Pathfinder Economic Flash

Enhancing Confidence in the Sri Lankan Economy

Bold Measures

The government of Sri Lanka introduced a number of bold macroeconomic stabilization measures in February/March 2012. These were necessary as the country was on a trajectory to a very destructive balance of payments crisis. It is still too early to determine whether enough has been done to stabilize the balance of payments, particularly the trade deficit. As the Pathfinder Foundation has pointed out in several previous articles, the trade deficit doubled last year, despite a 22% increase in exports. The current account deficit deteriorated from 2.8% of GDP in 2010 to 6.8% in 2011. The overall balance of payments was in deficit to the tune of $1 billion. The deterioration in the external account led to pressure on the currency and a hemorrhaging of reserves.

No Room for Complacency

It is still too early to be confident that the courageous measures introduced by the government are sufficient to stabilize the country's external account. This is particularly so, as the risks associated with global economic performance have become much more elevated. The persistence of the Euro Zone crisis, the fragility of recovery in the US and the slowdown in China and India have combined to create an adverse external environment for the exports of a country like Sri Lanka. The decline in oil prices, following the weakness in the global economy, will have a positive impact on Sri Lanka's trade deficit. However, the US sanctions on Iran and the potential loss of deferred payment terms for our oil imports could well reduce the beneficial impact of the falling oil prices.

Monitoring Performance, a Must!

The data for 1Q2012 continues to be worrying. Though there has been a slowdown in import growth this has been more than offset by the reduction in the rate of expansion of exports. The upshot has been a worse trade deficit in the first quarter of this year compared with the corresponding period in 2011. However, it is important to emphasize that the 1Q2012 data would not have reflected the full effects of the stabilization measures that were introduced in February/March. A clearer picture will emerge once data for April and May become available. It is of paramount importance that the authorities monitor the developments in the country's external account very carefully to ensure that the desired trajectory of stabilization is attained. Failure to do so will inevitably lead to a devastating balance of payments crisis, particularly, as Sri Lanka is now more exposed to international capital markets and the assessment of its economy by rating agencies.

“Net” & “Gross” Foreign Reserves

In assessing the health of the country’s external account, it is important to differentiate between “net” and “gross” foreign reserves. Evidence is emerging that there has been some loss even in “gross” reserves in recent weeks. In addition, the “net” reserves position continues to be a matter of concern. It is important to recognize that it is not possible to borrow one’s way out of the current predicament. Recourse to borrowing (by the Government or Banks) can only postpone for a short time the inevitability of serious balance of payment pressure. A sustainable external account can only be achieved by effective stabilization measures that are supported by reforms that strengthen the growth framework of the economy (see Economic Alert 27).

IMF: Looking Beyond Stand – By Arrangement.

In the prevailing uncertain global and domestic environments, it is reassuring that the Senior Minister of the International Monetary Cooperation has indicated that the authorities are considering a follow-on arrangement to the current IMF Stand-by Agreement. The IMF team currently in the country is in the process of undertaking an assessment in relation to the release of the final tranche ($500 million) of the existing Stand-by. The negotiation of a successor to the current arrangement assumes greater significance now that Sri Lanka is exposed to the whims and fancies of international capital markets which have become extremely risk averse in the current global environment. At present, foreign holdings of short-term Treasury instruments exceed $3 billion. In addition, the government has issued Eurobonds worth $3 billion, of which $500 million needs to be rolled over later this year. The upshot is that over $3.5 billion of foreign holdings of treasury instruments needs to be rolled-over, during the next 6 months. Priority would need to be attached, therefore, to maintaining foreign investor confidence.

Uncertainties, Vulnerabilities and Safeguards

In the same vein, it is also instructive to examine the performance of Foreign Direct Investment (FDI). Such flows amounted to $220 million in 1Q2012. On a pro rata basis, this falls considerably below the level required to attain the $2 billion target set out by the authorities. It also falls short of the investment path required to meet last year’s FDI figure of $1 billion. One may conclude that it is currently a major challenge to maintain investor confidence in the Sri Lankan economy. The risk appetite in international markets is low and the risks associated with the domestic economy are high. Such a conjuncture of events places an extremely high premium on maintaining investor confidence. In this connection, it would be in the country’s interest to maintain an arrangement with the IMF to provide comfort to investors in these difficult times. A lack of such an arrangement would make Sri Lanka vulnerable not only in terms of accessing additional resources but there may well be difficulty in preventing the flight from short-term Treasury instruments (it is worth asking the question whether the recent Bank of Ceylon $500 million bond issue would have been as successful without an IMF arrangement being in place). The consequences would be severe for the people of the country.

Good politics: Pragmatism not Dogma

In assessing the merits of an IMF agreement, it is important to be pragmatic and avoid dogma and ideology or allow manipulative and rent seeking behavior to set the agenda. It is also important to recognize that the character of the IMF is evolving as the G20 supersedes the G8 as the premier forum for international economic decision-making. Large emerging counties like Brazil, China and India are having an increasing voice in running the institution. It is noteworthy that China decided to channel its support for Europe through the IMF. One should also remember that the IMF agreed to release the Stand-by financing in 2009, despite opposition from some major countries, due to the positive intervention of India.

Even if the authorities determine that additional borrowing from the IMF is not required (even if the costs would be less than half that demanded by international capital markets) it is possible to have a IMF Board or Staff monitored arrangement which would provide comfort to investors, while not adding to Sri Lanka's external liabilities.

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