Pathfinder Economic Alert

Central Bank of Sri Lanka (CBSL) - Reserve Bank of India (RBI) SWAP Arrangement

Indian support in time of need

The RBI has stepped in to provide timely support to Sri Lanka when its external finances were deteriorating and the currency was under pressure. The $400 million, drawn upon by the CBSL under the SWAP arrangement with the RBI, was one of the outcomes of Prime Minister Modi's visit to Sri Lanka. There is a further $1.1 billion which can be utilized. These arrangements are providing much-needed insurance against depleting external reserves and a boost to the creditworthiness of the country. However, it is important to realise that the support provided by the SWAP arrangement with the RBI only serves to buy time. It does not address the underlying causes of the elevated risks associated with the country's external position.

SWAP arrangements among Central Banks are found in many parts of the world. They provide insurance against reserve depletion stemming from 'shocks'. For instance, the Central Banks of several East and South East Asian countries established the Chiang Mai Initiative after the Asian Financial Crisis. It is a multilateralized currency swap arrangement among the 10 members of ASEAN, China (including Hong Kong), Japan and South Korea. It was initiated as a series of bilateral agreements in 2000 and was subsequently multilateralized in 2009. It currently draws on a foreign exchange reserve pool of $240 billion. However, such arrangements are not designed to be a remedy for weak macroeconomic policies (e.g. poor fiscal/monetary policy coordination) and/or a failure to address structural issues. They are designed to manage short-term liquidity problems. As such, it is important that support being provided by the RBI does not weaken the resolve to implement reforms to build up 'earned reserves' as a means of achieving a sustainable external position conducive for an accelerated growth trajectory.

Sri Lanka's external reserves declined from $ 9.2 billion in August 2014 to $ 6.9 in March 2015. They subsequently increased to $ 7.4 billion in April 2015 largely due to the drawn down of $400 million from the CBSL's SWAP arrangement with RBI. The latter has, therefore, provided timely and much needed support at a time when the country's external position was becoming increasingly fragile with downward pressure on the value of the Rupee. The problems were compounded by the special characteristics of the current political interregnum, with anticipated Parliamentary elections, which are not conducive for implementing economic reforms. India's assistance has been particularly helpful as the last IMF Mission (January 2015) concluded that Sri Lanka did not require external financing support. It took the view that there was no 'balance of payments need' (the rationale for IMF lending) at that time, especially due to the cushion provided by the fall in global oil prices. However, since then a combination of importer demand boosted by expansionary fiscal and monetary policies, external debt repayments, the outflow of foreign funds from Rupee securities and the use of reserves to defend the currency have exerted downward pressure on the country's reserve position. The $400 million support from the RBI has helped to stem the tide and contain uncertainty in the short-run. Market sentiments are also likely to be bolstered by the fact that a further $1.1 billion can be drawn upon under the SWAP arrangement with the RBI.

As mentioned above, SWAP arrangements provide short-term financing (the maturity and interest rates associated with the CBSL/RBI arrangement are not in the public domain). As such, while the RBI support is much needed at this time, it only serves to buy time. It does not resolve the problems related to the unsustainable trend in aggregate demand and the long-standing structural weaknesses of the economy. These are problems which need to be addressed as soon as the elections are over.

The policy-makers are faced with, inter alia, four key challenges:

1. The deteriorating fiscal position which needs to be addressed through a mix of revenue measures and expenditure cuts.
2. Monetary policy has been relaxed at a time when the fiscal situation is worsening. The budget deficit was 6% of GDP in 2014 against a target of 5.2%. On current policies, it is likely to deteriorate further in 2015. At the same time, monetary policy has been eased with the CBSL's Standing Lending Facility Rate (SLFR) being reduced by 100 basis points to 7% and the Standing Deposit Facility being uncollateralized since January 2014. The SLFR was reduced by 50 basis points as late as April 2015. It is important to have sound monetary / fiscal policy coordination.
3. The growth momentum is slowing down. It is important to transition very quickly from the previous external borrowing financed infrastructure development based growth model, which no longer has any headroom, to export – led growth, driven by private investment, including a major role for FDI.
4. As a lower-middle–income country, Sri Lanka is no longer able to compete with low-income countries on the basis of competitive wages. At the same time, it lacks the quality of human resources required to compete with middle-income countries. This is an important dimension of the middle-income country trap. The highest priority must, therefore, be attached to upgrading Sri

Lanka's human resources through improving our education, training and skills development.

The Pathfinder Foundation (PF) is updating its Blueprint for reform, C***harting the Way Forward: Prosperity for All.*** It will be distributed to political parties to inform the preparation of their manifestos in the lead up to the anticipated Parliamentary elections. It will also be available on the PF website www.pathfinderfoundation.org in all three languages.

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