Pathfinder View Point - 1

Avoiding Bleeding of Forex Market

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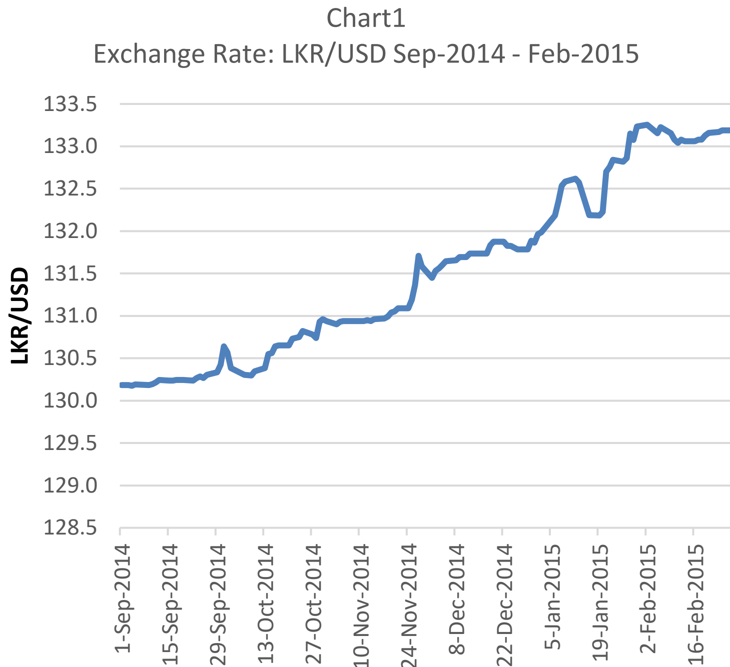
There were two shocking items in the Sri Lankan media during the past few days that caught the attention of the Pathfinder Foundation (PF) which focuses on Sri Lankan policy issues:

- First, is that the Central Bank of Sri Lanka (CBSL) has sold over USD 700 million during the five month period from the end of August 2014 to January 2015 to defend the exchange rate; this has prevented the exchange rate from depreciating more than 2.5% against the USD during the same period. With political imperatives taking precedence over the economic issues, this has continued after January too. Chart 1 shows that, we have stabilized the exchange rate in the month of February 2015, by containing the possibility of depreciation through a combination of the use of reserves to defend the Rupee and moral suasion by the CBSL.

- The second news item is the discussion that the Sri Lankan government has engaged in with the IMF to seek credit up to USD 4 billion dollars, as the country's reserves are coming under pressure from strong credit growth and repayment of an earlier facility with the Fund. However, the IMF staff who visited the country recently on a post-program monitoring mission has concluded that there is no necessity for balance of payments support at the present time. They contend that the savings on the oil import bill, due to the decline in oil prices, will offset any deterioration in the trade account due to the increase in consumption (Sri Lanka has a high import component in its consumption expenditure) resulting from the relief measures in the Budget (Nov 2014) and the Interim Budget (Jan 2015).

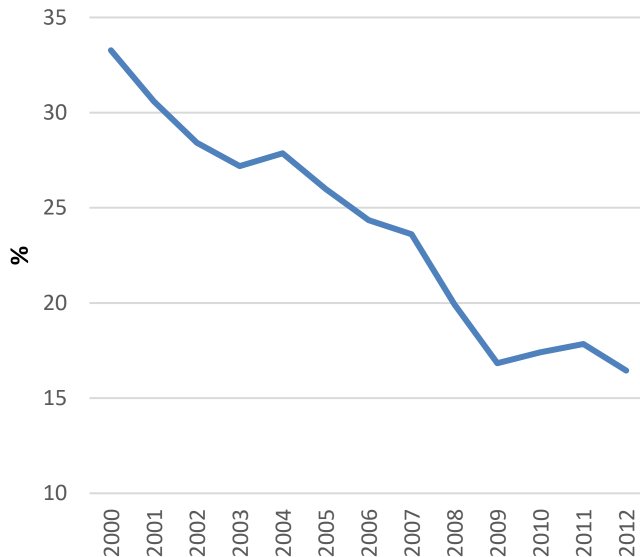


There are, however, concerns about the long-term economic implications of the –pressure in the Sri Lankan foreign exchange market. Simply, it is all about "bleeding in the Sri Lankan foreign exchange market" which will eventually result in nothing but pain at the end of the day – more and more pain year-by-year. Before we turn to this issue, let me briefly outline some fundamentals of the foreign exchange market.

Exchange rate: flexibility and stability

The exchange rate has to be flexible and stable – the most important two qualities of a well-managed exchange rate. If the exchange rate is to be fairly flexible, it should respond to market forces – foreign exchange inflows (supply) and outflows (demand). If it is to be fairly stable, it should be managed by the Central Bank by changing its stock of official foreign exchange reserves to offset market imbalances. Thus, the two most important qualities that we expect and respect in a foreign exchange market seem to be contradictory, because it appears that a country cannot have both together. Actually, they are not, although it may still be true in the Sri Lankan context.

The bottom line of a better-managed exchange rate is that it should reflect the country's globally competitive productive capacity. Much of the responsibility in this area is outside the Central Bank's purview. The Central Bank knows how to manage the exchange with fair flexibility and stability, when the economy performs better in the area of its globally competitive productive capacity.



Where do we see the exchange rate reflecting the country's productive capacity? It is seen in the balance of payments (BOP) which records the country's foreign exchange inflows and outflows:

- The Current Account of the BOP should reflect that its most dynamic foreign exchange inflow is through export performance. Yet, Sri Lanka's exports show dismal performance (Chart 2). The fastest growth in the current account has been private remittances – which is not at all a sign of the productivity and competitiveness of the domestic economy.

- The Financial Account of the BOP should reflect the importance of foreign direct investment (FDI) inflows in which Sri Lanka has struggled to secure even USD 1 billion a year. This is about 1/4 to 1/3 of the inflows attracted by countries like Malaysia, Thailand and Vietnam on a per capita basis. Instead, the most important item in the financial account is attributed to the government's foreign borrowing, which is also not necessarily a sign of the strength of the economy.

It is useful to examine how the CBSL has built up its stock of foreign reserves to over USD 8 billion from their historical low level of USD 1.5 billion in early 2009, at a time when both exports and FDI inflows were recording sluggish performance. This was possible as Sri Lanka became a lower-middle-income country (above USD 2,000 per capita income). This enabled it to acquire a rating and access international capital markets. At that time, there was significant headroom for such borrowing as Sri Lanka had negligible commercial borrowing. As a result, it has been able to raise USD 5 billion (????) through international bond issues and attract a further USD 3.5 billion of foreign institutional investment in Rupee securities. However, the headroom for such borrowing is now constrained (other than roll-overs). Going forward, it will become more difficult to support the Rupee through foreign commercial borrowing.

On the same track

The economy has not performed well in the areas where its exchange rate should have reflected the country's productive capacity. On the top of that the government's outstanding foreign debt has increased from USD 11 billion in 2004 to USD 44 billion in 2014, resulting in continued increase in its debt service commitment. As reported, the foreign debt service commitment for the current year is estimated to be over USD 5 billion.

With the foreign debt getting matured, the pressure on the exchange rate is more than ever before. The government is yet to declare its policy reform agenda, after delivering a populist budget with no indication of its policy directions. What all this means in terms of the foreign exchange market is that it will become increasingly difficult to mount a defence of the exchange rate with increased borrowings and/or reduced foreign reserves in the months to come. Postponing the reform agenda is not without cost. The reality is that this cost is rising fast. It is worthwhile to inform the public regarding the economic realities of the country and the reform process that is needed to arrest the deep-rooted economic challenges.

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