

'Gala Time in Rainy Days' Macroeconomic Implications of the Financial Inflows to Sri Lanka in 2009

Introduction

With the approval of the International Monetary Fund (IMF) Stand-By Arrangement in July 2009, Sri Lanka narrowly escaped from a serious macroeconomic crisis. The macroeconomic crisis emerged from two fronts, internally and externally. It was initially a home-grown problem due to worsening fiscal and external finance positions of the country for many years. Externally, the problem was aggravated by the global oil and food crises during 2007-2008 and the transmission of the adverse impact of the global financial crisis since the latter part of 2008.

The IMF Stand-By Arrangement was followed by an upsurge in capital inflows, largely as financial investments in government securities, including the United States Dollar (USD)-denominated development and sovereign bonds. The respite could be temporary and dangerous as the highly volatile capital inflows could also reverse suddenly dragging the balance of payments into the same problem. In this context, the main issue in question is whether the country has actually avoided its fundamental macroeconomic imbalances.

This paper draws attention to the macroeconomic implications of the IMF Stand-By Arrangement and the resulting capital inflows and outlines the policy options needed for achieving the sustainable macroeconomic stability.

Getting into Trouble

Sri Lanka's balance of payments never reflected a sustainable

improvement in the past, since more stable and autonomous foreign exchange earning sectors did not expand adequately. Compared to many other high-performing Asian countries, in Sri Lanka exports grew slowly, service trade was trivial, tourism sector never performed well, and foreign direct investment was marginal. The past few years were marked by a worsening trade deficit which increased constantly from 8 percent of gross domestic product (GDP) in 2003 nearly to 15 percent of GDP in 2008 (Figure 1). During this period, exports grew on average by less than 10 percent per annum. However, the balance of payments did not reflect a major problem, because, basically, the problem was hidden behind the growing private remittance inflows and the government's foreign borrowings. Private remittances, being the fastest growing foreign exchange earning sector, recorded on average nearly a 15 percent growth per annum during 2003-2008. The government's foreign borrowings continued to rise, together with commercial borrowings started since the late 2007.

The rising global energy and food prices exerted further pressure on the balance of payments as well as on the government finance. According to the import value indices (Central Bank of Sri Lanka (CBSL), 2008), during the

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five-year period of 2004-2008, the import value of food and beverages has increased by 90 percent and that of crude oil by 118 percent. Particularly in the case of fuel as well as other related public utilities, public transport and fertiliser subsidies, the domestic price adjustments were lower than the world price hikes. This created pressure on the government finance and increased the losses made by many state-owned enterprises and institutions, such as, the Ceylon Petroleum Corporation, Ceylon Electricity Board, Sri Lanka Transport Board and the Sri Lanka Railways.

The world market price hikes were followed by the global financial crisis which resulted in a sharp contraction in export earnings and a sharp increase in financial outflows. According to point-to-point changes in quarterly export

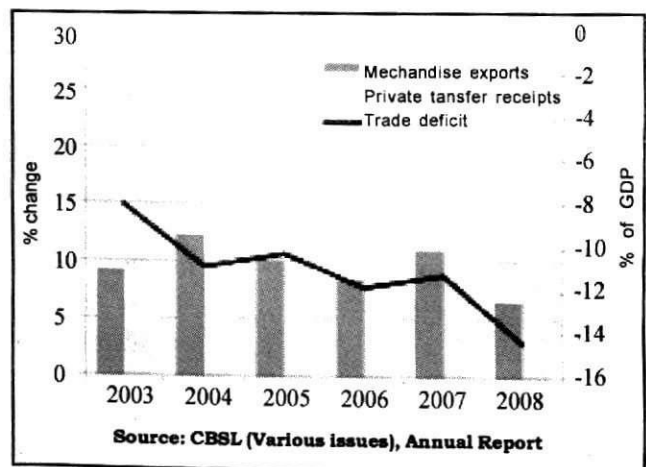


Figure 1: Exports, remittances and trade deficit in Sri Lanka, 2003-2008

Table 1: Point-to-point change in exports (%) in Sri Lanka, 2008-2009

	Jul-Sep 2008	Oct-Dec 2008	Jan-Mar 2009	Apr-Jun 2009
Tea	28.3	-7.2	-20.8	-17.4
Rubber	20.7	2.8	-37.4	-16.3
Minor export crops	47.8	-26.0	-27.7	-35.6
Gem and jewellery	3.7	72.7	-20.6	-13.3
Textile and garments	5.5	6.6	5.9	-13.5
Other manufactures	-10.8	-17.0	-27.3	-41.0
Total exports	10.0	-2.8	-12.6	-23.3

Source: Central Bank of Sri Lanka and Export Development Board, Sri Lanka.

earnings, total exports which contracted by 2.8 percent in the fourth quarter of 2008 continued to fall by 12.6 percent and 23.3 percent respectively in the first two quarters of 2009 (Table 1). The main export sector – textiles and garments – which account for about 43 percent of total exports has sustained its export growth at around 6 percent in the third and fourth quarters of 2008 as well as in the first quarter of 2009. But, it recorded a contraction by 13.5 percent in the second quarter of the year. Other manufacturing exports which account for one-third of total exports showed a growing contraction throughout all four quarters reaching the highest contraction by 41 percent in the second quarter of 2009. The main agricultural export crop – tea – has also recorded negative rates of growth since the fourth quarter of 2008.

Even if both ‘autonomous’ and ‘accommodating’ capital flows taken together, there was significant reduction in net capital inflows to USD 298.2 million during the period of 12 months ending March 2009 from USD 1985.6 million in the corresponding period in 2007/08 (Table 2). Particularly, the short-term capital recorded net outflows amounting to USD 1157 million in the fourth quarter of 2008 and USD 697 million in the first quarter of 2009. This appears to have been contributed by the repayment of the government’s short-term loans reaching maturity during this period as well as the increased withdrawal of foreign investment in government securities.

The monetary authorities were left with two options to manage the emerging balance of payments crisis. The first is to release the pressure on the balance of payments through exchange rate

depreciation. The second is to use the foreign exchange reserves to fill the gaps in foreign exchange shortage by averting the pressure on the exchange rate. In fact, many countries, including Sri Lanka’s major trading partners in the Western Europe and its competitor countries in Asia faced with the global financial crisis, allowed their exchange rates to depreciate against the USD. But, Sri Lanka resorted to the second option. As reported by the *Press Release* of the Central Bank of Sri Lanka (December 30, 2008), the increased outflow of foreign currency during late 2008 was managed due to prudent build up of foreign exchange reserves. However, the outcome was the sharp fall in official foreign exchange reserves from around USD 3.5 billion in mid-2008 to about USD 1.2 billion by the end of the first quarter of 2009 (Figure 2). Beside the fact that Sri Lanka never had a comfortable reserve position, when the reserves deteriorated to critical limits adequate to about 6 weeks of imports, the country was left on the doorstep of a balance of payments crisis. Given the magnitude of the problem, the government’s borrowings together with both bilateral and multilateral aid flows during the first half of the year appear to be too small to fill the gap.

IMF Assistance and Capital Inflows

The IMF finally approved its much-awaited Stand-By Arrangement after the controversies and chaos that delayed the IMF assistance to Sri Lanka. The Stand-By Arrangement amounts to USD 2.6 billion that will be disbursed in eight tranches during a period of 20 months, ending March 2011, subject to the quarterly reviews on

Table 2: Net financial inflows (USD million) to Sri Lanka in 2007/09

	Long-term private	Long-term government	Short-term	Total
<i>Annual totals</i>				
2007/08 (Apr-Mar)	683.7	770.4	531.5	1985.6
2008/09 (Apr-Mar)	746.4	213.6	-661.8	298.2
<i>Quarterly totals</i>				
Q2-2008	211.4	177.1	526.5	915.0
Q3-2008	182.3	135.7	665.9	983.9
Q4-2008	172.0	-198.1	-1157.0	-1183.1
Q1-2009	180.7	98.9	-697.2	-417.6

Source: CBSL (monthly issues), *Selected Economic Indicators*.

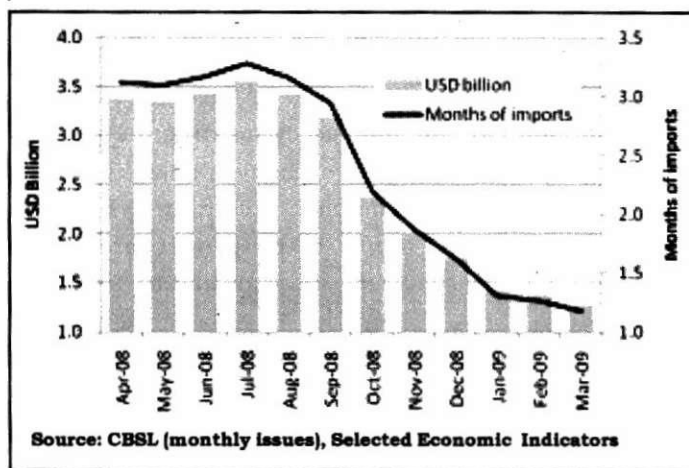


Figure 2: Gross official reserves of Sri Lanka, 2008-2009

economic performance. The first tranche of the loan, amounting to USD 322 million was provided immediately after the approval of the Stand-By Agreement. After a grace period of one year, the loan, if used, is repayable within four years commencing in April 2012. The interest rate comprising the service charge and the fixed margin is 1.3 percent, and could be higher depending on the outstanding loan amount in relation to the Sri Lankan quota at the IMF. The facility was provided in order to rebuild the foreign exchange reserves and strengthen the balance of payments.

This was intended to create more space for the government to improve its fiscal position and monetary stability as well as to release resources to strengthen

IMF assistance to embark on a programme of economic reform and post-conflict reconstruction. This programme included achieving the budget deficit to 5 percent of GDP by 2011 from a target of 7 percent of GDP in 2009, and strengthening the international reserve position, allowing greater exchange rate flexibility. In addition, the programme included strengthening the financial system with improvements in regulatory mechanism and supervision as well as protecting expenditure on transfers to the most vulnerable groups of the population and on post-conflict assistance. The *Technical Memorandum of Understanding* specifies the performance criteria in relation to fiscal targets, monetary targets, and external sector targets that Sri Lanka should achieve and maintain

the safety net and resettlement programmes in the conflict-affected region. According to the *Press Release* of the IMF (July 24, 2009), the Sri Lankan authorities have sought

in relation to the IMF Stand-By Agreement.

The approval of the IMF Stand-By Agreement triggered capital inflows, mainly, as investments in government securities. After the relaxation of the foreign investment in Treasury Bond market in December 2007, and the opening up of the Treasury Bill market for foreign investment in May 2008, now, foreign investment in government securities is allowed up to 10 percent of the outstanding securities in the respective markets. At the same time, the government continued to issue USD-denominated development and sovereign bonds. The Central Bank intervened in the foreign exchange market by purchasing foreign exchange, and avoiding exchange rate appreciation. As a result, Sri Lanka could avert the balance of payments crisis. The *Press Release* of the Central Bank of Sri Lanka (October 20, 2009) revealed that, by the end of August 2009, the gross official reserves have increased to USD 3.9 billion, out of which, over USD 1 billion comprised of foreign investment in government securities.

As envisaged, the approval of the IMF Stand-By Agreement improved the investor confidence that had deteriorated prior to the mid-2009.

First, it averted the possible and painful exchange rate depreciation that would have affected negatively the capital and interest gain of the foreign investments in government securities. Secondly, the conditions attached to the IMF assistance in relation to the fiscal policy, monetary policy, and balance of payments withered away the risk and uncertainty

Table 3: Budget estimates and achievements of Sri Lanka, 2009

	Revenue	Expenditure	Deficit
2008 actual: Rs. Billion	709.4	1016.7	307.4
as % of GDP	16.0	23.0	7.0
2009 estimates: Rs. Billion	855.0	1191.7	336.7
as % of GDP	16.4	22.8	6.5
Estimated annual change (%)	20.5	17.2	9.5
<i>Half-year Performance</i>			
Jan-Jun 2008: Rs. Billion	313.4	469.4	156.0
as % of GDP	15.0	22.4	7.4
as % of annual budget (%)	44.2	46.2	50.8
Jan-Jun 2009: Rs. Billion	290.5	546.3	255.8
as % of GDP	13.1	24.7	11.5
as % of annual estimates (%)	34.0	45.8	76.0

Source: GOSL (2008), *Budget Speech 2009*, CBSL (monthly issues) *Selected Economic Indicators*.

resulting from macroeconomic imbalances. Thirdly, the government securities and the USD-denominated international bonds offered lucrative capital and interest gains that are significantly higher than the international standards. Finally, the frequent downward revisions in the domestic interest rates further increased the capital gains of the foreign investments in USD-denominated bonds. The latest USD 500 million 5-year sovereign bond issue in September 2009, according to the *Press Release* of the Central Bank of Sri Lanka (October 16, 2009), was over-subscribed by more than 13 times.

Is the Problem Over Now?

As far as the composition of the current capital flows, including the IMF Stand-By Agreement, are concerned, the international reserves appear to have built upon international loans that have to be repayable. The foreign investments in government securities and USD-denominated bonds reach maturity extending up to 5 years, while the previous foreign investments have already reached their maturity period. Therefore, the capital inflows are accompanied by capital outflows as well.

There is also a danger of potential capital outflows that can occur sooner than expected. Much of the foreign investment in financial assets is based on investor confidence and speculation. Any change in underlying conditions of the investor confidence and speculation can cause sudden capital outflows, dragging the balance of payments into the same crisis that Sri Lanka had to face prior to the approval of the IMF Stand-By Agreement.

The main issue is whether Sri Lanka has actually embarked upon a programme of achieving fiscal and

monetary discipline in order to rebuild strong reserve position as stated in the conditions attached to the IMF assistance.

Fiscal prudence, far behind the target

In the past few years, the reform process required for fiscal prudence was virtually abandoned, while there has been a massive increase in public expenditure. This compelled the government to resort to the increased borrowings from both domestic and foreign sources, including the commercial borrowings from abroad. The Fiscal Management (Responsibility) Act of 2002, that was aimed at improving management, transparency and accountability of public finance, compelling the government to reduce the budget deficit to 5 percent of GDP by 2006, became totally ineffective after 2004.

According to the *Budget Speech 2009* (Government of Sri Lanka (GOSL), 2008), however, the government envisaged a significant improvement in its fiscal position for the coming financial year, January - December 2009. The government revenue was estimated to rise by 20.5 percent and the expenditure by 17.2 percent, compared to the previous year, resulting in a substantial decline in budget deficit from 7.0 percent to 6.5 percent of GDP (Table 3). According to the first half-year performance of the budget, the government has been able to generate only 34 percent of the estimated annual revenue, compared to 44.2 percent of the corresponding period of the previous year. The completion of the government expenditure amounting to around 46 percent is roughly as same as that of the previous year.

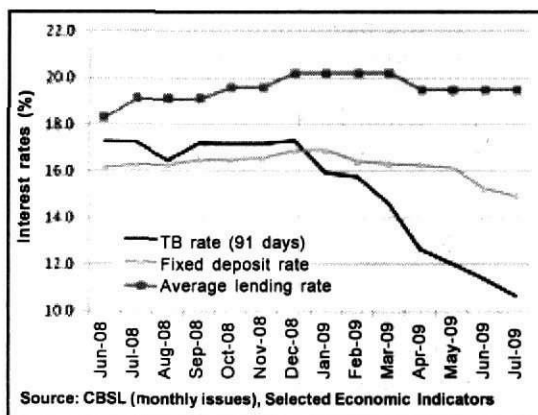


Figure 3: Monthly interest rate movements in Sri Lanka, 2008-2009

The achievements of the estimated revenue and expenditure outlays show that 76 percent of the estimated annual budget deficit has already been reached within the first half of 2009, recording a budget deficit at 11.5 percent of the GDP. Given the dismal budgetary performance during the first six months of the year, the fiscal targets attached to the IMF Stand-By Agreement seem rather unrealistic. This has been admitted in the *Press Release* of the IMF (September 22, 2009) which stated that the fiscal target is ambitious, but the government is committed to taking necessary steps to improve the fiscal position for the remainder of the year.

Monetary relaxation for deficit financing

Even though the fiscal space was shrinking, the monetary sector had an easier time for expansion due to the decline in inflation. According to the *Press Release* of the Central Bank of Sri Lanka (April 22, 2009), the policy measures were taken to ease monetary expansion and to reduce the policy interest rates against the continuing decline in the general price level and the domestic demand. However, the falling interest rates appear to have brought about benefits more to the government for deficit financing than to the private sector for investment.

Although the policy rates and the interest rates on government securities declined sharply, the commercial banks appeared to be reluctant to respond to the relaxed monetary policy stance. For instance, the 91-day Treasury Bill rate declined steadily from over 17 percent in the late 2008, to below 11 percent by July 2009 (Figure 3). But, the average lending rate of the commercial banks remained around 20 percent, while the fixed deposit rate has shown only a marginal decline.

In fact, the commercial banks also had an easier time with the increase in bank deposits since the latter part of 2008 to reduce the lending rates and to expand credits. The bank deposits increased by 9 percent in the first half of 2009 compared to the deposit growth at 4.2 percent and 3.5 percent in the first and second halves of 2008 respectively (Table 4). The increase in bank deposits was also contributed by the transfer of deposits from the private financial companies which lost the public confidence during this period. Presumably most of these transfers flowed into the state banks which control a large share in the financial market. However, the total bank loans, which grew by 6 percent in the first half of 2008 recorded a falling rate of growth by 4.9 in the second half of 2008 and by 1.2 percent in the first half of 2009. It should also be noted that total bank loans include increased credit to public institutions as well. Given the higher risks of private lending caused by the economic

downturn and the increase in non-performing loans, apparently, the banks adopted a cautious lending practice in the recent past. But, this has not affected the banking performance, because, they enjoyed the opportunity to divert their increased deposits to lend to the government for deficit financing. Bank investment in government securities increased by 20.2 percent in the second half of 2008 and by 48.9 percent in the first half of 2009. When deposits grew by Rs. 127 billion during the first six months of 2009, loans increased only by Rs. 13 billion, but investment in government securities by Rs. 103 billion. The net beneficiary of the relaxed monetary policy stance is, therefore, the government and not the private sector.

Concluding Remarks

The key issue is that, although the IMF assistance and the subsequent capital inflows helped the country to avert the possible balance of payments crisis, the respite seems to be temporary and could be dangerous. The conditions attached to the IMF Stand-By Agreement and the related economic performance could avoid this danger in achieving sustainable balance of payments position. In achieving a sustainable balance of payments position, Sri Lanka will have to depend more on trade performance in the current account and on foreign direct investment in the

financial account than on borrowings and volatile capital inflows. This will also help the country to get the

economy on right track, ensuring a sustainable rapid growth.

The conditions attached to the IMF Stand-By Agreement have opened up an important opportunity to embark upon a bold reform process to ensure fiscal and monetary discipline. But, the macroeconomic performance so far appears to be lagging far behind the expectations. It is not wise to think that the reserve position is comfortable now and that there will be more foreign exchange flows with the anticipated revival of tourism and some foreign direct investment flows. It is also not the issue whether the country is able to receive the remaining tranches of the IMF Stand-By Agreement. The more important issue is whether the country is prepared to exploit the opportunity that has accompanied by the IMF assistance and face the challenge of reforms.

Acknowledgement

This paper benefited immensely from the Seminar on the IMF Stand-By Arrangement, organised by the Pathfinder Foundation. The author wishes to thank the Pathfinder as well as the resource persons, Anura Ekanayake, Saman Kelegama, W.D. Lakshman and G. Uswattearachchi who made valuable presentations at this seminar.

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Table 4: Commercial banking performance in Sri Lanka, 2008-2009

	Bank loans	Government securities	Bank deposits	Excess liquidity
Rs. billion				
Jun-08	1092.5	182.8	1362.6	19.4
Dec-08	1146.4	219.7	1410.6	20.6
Jun-09	1159.7	327.1	1537.6	22.0
Change (%)				
Jun-08	6.0	9.4	4.2	8.2
Dec-08	4.9	20.2	3.5	6.1
Jun-09	1.2	48.9	9.0	6.9

Source: CBSL (monthly issues), *Selected Economic Indicators*.