aid of other nations and the govt. economic policies, led to a record high economic growth rate. The economies of both countries again are facing a period of contraction from 2006 onward. This may be due the downturn in the world economy.

These stages of economic downturn and prosperity shown in the business cycle are explained in more detail below.

2. 1 Contraction & Trough

Contraction starts once the economy reaches its peak and further progress becomes difficult. When the economy reaches to its peak, economic growth starts to slowdown, as there will shortages in the economic resources (Dornbusch, et al. 2008) The increasing prices, wages and interest rates would eventually halt the demand for the output and reduce the level of sales. The reduction in sales means that firms will now be holding excess supply and will reduce production and will focus more on selling their excess output. The decline in production will result in fewer amounts of resources being required by the producers. Since the producers now have a pile up inventory they will reduce purchases from suppliers. As the production of output reduces, firms will no longer require the service of some of their employees. Firms start to lay off some of their employees, starting the fear of unemployment among the labor force (Blanchard , 2009). This fear for a hardship for the future will encourage saving. The reduction in consumer spending will lead to lower profits or even losses for the businesses. Some businesses will even go bankrupt discouraging further investments. In the contraction period the national output starts to decrease as well as prices and incomes and unemployment begins to increase(Delong & Olney, 2006).

The contraction stage for both countries is in the same period as per diagram 1. The economies are experiencing contractions from 1998 – 2001 and 2006 – 2009.

Trough

Trough is the lowest point of the contraction where the economy takes the turn. At this point countries would have unemployment rate at its highest, inflation will be low and the national output will also be at its lowest. There will be unused capacity within the economy although investments will be less due to high uncertainty towards the economy (Chamberlin & Yueh, 2006).

2. 1. 1 Maldives

During the past ten years, Maldives had experience two periods of economic contractions. These were during the periods of 1998 – 2001 and 2006 – 2008.

Figure For the contraction in Maldivian economy from 2006 to 2008 the annual percent change in real GDP had decreased from 17. 98 to 5. 84(Figure 1). This was mainly due to the adverse effects on tourism during this period because of the world financial and economic downturn. The fishing industry, the other major contributor to the Maldivian national output, had also declined during this period as the oil price had risen during these years.

The rate of inflation was on the rise mainly because of the increase in import prices, oil prices and rise in wages of the public sector as well as the large increase in government expenditure. The rate of unemployment rate is not known for all the years due to lack of data, however, for 2006 the unemployment rate stood at 7. 9 percent.

2. 1. 2 Sri Lanka

Sri Lanka continued on an economic expansion path in 2006 showing a record of 7. 4 % which was the highest since 1978. This growth arose mainly from the service sector which grew to 8. 3 % during the year and this contributed the highest at 62. 6 %. In Contrast the growth rate in 2007 and 2008 declined compared to 2006 which was recorded at 6. 8 % and 6 %respectively. Growth rate in agricultural sector (5. 7%) in 2007 was moderate due to drop in production of major crops like tea and paddy, but performed well in the first half of year 2008. Industrial sector maintained a growth over 6 % till first nine months in 2008 but declined to 5. 9 % in the end. This was due to global slowdown.

Unemployment rate dropped substantially to 6. 5 % during 2006 and continued its declining trend and dropped to the lowest rate of 5. 2 % in 2008. This was mainly due to increased employment in the agriculture and construction sectors and increased in self employment.

In 2006, during the early years Sri Lanka experienced a decelerating trend in inflation, which was mainly due to high monetary expansion as well as high government expenditure and borrowings. In 2007, CPI moved in an upward trend increasing to 15. 8 %. This was due to terrorist disturbance in the paddy producing areas, bad weather conditions and high demand for rice due to high price in substitutes, and also high price of domestic agricultural commodities. Also due to rise in global oil and gas prices adjustment to some commodities were needed. Also, shortage in global supply and increased in demand in international commodity market caused to raise the price of major imported food commodities.

Inflation reached to its peak in mid of 2008 to 28. 8 % and declined significantly to 14. 4 %, mainly due to the continued tight monetary policy measures by the Central Bank and the sharp declined in the international commodity prices . The increased in CPI was also fuelled by the low supply of domestic agriculture products and also high price in the international market of some imports. Meanwhile, increased in electricity charges which caused to raise price levels was also attributed in increased in inflation.

2. 2 Recovery / Expansion & Peak

Recovery phase of business cycle comes, if government makes good decisions and productive capital investments during the period of trough or recession. In the phase of recovery economy starts to get its position and gross domestic product starts to expand instead of getting worse. Effective physical and monetary policies by the government at the time of recovery would help the economy to gear up the economic activities and establish again until it reaches to peak. In other words it is also called as expansion period of economy. Expansion occurs after an economy reaches to its previous favorable position (Blanchard , 2009).

During the months of expansion it is the best time for investment and it is well-known golden time for stock market investors. When an economic expansion occurs stock goes up more than at any other time.

During an economic expansion, demand for the goods and services are increased as consumers feel certainty in the economy which leads to increase their spending. More spending in the economy encourages further economic expansion such as increasing productivity, improve standard of living, and reduce unemployment by creating lot of job opportunities in the economy (Dornbusch, et al, 2008).

When the economy reaches its peak, the output of the nation will be at its highest, investments, inflation and incomes will be high and unemployment will be at lowest. Firms will enjoy a higher profit in this period.

2. 2. 1 Maldives

The economic situation of Maldives was improving throughout the years from 2001 to 2006. During this economic prosperity the annual percent change in real GDP had increased from 3. 45 in 2001 to 17. 98 in 2006(Figure 1).

Figure The major contributors the Maldivian national output, the fisheries and tourism sector had prospered during this period (figure3). Although at the end of the year 2004 the nation was almost swept away by the tsunami, the destruction faced to the economy was eventually put on track with the help of foreign aid and government investments in rebuilding the infrastructure of the country, thus aiding the growing construction industry in Maldives.

The total government expenditure and revenue for this period shows just how much the economy was prospering (figure 4).

Figure – Annual percent change in Govt. Revenue and Expenditure

The changes in unemployment rate cannot be clearly seen due to lack of data; however the number of expatriate workers had vastly increased. Unemployment rate had increased from 2000 to 2006 from 2. 3 to 7. 9 percent.

Since, Maldives is heavily dependent on imports, any changes in the world economy has a huge impact on the domestic price level. Inflation rates largely reflect the world economic trend.

2. 2. 2 Sri Lanka

In the year 2001, global recession and low rain fall caused to face an economic slowdown throughout the year; agriculture (-3%), Industry (-2%), Services (-0. 5%) and Sri Lanka experienced a negative growth rate of 1. 4 percent for the first time after 1948. As a result of favorable international environment, peace process and sufficient monetary policy, the economy of Sri Lanka recovered and recorded growth rate of 4 percent in 2002 and it accelerated in 2003 to 5. 9%. Mainly growth was achieved through service sector. Due to the adverse shocks, increase in international oil prices, drought, floods and tsunami disaster at the end of 2004, annual growth had fallen to 5. 4 percent.

Shortage of supply in agricultural products cause inflation rate to push upward recording 14. 2 percent of average inflation in 2001. Tight demand management policies by central bank, increasing number of controlled prices and expansion of domestic production cause reduction of inflation rate to 9. 6% in 2002 and 6. 3% in 2003. Consequently, the factors used to stable the price level are related to supply side of the economy, drought and import price of key commodities generated cost-push inflation. And average inflation rate turn unfavorable to 7. 6% in 2004.

The slowdown in both economic growth and investment expansion during the year 2001 and 2002 resulted increase of unemployment rate marginally to 7. 8% and 9. 1% respectively. Economy recovery, mostly in service sector, and employment opportunities under the policy of new government, unemployment rate was declined in 2003 and 2004.

Increasing country's external reserve, expansion of external factors and recovery of export shows an overall surplus balance of BOP in 2001, 2002 and 2003, well below the target. In 2004 there is an adverse balance on BOP because of raising reserve money caused expansion of domestic assets and reduction of net foreign assets.

Macroeconomic Policies

Sustainable economic growth is achieved by utilizing the monetary and fiscal economic policies efficiently. Monetary policies are mainly focused on controlling the money supply within the economy through the use of instruments such as controlling interest rates, reserve requirements, exchange rates, etc. Fiscal policies are aimed at influencing the aggregate demand in the economy by using tools such as taxation and government spending (Delong & Olney, 2006).

3. 1 Maldives

To maintain stable economic growth, the central bank of Maldives, Maldives Monetary Authority (MMA) employs various monetary policies. One of those policies is to maintain a stable exchange rate to have price stability in the country. The instrument used to achieve this was to maintain a Minimum Requirement Reserve (MRR), MMA CDs, T-Bills, Repo Facility, Lombard facility and Rediscount facilities. These tools are used to control the money supply within the economy. When the economy moves into a contraction period these policies aim at increasing the money supply within the economy. For instance, when the economy faced a contraction in the aftermath of tsunami, MMA increased the money supply by selling T-Bills to finance the large investments of the government and the MMR was reduced thus, increasing the money supply in the economy. When the money supply increases and interest rates fall, the consumer spending increases increasing the demand for goods and services. However, in recent years, especially during 2008 and 2009, monetary policy instruments were mainly used to provide short credit facility to the government leading to rapid increase in money supply resulting with a high inflation and a shortage of foreign exchange.

3. 2 Sri Lanka

During the year 2001 Sri Lanka experienced a negative economic growth rate since 1948. To recover and achieve a high economic growth, Central bank started and continued to use fiscal consolidation process, increasing public investments, strengthening debt management and restructuring public enterprises. More over efforts were taken to reduce recurrent expenditures, setting up low interest rates hoping to reduce interest cost. Country’s total external reserve increased and stabilized the exchange rate enabling the central bank to purchase foreign exchange from the market. To improve domestic rupee liquidity central bank purchased foreign currency and shifted entire interest rate structure downward. In order to avoid cost push inflation, government increased the number of controlled price level. All these policies led to speed up economic growth of the country at the end of 2002. And to maintain this growth, government continued fiscal consolidation policies and tight monetary policy. And to gain a sufficient surplus balance on BOP some imports were controlled by imposing marginal requirements against letter of credit. In 2007 fiscal debt and public debt continue to improve despite the lower revenue collection during the year.

These were achieved by rising defense expenditure, domestic interest rates, tax and duties. Government was able to reduce deficit financing from domestic banking sources. Government opted to switch more external borrowings in response unpredictable and rising domestic market interest rates.

Conclusion

As we observe economic trends of these two countries, both countries had fluctuations on their economic growth. As two countries are developing countries, fluctuations on their economy are mainly related to world economy. Reflections of natural disasters are the second major factor that caused slowdowns in the economic growth of these countries. Terrorist attack on 11th September 2001 and Tsunami disaster caused economic downturns for both countries. During the periods of recession and contraction, the central banks used several policies to recover their economy. Even though central bank of Maldives uses only monetary policies to sustain their economy, government of Sri Lanka used both fiscal and monetary policies to retain their favorable economic position.

Appendices