SRI LANKA: BORROWING TO GET RICH

By Hiran Perera

Head of Wholesale Risk, HSBC

After the military success Sri Lanka requires to focus its urgent attention on the economy. Now is the right time. With prosperity comes equality in which the disparities among communities will decline. If all the people among this single nation were to become affluent with little or no competition for resources, amidst increasing freedom of movement and exchange of trade, the ethnic problem will become more tractable. An affluent population would engender tolerance for different ideologies, a love for and an appreciation of different arts and cultures, and this could ultimately promote the wellbeing of the people.

Sri Lanka has a wealth of resources at its disposal. Although it does not possess natural resources in tangible form, it does posses them, however, with the 20million people at its disposal to carry out its future plans. Strong leadership along with a certain degree of boldness and singled-minded purpose will drive the population to harness the resources available in the world today and make Sri Lanka another example of undiminished economic success. Sri Lanka can indeed, become the "pearl" of the Indian Ocean.

Successful Borrowing

Experts from all corners of the world would say that sovereigns such as Sri Lanka must not borrow too much. Borrowing has been likened to a millstone around one's neck whose weight neither this generation nor future generations could bear. Today, we may ask the most important question, which is the country that borrows the most and is the strongest in the world. America is the world's biggest debtor but the whole world is indebted to it!

US has one obvious advantage, which neither tiny Sri Lanka nor even the consolidated power of the EU possess. US is the single most important reserve currency (61%) of the world (Table 1). With its fiat stamped upon a majority of international trades and contracts — with such trades being executed in US dollars, the US can issue paper or electronic money and buy anything and everything the world has. This is facilitated because other countries store their surplus wealth by buying US treasuries and assets. The unique feature of the reserve currency status is that whatever the US buys, notwithstanding the quantum of money outside its borders, it never lessens or takes away from the American economy but aggrandizes it. The only thing that stacks up is its public debts.

They can feed their 761 US military bases across 156 countries with no effort on their part. If the Americans have a military base in Japan, the Japanese will feed them using their own resources. The host country of the US bases will provide food, clothing and shelter and the

Americans will pay in US dollars. Japanese will then deposit this money with a Japanese bank whose counterparty or correspondent bank may be another US or a Japanese bank domiciled in US territory. What is the underlying transaction? The US government has issued nothing but paper money – cheques for millions of US dollars – and thereby fed its army. The Americans have got real value out of this arrangement but the Japanese will have real value only when they decide to spend the US dollars.

The Japanese may now decide to buy goods and services from China, since importing Chinese items may be cheaper than getting them from the US. The Chinese will expend their own resources and export goods to Japan. As the US currency is one of the major currencies to be used in execution and exchange of trade transactions (another advantage) Japan will use US dollars to pay for the bill. The Chinese will bank the US dollars like the Japanese did in the first instance. Has the US gained from the second transaction between Japan and China? Of course, its currency has become global fiat. Moreover, when the US decides to trade with any country it is never subject to exchange rate variances; the rest of the world, however, is!

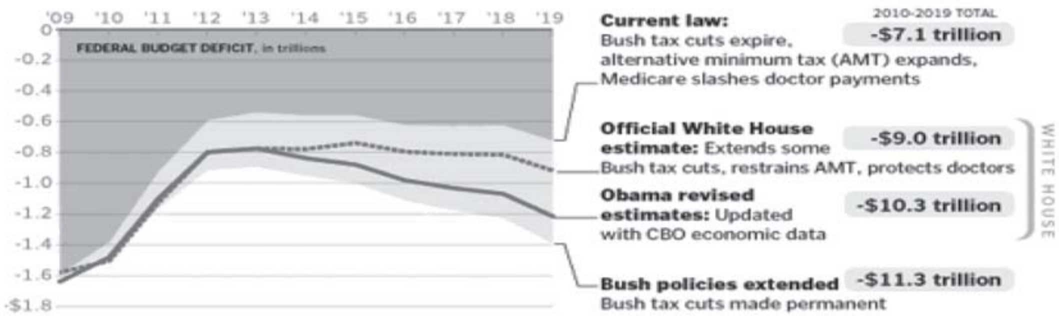
Global currency reserves

Currency composition of official foreign exchange reserves

	'95	'96	'97	'98	'99	'00	'01	'02	'03	'04	'05	'06	'07	'08	'09
US dollar %	59.0	62.1	65.2	69.3	70.9	70.5	70.7	66.5	65.8	65.9	66.4	65.7	64.1	64.1	61.5
Euro %					17.9	18.8	19.8	24.2	25.3	24.9	24.3	25.2	26.3	26.4	28.1
Pound sterling %	2.1	2.7	2.6	2.7	2.9	2.8	2.7	2.9	2.6	3.3	3.6	4.2	4.7	4.0	4.2
Yen %	6.8	6.7	5.8	6.2	6.4	6.3	5.2	4.5	4.1	3.9	3.7	3.2	2.9	3.1	3.0

Sources: 1995-1999, 2006-2009 IMF: Currency Composition of Official Foreign Exchange Reserves
1999-2005 ECB: The Accumulation of Foreign Reserves

The American trade deficit is extremely high compared to the rest of the world, while China is in surplus —almost 1 trillion US dollars in 2010. Recently, China declared to the US, “We own you!” Actually, the Americans need to borrow 2 billion US dollars per day to uphold and upkeep their way of life. This is exactly how the Americans do business with Asia and the rest of the world. In 1835, the US public debt was zero. After the financial crisis in November 2008, US foreign and domestic debt level (public debt) has almost increased significantly to 89 percent of its 13 trillion dollar economy. Does anyone complain? Does anyone worry about its ability to repay debts?



Borrowing Options

For Sri Lanka to re-consider its borrowing appetite, assessing its debt repayment capacity is imperative for further borrowings. The US example shows otherwise. However, Sri Lanka’s balance sheet and revenue generation capabilities must be enhanced by every cent of foreign money borrowed. The IMF has a different understanding about foreign debt. The IMF will stipulate that Sri Lanka needs good fiscal discipline to secure its standby arrangement and support package and the IMF will enforce this at whatever cost. It praises countries in Asia and sub-Saharan-African nations which do not borrow from other countries for exercising such fiscal discipline and for tightening their belts. IMF and World Bank will grant such countries small concessions as incentives and sweeteners to ensure that poor countries will stay poor. The biggest beneficiaries are Western Corporations and multinational companies that do business with poorer countries and profit from them.

In addition to the US, Britain, EU, Japan and now Australia have the property of their currency being a world reserve currency. Exchange rates of the home currency are primarily affected by lower stock of foreign currency reserves – following greater value of imports as opposed to exports, which is one reason for the Sri Lanka rupee to depreciate since independence. Trading currencies are limited to a basket of major currencies such as USD, GBP, EUR, JPY CAD, CHF. AUD, SEK and NYZ while most other currencies are inextricably pegged to the US dollar. China, it may be said is an exception to this rule. Due to the supply of cheap labour and its vast resource base, US and Western companies have invested large sums of money and set up manufacturing plants and facilities in China. China has so far used a strategy of artificially keeping its currency lower to gain access into larger US markets defying and undercutting other Asian exporting countries. China has indeed succeeded. But we are not China and our resources are comparatively limited.

Western Lesson

We must therefore learn from the West and there is one important remedy underpinning all this —we must improve our flagging balance sheet. Our assets are dilapidated, outdated and hardly fit for revenue generation.We need to upgrade our road network, energy supply, housing, cars, agro-base, transport systems and education. Currently, we are lagging far behind other nations. Our housing is limited and our buildings old. Sri Lanka's fleet of vehicles is virtually the backyard for unwanted Japanese vehicles. In this light, Sri Lanka's balance sheet needs to be upgraded rapidly. How must we start? We have no capital resource such as oil or commodities such as gold, silver, iron, and palladium or new technology to brandish. Yet we can borrow and borrow and use this pool of funds to fast-track infrastructure development and upgrade Sri Lanka's balance sheet. Fortunately, this is currently taking effect thanks to this farsighted infrastructure strategy in place by the incumbent government.

Sri Lanka's debt servicing capability is unblemished. We must maintain this at any cost and there are two ways we can yet do this despite increasing foreign and domestic debt levels. When our infrastructure gets a boost we can borrow more to repay debts and/or we must galvanize the economy to such an extent that we generate massive export revenues from the exchange of goods and services.

We need to start by slashing all duties on consumables and investment goods to zero and make Sri Lanka the world's No. 1 tourist and duty-free destination. If we do so, our economy will emulate those of Singapore, Dubai and Hong Kong and we can do it better. We can learn from the pains that those economies underwent during their transformative stages. If the unshackling of all duties is initiated that could have dire consequences if there is no proper economic plan and vigorous monitoring system in place. Our domestic industries will become uncompetitive overnight and Sri Lanka's trade deficit would balloon. Subsidies for the agro-based economy would need to continue through this borrowing regime until such a time the economy matures. If we borrow considerably and have significant reserves of foreign currency drawing rights in store the transition could become seamless.

It is known that if the Central Bank holds foreign currency and deploys LKRs into the market it could causes inflationary pressures. Yet this can be avoided by allowing local companies to hold and use foreign currencies to pay for and settle their debts. A freely convertible exchange policy is therefore essential, subject to an interest rate policy. The flip side, of course, is that we will expose ourselves to unscrupulous foreign exchange speculators in the likes of George Soros to punish such countries by using his wealth. Today, Malaysia has not forgotten what he did to them in 1997 which sealed the Asian financial crisis.

Bold Leadership

Thereafter, it must become mandatory by an act of law that that all shops in Colombo and in urban cities must be kept opened till 10.00 P.M. Bold business leaders must take the lead. When our shops are filled with the best of all the branded goods, which should be cheaper than those of other Asian tourist destinations, there will naturally be an exponential influx of tourism in Sri Lanka. It would be a natural boon to the economy and Sri Lanka's leisure sectors would boom. More and more shopping complexes and trading centres will open and construction activities will take place to exploit the huge opportunities that will be thrown open by the flood of tourism and unprecedented exchange of trade.

Unemployment will be solved rapidly with more demand for semi-skilled personnel coming in from sophisticated shopping areas and precincts. Our rural folks will increasingly migrate to centres of prosperity when economic activities in those urban areas start expanding in the country. There should be "controlled" bars to entertainment and such areas could be carved out as it is done in Singapore. With the exchange of goods and services being the major focus of the economy, Sri Lanka's tourism is bound to thrive. Government revenues will fundamentally come through taxes which these trading houses, shopping centres and superstar luxury hotels will earn. It is likely that tourists will pay more money for accommodation and for a world class experience if they can also buy top-of-the-range goods cheaper than what is available in their own countries.

In the age of information and technology are we bracing ourselves for a future we cannot predict and understand. The traditional values are unlikely to exist in their current form with Facebook now emerging as the new internet platform for social networking. What is better, we may ask. Is it a weak economy with people chained by poverty, or reasonable affluence based on a robust economy to free them from enslavement to ideologies of antiquity? The state must not fear the critics since they are needed in any society to ensure that there are proper checks and balances in society — a disciplined and well paid police force is therefore vital.

This is our hour of reckoning. We need to be bold and we need not unnecessarily fear the consequence of borrowing too much. There is a significant difference when an individual or a corporate entity borrows as opposed to when a sovereign state borrows money. Individuals borrow for short term whereas governments can borrow for 50 – 75 years. If we look at various countries that went through various crises such as Argentina and South East Asia or, now Europe – Greece, Portugal, Spain and Hungary – they all seem to be better off than Sri Lanka and after this financial crisis passes, they too will come out of the woods looking yet better and stronger still. America has borrowed so much from everyone but there is still an implicit confidence in its economic power even though the Americans had triggered the worst financial woes since the great depression.

We must, of course, judiciously employ money that is borrowed for capital investment as well as for recurrent ones instead of it leaking out. The money we borrow must find its place somewhere in the country's balance-sheet-upgrading exercise. Once Sri Lanka's balance sheet improves and revenue account surges, its sovereign rating will correspondingly improve. When this occurs we could raise sovereign or even corporate bonds from the international market and borrow at cheaper rates, and much more. After independence, how did the Singaporean dollar become an alternative trading currency in Asia while the LKR lags behind in the doldrums of obscurity? If we pursue this path of first importing all the best items of American, European and Asian goods, we will also one day be able to reproduce them locally. It is also right time to stop the exodus of the brain drain. President Mahinda Rajapaksa won the war; now he can implement these economic plans with resounding results.