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Sri Lanka must sacrifice growth for stability: economist

Feb 19, 2009 (LBO) - Sri Lanka's government should focus on restoring macro-economic fundamentals which have deteriorated in recent years to help it overcome the global economic crisis, even if means slower growth, an economist has said.

"Restoring macro-economic stability should be the priority in 2009 even if it means lower growth," Dushni Weerakoon, Deputy Director, of the Institute of Policy Studies, a think-tank, said

"It will minimise the destabilising effects of the economic crisis and enable the government to retain the policy flexibility to respond better to the external crisis."

Lower inflation and global commodity, especially oil, prices should help the economy, she said.

But there were concerns over falling export earnings and foreign exchange reserves and the balance of payments position, she told a seminar on Sri Lanka's response to the global economic crisis organised by the Institute of Policy Studies.

The island economy has been resilient with buoyant growth and a progressive reduction in the unemployment rate in recent years despite having to cope with an ethnic insurgency.

"These developments have been made in the context of significant challenges that the economy and country faced on the domestic and external fronts," she said.

On the external front Sri Lanka had to grapple with high and rising global oil prices while it also had domestic policy issues owing to intensified military conflict and recovery from the Indian Ocean tsunami.

Resources had to be set aside for both while the government had to do normal development activities.

But macro-economic fundamentals remain weak with inflation still high and a deteriorating current account position, Weerakoon said.

Although there were expectations of an exchange rate adjustment to cope with these problems, the rupee was held fairly steady until late last year, and the real rate was still considered too high.

"Sri Lanka is entering the economic crisis with weak public finances, high inflation and currency appreciation that perhaps is not the best platform on which to meet fresh challenges to the economy," she said.

Difficult Balance

In setting monetary policy, the government has a difficult balance to strike and the policy "must not be too tight or too loose that the grip on inflation slips," Weerakoon said.

With domestic inflation remaining high despite sharp falls in global commodity prices, it was clear that domestic policy bears the main responsibility for the island's inflationary spiral, prompting a tightening of monetary policy .

Although a depreciation of the rupee would make Sri Lankan products cheaper, it can add to inflationary pressure and increase external debt obligations, Weerakoon said.

Exchange rate management has a bearing on the reserves position and it was clear there has been a drop in reserves in the latter part of 2008, which was also partly because some foreign investors withdrew funds because of the global credit crunch.

"Having enough reserves is important," Weerakoon said. "They need to be large enough to draw on if foreign flows dry up."

It was difficult to make a judgement on the calls for a large devaluation of the rupee, as it can lead to speculative behaviour and a run on the currency, Weerakoon said.

"There are significant risks to implementing a large devaluation now if reserves are not seen enough to manage a given rate," Weerakoon said.

"If the market thinks the new rate can't be defended, there'll be pressure, and if the new rate cannot be defended then it will be worse."

The alternative of re-imposing exchange controls or allowing a free float is also not attractive or desirable.

"The most prudent options would be to rebuild our reserves as quickly as possible," Weerakoon said. "To use whatever means are at our disposal to build up reserves."

If the central bank succeeds in raising 500 million dollars from the diaspora and currency swaps with other central banks, as planned, it could allow the country to adopt a more flexible exchange rate policy.

Peg Mentality

However other analysts, including the International Monetary Fund, have pointed out the exact opposite: that a depreciation will actually preserve reserves and tighten domestic demand.

Countries like Sri Lanka run 'managed floats' or soft pegs - usually with the US dollar - where the monetary base is backed by both domestic and foreign assets, making an unstable mix that can easily deteriorate into high inflation or balance of payments crises.

Floating rate central banks - including the Federal Reserve – do not acquire foreign reserves, but generates the entire money supply out of domestic assets, usually treasury bills.

Ajay Shah, an Indian economist who also spoke at the forum said India's Reserve Bank had unexpectedly broken with typical soft-pegged thinking to allow its currency to fall steeply against the dollar in the style of a free floating central bank.

In India there has been in-depth debate on exchange rate policy in the run up to what authorities call the 'full convertibility' of the rupee.

Australia, New Zealand and the Euro region had also allowed their currencies to float down as the US dollar shot up amidst a rush for liquidity and excess reserves zoomed in the Federal Reserve system.

Though India has learned its monetary lessons well, especially after the balance of payments crisis in 1991, which gave reformers the upper hand in economic policy, other countries have yet to understand the dangers of 'managed floats'.

Almost a decade after the East Asian crisis (and losing its central bank governor), economists say Indonesia has learnt little about either soft-pegs or floating exchange rates.

"Notwithstanding having nominally floated the rupiah in 1997, the central bank has never overcome its aversion to fully floating exchange rates," Steve H Hanke and Ross H McLeod, wrote in an op-ed piece called [Indonesia's Monetary Muddle \(Read link\)](#) in the Wall Street Journal on February 09.

"Instead, Bank Indonesia has "managed" the float, intervening simultaneously in the foreign exchange market and the domestic money market. In essence, it has both exchange rate and monetary policy targets, and these often contradict each other."

To control exchange rates and interest rates (or domestic money supply) at the same time, the central bank 'sterilizes' its interventions.

This can cause a balance of payment crisis and loss of reserves, or an excessive build up of reserves and high interest rates, depending on the direction of sterilization.

Carbon Copy

Both Indonesia and Sri Lanka had seen almost identical monetary policy and consequences.

"Until late last year, Bank Indonesia purchased U.S. dollars continuously, preventing the rupiah from appreciating," Hanke and McLeod wrote.

This pushed up domestic interest rates and created a 'carry trade' opportunity to borrow dollars and invest in Indonesian government securities, mirroring what happened in Sri Lanka.

"Paradoxically, the attempt to provide a war chest against balance of payments shocks had the perverse effect of heightening vulnerability to sudden, destabilizing capital outflows," Hanke and McLeod wrote.

"In recent months, the central bank has spent some \$8 billion of its \$60 billion in reserves to shore up the currency."

In Sri Lanka the worm, (direction of sterilization) turned in September. Since then Sri Lanka has lost more than half its foreign reserves, according to some estimates.

"Indonesia's attempts to hold markets away from a fundamental equilibrium have left the country more vulnerable than need be," Hanke and McLeod pointed out.

"Indeed, it was this kind of unsustainable exchange- rate regime that contributed to Indonesia's plunge into chaos and the abrupt end to the 32-year Suharto era in 1998."

Ajay Shah said the Reserve Bank had 'got it quickly' and allowed the rupee to fall and prevented speculation.

"Allow the depreciation, take it in the nose and get it out of the way," Shah said.

"It is not a manipulated rate. It is market rate."

Fiscal Room

Weerakoon also noted that Sri Lanka had hardly any room for a fiscal stimulus package with revenue growth below what was expected.

"It seems Sri Lanka has retained very little capacity to respond to the emerging downturn in the global economy," she said.

The government's 15 billion rupees fiscal stimulus package was marginal in scope and would have to be financed by cuts in spending.

"It means it is not strictly a stimulus package but a re-allocation of existing spending to other identified areas, particularly export sectors which needs a bit more support to face the downturn," said Weerakoon.

The sustained reduction in inflationary pressure was a positive feature, however.

"It means there is room to allow some easing of monetary policy," Weerakoon said.

The country can also expect an improvement in the trade balance as the reduction in spending on imports would outweigh the fall in export earnings, while foreign remittances are not seen being eroded much.

But access to capital would be difficult as tighter markets means the government would not be able to borrow with foreign investors having lost their appetite to invest in emerging markets.

She said the 2009 forecast put a lot of emphasis on foreign borrowing to bridge the budget deficit, but if enough funds cannot be raised because of the current crisis, that would put pressure on domestic borrowings.