The Pathfinder Economic Alert

Sustainable Solutions or Unsustainable Borrowings?

Widening Trade Deficit

Concerns regarding Sri Lanka's trade deficit have become elevated. It amounted to $6.9 billion in the first nine months of 2011 and is projected to exceed $8 billion by the end of this year. The corresponding figure for 2010 was $5.2 billion. This represents a projected deterioration of 73.1%. This decline has taken place despite a 27.7% increase in exports ($7.8 billion) in the first three quarters of this year. However, this improvement in exports was more than offset by a 51.8% increase in imports ($14.7 billion). The upsurge in imports has been fuelled by an expansion in private sector credit. This makes it important to explore whether this combination of events was an inevitable consequence of interest rates declining at a time when the real effective exchange rate was significantly over-valued (by about 20%).

Are We Defending the Indefensible?

The negative trends on the external account have led to pressure on the exchange rate. As at the end of November 2011, the CBSL had spent over $2 billion to defend the currency. It has been stated that there would be capital flows to the tune of $1 billion in the fourth quarter of 2011. This money is to be raised through increasing the limit on foreign holdings of treasury bills and bonds from 10% - 12.5% and encouraging commercial banks to take advantage of their strong balance sheets and low leverage to raise their Tier 2 capital through foreign borrowing. While this may serve to alleviate the immediate cash flow challenges posed by the loss in reserves, it does not address the substantive problem, which is the sharp decline in non- borrowed reserves.

Increasing Non – Debt Creating Earnings & Inflows

The answer to the problem is not more borrowing. No individual, company or country can go on borrowing indefinitely. Rather, the solution is to ensure a policy mix that increases the export of goods and services and enhances the non – debt creating inflows (exports, FDI, portfolio flows into stock market and remittances). It is also important to consider whether the measures introduced for even more borrowing will yield the expected results at a time when risk aversion has increased in global markets (capital inflows to emerging economies has declined) and credit conditions (rates and standards) have tightened.

Credit to Authorities

The authorities, to their credit, have initiated demand management measures in response to the deterioration of the external account. The tightening of fiscal policy has been maintained through a reduction in the budget deficit. In addition, interest rates have been increasing, in recent weeks as liquidity in the system has declined.

A failure to take effective action to stabilize the external account could result in severe financial stress, even a debt crisis. It is important to emphasise that Sri Lanka is nowhere near a crisis. However, effective remedial action needs to be taken very early. The authorities need to build on the measures they have already taken by adopting a pragmatic approach that deploys all macro-economic instruments in a balanced way.

A Pro-Growth Strategy: Policy Mix of Gradual Depreciation and Interest Rate Adjustment

In this regard it is important not to put the whole burden of adjustment on monetary policy (increased interest rates). This has been the general practice adopted in Sri Lanka over the last 30 years. However, increased interest rates raise the cost of funds in the economy and have a negative impact on growth and productive employment. On the other hand, addressing the excess demand in the system through depreciation of the currency, gradually over time, is a more growth and employment oriented approach. It provides a boost to both exports and import competing goods and services. However, as the import content of Sri Lanka’s basic consumption bundle continues to be high, exchange rate adjustment has a negative impact on the cost of living. The challenge is to identify the appropriate balance in deploying these instruments in a manner that maximises both growth/employment on the one hand and containment of inflation on the other. In seeking this balance, it is important to be pragmatic rather than dogmatic in any particular direction. The 8% growth target cannot be realistically achieved without a balanced approach to macroeconomic management.

Action Now or Politically Disruptive Shock Treatment Later

It is also important to stress that timely action now will avoid extremely painful and disruptive "shock treatment," if the situation is allowed to deteriorate. Failure to take effective action very early to stabilise the economy can have dire consequences in the future. The medium-term challenge is to increase the productive capacity of the economy, particularly exports through improving competiveness.

The PF would welcome a critique of its analysis above from the authorities, such as the Treasury and CBSL, as well as think-tanks and researchers. A debate on these issues will help prudent policy formulation and is very much in the national interest.

This is the Twenty –third in the series of Economic Alert's by the Pathfinder Foundation.

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