Economic Dialogue

By The Pathfinder Foundation

Facing Macro Economic Policy Challenges

What was happening?

Sri Lanka experienced a dramatic decline in its trade balance during the second half of 2011. The trade deficit which was $5 billion at end-2010 almost doubled to $9.7 billion at the end of 2011. In simple terms, we have spent much more on imports than we have earned through exports of goods. The earnings from services, remittances and net capital inflows were insufficient to offset the much larger trade deficit.

In life one has to limit ones expenditure to the capacity to earn and borrow responsibly without getting into difficulty. The deterioration in the trade balance was due to a significant rise in imports. This led to a sharp rise in the demand for foreign currencies resulting in pressure to borrow even more from abroad or use our hard earned exchange reserves. An appropriate response would have been to take early corrective measures as soon as it became apparent that the trade deficit was worsening.

Instead of introducing the necessary policy reforms to reduce the demand for import, the authorities resorted to spending $3.6 billion of the country's reserves in an unsustainable effort to defend the value of the Rupee. The inevitable result was that the country's gross reserves, which also included significant foreign borrowing, were markedly reduced.

How did Trade Deficit expand so fast?

The increase of international petroleum prices from $78 per barrel in 2010 to $110 per barrel in 2011 alone accounted for $1.5 billion of the deterioration of the trade balance. The remaining $3.2 billion worsening of the trade deficit was to misaligned policies.

The exchange rate (how many Rupees to buy 1 Dollar) has been over valued over a period of time. When our currency is overvalued it naturally makes imports cheaper and increases demand for them. Simultaneously, Central Bank Policy Interest Rates were reduced and Commercial Banks were encouraged to increase lending. The combination of an overvalued exchange rate, cheap money and pressure on banks to lend inevitably resulted in a credit boom which fuelled an unsustainable increase in imports, pressure on the Rupee and a sharp depletion of reserves.

Bold remedy from the President or…?

After the devaluation of the Rupee by 3% in the budget speech there was considerable dilly dallying by the Central Bank and Treasury authorities. It appeared that intervention at the highest level of the country eventually paved way for the adoption of a flexible exchange rate. Greater flexibility in exchange rate management was accompanied by a 0.5% increase in policy interest rates. Market interest rates have increased by considerably more. While maintaining selective subsidies, the prices of fuel and electricity were raised to reflect cost of imports or production. The commercial banks have been advised to restrict their lending growth to 18%. Additionally they have been requested by the Central Bank to borrow abroad providing one year guarantee to share exchange rate risk.

The outcome of this unprecedented move towards market based flexible exchange rate has been evident from the very beginning. During the past couple of months the amount of savings due to non intervention in the market by the Central Bank has reached $700 million, according to authoritative sources. In other words if we continued on the path of maintaining the overvalued exchange rate, Sri Lanka would have faced a severe balance of payment crisis or near bankruptcy by the fourth quarter of this year.

What further policy improvements?

While the government's (the President?) unprecedented, bold macroeconomic policy adjustment is appreciated by non partisan economists and informed public, further consolidation of these reforms is necessary to avoid crisis situation and for faster economic growth on a sustained basis.

To begin with the Central Bank and the Treasury need to closely monitor developments and trends in the movements of the following variables:

I. The trade deficit
II. Current account deficits of the balance of payments
III. Foreign reserves and
IV. Foreign debt sustainability.

In the process the authorities have to be vigilant, use sound economic analytical tools before introducing necessary macroeconomic policy changes. For example, if the policy makers notice further deterioration of the trade or balance of payment deficit immediate measures to constrain import demand needs to be implemented. In advising the political masters the policy makers will have to use their economic analytical skills and their wisdom rather than personal or group preferences for short term gains. Furthermore great care needs to be taken to ensure that the country does not undertake unsustainable borrowings which can result in future crisis like that experience by Greek and others at present.

Warning!

The policy makers, politicians and the government should be aware that Sri Lanka in this globalized environment needs to continue with prudent macroeconomic policy reforms that have been introduced recently. In general, we tend to underestimate the negative impact of bad policies when the going is good. For an example, if a short term decline of fuel and other import prices or increases of export prices are experienced, policy reversals for petty, selfish gains may be encouraged at the expense of long term stability and faster growth. With the accumulation of reserves there may be those who would like to intervene in the market, with hard earned foreign reserves, to prop up the Rupee against foreign currencies without understanding or considering the underpinning economic fundamentals. It is important to avoid such basic errors.

It is also up to the political leadership to work with the skillful, selfless policy makers to prevent such misaligned market interventions by a rent seeking few.