BRAVE OLD WORLD: SRI LANKA'S ECONOMY IN THE POST CRISIS WORLD

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Background

In June 2013 the US Federal Reserve indicated that the improvements in the housing and labour markets in the United States would enable a gradual reduction in the extraordinary monetary policy measures that were hitherto in place to stimulate the economy. This triggered sharp discord in global markets, particularly in emerging economies, as interest rates shot up and currencies depreciated rapidly. The era of vast quantities of cheap money that had supported investment and growth in emerging markets was coming to an end. Sri Lanka too has benefitted significantly from the flood of liquidity in global capital markets – and the anticipated impacts of what is now known as "tapering" have already had an impact on the economy. The banking and finance environment in Sri Lanka has also been influenced by these developments, and the evolution of the global and local economy and financial markets will undoubtedly have important implications for the sector in the coming years.

An Extraordinary Decade

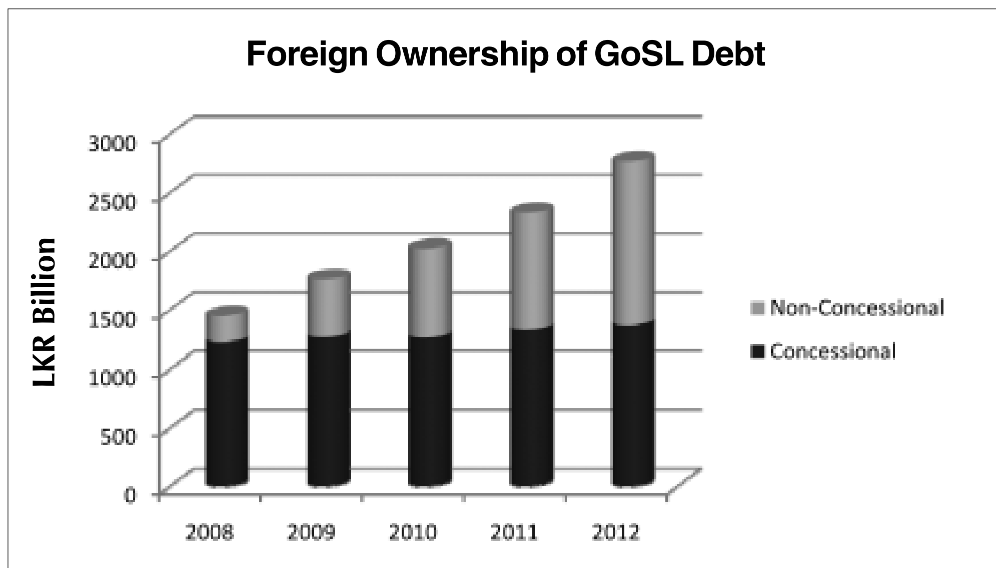
A number of fairly extraordinary circumstances characterized the global economy over the last decade. The decade can be separated into two stages. In the first stage, in the immediate aftermath of the dot com bubble in the year 2000, the US Federal Reserve loosened monetary policy and provided fiscal stimulus to trigger significant economic growth and the prosperity in the US. At the same time, the Euro members too enjoyed strong economic performance following harmonization of monetary policy and exchange rates, and China's integration with the global economy through WTO entry in 2001 supported a major growth spurt in that country as well. The global economy was growing at unprecedented rates, and that too without triggering much inflation. During this period the export sectors in several emerging/frontier markets enjoyed a boom, with strong commodity prices and robust demand in advanced economies. All of this came to a halt with the financial crisis that started in the US and spread to Europe in 2008 – exactly five years ago.

In the second stage, the crisis triggered an even more substantive response by governments around the world – with major monetary and fiscal stimulus provided by the US, Japan, Europe, the UK and China. This prevented a repeat of the great depression of 1929 by creating vast

quantities of liquidity that flooded world markets, pushing down interest rates in markets across the globe. In September 2008 the US Federal Reserve's balance sheet was around US$ 900 billion, whereas by September 2013 it had increased fourfold to US$ 3.6 trillion. The latest episode of Fed balance sheet expansion has been known as Quantitative Easing (QE), where the Fed purchased US$ 85 billion per month of US treasury securities and mortgage backed securities from the market, pushing yields on these assets down. As a result, the US 10 year treasury bond yield which was 4% in September 2008 had fallen to 1.6% in April 2013 (reaching a low of 1.47% in July 2012). Lower interest rates spread across the world and supported rapid growth in emerging economies, whilst the fiscal and monetary stimulus in China supported a commodity boom which in turn enabled commodity dependent economies from South Africa to Brazil to enjoy strong growth. These factors contributed to the emerging economies' continued boom despite a slowdown in advanced economies.

A Favourable Environment for Sri Lanka

The developments in global financial markets had important implications for Sri Lanka. Historically Sri Lanka has had relatively low savings rates and has relied on capital inflows from development agencies and other donors to finance growth. With the increase in the country's per capita GDP and subsequently shifting out of low income classification, the inflows of aid naturally declined. The government had to replace this off-shore capital by tapping commercial markets. The government's debut 5 year issue in 2007 raised US$ 500 million at a yield of 8.25%. From 2006 the government also gradually opened up the LKR treasury market for limited foreign investment.



Source: Central Bank of Sri Lanka data

It was indeed fortunate that at the same time that the government began to open up to foreign capital flows, global markets became very liquid and investors were keen on yield seeking assets. Accordingly, Sri Lanka was increasingly able to attract relatively cheap foreign capital to finance growth. Foreign capital also played an important role in supporting the balance of payments, particularly given the sharp increase in the current account deficit in 2010/11. Foreign investment in treasury securities and government borrowings through sovereign bonds and Sri Lanka Development Bonds enabled capital account inflows which supported the Rupee during this period. In more recent years, off shore borrowings by commercial banks have also added to this support for the LKR. In sum, the easy access to relatively cheap off-shore capital enabled Sri Lanka to control domestic interest rates at relatively low levels and also retain LKR value despite a growing current account deficit.

Financing Sri Lanka's Trade Deficit (2012)

Item	US$ Million
Trade Deficit	9,313
Remittances	5,985
FDI (net)	813
Portfolio Investment (net)	305
Services (net)[1]	1,250
Commercial bank borrowings	973
Inflows to the government	5,257
- Of which foreign investment in Treasury bonds and bills	2,236

Source: Central Bank of Sri Lanka data

Changing Tide

In May 2013 the Federal Reserve of the United States hinted that the extraordinary monetary easing measures through QE would be gradually phased out as the US economy shows signs of recovery. An extended period of loose monetary policy creates material macroeconomic risks, particularly relating to the mis-pricing of risk and thus misallocation of credit, leading to asset price bubbles. Therefore, as soon as the economy began to demonstrate signs of recovery, it was always likely that QE would gradually be phased out. The labour market and the housing market in the US have demonstrated positive signs of recovery and a number of other indicators in the US, including household and government debt reduction, do indicate that there is a sustainable recovery in process.

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[1] Services include earnings from tourism. In 2012, whilst tourism income was US$ 1,039 mn, Sri Lanka's expenditure on travel abroad was US$ 710 mn, resulting in net earnings from tourism being US$ 328 mn

Ever since the indication by the Fed that QE would be phased out, there has been a volatile reaction in global capital markets. Expectations of stronger US economic growth and QE tapering have pushed up yields on the benchmark US treasury rates and resulted in capital shifting out of perceived riskier markets in emerging economies, causing exchange rate depreciation in these markets and forcing interest rates to increase as well. Investments have also left assets such as gold which attracted investment as a hedge against the impacts of QE – that is US $ value erosion and inflation.

Despite a delay of tapering from the expected announcement in September 2013, the policy direction has been set by the Federal Reserve. Unless there is a material shift away from recovery in the US economy, QE tapering will take place and the resulting impacts will manifest in global markets. Therefore, the era of abundant global capital and rock bottom interest rates will likely come to an end during the next 18 months or so.

The China Factor

Demand from China has been another major driver of growth in many emerging economies, particularly those that are reliant on commodities. In the last decade or so China's economy has been driven by investment and exports, supported by fiscal and monetary stimulus in the last few years. However this model is not sustainable, and the new Chinese leadership that took over in March 2013 appears to be keen on transforming the country's economy into a more sustainable model where domestic consumption and investment are more balanced. This transition would however take some time to materialize, and in the interim, there would be a slower, less resource intensive growth in China. Going forward we're more likely to see China growing at 6-8% than the 10% plus growth rates seen in the previous decade. The transition period could also see some stresses in real estate and financial markets – particularly if there is a rise in non-performing loans that took place during boom years.

Given the impact of Chinese demand and US QE on commodity prices in recent years, a less resource intensive growth in China and withdrawal of QE also spells negatives for commodities and countries that rely on commodity exports. Many emerging economies from Indonesia to Brazil, Russia and South Africa (and advanced economies like Australia) face this problem since commodity exports have had a big influence on their economic fortunes. Therefore, higher global interest rates and moderation in commodity prices entails that many major emerging and frontier markets may not have the same growth prospects that they enjoyed in recent years. At the same time, demand in the US, whilst recovering, will not grow at the same robust pace that was experienced in the previous decade for some time, and Europe's recovery is likely to be far more protracted. In sum, global economic growth is likely to return to a far more modest pace than what we have experienced in the last decade or so: the brave old world.

Implications for Sri Lanka

These global developments have far reaching implications for Sri Lanka. Already the interest yields on emerging/frontier market debt have increased. This was evident in the secondary market yields on existing GoSL and Bank of Ceylon bonds and more pronounced in the yield (8.875%) on the National Savings Bank issue of September 2013. The higher rates will make it more difficult for GoSL and other financial entities and corporates from Sri Lanka to tap global capital markets. This entails greater reliance on domestic capital markets to finance growth. Higher demand for the limited pool of domestic savings would ultimately result in domestic interest rates increasing further. Higher interest rates will of course make it more difficult for the economy to grow at the 8% and above levels envisaged by the government.

A second key implication is for the balance of payments and exchange rate. Sri Lanka's current account deficit increased quite significantly since 2010, as a higher growth rate triggered an increase in imports. Capital inflows from foreign sources into both debt and equity markets of the capital account were a major source of countering the deficit in the current account of the balance of payments. If these capital inflows decline in a significant manner, in line with global capital market developments, Sri Lanka could experience increased depreciation pressure for the Rupee as well. A weaker Rupee would have important implications for the domestic price level and more importantly for meeting outstanding foreign currency denominated debt obligations.

Thus far foreign investors have not sold out of Sri Lankan debt holdings to the same extent as has been experienced in other emerging/frontier markets. The relatively high yield on Sri Lankan debt and relatively low liquidity of this market has helped retain investors thus far. However, as global interest rates continue to increase, the yield differential between Sri Lankan yields and foreign yields will diminish, and coupled with higher depreciation risk, foreign investors may not find Sri Lankan debt as attractive as before. An important short term risk is that of a sudden sell off by foreign investors – this could be triggered by a material worsening of Sri Lanka's fiscal position and short term external liabilities position, or even a default in another emerging/frontier market which triggers a broader sell off. A deterioration of Sri Lanka's international credit ratings would certainly have a negative impact due to rating based investment thresholds maintained by some of the investment houses. Such a risk could trigger a rapid and large depreciation of the Rupee and a sharp increase in domestic interest rates.

Fiscal Imperative

From a macroeconomic policy perspective, the key to addressing many of these risks is a more concerted reduction in the budget deficit. This would help reduce demand for the limited pool of domestic savings which are required for investment and also reduce pressure on the current account deficit. The government has succeeded in reducing the budget deficit to a commendable degree in the post war environment, however, the emerging global economic landscape would warrant a more urgent approach to this exercise. One concern is the decline of tax revenue as a percentage of GDP. At present Sri Lanka has among the lowest revenue to GDP

ratios among peer countries, and this has been an important concern particularly since 2012.

Country	Government Revenue as a Percentage of GDP (2011)
India	18.5%
Malaysia	21.9%
Thailand	22.7%
Vietnam	27.7%
Philippines	17.3%
Indonesia	17.8%
Sri Lanka	13%

Source: IMF Data

Improving tax administration to enhance collection capability is a key to addressing this problem. However, the tangible benefits of such reform have relatively long gestation periods, and therefore warrant closer attention to the expenditure angle to address short term requirements. Several measures have been proposed in the past to help curtail government expenditure – including improved targeting of subsidies and transfers and divesting stakes of certain State Owned Enterprises, without necessarily losing government ownership. A good example of such a reform was in the telecommunication sector, where the government of Sri Lanka retained ownership control over Sri Lanka Telecom, but divested a stake to other investors and liberalized the sector to competition. The overall service standard in the sector improved and there were numerous benefits to the economy through improved connectivity and communication technology.

Alternative Inflows

With the more challenging environment for attracting investment into debt and equity markets, the role of FDI and growing export incomes through services become paramount. These inflows would be essential to address Sri Lanka's short term external liabilities. It is in this arena that Sri Lanka's long term potential is most apparent. Recent government policy has been in the right direction, in terms of attempting to position Sri Lanka as a hub for international services, catering to the Indian Subcontinent region. Along with the development of the ports of Colombo (now the only port in the region able to cater to the largest vessels with 18m draft) and Hambantota as an industrial bulk port, the recent commercial hub act goes a long way in positioning Sri Lanka as a destination for entrepot trade, logistical services and value added exports. The commercial hub act will enable imports to enter the designated areas (2 sea ports, 2 airports and 2 free trade zones) without customs procedures and expenses and then be re-exported using Sri Lanka's location to make it a transport and logistics hub. This has the potential to create substantial investments and value added export industries. However, this would also need the right type of investments in the logistics space, the supporting infrastructure and importantly the skilled labour capability.

This is supported by the discussion, which is gathering momentum, of Sri Lanka entering a Free Trade Agreement with China which would double the country's free market access to reach over 2.5 billion people. These developments would help position Sri Lanka as an attractive destination for market seeking investment catering to regional markets. The value added export manufacturing sector of course requires a number of parallel reforms, including in infrastructure (particularly in the energy sector to reduce generation cost), human resources (to improve the school of skilled labour – not only in tertiary education but also in vocational and technical education catering to this sector) and also the financial sector to improve availability of affordable capital to finance such investments. Flexibility of the currency is also an essential feature of supporting competitiveness of industries seeking to attract alternative inflows.

Growth in the Post Crisis World

One important question is where would there be demand for such exports of goods and services in a post crisis world where global growth has moderated significantly. One way to look at this is the fact that Sri Lanka still has very low global market shares in relative terms and therefore has room to grow its exports by capturing market share. Furthermore, in emerging and frontier markets, where Sri Lanka has even lower market shares, even "slow growth" of say 6% in China, would add over US$ 300 billion to the global economy each year that is five times Sri Lanka's GDP each year. Therefore export market potential is still substantial assuming of course a high quality product is sold in an efficient manner. For this, the necessity for human resource development once again is the key.

Growth in the domestic economy would be more challenging. In recent years a lot of Sri Lanka's domestic growth has relied on monetary and fiscal stimulus, coupled with the short term peace dividend. Going forward, fiscal space has eroded significantly and interest rates are likely to rise, as explained earlier. In this context, generating growth over 6.5% on a sustainable basis will be very challenging without a strong export oriented impetus. More sustainable growth would require a number of reforms to address certain uncompetitive sectors in the economy, freeing them up to greater competition. In agriculture for instance, current production choices and methods are highly unproductive consuming 32% of the labour force to produce 10% of GDP. There is tremendous value in value added agriculture and biotechnology, which is completely unexplored in Sri Lanka. The fundamental driver of growth in an economy is productivity, and exposing some of the uncompetitive sectors of the economy to more market determined forces will help unleash this productivity in the longer term. Of course this process needs to be approached in a gradual, measured manner, where losers are compensated and significant social disruption is avoided.

The Role of the Financial Sector

The financial sector in Sri Lanka is likely to see some significant changes in the coming years. It will be more difficult to tap international capital markets and therefore the industry will be competing for a relatively small pool of domestic funds. As interest rates edge up and growth moderates, there could be some weakening of credit quality. However, positive real interest rates

are required to generate the savings necessary to support longer term investment and growth. The changes in the global market have also eroded the viability of one of the major high margin and perceived low risk products – gold backed loans. This sector was also instrumental in supporting financial inclusion – at least in a relatively unsophisticated manner. The pawning segment will not die out, but it will have to be managed with stronger emphasis on risk, and will no longer provide the same returns to banks. The emerging regulatory agenda will also have an impact on costs and returns. Non-bank entities such as telcos are also capturing market share in the payments sphere which was hitherto dominated by the financial institutions.

All of these factors will contribute to lower profitability of the sector, and with increased competition, will necessarily lead to some M&A activity in the industry. Sri Lanka also relies too much on the banking sector for raising capital, and whilst there has been some improvement in the size of the debt and equity markets in the economy, this remains relatively small. Further entrenching macroeconomic fundamentals and reforms to develop the corporate debt market, many of which are in the pipeline, would be necessary to develop this area. Technology will also be crucial both in terms of a lower cost distribution channel for the financial sector and also in terms of creating new products and services to cater to changing lifestyles and preferences of customers.

Conclusion

In conclusion, the coming decade will produce a number of challenges for Sri Lanka and other emerging/frontier markets. With the end of easy access to concessional financing from aid agencies and the end of abundant low cost capital in global capital markets, Sri Lanka will need to go about the hard way of financing growth. This would entail developing domestic savings and implementing reforms that reduce state consumption of domestic savings, thereby freeing up more capital for investment in productive activities where the country has true comparative advantages. There is a risk in the short to medium term of going through disruptive volatility, particularly through interest shocks and exchange rate volatility, and it is necessary to make prudent preparations to absorb such shocks. In the long term though, the potential of the country remains very positive indeed. It is encouraging to note the steps taken by the government to unleash this potential by taking the steps to position the country as a logistical hub. There is also tremendous untapped potential in both agriculture and manufacturing, both of which require further investment in human resources in order to extract higher value.

It is therefore ironic that even though Sri Lanka is likely to find itself in a brave old world in terms of the global economy and capital markets, it remains in a brave new world in terms of opportunity and untapped potential.

The views expressed in this paper are those of the author alone and do not necessarily represent the views of any of the institutions that he is associated with.