**The Pathfinder Economic Alert**

# Time to Act is Now: Good to Learn from Others Mistakes.

- The cost to the people of policy mistakes increases as a country moves from low to middle-income level.
- Trade deficit is increasing sharply.
- The proportion of the trade deficit unfinanced by remittances is increasing.
- Non-borrowed reserves are declining.
- The headroom for further commercial borrowing is much reduced.
- Timely remedial action can avoid far more painful measures later.
- The adjustment of the exchange rate is the most growth and employment oriented option.
- Important lesson from previous middle-income country crises is that one should not both support the exchange rate and hold down interest rates when the external situation is deterioratin

Sri Lanka is now a lower-middle-income country. Moving out of low-income country status and a reliance on handouts is certainly a source of pride for all Sri Lankans. However, this newly won status also places greater responsibilities on the shoulders of the policy-makers, particularly in the Central Bank of Sri Lanka (CBSL) and the Ministry of Finance. With lower-middle-income country status, a nation loses access to concessional resources (aid) and experiences greater exposure to the discipline exerted by commercial markets. This places a very high premium on prudent macroeconomic management based on timely action. The costs of policy mistakes have become dramatically higher.

There has been a perceptible deterioration in the country's external position in recent months. Sri Lanka was able to achieve the targeted 8% growth rate in 2010, while maintaining a sustainable external position. This was facilitated by imports being contained by bringing on stream

unutilized capacity and unsold stocks. This was made possible by the below trend growth of 3.5% in 2009. However, as the economy fulfills its growth potential, the weaknesses in the current macroeconomic framework are emerging.

The trade account recorded a deficit of USD 5 billion in 2010. Remittances (USD 4 billion) financed 80% of this. In 2011, exports have experienced commendable growth. However, imports have been increasing even more quickly resulting in a sharp deterioration in the trade deficit. This is unsurprising given the appreciation in the real effective exchange rate in recent years. An overvalued exchange rate subsidises imports in effect. Remittances are now expected to finance only 55% - 60% of the trade deficit this year. This means a greater share of the trade deficit has to be financed by receipts from services (particularly tourism, ports and airports), non-debt creating capital flows (particularly FDI) and commercial borrowing for the overall balance of payments to remain in surplus.

Tourism and other services receipts, as well as FDI, are expected to increase significantly this year from low bases. However, they will not rise sufficiently to offset the 40% - 45% of the trade deficit which is now unfinanced by remittances. This means the country will need to resort to additional commercial borrowing. Sri Lanka has had the headroom to undertake substantial commercial borrowings in the last couple of years because there was very little of it, when the country was receiving large amounts of foreign aid. However, the stock of commercial debt has now reached the point where greater caution needs to be exercised. The policy-makers have three instruments at their disposal to tackle the increasing imbalances in the external account:

I. They can take demand out of the system by tightening fiscal policy (increasing taxes, cutting expenditure or a combination of the two). However, Sri Lanka is already in the midst of an ambitious trajectory of fiscal consolidation. Further tightening would result in curtailing development programmes, cutting back on basic services or a combination of the two.

II. They can tighten monetary policy (increase interest rates). There is some scope for this as banks are experiencing some difficulty in mobilizing deposits. (This seems to indicate that real interest rates may not always be positive.) However, the room to maneuver is limited as a significant increase in interest rates would have a negative impact on growth and employment just as the economy is gaining momentum after the end of the conflict.

III. There can be more flexible management of the exchange rate (orderly depreciation). This will result in some inflation and an increase in the cost of servicing foreign debt. On the positive side, it will have the advantage of making exports and import substitutes more competitive. There are therefore, powerful growth and employment effects.

There are no easy options. However, timely action now will be far less painful than the Greece-like austerity measures that would be necessary if policy-makers do not undertake remedial measures to avert a financial crisis. Adjustment of the exchange rate offers the most growth and employment-oriented policy option.

The headline gross reserves figure is often cited as a sign of the economy's robust health. Gross reserves amount to a historical high of USD 8.5 billion (6 months of import cover). However, a significant amount of it is borrowed with 37% constituting short-term debt that can be very quickly reversed. It is a source of concern that non-borrowed reserves have been declining. The CBSL has had to expend USD 700 million (July & August 2011) to defend the Rupee. More has been spent this month. This is not a sustainable position. It is important to recognize that markets tend to be more generous than they should be when the going is good. They also punish countries more than they should when confidence is reversed.

The policy of simultaneously supporting the currency and holding down interest rates while the external position is deteriorating is a recipe for a financial crisis. This was a lesson that emerged very clearly from the middle – income country financial crises experienced by several Latin American countries in the 1980's & 90's. These lessons must be absorbed by policy-makers in the Treasury and Central Bank. Timely and orderly adjustment would avoid far more disorderly and painful measures in the future. On balance, the exchange rate offers the best option for growth and employment-oriented adjustment. Many commentators bemoan the fact that Greece, as a member of the Euro Zone, does not have the option of depreciating its currency to get out of its current crisis.

Sri Lanka is not on the verge of a crisis. However, we seem to be moving from a green to an amber light. The time for action is now. The authorities must be pro-active to avoid much more painful adjustment (without the benefit of aid money) later. It would be good to learn from the mistakes from others rather than repeating them ourselves.

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

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