The Pathfinder Economic Alert

Economic Governance: The High Costs of Poor Performance or High Returns of Sound Management.

The Standard and Poor's (S&P) Rating Services assigned a score of 8 (very high risk) to the Sri Lankan economy and banking industry last week. The role of ratings agencies in the lead-up to the global financial crisis (2008) was certainly highly questionable. There are also issues related to their accountability. Despite this, and setting aside the merits or otherwise of S&P's assessment, this episode serves to highlight the following:

1. market sentiment matters and the costs of macroeconomic policy mistakes are significantly higher now that Sri Lanka is a lower-middle-income country with increasing exposure to international capital markets; and

2. the quality of economic governance is a crucial determinant of investor confidence. Poor governance can override sound fundamentals. For instance, the Sri Lankan banking systems is well capitalized, liquid and fundamentally sound. Yet governance issues, including conflicts of interest, have contributed to one of the world's leading rating agencies categorizing it as "very high risk".

There is an urgent need to understand the appropriate messages from this episode, as the balance of probability is that news related both to the economy as well as the corporate sector is likely to get worse over the next six to twelve months, before it gets better. The risks associated with the economy arising from adverse global economic developments and policy misalignments could well be compounded by the effects of a possible drought on production and power generation. The length and depth of the inevitable economic downturn would depend on the robustness of the policy response. All this places a high premium on sound policy-making. It is also important to recognize that negative news travels across borders quickly and widely in today's world.

Costs of Macroeconomic Policy Mistakes.

As the Pathfinder Foundation has pointed out many times, Sri Lanka's macroeconomic policy making now takes place within a new paradigm, following the country's graduation to lower-middle-income country status. The basic model that has existed in the post -1977 era has involved the country "living beyond its means". There have been poorly designed and ill-targeted subsidies and transfers. In addition, productivity, particularly in the public sector and agriculture, has been very low. This has meant that the level of wages that can be sustained without fueling inflation has been too low to accommodate international prices, particularly of fuel and energy. As a result, there has been constant pressure to supplement wages through subsidies and transfers, often with money the country did not have. In recent times, the exchange and interest rates have also been used to artificially boost domestic consumption and investment.

Sri Lanka has been able to live beyond its means over a sustained period as it has been a 'donor darling'. The traditional donors were extremely generous because they were keen to demonstrate that a country with a liberal polity and economic liberalization after a long period of dirigiste policies could deliver positive development outcomes.

The time has now come to re-think the old model as it is no longer sustainable. Sri Lanka graduated to lower-middle-income country status, in 2009, when it crossed the $2000 per capita income threshold. It has been able to sustain the old model over the last couple of years because there has been significant headroom for commercial borrowing. When then country was receiving generous amounts of concessional assistance, it undertook little or no commercial borrowing. As a result, there has been scope to continue the "living beyond one's means" model by borrowing from international capital markets on commercial terms. This is what European countries today (e.g. Greece) and several Latin American countries in the 80's and 90's have done.

It is important to recognize two implications of the course of action pursued during the last two years. First, the headroom for commercial borrowing is now much smaller. Second, commercial borrowing (Eurobonds and foreign holdings of Treasury Bills and Bonds) now exposes the country to the "tyranny" of rating agencies and international capital markets. Experience from other parts of the world (most recently in Europe) demonstrates that market confidence can turn very quickly when ratings turn negative, with a rapid flight of money out of the country and a closing of access to further borrowing from international capital markets (the costs become prohibitive).

In this connection, PF reiterates the case for learning from the macroeconomic policy mistakes made last year in relation to the exchange and interest rates. It lauds the bold and courageous stabilization measures introduced in Feb/March 2010 and calls for their continuation. As mentioned above, the new paradigm places a high premium on sound macroeconomic management. The S&P rating is an amber light, particularly as bad news is likely to greatly

outweigh good news on the economic front over the next six to twelve months. **The economy is likely to experience a perceptible slowdown. When this happens even small mistakes become magnified and affect market sentiments. Warren Buffet, the legendary investor has said: "When the tide goes down you see who is swimming naked".** In such a context it is crucial that the authorities demonstrate that they are on top of the situation and that they are acting proactively and decisively to restore macroeconomic stability. Policy- making should be consistent and predictable across the government. A greater degree of transparency and explanation can also assist in creating a more stable macroeconomic environment for all economic agents.

Economic Governance: No Short Cuts to Growth.

The second message to be drawn from the S&P rating is that investor confidence can be influenced by perceptions regarding the quality of economic governance. The S&P statement refers, inter alia, to the weak governance and transparency of banks and conflicts of interest. Here again, the S&P rating should be seen as a warning light that triggers a learning process regarding the importance of strengthening economic governance. The key message is that even sound fundamentals can be overridden by concerns regarding poor governance. As mentioned above, Sri Lankan banks are fundamentally sound at the present time. Yet, concerns regarding governance issues, in combination with a worsening economic outlook, seem to have triggered an adverse S&P rating for the economy and the banking system.

The experience of the last two years has demonstrated that 8% growth cannot be sustained through a mixture of manipulated macroeconomic policies and a deal-by-deal approach to investment. Growth cannot be sustained at 8% without investment increasing to 35% of GDP. It amounted to 30% of GDP last year. However, even this figure may well decline in 2012 as domestic investment is likely to be adversely affected by increased interest rates and, in the short term at least, exchange rate depreciation. It is not clear that foreign investment will compensate for this, despite a more attractive exchange rate.

Public investment has been capped at the current level of 6% of GDP to achieve the government's important fiscal consolidation targets. The shortfall in investment has, therefore, to be met by increased private investment, domestic and foreign. For this one needs, inter alia, an improvement in economic governance, which is based on stronger institutions, rules, regulations and the sanctity of commercial contracts rather than on discretion. A system that is overly reliant on discretion has excessive risk and uncertainty built into it. Instead, the focus of economic governance should be on improving the overall investment climate. This requires action on several fronts (see previous PF Economic Alerts). Sadly, there are no short cuts as we have found out through the experience over the last two years.

Conclusion

The S&P rating is an amber light that has drawn attention to fundamental concerns that have an important bearing on the development prospects of the country. Sustained accelerated growth would not be possible without a continuation of the bold and courageous stabilization measures introduced in Feb/March 2012 and a concerted effort to improve economic governance. Misaligned macroeconomic policies (fiscal as well as exchange and interest rates) and poor economic governance can serve to trigger a non-virtuous downward spiral which could well lead to a major economic crisis. Sri Lanka is nowhere near its "Lehman Brothers moment". However, it is important to heed the amber signals to ensure that it is avoided.

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

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