SUNDAY OBSERVER
Sri Lanka's English Newspaper with the largest circulation

Crises in Japan, Middle East, West Africa will not hinder global recovery - Dr. Saman Kelegama

In a globally integrated economy any socio-economic, political issue or natural disaster creates ripples of consequences on each and every economy, be it big or small.

Political crises in the Middle East and West African countries and the triple disaster in Japan have created panic about the future of the global economy. Executive Director and Fellow, Institute of Policy Studies of Sri Lanka, Dr. Saman Kelegama in an exclusive interview with 'Sunday Observer' did an in-depth analysis on the impacts of these issues on the Sri Lankan economy.

Dr. Saman Kelegama

Q: Two global events, the triple disaster in Japan and the political crisis in the Middle East are posing a threat to the global economy. What is the direct impact of these crises on the Sri Lankan economy?

A: These are two different events and not inter-related, so we need to separate them to identify the impact.

Both events have created global uncertainty in regard to oil prices, behaviour of the Yen, capital flows, etc. Moreover, the impact of these two events on the above mentioned variables is amplified by increased speculative activities normally associated with uncertainty.

In regard to oil prices, there will be an escalation due to the crisis in the Middle East and North Africa, but oil prices will not escalate as it did in 2008 to levels above US$ 140.

Most experts are of the view that the average oil price in 2011 will increase to about US$ 105 due to the current crisis, although it has peaked to US$120 a barrel in international trading (Brent Crude oil price).

What is important to note is that other than Libya, all other crisis ridden countries in North Africa (Egypt and Tunisia) and Middle East (Bahrain and Yemen) are not oil exporters.

Moreover, Libya accounts only for a small proportion of international oil production. It accounted for 1.5 million barrels a day (MBD) compared to 2.4 MBD of Iraq, 2.5 MBD of Kuwait, 2.8 MBD of UAE, 4.1 MBD of Iran, and 10.1 MBD of Saudi Arabia (data for 2009).

Thus, disruption in oil production in Libya is not going to have a major impact on international oil supplies but speculative forces are working on a possible spread of the crisis to the major oil producing countries like Saudi Arabia and Iran.

Sri Lanka's oil import bill was approximately US$ 3 billion in 2010 out of a total import bill of approximately US$ 13 billion (approximately 23 percent of imports).

On the other hand, our export earnings in 2010 were close to US$ 8 billion and remittances amounted to US$ 4 billion. With all other capital inflows (FDI, borrowings, portfolio capital, etc.), Sri Lanka will record a balance of payment surplus in 2010. Thus, absorbing the crude oil price increase in 2011 will not be a major problem.

There are reasons to believe that our export earnings in 2011 will improve with the increasing ready-made garment exports (Sri Lanka seems to have gained from the crisis in Egypt, strikes and work stoppages in Bangladesh, and escalating cost of production in China), and increasing rubber prices.

When oil prices go up, the price of synthetic rubber also goes up and as a result the demand for natural rubber goes up.

Although rubber prices dropped due to the events in Japan as speculation grew that demand for rubber from the motor vehicle industry in Japan will decline, in the medium-term the "oil price effect" on rubber will be stronger than the "Japan crisis" effect.

The increasing tea prices (again the relatively high prices were disturbed by the Egyptian crisis, but with normalcy returning to Egypt, good prices should prevail).

There will not be a major disruption in remittances as the key destinations for Sri Lankan migrants (Saudi Arabia, Kuwait, UAE and Qatar) have not been affected by the crisis.

There are concerns on the escalating import bill.

Tokyo, JAPAN : Foreign currency traders call orders under a sign posting the foreign exchange rate between the US dollar and the yen, as well as share prices at a foreign exchange market in Tokyo on March 17. The Japanese yen continued to surge in early Asian trade, hitting a new record high of 76.52 yen against the US dollar since World War II following Japan's disastrous earthquake and tsunami. AFP

The Ceylon Petroleum Corporation's losses in 2009 was close to 0.5 percent of GDP and its monthly losses are close to Rs. 2 b. With international oil prices gradually increasing, the government will find it extremely difficult to absorb these price increases either in the form of a subsidy or by removing duty (tariffs) applicable to oil imports, and there may come a situation where a part of the price increase may have to be passed on to the consumer.

Oil imports are influenced by many factors. When rain declines, Sri Lanka's dependence on oil for electric power generation increases but with the rains that we received in January/February, the hydro power generation was at its peak and there was no need for excessive oil dependence for power generation.

However, car sales increased. During January to October 2010 motor vehicle imports have increased to 285,000 compared to 164,000 during the corresponding period in 2009.

This in turn means that after the global economic recovery in 2010 and as a result of tariff reduction for motor vehicles in June 2011, the demand for motor vehicles has gone up and with it the demand for oil.

These are areas where we have to keep a close watch in the context of the escalating oil import bill.

The Japanese crisis will also not have a significant impact on Sri Lanka. Japan is not a major export market for Sri Lanka, accounting only for two percent of total exports from Sri Lanka.

Most Japanese imports such as electronic goods and motor vehicles are produced and supplied to Sri Lanka from other countries, so in regard to trading there may not be a major problem.

However, as Japan will focus more on reconstruction and rehabilitation, there will be less emphasis on bilateral aid. Japan has been the largest donor for Sri Lanka for many years and Japan will find it difficult to maintain this position in the coming years.

Q: What is the significance of Japan in the global economy and how will it affect the other economies?

A: Japan is the third largest economy in the world after the USA and China (both in nominal GDP and purchasing power parity).

Japan’s main trading partners are USA and China.

Nineteen percent of Japanese exports and 23 percent of Japanese imports are for/from China, and 17 percent of Japanese exports and 11 percent of Japanese imports are for/from USA.

The Tokyo stock exchange is the second largest in the world by market capitalisation. Japan has a large industrial base and is home to some of the largest and technologically advanced motor vehicles, electronics, machine tools, etc.

Japan is home to 326 companies from the Forbes Global 2006.

In the global foreign exchange market, the Japanese Yen is the third most traded currency after the US dollar and the Euro. Low interest rates since the mid-1990s combined with ready liquidity for the Yen have prompted investors to borrow money in Japan and invest in other currencies. This is known as ‘Carry Trade’.

Thus Japan’s public debt per GDP is about 220 percent - the largest ratio among industrial countries. Given this strength and peculiarities and the inter-linkages with the global economy, obviously any major event in Japan is bound to have an effect on most other economies. The impact will vary depending on the links with the Japanese economy.

Q: Appreciation of Yen is a major concern and leading Central Banks have launched a coordinated intervention to stabilise the Yen. How does the Yen appreciate and what are the impacts of it on the global financial system?

A: The Yen appreciation gathered momentum just before the global economic crisis.

Yen appreciation is due to many factors. First, Japan has a huge balance of payment surplus.

Second, heightened concerns on the US economic outlook have triggered capital outflow from US, Europe, and emerging economies to the Yen, which is regarded as a relatively safe asset. Moreover, Japan’s financial system has been less hurt than the US and EU.

Why did the Yen appreciate soon after the disaster when we expected the opposite effect? This was due to: (a) As we all know, Japanese are big purchasers of foreign securities.

They have bought many foreign assets: American, European and Asian bonds. Japan is one of the world's biggest net creditors with US$ 3 trillion of net overseas assets.

The crisis in Japan has caused some investors to sell foreign assets and bring back money to Japan.

This creates additional demand for Yen and pushes its value up, and (b) expectations that Japanese insurers and companies will bring money home to pay for claims and reconstruction.

A strong Yen is an impediment to the export-driven economy of Japan and contributes to further deflation of the Japanese economy which in any case is growing very slowly.

The G-7 decided to intervene in the currency markets to slow the appreciation of the Yen.

The concern is that further appreciation would hamper Japan's recovery effort by making Japanese exports less competitive.

The intervention in the currency market by G-7 has been welcomed by the Japanese Finance Minister, Yashiko Noda.

After the intervention, the US dollar amounted to 81.48 Yen compared to the value of 76.25 Yen on March 17.

On the implication of an appreciated Yen on the global economy: Yen appreciation has created a new structure that has consolidated into the Japanese economy and reduced the manoeuverability of policy variables in the Japanese economy.

This structure has to be gradually weakened.

What is this structure ? I referred to 'carry trade' earlier.

Now a basic description of the Yen carry trade is that traders borrow Yen in Japan at low interest rates, convert the Yen into another currency, and invest the funds at a higher interest rate.

The trader then earns the interest rate spread between the two currencies, but bears the risk that the Yen will appreciate before the loan is repaid.

It is not easy to measure the total size of the Yen carry trade, but it is massive. This fact highlights the concern of what will happen if the Bank of Japan raises interest rates significantly. The Bank of Japan has been threatening to raise rates for years, but has not done so.

Why ? If the Bank of Japan raises interest rates it could undermine the cheap leverage that has been available for so many years.

The unravelling of these trades could no doubt have a major impact on global financial markets. International financial markets have evolved into a single global economy and it is important to watch the Bank of Japan.

Q: How does it affect Sri Lanka, our debt payments and trade? A: Japan is the largest lending country in the world. Japan accounts for more than 25 percent of bilateral claims on developing countries.

A large part of Japanese exposure (approximately 60 percent) is in Asia.

In some Asian countries, more than 25 percent of their long-term debt is Yen denominated (in Thailand it is close to 50 percent).

In Sri Lanka, Yen denominated debt is about 26 percent compared to 19 percent of US dollar debt and 8 percent of Euro debt. Thus, Yen appreciation vis-a-vis the US dollar is bound to have an effect on the debt situation in Asian countries like Sri Lanka.

In Sri Lanka, public debt per GDP is above 80 percent and as per the agreement with the IMF we have to bring this ratio to about 65 percent in the next 2-3 years.

In this context, an appreciated Yen will be of concern because Yen-based debt payments will escalate.

I think the end of deflation in Japan has been brought forward by this disaster. Japan will get out of the ‘liquidity trap’ and its domestic demand will increase.

Although not a large export market, this will mean that Sri Lankan exports to Japan will have more demand in the future.

One can say so because after the Kobe earthquake (which hit a large city unlike the present tsunami), the economy shrunk in the quarter following the disaster but large scale rebuilding saw a boost to the GDP in the following quarter.

Since the Yen is kept at a level just above 80 per US$ with G-7 intervention it will be good for Asian countries like Sri Lanka which has more than a quarter of its debt denominated in Yen. A weaker Yen will reduce the debt servicing burden for Sri Lanka.

Q: Will all these issues reduce global economic growth further reversing the recovery?

A: Not necessarily, because Japan coming out of deflation is good for the rest of the world.

The tsunami devastation is in a sense an opportunity in disguise for Japan to rise out fast from the calamity.

The Middle East and North African crisis will not have a major impact on oil prices as explained earlier. Although there is much uncertainty from both these events, they cannot make major inroads to reverse the global economic recovery.

Q: Two factors are posing pressure on oil prices, possible supply disruption due to Middle East political tension and possible demand increase after the nuclear plant tragedy in Japan. Will this lead to another oil shock?

A: There is now speculation that the demand for oil will increase, as developed nations may have concerns on expanding nuclear energy.

But this maybe a temporary phenomenon. There was similar speculation after the Chernobyl disaster in 1986 but once the radiation levels subsided, it was business as usual. Nuclear plants have expanded with better safeguards.

The demand for oil will increase due to the cut down on nuclear energy is premature.

Also to say that there will be a major disruption in oil supply due to the North Africa and Middle East crisis, may also not be accurate.

The winter season is over in Western countries and their economic recovery is slow.

Thus the demand for oil will not see an exceptional increase.

The growth of India and China along with the rest of Asia is generating a high demand for oil but this phenomenon was there before the twin crises in Japan and the Middle East. Thus, I do not foresee another major oil shock.