Pathfinder Foundation Economic Alert

Reviving Growth –Let the political leaders and policy makers be serious

The Challenge- from borrowed to earned reserves and beyond

The challenge for Sri Lanka is to develop a policy framework that would stabilize the economy; boost investment and growth; and earn rather than borrow reserves. All shades of political opinion are now focused on these issues. The Pathfinder Foundation (PF) is, therefore, raising a number of issues in this piece to stimulate thinking and debate.

By 4Q 2011, it had become apparent that the country was headed for a serious balance of payment crisis. This may be attributed to adverse external developments and a misaligned macroeconomic policy framework involving an overvalued exchange rate, expansionary monetary policy and an unsustainable fiscal deficit (particularly when the 2% of GDP losses of SOE's are included in the government balance sheet).

Growth was buoyant (8% in 2010 and 8.3% in 2011). However, it had been driven by a policy framework that led to declines in tradables and exports as a percentage of GDP. This was clearly unsustainable, particularly in a country with a market of only 21 million people. The pressure that emerged in the balance of payments was, therefore, inevitable. The exchange rate came under pressure and $3.6 billion was expended in an effort to defend it. Reserves declined from $8 billion in August 2011 to $5.5 billion in January of this year.

In Feb/March 2012, the authorities implemented a package of very bold stabilization measures to address the rapidly deteriorating balance of payments and external reserve level. The exchange rate was depreciated; interest rates were increased; a credit ceiling was imposed; tariffs were adjusted; and administered prices were shifted upwards. Subsequently, aggregate demand has also been reduced by cuts in planned public expenditure, particularly investment spending.

Can We Relax? Reduce Interest Rates? Remove Credit Ceilings? No way

The tightening of policies combined with the adverse external environment, have inevitably restricted domestic investment and growth, which has slowed down sharply. It is now expected

to decline to 6.5% for this year (about 5.5% in 4Q 2012) as against the government's target of 8%. This raises the question whether the country's external position, monetary conditions and fiscal outlook have improved sufficiently to relax policies in order to create a more growth-friendly macroeconomic framework.

Sri Lanka's gross external reserves have increased from $5.5 billion in January 2012 to $7.1 billion as of August 2012. On the face of it, this seems to make the case for a loosening of macroeconomic policies to boost investment and growth. However, recent trends in the balance of payments, in a context of continuing sluggishness in key export markets, particularly the EU, combined with inflation at near double digit levels (with monetary aggregates still at elevated levels), and pressure on the fiscal deficit target, argue for a continuation of the current restrictive policy stance.

The stabilization measures have resulted in a decline in import growth to 0.6% (in USD terms) during the period January to July 2012. In July of this year, imports declined by 24.9%, indicating that there is now a sharp slowdown in imports as the stabilization policies take hold. However, the containment of imports has been constrained by a sharp increase in the bill for petroleum products. It is expected to rise to $6 billion (an increase of 33%) during 2012. This may be attributed to a greater reliance on thermal generation following the drought; increasing costs arising from the impact of the sanctions imposed on Iran (this has led to an increase in imports of more expensive refined products); price movements in international oil markets (including speculative activity); and recent closure of the Sapugaskanda refinery.

The benefits of containing the import bill have been offset by a 4.6% (in USD terms) decline in exports during the period January – July 2012. This may be attributed mainly to weakness in the external markets, especially for apparel, and drought-affected supply disruption in the case of agricultural products.

The slowdown in both imports and exports reflects the sharp decline in the growth momentum in the economy. These trends have resulted in the trade deficit worsening by 6.3% (to $6.3 billion) during January – August 2012. Imports are expected to slow down further in the last five months of this year as the credit ceiling takes effect and public expenditure is re-phased. Export growth is also likely to be subdued due to sluggish external demand. As a result, the trade deficit for 2012 is projected to be $10 billion - $11 billion not significantly different from the $10 billion recorded last year, despite the stabilization measures implemented early this year.

While the prognosis for the trade account remains negative, there have been some positive developments in terms of earnings from tourism and non-debt creating inflows. Tourism receipts have increased by 23% in January to August 2012 and are expected to amount to about $1billion for the year. In addition, remittances are projected to reach $6 billion (an increase of 20%) this year. In addition, net portfolio flows to the stock market currently amount to about $230 million,

after recording negative flows last year. As against this, FDI flows have amounted to a disappointing $452 million, in January to June 2012, against an annual target of $2 billion.

Remittances and tourism receipts, despite significant increases, will not offset the trade deficit of $ 10 billion - $11 billion. As a result, the current account of the balance of payments will record a reduced but still unhealthy deficit. Furthermore, the combination of positive portfolio flows and disappointing FDI figures will not be sufficient to set off the current account deficit with non-debt creating flows, leaving a financing gap in the overall balance of payments. This will be a call on external reserves/additional borrowing. Though gross reserves have increased impressively (see above), the trend in the current account and non-debt creating capital flows confirm that this improvement has been through 'borrowed' rather 'earned' resources. The borrowings have included the $1 billion bond issue; the last tranche of the IMF standby; and foreign purchases of treasury bills and bonds. Long-term loans to the government amounted to $2.3 billion (Jan – August 2012); and net inflows to treasury bills and bonds recorded $821 million. It is important to note, that net reserves are negative and gross reserves amount to 85% of Sri Lanka's total external obligations over the next 12 months (100% is considered a comfortable level). In assessing these figures, it is important to recognize that they include long-term borrowing.

Sri Lanka is nowhere near a financial crisis. However, the external, fiscal and monetary conditions are still not in place to relax macroeconomic policies.

Debt Burden- Why not Move from Accumulating to Reduction

This is reinforced by developments on the external debt front. The stock of public debt as a percentage of GDP has been declining. It is expected to fall to a little over 70% of GDP this year, compared to 78% in 2011. However, it is important to highlight that this favourable development masks some worrying underlying trends:

- The stock of foreign debt in total public debt has increased, thereby raising risks associated with the economy.
- The share of commercial debt in total public debt has also increased.
- Within that, external short-term debt has also increased.
- As a result, despite the decline in the stock of government debt as a percentage of GDP, the external debt-service ratio is heading in a troubling direction.

All this indicates that there is limited headroom for additional commercial borrowing from abroad to boost investment and growth.

In addition, the fact that the authorities have had to intervene in the currency and money markets is clearly an indication that the stabilization process is not as yet complete. As result, neither a

loosening of macroeconomic policies nor recourse to substantial foreign borrowing are prudent options for reviving growth.

A Way Ahead

The authorities will have to persist with the planned trajectory of fiscal consolidation, a realistic exchange rate and restrictive monetary policies. The continuation of the necessary stabilization measures will not create the conditions for reviving growth or earning sufficient external reserves. This serves to reinforce the case for a new wave of structural reforms that would not only revive growth on a sustained basis but also create the conditions for earning rather than borrowing reserves (i.e. expanding exports) to extend the capacity of the economy for expansion.

As emphasized in previous PF articles, this requires

1) A policy framework (particularly the exchange rate and trade policy) that reverses the decline in tradable and exports as a percentage of GDP and

2) Importantly an initiative to implement public private partnerships.

The Budget Speech this week offers an opportunity to reinforce fiscal consolidation and embark upon much – needed reforms which strengthen the framework for growth and export expansion.

This is the Thirty Ninth in the series of Economic Alert articles published by the Pathfinder Foundation. Readers' comments are welcome at www.pathfinderfoundation.org

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