Pathfinder Economic Flash

Bite the Bullet Early or Take the Bullet Later: The Importance of a Timely IMF Arrangement

Temporary Separation not Divorce

The announcement that negotiations between the Government of Sri Lanka (GoSL) and the International Monetary Fund (IMF) have been halted raises a number of concerns. It has been indicated that a major issue discussed related to budgetary support through an IMF Extended Fund Facility (EFF) Arrangement. Reports have also stated that the amount being negotiated was $1.5 billion over three years. The GoSL has adopted the position that it did not require any balance of payments support as its gross reserve position was adequate. From its perspective, the conditionality attached to an IMF arrangement would only be judicious, at this point in the political cycle (i.e. electoral calendar), if there was budgetary support forthcoming at a time when fiscal space is been squeezed sharply, most notably by a significant decline in revenue. Expenditure pressures also continue unabated and are likely to increase as major elections begin to loom up on the horizon.

It is instructive to examine the difficulty the IMF has in providing budgetary support. The Fund's primary business is to provide balance of payments financing. Budgetary support is provided on an exceptional basis to countries which have either lost access to capital markets (e.g. Egypt, Greece and Pakistan) or have had no access to such financing (e.g. low-income countries). Sri Lanka, on the other hand, continues to have access to commercial borrowing from international capital markets, even though the government has adopted the prudent position of not financing the budget deficit through such borrowing this year. Instead, banks and corporates are being encouraged to do so. The Central Bank is then able to purchase the foreign exchange from them with Rupee funds to bolster the external reserves. This process, if undertaken prudently on the basis of the strength of balance sheets, also enables the banks and corporates to enhance their capital base/liquidity ratio. However, in this regard, it is important to take full cognizance of the implications of the massive CEB/CPC losses on the balance sheets of the two State banks.

While this approach has reduced the pressure on gross external reserves, in the short-term, the significant increase in government borrowing from domestic sources (both bank and non-bank) that is now anticipated will "crowd out" private economic activity (through upward pressure on interest rates) and increase inflationary pressure, particularly if the Central Bank prints money (i.e. buys government paper) to fund the budget deficit, now that foreign borrowing has been excluded.

It should also be noted that while the IMF was not able to earmark the whole of any prospective EFF financing for budgetary support, it has the flexibility to make a part of the money available to fund the budget deficit. However, the IMF's Executive Board would not have countenanced a program that did not have strong revenue enhancing measures in a context where revenue had declined to 11% of GDP in 2012. At the same time, a government at the current stage of the political cycle would find it difficult to undertake revenue measures

which would cast added burdens on the people, particularly as they would come on top of the austerity measures introduced in Feb/March 2012.

While the politics of the halting of negotiations between the GoSL and the IMF are understandable in a competitive/adversarial polity, it is important to explore the economic implications of such a development.

Economic Implications

Sri Lanka is not on the brink of a crisis. However, the combination of the persistent structural deficits in the budget and the current account of the balance of payments as well as the over-reliance on "borrowed" rather than "earned" external reserves implies that the economy is on an adverse path. A crisis would eventually be inevitable unless a package of reforms "stabilization measures and structural reforms" are undertaken relatively soon.

The risks already attached to the economy, as a consequence of these imbalances have been amplified by the decision not to go ahead with a Fund program. The key flash point is likely to be roll-over risk where foreign institutional investors are not willing to renew their holdings of short-term Treasury Bills and bonds that have to be rolled over every 3, 6 or 12 months. 80% of this short-term debt is said to be held by US institutional investors whose risk appetite can change very quickly. These investors have found Sri Lankan Government instruments attractive as they are aggressively seeking higher yields in emerging and frontier markets in a context where returns are very low in the advanced economies. However, they are likely to view the breaking-off of the negotiations on a Fund arrangement with concern as there is a perception among international market participants that countries do not default in the midst of an IMF program. Hence the absence of a Fund programme is likely to have an adverse impact on their perception of risks associated with the Sri Lankan economy.

It should also be noted that not having an IMF program reduces the room to maneuver and places an even higher premium on prudent macroeconomic management. The risks associated with the economy have been elevated. It is similar to driving without a seatbelt. International market participants will, therefore, become more circumspect and risk averse in assessing the Sri Lankan economy. In such a context, an over-relaxation of monetary policy (interest rates), loose fiscal policy (weakening of fiscal consolidation) or inflexible management of the exchange rate (an overvalued Rupee) could well lead to a loss of confidence and even trigger an external payments crisis if institutional investors become reluctant to roll over their holdings of short-term government debt.

The Case for Economic Reforms: Beyond an IMF Arrangement

The challenge for the leadership and policy-makers is to exercise prudent macroeconomic management. This will require a scaling down of the growth target to about 6% while maintaining inflation in the high single digit range. At this point, it is better to drive the engine at 30 miles per hour and avoid overheating rather than try to drive it at 60 miles per hour and blow a gasket. A period of very cautious and prudent macroeconomic management should be followed at the beginning of the next political cycle by an ambitious reform package. There is a strong case for arguing that such a reform effort should be supported by a new IMF arrangement not only for the money that would cost less than half of that raised in international capital markets but, more

importantly, to boost confidence and render the economy more attractive to both domestic and foreign investors for whom economic stability is a critical determinant of investment locations. The availability of IMF support will reduce the costs incurred by both the government and corporate on their foreign commercial borrowings. There should be a relatively brief separation rather than a breakdown in the Sri Lanka/IMF relationship.

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