The Pathfinder Economic Alert

A Stitch in Time Saves Nine
Facing the short-term economic challenges

The macroeconomic imbalances

Sri Lanka has achieved a growth rate of 8.3% last year and inflation fell to 4.9% year – on- year in December 2011. These are noteworthy achievements at a time when the global economic landscape has been hostile with a slowdown in the US and a crisis in Europe; key markets for Sri Lanka's exports and tourism. The Central Bank and the Treasury deserve credit for their role in the attainment of such positive growth and inflation outcomes in the context of a difficult global economic landscape. However, there are balance of payments pressures that have emerged which require an immediate policy response. The Pathfinder Foundation (PF) has issued two Economic Alerts (no's: 19 & 23) in recent weeks, drawing attention to the unsustainable trends in the country's external account. In our view, the need for early remedial action is so pressing that the subject merits yet another call for the authorities to initiate decisivemeasures to address the excess demand in the system. The difficult international economic environment will increasingly influence policy formulation in the period ahead. It will necessitate a re-thinking of the current policy stance.

In our view, the country is not confronted with a temporary cash flow problem. Instead, the combination of anovervalued exchange rate and low interest rates has led to an inevitable worsening of the trade balance. The sharp deterioration in the trade account has not been sufficiently off-set by non-debt-creating inflows (such as earnings from tourism and other services, remittances, foreign direct investment and portfolio flows into the sock market) to prevent a rapid running down of the country's reserves in the second half of 2011. The hostile external environment makes it highly unlikely that this worrying trend will be reversed without a strong policy response.

There is an urgent need for a balanced approach to macroeconomic management deploying all the instruments available to the authorities. These include the exchange rate, interest rates and fiscal measures. The PF has argued, in previous Economic Alertsthat experience from Latin America and elsewhere clearly demonstrates that an attempt to defend the exchange rate and keep interest rates down at a time when the trade deficit is increasing sharply invariably leads to a financial crisis.

It has been argued that the problem is temporary and that increased exports (19%); remittances (25%); FDI (100%)-[there is a tendency to confuse the value of projects signed with actual inflows, ignoring the lags and leads involved]and tourism (41%) would resolve the problem during 2012. This raises the question as to whether one can count on such a bullish performance at a time when Sri Lanka's key export markets (US & Europe) are experiencing very sluggish growth and investors have become extremely risk averse. In fact, risk appetite in international markets has declined to a point where a recent German bond sale generated negative yields i.e. investors were willing to pay Germany to lend to it in their search for a safe haven. In such a context, it would be extremely risky to count on "a business as usual" strategy to address the deterioration in the country's external account.

The scale of the problem

As pointed out in previous Economic Alerts, the trade deficit has declined from US $ 5.2 billion, in 2010 to US $ 7.7 billion as at end-October 2011. It is likely to have reached US $9 billion by the end of the year. It is particularly worrying that this dramatic decline in the trade account has taken place despite a robust export performance (27.7% growth), a sharp increase in remittances (25%) during the first nine months of 2011, as well as a doubling of FDI during the course of last year. As mentioned above, the combination of an over-valued exchange rate and low interest rates have triggered a rapid growth in private sector credit, which has fuelled a boom in imports.

The deterioration in the external account has led to substantial pressure on the Rupee and the authorities have expended over US$ 3 billion (SLR 350 billion) of the country's hard-earned reserves in defending the currency, since July 2011. This has been a major contributor to a worrying decline in reserves in the second half of 2011. Gross reserves have fallen from a peak of US $8.2 billion (end August 2011) to $ 6 billion (end November 2011). In addition, net reserves are clearly negative given the scale of external borrowings. This position is unsustainable.

It is noteworthy that Sri Lanka's defence of its currency is at odds with the response of its competitors in the Asian region; who have allowed their currencies to depreciate. The Indian Rupee, for instance, has depreciated by 16%. Sri Lanka has, therefore, not only run down valuable reserves but also lost competitiveness. This means that the capacity to earn (rather than borrow) its way out of the problem has been curtailed. The large-scale use of reserves to defend the currency raises questions about the robustness of the regulations that govern theiruse. It is important that there are clear and well-understood regulations and processes associated with the deployment of the country's reserves.

The policy response so far

The one-off three percent devaluation of the currency in the last budget speech (21 November) has proved to be inadequate. Approximately US$ 1 billion has been spent to defend the Rupee since then. The one-off nature of this measure seems to indicate that it was motivated by the need to contain the budget deficit to a level that was consistent with the government's fiscal consolidation programme and the conditionality built into the IMF stand-by loan. It did not mark a shift to a more flexible exchange rate policy.

On monetary policy, thepolicy rates have remained unchanged. However, there has been some upward pressure on both borrowing and deposit rates as liquidity in the system has become more constrained. As in the case of the pressure on the Rupee, this reflects the power of market forces.

While the authorities have defended the exchange rate and left policy interest rates unchanged, they have sought to address the immediate cash flow problem by resorting to further borrowing. The limit on foreign holdings of Treasury Bills and bonds has been increased from 10% to 12.5 %(there has been negligible take-up so far) and commercial banks are being encouraged to take advantage of their strong balance sheets and low leverage to borrow abroad. The latter measure requires great caution. At a time when the currency is under pressure, any foreign borrowing means taking on significant foreign exchange risks onto the banks' books. It is also worth recalling that the Asian crisis was not due to the sovereign debt. It stemmed from the banking system. The answer to the current disequilibrium in the external account is clearly not more borrowing.

The policy challenge

The challenge is to formulate a mix of policies that increases the exports of goods and services as well as non-debt creating inflows (remittances, FDI and portfolio flows). In a previous Economic Alert,PF set out the pros and cons of using different macroeconomic policy instruments to stabilize the economy by reducing excess demand in the system. It is important, at this point, to have a strongly pragmatic, problem-solving focus. Consideration should be given to all macro-economic instruments to develop the most growth and employment – friendly trajectory of economic adjustment.

A way forward

There arestrong indications that the current macroeconomic policy framework is unsustainable, as evidenced by the large-scale haemorrhaging of reserves and the upward pressure on interest rates through powerful market forces. It is not possible to defy these forces indefinitely without experiencing a severe crisis. Experience from other countries demonstrates that the social and political costs of such crises are extremely damaging. It is the poor and vulnerable who suffer most when austerity measures are forced on the population. The pain tends to be so severe that the aftermath of such crises inevitably has major political ramifications. There is invariably regime change.

There is still time for a decisive policy response. The PF calls for a judicious mix of currency depreciation and interest rate increases, which stabilize the economy while protecting growth and employment and containing the pain experienced by the poor and vulnerable. Some pain is unavoidable. However, inaction, at this point, will eventually result in far more pain as “shock treatment” is administered rather than the more orderly adjustment that is still possible. However, the window of opportunity is closing fast.

Good economics is good politics

Sri Lanka, has, so far, not been compelled to learn that good economics is good politics. This is because the country has been able to live beyond its means over the last 30 years through the generous support of the donor community. As an early reformer (1977) with a pluralistic polity, this country benefited from the traditional donors’ strong interest in demonstrating that liberal economics and politics generate positive development outcomes. However, attaining lower-middle-income status has brought about a qualitative change. It has been a game changer because Sri Lana is no longer eligible for concessional financing. The country is now exposed to the whims and fancies of international capital markets which have become extremely risk averse in the current global environment.

In such a context, negotiation of a successor to the current IMF arrangement, which is about to end, assumes greater significance. The lack of comfort associated with the absence of an IMF arrangement will greatly increase the country’s vulnerability by dampening foreign investor confidence at this time. However, the IMF, or any other bank/financial institution, will not support an individual, an enterprise or a country pursuing “bad economics”. The IMF disburses money that is raised from tax-payers from around the world, including Sri Lankans. It does so with no collateral. Instead, it imposes conditions, which it believes are necessary to ensure the country will be creditworthy enough to repay its tax-payer financed loans.

The current policy stance is, above all, not good for the country. It is also unlikely to facilitate the negotiation of an arrangement of the IMF. The PF does not advocate policy development being determined to please any external agency. The PF’s overriding priority is to advocate on behalf of the interests of millions Sri Lankans. The imbalance in the country’s external account should be addressed decisively for the benefit of the people of this country.

Losers from and an Over Valued Exchange Rate: Migrant workers, farmers and other local producers.

An over-valued exchange rate subsidises foreign producers at the expense of hundreds of thousands of local ones. Small farmers and businesses, as well as local corporates, are severely disadvantaged in their efforts to compete against imports. Exporters are also made less competitive.The cost in terms of income and employment foregone is considerable. The size of the budget deficit and the level of public debt, combined with the country's exposure to international capital markets, no longer make it feasible to provide compensating concessions and subsidiesto domestic producers, without entering a Greece-type crisis. The current exchange rate subsidises consumers at the expense of producers. This is not sustainable and it is certainly not the route to improving the prosperity of the people of Sri Lanka.In addition, an over-valued exchange rate deprives migrant workers, including housemaids and unskilled workers as well as their families, of the full rupee value of their remittances. These people, many of whom are less affluent, provide crucial support for the economy. Yet they are being short-changed.

Strengthening the growth framework

The urgent need is for measures that make us live within our means. However, it is important that these are supplemented with reforms that strengthen the growth framework. Arguably, the most important priority, in this respect, is improving the investment climate for both domestic and foreign investors. The essence of development comes down to improving productivity through increasing the quantity and quality of investment. Sustained non-inflationary growth in the incomes of the people cannot be achieved without this. Previous Economic Alerts have dealt extensively with the ways and means of improving the investment climate. The adverse macroeconomic trends,and the remedial action that is inevitable, render it even more important to accelerate the necessary reforms for strengthening the growth framework.

Conclusion

In concluding, the PF would like to reiterate a quote from the chief architect of China's reforms Deng Xiaoping said at the Third Plenary Session of the 11th Central Committee of the Chinese Communist Party (CPC) in 1978 that ***"If a party, a country or a nation does everything by sticking to dogmas, follows an ossified way of thinking and is prevailed over by superstition, then it can never move forward, its hope of life will die, and either the party or the country will be doomed…"***This valuable message should guide policy-making at this difficult juncture.

This is the Twenty - Fourth in the series of Economic Alert articles published by the Pathfinder Foundation. Readers' comments are welcome at pm@pathfinderfoundation.org