



Seminar on
Global Economic Crisis & Sri Lanka

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Sri Lanka's Response to the Global Economic Crisis

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Sri Lanka: Impacts

- Positives
 - Reduction in international oil prices
- Negatives
 - Falling commodity price impacts on exports
 - Shrinking global export markets
 - Reduced global financial flows – FDI, other capital, remittances, etc.

⇒ Net impact likely to be negative; official growth forecast for 2009 revised down already



Domestic Preparedness

- Has Sri Lanka retained the capacity for policy flexibility to respond effectively?
- Can we offer a meaningful fiscal stimulus?
 - Cut taxes/increase expenditures
- Is there scope for a monetary policy stimulus?
 - Reduce interest rates
- What is the scope for exchange rate management?



Positives of Economic Performance

- GDP growth has been buoyant
 - 6.5% p.a. on average during 2005-08
- Progressive decline in rate of unemployment
 - 7.2% in 2005 to 5.5% in 2008
- Achieved in the midst of complex challenges
 - External oil price shock from 2004
 - Higher spending needs from 2005/06
 - Defence
 - Development (post-tsunami reconstruction, infrastructure, etc.)



Fiscal Policy Indicators

% of GDP	2004	2005	2006	2007	2008a
Total revenue	14.9	15.5	16.3	15.8	18.0
Tax revenue	13.5	13.7	14.6	14.2	16.2
Total expenditure	22.8	23.8	24.3	23.5	25.0
Current	18.6	18.1	18.6	17.4	17.1
Capital	4.2	5.8	5.6	6.1	7.9
Deficit	-7.9	-8.4	-8.0	-7.7	-7.0
Government Debt	102.3	90.6	88.7	85.8	82.3

Notes: a: Estimates
Source: CBSL, *Annual Report*, various issues.



Adverse Developments on Economic Front

- Spiraling inflation
 - Annual rate rose from 9% in 2004 to 22.6% in 2008
 - Sharply widening external current account deficit
 - Increased -3.1% of GDP in 2004 to >5% in 2008
 - 'Managed' exchange rate
 - Nominal depreciation of 0.9% in 2007
 - 'pegged' at Rs/\$ 108 Jan-Sep 2008
- ⇒ SL entering global downturn with weak public finances, high inflation and currency support



Deficit Financing

% of GDP	2004	2005	2006	2007	2008a
Deficit	-7.9	-8.4	-8.0	-7.7	-7.0
Foreign	2.2	3.3	2.5	3.7	3.3
Domestic	5.6	5.1	5.5	4.0	3.7

Notes: a: Estimates
Source: CBSL, *Annual Report*, various issues.

- Fiscal rigidities driving macroeconomic imbalances not addressed
- Responsibility for ensuring macroeconomic stability fell unduly on monetary policy



Monetary Policy Response

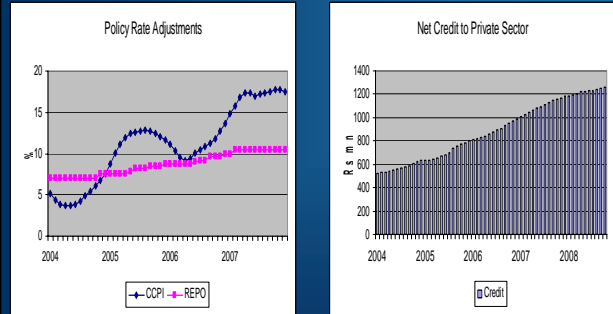
- Post-2005, rising inflationary pressures called for extra vigilance with regard to ensuring price stability
 - Tighter monetary policy may have dampened growth, but ensured a more stable macroeconomic environment

“if interest rates are allowed to remain unchanged for the most part, this will cushion the initial impact on output, but at the risk of higher inflation later...and that the most pervasive risk of such a strategy is that in an environment of heightening inflationary expectations, monetary policy may need to be tightened more than when inflationary expectations are low.”

IPS, *Sri Lanka: State of the Economy 2005*, p.2



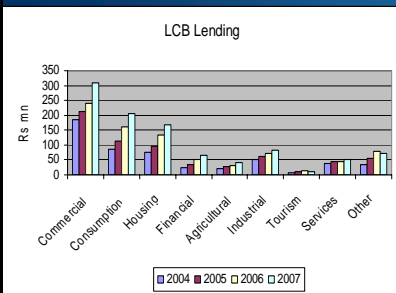
Trends in Some Monetary Indicators



Source: CBSL, *Monthly Economic Indicators*, various issues.



Financial System Stability



- Average NPL ratio for banking industry estimated to have increased from 5.2% to 6.5% in 2008

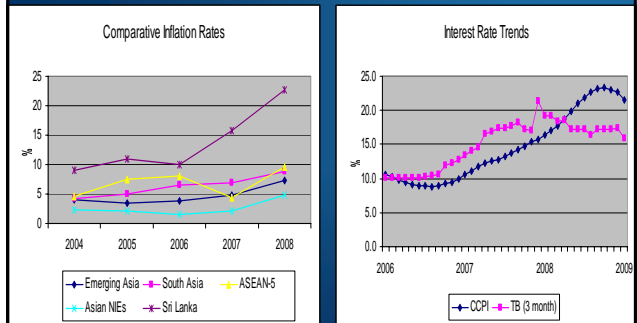
“If central banks hold interest rates low, this will encourage risk taking in financial markets”

IPS, *Sri Lanka: State of the Economy 2006*, p.4

Source: CBSL, *Annual Report*, various issues.



2007: Monetary Policy Tightening



Source: IMF, *World Economic Outlook*, various issues.

Source: CBSL, *Monthly Economic Indicators*, various issues.



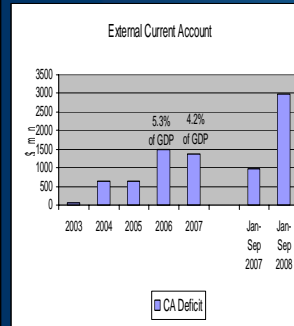
Rising Exposure to Short-term Foreign Currency Borrowing

Date	Type	Amount (\$ mn)	Maturity	Due 2009
Jun 2006	SLDB	250	2 yr	
Jun 2006	SLDB	50	3 yr	Jun 2009
Aug 2006	SLDB	175	3 yr	Aug 2009
Sep 2006	SLDB	70	2 yr	
Sep 2006	SLDB	35	3 yr	Sep 2009
Dec 2006	Syndicated loan	100	3 yr	Dec 2009
Mar 2007	SLDB	215	2 yr	Mar 2009
Oct 2007	Sovereign Bond	500	5 yr	
Jun 2008	Syndicated loan	150	3 yr	
Jun 2008	SLDB	230	2 yr	
Sep 2008	SLDB	60	2 yr	

Source: www.cbsl.gov.lk

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A Sharply Deteriorating External Current Account



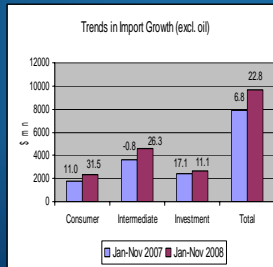
Source: CBSL Annual Report, and Monthly Economic Indicators, various issues.

- Weakening trade balance offset by rising remittance inflows
- However, current account deficit has averaged 4.5% of GDP during 2006-07
- Set to further weaken sharply in 2008

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Required Policy Response

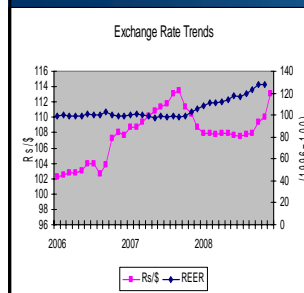
- A large deficit carries risks
 - Economy and currency may struggle if capital inflows suddenly dry up
 - Nature of capital flows financing deficit matters
- Growing and sustained current account deficit calls for adjustment in currency
- Leads to relative price change
 - (Net) positive effect on exporters & producers of import substitutes
 - Rupee price of imports go up
- Attraction of steady exchange rate
 - Contain inflationary pressures and
 - External debt service



Source: CBSL, Monthly Economic Indicators, various issues

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Nominal and Real Exchange Rate Trends



- Nominal depreciation of only 4% between Sep. 2007-Sep.2008
- Appreciated from Oct. 2007 on the back of capital inflows
- Nature of capital inflows financing deficit matters
 - Short-term capital inflows may not be related to current demand for SL goods & services, but leads to upward pressure on exchange rate
- Managed intervention in 2008
- REER appreciated by as much as 25% between Nov 2007-Nov 2008

Source: CBSL, Monthly Economic Indicators, various issues.

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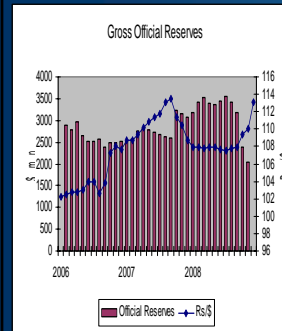
Impact on Sri Lanka's Reserves

	Dec 2007		Nov 2008	
	\$ mn	Import months	\$ mn	Import months
<i>Excl. ACU</i>				
Official	3063	3.2	2030	1.7
Total	4511	4.8	3336	2.8
<i>Incl. ACU</i>				
Official	3508	3.7	2608	2.2
Total	4956	5.3	3914	3.3

- \$650 mn inflow to Treasury bills & bonds fell to \$212 mn by end 2008
- Reserves were used to defend currency
 - Monetary policy made complicated by currency defence and liquidity injections

Source: CBSL, *Monthly/Weekly Economic Indicators*, various Issues.

Implications for the Exchange Rate



- Official reserves declined from peak of \$2.7 bn in July 2008 to \$2 bn in Nov 2008
 - Decline from 3.2 to 1.7 months of imports
- Reserves need to be large enough to draw on if foreign currency funding suddenly dries up

Source: CBSL, *Monthly Economic Indicators*, various Issues.

Policy Flexibility: Fiscal

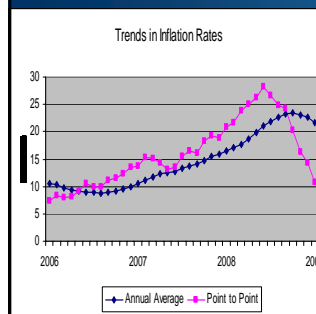
Public Finances

% growth	Budgeted 2008	Jan-Nov 2008
Revenue	32.8	19.8
Tax	33.1	19.0
Expenditure	24.1	19.2
Current	14.5	18.1
Capital	51.4	22.4

- No room for fiscal stimulus if price stability is to be achieved
- Rs. 16 bn stimulus will have only a marginal impact
 - Amounts to only a 2% increase in budgeted current spending for 2009
- To be financed by cuts in expenditure
 - Not strictly a 'stimulus' package

Source: CBSL, *Monthly Economic Indicators*, various Issues.

Policy Flexibility: Monetary

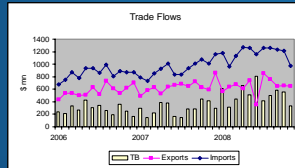


- Lagged effect of tighter monetary policy since 2007 taking effect
- Will allow for an easing of interest rates in coming months
- However, a sustained reduction of interest rates tied into outlook for external sector

Source: www.cbsl.gov.lk

External Sector Prospects: 2009

- Current account likely to remain under significant stress
- Capital flows will be adversely affected
- Overall BOP will be weak
 - overall surplus declined from \$516 mn in July 2008 to \$173 mn by September 2008
- Immediate concern is with regard to impact on exchange rate and appropriate policy response



Source: CBSL, *Monthly Economic Indicators*, various issues.

Remittance inflows will likely remain steady for now

- Increased by 17.4% Jan-Nov 2008, compared to increase of 15.1% Jan-Nov 2007

Exchange Rate: A Large Devaluation?

- Potential risks are high
 - If reserves are perceived to be inadequate to 'manage' a given rate
 - If markets do not have confidence that any new rate can or will be defended
 - Market pressure will mount against currency
- If the new rate cannot be defended, then outcome could be worse
- Only 2 other real alternatives
 - Re-impose stringent exchange controls
 - Allow currency to float freely, backed by IFIs
- Immediate steps needed to build up reserves
 - Promotion of Treasury bills & bonds amongst SL diaspora
 - Currency swaps with other Central Banks, etc.

Can a Monetary Policy Stimulus be Sustained?

- Declining inflation will allow a more flexible exchange rate policy
 - Interest rate cut and/or depreciation will help to stimulate SLs aggregate demand
- However, easing of interest rates will depend on need for short-term foreign capital
 - Flows tied to interest rate differential, expected depreciation rate
- Will also depend on fiscal developments
- Current outlook suggests flexibility to sustain a monetary policy stimulus over the year is also very limited

Growth in Fiscal Financing Needs

%	2007	2008	2009
Foreign	82.5	-6.6	25.1
Domestic	11.4	27.2	-0.8
Total	17.3	11.1	9.5

Source: Ministry of Finance, Budget 2009.

Thank You

www.ips.lk