The Pathfinder Economic Alert

Elevated Risks in the World Economy: What are the Implications for Sri Lanka?

Introduction.

Recent political developments in North Africa and the Middle East, and the destructive earthquake and Tsunami in Japan, have created major uncertainties related to oil prices and international trade, resulting in elevated risks for all countries. The impacts of these phenomena are global in reach and will, therefore, have ramifications for the Sri Lankan economy. There are several channels through which the effects are likely to be transmitted: oil prices; tea and rubber prices; remittances; capital flows; changes in the value of the Yen; and businesses dependent on Japanese imports. At the macro level, prices (inflation), the balance of payments and possibly the budget are likely to be affected.

Worst Case Scenario.

The worst case scenario would entail the unrest in North Africa and the Middle East spreading to major oil producers and important destinations for Sri Lankan migrant labour, as well as nuclear catastrophe in Japan. This scenario would have a severe impact on the global economy with negative fallout for Sri Lanka and the rest of the world. However, at this point, this scenario seems highly unlikely. In the short-term, the effects of these events are likely to be amplified by increased speculative activity that is inevitably associated with uncertainty and elevated risks. In the medium – term, the outcomes may well be more sanguine. It would be useful to examine each of the transmission channels identified above to assess how they might play out in the short and medium term.

Oil Prices.

Citi bank, in a recent research note, expects oil prices to increase from $90 to $105 in 2011. Of the countries that have experienced major political disruption, only Libya is a significant oil producer. However, it accounts for a very small proportion of total production. Tunisia, Egypt, Yemen and Bahrain are not oil exporters. Oil prices are unlikely to experience a very sharp spike (as in 2008), provided the unrest does not spread to major oil producers such as Saudi Arabia, Iran, Kuwait, UAE and Iraq. There are also other factors that mitigate against a sharp rise in oil prices. These include the capacity of OPEC members, particularly Saudi Arabia, to ramp up production very quickly (it is in Saudi Arabia's strategic interest not to push the US and Europe back into recession as a result of a spike in oil prices, given its large investments, particularly in the US). In addition, there will be a lull in demand for three/four months with the onset of spring in the northern hemisphere. Demand is unlikely to pick up again in this region until the summer driving season in the US. Hence, there are both supply and demand side factors which can assist in containing oil price increases in the short run.

The Citi bank research note argued that Sri Lanka would be able to absorb a $105 per barrel oil price without undermining macroeconomic stability due to buoyant tea and rubber prices; remittances; and capital inflows. The impact of the recent events on these will, therefore, be an important determinant of Sri Lanka's capacity to absorb any increases in oil prices. Of course, if the worst case scenario described above comes to pass, the ensuing global slowdown would result in a decline in oil prices.

In the long run, the potential nuclear disaster in Japan could lead to a re-thinking of the mix of energy sources around the world. There could well be greater reliance on thermal and renewable sources of power generation going forward. Sri Lanka's long term choices in terms of the mix of energy sources would need to take this into account.

Tea Prices.

Tea prices, which were at elevated levels, are being adversely affected by the developments in Egypt and Libya which are significant markets for Sri Lanka. The stabilization of the situation in Egypt is likely to mean that the disruption of exports to that market would be short-lived. The picture is much more uncertain in the case of Libya. While prices are likely to be volatile in the short-term, the medium-term outlook for tea prices will be determined by developments in the major markets such as Iran, Iraq, Egypt and the CIS region, as well as the reduction of India's exportable surplus with higher incomes and domestic consumption.

Rubber Prices.

Rubber prices are being influenced by two contrary pressures. On the one hand, higher oil prices are making rubber products more competitive vis a vis hydrocarbon based synthetics. Increased oil prices, combined with higher demand in large emerging market economies, particularly China, have resulted in record prices recently. On the other hand, the disruption to industrial production in Japan has reduced global demand and resulted in prices coming off these record levels. The medium-term outlook for rubber is likely to be determined by the combined effects of trends in oil prices and the capacity for bounce-back in Japan. As mentioned above, oil prices are likely to be higher in the short-term , without experiencing spikes similar to 2008. In the longer term, the rise of incomes and the change in consumption patterns in large emerging market economies are likely to exert upward pressure on fuel prices. With many more cars and white goods being sold in these countries, the demand for rubber is likely to be buoyant with a favourable impact on prices.

In the short run, however, the speed of stabilization in Japan is likely to be a key determinant of rubber prices. It is fortuitous that the worst effects of the earthquake and the Tsunami in Japan were centred on a relatively remote part of the country (unlike Kobe which was a key port). The plant and machinery associated with Japan’s industrial might remains largely intact. The disruption to production has been caused by the rolling power cuts. Japan is a very wealthy country and its people are stoic, disciplined, hardworking and resilient. One would, therefore, expect Japan to bounce-back rapidly, provided the threat of nuclear catastrophe is avoided. Though some volatility can be expected in the short-term, the prospects for rubber prices are likely to be favourable in the medium and long term, unless the worst case scenario, described above, materializes resulting in a severe global recession.

Remittances.

As in the case of tea, the countries, which are the most important destinations for Sri Lankan migrant labour (Saudi Arabia, Kuwait, Qatar and UAE), remain unaffected to date by the unrest in that region. There will be some impact on remittances in the short-run as a result of the disturbances in Libya. However, this will not be significant in terms of the balance of payments.

Over the medium to long term, the political pressures that have been unleashed are likely to compel all governments in the region to seek employment for their young and rapidly increasing populations. Saudi Arabia has significantly increased its welfare handouts to its indigenous population. However, this type of intervention may not be sufficient. There is likely to be pressure for gainful employment to keep the increasing number of young people occupied. The politics of handling the demographics of the region could compel countries, which currently receive many Sri Lankan and other migrant workers, to increase wages and absorb more locals into the labour force. This could have an impact on the rate of growth of remittances in the future.

Capital Flows.

Capital flows are unlikely to be affected by recent events, unless the worst case scenario materializes and there is a severe global slowdown. Japan has been our largest bi-lateral aid donor for many years. The country already faces a bleak fiscal position and the rapid ageing of the population is compounding the problem. The costs associated with recovery, rehabilitation and reconstruction, following the earthquake/Tsunami, will put further pressure on the country’s finances. These pressures could result in cuts in the aid budget. However, even without this, it is likely that Japan’s aid to Sri Lanka will be reduced now that the country has achieved lower – middle- income country status.

Though there has been negligible Japanese private investment in Sri Lanka to date, the crisis could provide an opportunity for attracting Japanese businesses that are seeking safer destinations for relocation. In addition, new areas such as the provision of Geriatric care for an ageing population in a country which has close religious and cultural relationships could also be explored.

In addition there could be a diversion of funds from stock markets in emerging economies, including Sri Lanka, to take advantage of the opportunities in the Japanese equities market which now seems over sold. Foreign funds could prefer attractively priced Japanese equities over richly priced Sri Lankan stocks.

Changes in the Value of the Yen.

The Yen has strengthened to record post- World War II levels on the back of intervention in the markets by the Bank of Japan. However, there is likely to be a weakening of the Yen, if economic activity is disrupted for any length of time. It is noteworthy that any reduction of Japanese aid could be mitigated if the disruption caused by the earthquake/Tsunami results in a weakening of the Yen, as a sizeable share of Sri Lanka's foreign debt is denominated in Yen. A weaker Yen would reduce the burden of servicing this debt.

Businesses Dependent on Japanese Imports.

Though the plant and machinery of Japan's mighty export industries remain intact, the disruption to power supplies has curtailed production and exports. This is likely to affect businesses that are dependent on imports directly from Japan. The extent of the disruption will depend on local stock levels and the speed with which the situation is normalized in Japan. It should be noted, however, that a major share of Japanese imports, including motor vehicles, are produced and shipped from other countries. Furthermore, Japan is not a major export destination for Sri Lanka accounting for only two percent of the total.

Conclusion.

It is difficult to draw firm conclusions about the effects of the recent events in North Africa/Middle East and Japan on the Sri Lankan economy as there is still considerable uncertainty regarding the panning out of future developments in these areas. It is a moving picture that is changing almost hour-by-hour. This note attempts to make a very preliminary assessment of some of the determinants of the short and long term impacts of these events and to identify the risks involved. A more detailed and substantive assessment needs to be undertaken once there is greater clarity regarding the eventual outcome of these events.

The various impacts described above can have implications for the balance of payments, inflation and the budget. The upside scenario of an average oil price not in excess of $105 in 2011 and rapid normalization in Japan, is likely to entail very manageable effects for the Sri Lanka economy. However, significantly higher oil prices and severe dislocation in Japan due to a nuclear catastrophe will have very adverse impacts not only on the Sri Lanka economy but also on the World economy. The ensuing economic downturn is likely to be more severe even than the recession in 2008/09, particularly as recovery continues to be fragile in major economies, particularly the US and Europe.

This is the seventh in the series of Economic Alerts issued by the Pathfinder Foundation.

Readers' comments via email to info@pathfinderfoundation.org are welcome.