The Pathfinder Economic Alert

Commendable Start: Now for the Finish

Avoiding a Crisis

The Pathfinder Foundation (PF) commends the Treasury and Central Bank for the policy measures introduced recently. This has prevented an external payments crisis. Without remedial action, the country would not have been able to meet its debt obligations and/or finance essential imports within a short period of time. There is considerable evidence from around the world that payments crises have a devastating impact on living standards and results in political instability. The poor and vulnerable bear a disproportionate share of the pain. The actions taken are, therefore, necessary and unavoidable. The PF has called for the use of the full range of macroeconomic instruments to tackle the imbalance in the external account. It, therefore, welcomes the measures that have been taken by the authorities. They are courageous and have improved the prospects of stabilizing the economy and securing a more favourable medium-term outlook.

Lower-middle-income country status requires Sri Lanka to operate within a new paradigm. It is no longer eligible to be bailed out with concessional money. In this new situation, a higher premium has to be attached to sound macroeconomic management. The costs of policy mistakes have increased in terms of the pain that they impose on the people. It is important to recognize that an inappropriate mix of policies and/or a failure to effect timely action results in more painful and disruptive measures later.

In the short term, the country will have to take the medicine and live through a difficult period due both to adverse trends in the global economy, as well as the imbalances induced by domestic policies. However, the medium-term prospects of the country remain favourable, provided effective action is maintained to stabilize the economy and structural reforms are introduced to increase the competitiveness of the economy, particularly the export and import competing sectors.

Short-Term Economic Stabilization

As mentioned in previous Economic Alerts, the combination of an overvalued exchange rate and the reduction in interest rates led inevitably to a sharp rise in credit which, in turn, fuelled a rapid and an unsustainable increase in the trade deficit. The trade deficit increased from US$5.2 billion at end-2010 to about US$10 billion by end 2011, despite impressive export growth. The deterioration in the trade and current accounts was not compensated for by the increases recorded in remittances, tourism and FDI. Access to other borrowed and non-borrowed capital flows have also become more constrained due to increased risk aversion in global markets. This resulted in pressure on the Rupee and the expenditure of US$ 3.6 billion of the country's reserves (much of it borrowed) in defending the currency. The outcomes have been: (1) a loss of a quarter of the country's gross reserves; and (2) the Government's obligations in relation to Eurobonds, foreign holdings of Treasury Bills and the IMF stand-by loans now exceeding its reserves. These trends have resulted in a liquidity crunch that has resulted in the Government: (1) seeking to borrow abroad to meet the oil bills; and (2) encouraging commercial banks to raise tier-two capital through foreign borrowing.

The other major problem that has required attention is the performance of some state-owned enterprises, particularly the CPC and CEB. These losses are due, in significant measure, to the non-passing through of the increase in international oil prices and other operational inefficiencies. The CPC and CEB losses are extremely large and unsustainable. The magnitude of their losses is such that they are undermining the balance sheets of the state banks (Bank of Ceylon and People's Bank). These losses are ultimately a call on the Consolidated Fund. They would have to be settled either directly by the Treasury or else they would have to be eventually addressed indirectly by recapitalizing the state banks. Hence failure to address these losses would undermine the Government's fiscal consolidation programme. The decisive action taken by the authorities to adjust the prices of petroleum products and electricity is, therefore, necessary and unavoidable.

The Policy Response

It is against this landscape of an unsustainable trade deficit, destabilizing losses of state- owned-enterprises (particularly the CPC and CEB) and fragile fiscal outlook that the authorities have undertaken politically difficult but essential reforms. Having to deal with these problems concurrently has called for courage to implement the necessary austerity measures.

The Central Bank has adopted a more flexible exchange rate policy. The Monetary Policy Committee has raised the Repurchase and Reverse Repurchase Rates by 50 points. Credit growth has been limited to 18 percent (23 per cent where banks' additional lending is based on financing raised abroad).

In addition, the increases in the international prices of petroleum products have been passed through to customers. The increases in the prices of petrol (8%), diesel (37%), kerosene (49%) and furnace oil (77%) have been substantial by historical standards. There has also been a significant increase in electricity tariffs. These adjustments are unavoidable, given the magnitude of the losses incurred by the CPC and CEB.

The exchange rate depreciation and increase in fuel prices is also exerting upward pressure on other administered prices, such as bus (20%) and rail transport, milk foods, bread, cement and fertilizer.

It remains to be seen how much more has to be done by way of exchange rate depreciation, interest rate increases, adjustment to administered prices and fiscal measures to: (1) stabilize the country's external account; (2) address the large losses being incurred by State-Owned Enterprises (SOEs), particularly the CPC (Rs 100 billion) and CEB (Rs 40 billion); (3) and tackle the unsustainable imbalance between Government revenue and expenditure. The anticipated slowdown in growth will exert further pressure on revenue.

It is encouraging that the authorities, in responding to the potential crisis, seem to be moving from a more generalized scheme of subsidies for fuel and electricity to more targeted relief to specific sectors, such as fishing and public transport. This raises the question as to how best the country should provide a safety-net for the needy and those adversely affected by the costs of policy reforms. It has been argued that income transfers are a more effective means of providing social protection than subsidies which tend to be disproportionately captured by those who do not require them. However, the current Samurdhi programme provides income transfers to about 40 per cent of the population. This raises the question whether a lower-middle-income- country with a per capita income $2,800 and a poverty level of 8.9 per cent should have a social safety-net which covers such a large segment of the population. There seems to be a case for developing a better targeted safety-net which is able to provide greater protection for those who need it most.

Furthermore, as Sri Lanka becomes more exposed to the discipline of international markets and the rankings of rating agencies there is greater need for a well designed social protection programme to support people affected by the transitional costs of adjustment. The existing model, which is based on subsidizing essential items such as fuel, power and fertilizer, becomes increasingly unsustainable in a context where weakness in macroeconomic fundamentals will be unforgivingly punished by the markets. The shift to sectoral subsidies is a step in the right direction.

Impact of Policy Reforms

Investment, growth and employment are likely to be reduced in the short-term. Higher interest rates will increase the cost of funds and dampen growth and employment impulses in the economy through their impact on investment. Price increases will also reinforce the downward pressure on growth through a decline in domestic demand. In the short run, the exchange rate depreciation will also have a negative impact on growth/employment through its J-Curve effect. This implies that output will initially decline as a result of a reduction in economic activity due to the rise in the costs of imports. In due course, a more competitive exchange rate will provide a boost to export growth, provided macroeconomic stabilization is achieved and a conducive investment climate prevails. For instance, Vietnam has depreciated its currency by 30 per cent, since 2008, in response to its large current account deficit. However, Vietnam’s trade deficit started to narrow only recently; almost one year after the last currency depreciation of 6 per cent. Sri Lanka will not be able to sustain a higher growth trajectory, without fundamentally altering the anti-export bias it has usually had in its policy-mix over several decades. This is an important lesson to be learnt from the experiences of the successful countries in East/South East Asia.

One should also note that in the short-run the higher finance costs and the rise in import prices will exert considerable pressure on the viability of some businesses. The challenge for the private sector is to meet the short-term challenges through efficiency/productivity improvements and position itself to take advantage of the more propitious medium-term prospects. On a positive note, the increase in the Rupee value of remittances, as a result of the currency depreciation, will serve to boost domestic demand.

The reforms that have been introduced will also have an impact on **inflation**. The currency depreciation and the adjustment to administered prices (particularly on items with a relatively heavy weight in the consumption basket) will inevitably increase the cost of living. This has become necessary to reduce domestic absorption by pushing down aggregate demand in the economy. In plain language, this means that policies have to be introduced to ensure the country lives within its means. The need for corrective measures is even greater now that the headroom for borrowing, both domestically and abroad, has been reduced and the country is more exposed to the discipline imposed by international markets.

In assessing the impact of reform, it is important to highlight the implications of not implementing them. “Business as usual” would have led to a payments crisis with devastating impacts on growth, employment and wages/incomes along the lines experienced in Latin America in the 80’s and 90’s, and Greece today. The measures introduced, though painful, have gone a significant way towards averting a crisis and creating the conditions for macroeconomic stability and a stronger medium-term growth framework for the economy.

The authorities are presented with difficult choices regarding the trajectory of adjustment. They can go for a big-bang approach or else undertake more gradual adjustment. The former option involves greater pain in the short-run but stabilizes the economy and restores a more favourable framework for investment/growth/employment more quickly. The political risks involved in such an approach are greater. A more gradual approach would involve less pain but the country will experience a longer period of lower investment/growth/employment.

It must also be recognized that the increase in prices are inevitably resulting in wage and income pressures. However, as the country needs to tighten its belt and live within its means, any wage/ income increases should not undermine the potential gains of the reforms; thereby derailing the overall stabilization programme.

Medium-Term Prospects

Sri Lanka's medium-term prospects continue to be favourable. As previous Economic Alerts have pointed out, there are no major "drags" on the prospects for the economy (eg civil conflict, terms of trade decline and demographic pressure) and economic geography is extremely favourable (Sri Lanka is located in the dynamic Asian region and in close proximity to the fast-growing Indian market). The challenge is to meet the short-term stabilization challenges, particularly the unsustainable trade deficit; the destabilizing losses of SOE's, such as the CEB and CPC; and the imbalance between public revenue and expenditure, while strengthening the growth framework of the economy. This can be achieved through successful short-term stabilization policies and continued efforts to improve the investment climate. Concurrently with the macroeconomic policy reform, priority also needs to be attached to improving the predictability and consistency of policy-making from the perspective of investors; implementing structural reforms to strengthen factor (land, labour and capital) as well as product markets; aligning education and skills development with the country's comparative advantage; supporting innovation and R&D; continuing efforts to improve Sri Lanka's rankings on investment-related global indices; and taking advantage of the country's favourable economic geography. Priority should also be given to PPPs as a means of maintaining the momentum of the Government's infrastructure development programme and achieving the investment levels required to attain the national growth target of 8 per cent.

Conclusion

It is encouraging that the Government has embarked upon courageous action to address problems arising both from developments in the global economy and misaligned domestic policies. It needs to be supported in its efforts to get through this painful period. Decisive action would minimize the time involved. However, the pain experienced will be mitigated by the increase in the Rupee value of remittances as well as a successful Maha harvest.

It is important to stress that a strong and high profile commitment to austerity throughout the system would greatly improve the climate for mobilizing the public support necessary for implementing painful but necessary reforms.

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