SUSTAINABILITY IN VOLATILITY; BANKERS' CHALLENGES

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Preamble

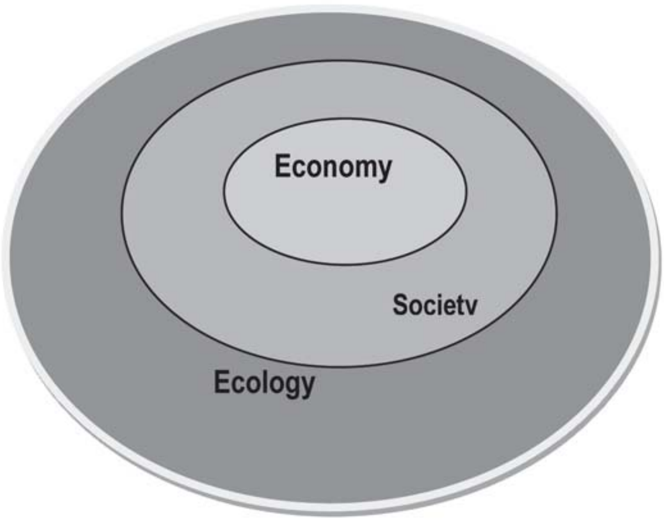
"Rupee down as IMF team visits" (FT, 12/06/12); "Sri Lanka's economy to slow down, Inflation to rise": IMF (Mirror Business, 16/06/12); "Sri Lanka sold gold worth US $ 1966 Mn in 2011" (Mirror Business, 13/06/12); "Colombo Bourse endures volatile trading week (Ceylon, Today 03/06/12); "Stock market turnover dips to over 03 year low' (Daily FT 03/07/2012).

The above few quotes obtained from a plethora of various articles appeared in print media in the recent past signify the volatility in the economy. High volatility leads to vulnerability. Volatility and vulnerability are reflections of the haphazard nature of the economic policies and poor economic governance in a country. As a result, these pose an immense threat to sustainability of the banking industry in any economy.

This article encapsulates the arenas of sustainability, volatility, causes for volatility, challenges faced by the banking industry in detail and finally elucidates on suggestions to the banks and the directions on how to reduce volatility and to enhance sustainability. This write up was penned during the last week of July based on the prevailing situation in Sri Lanka. Examples quoted in this treatise comprise banks and well known companies from the global arena.

What is sustainability?

Epitome of any business unit that ventures as a start up concern is to survive first, grow gradually and to sustain finally. Sustainability can be briefly defined as the long term maintenance of economic, social and ecological considerations. This can be illustrated as follows.



Perceiving sustainability only in terms of profitability is a misconception. This concept encompasses economic goals and non economic goals. The outer circle of the above diagram displays the exigency to protect the ecology. The existence of the society which is depicted in the centre circle depends only on the survival of the ecology. Conservation of these two, guides to a vibrant economy which is demonstrated as the core of the circle. Paying attention only towards the economy to derive benefits, disregarding the society and the ecology will have dire long term consequences. The way "Shell Gas" Multinational Corporation (MNC) strives to maximize the wealth in Nigeria, completely ignoring the society and the ecology is a classic example in this regard. This is the view from the universal perspective.

Sustainability from Banks' Perspective

Similar sentiments can be applied from an organization's perspective in micro level. An organization that aspires to achieve sustainability must focus on all three dimensions not merely one. However, from an organization's viewpoint the "sustainability concept" must be incorporated at the strategy formulation stage itself in order to achieve prudently defined and designed specific objectives. In this perspective, sustainability is a definite goal to achieve and for banks, sustainability is encompassed completely under the ***"triple bottom line'*** concept illustrated below.

"Triple Bottom-line concept" that was introduced by John Elkington in 1994, narrates that banks have to pay equal attention to 3Ps' namely the Profitability, the People and the Planet. Needless to say, all banks explore all avenues, as well as the loopholes, to maximize their profits in order to provide a reasonable return for the shareholders, enhance the corporate image and to demonstrate a consistent growth.

'People' dimension focuses how banks follow reciprocal practices towards the stakeholders such as the employees, customers, suppliers and the society. This is where the stakeholder theorem comes in to effect. When employees are considered as stakeholders, one has to ascertain whether banks simply perceive its employees as a strategic asset to gain competitive advantage or merely as a 'work force'. It is accepted, though debatable, that banks prioritize their customers over employees. But for suppliers, it is situational as it depends on their degree of significance and the bargaining power.

Banks must be reasonable and mutually beneficial to the society. This task is usually accomplished through implementation of Corporate Social Responsibility (CSR) projects, the crux of which is benevolence and altruism. The rational for such a philanthropic act is that the banks exploit the customer mercilessly to maximize their wealth. For instance, a particular bank in Sri Lanka attempts to extract at least a sum of US $ 500/ p.a. from each customer which is the minimum threshold to determine the productive nature of the account. Exploitation in this manner naturally engenders an obliged duty to "give back" a sizeable portion of the profitability to the society. Several research outcomes indicate that most organizations embark on CSR projects not for benevolence and altruism, but to win the Best Corporate Citizen award, as a 'marketing gimmick' or as a "strategic tool" which itself is unethical and contradicts the very concept of CSR. Sustainability is only assured if the 'people' survive. Therefore banks must take a more genuine approach when dealing with the "people" factor.

The ecological responsibility of a bank is denoted by 'Planet'. The British Petroleum (BP) catastrophe in 2010 occurred due to an oil spill in the Gulf of Mexico which completely destroyed the Atlantic Ocean, aquatic resources and livelihood of the people. As a Multinational, BP was primarily concerned only about maximizing their wealth. However, ultimately BP was forced to pay a colossal sum as compensation thus eroding their profits for the year 2010 substantially.

Protecting the planet is of utmost importance. With certainty, majority of banks are not involved in forest conservation, projects to reduce global warming, major recycling projects, or any other environmental conservation and energy saving projects. On the other hand, any ecologically responsible bank will not grant facilities to manufacture weapons, toxic gases, chemicals and dangerous material.

However it is questionable whether banks pay equal attention to the "people' and the 'planet' factors similar to the weightage given for wealth creation. Therefore this is a major challenge to banks operating in the contemporary world in order to strive for sustainability.

What is Volatility?

Volatility is the severity and the frequency with which changes in the economy occur more specifically with the oscillating macroeconomic environment. The other reasons for volatility are inappropriate and ad-hoc economic policies, lack of exports, exchange rate fluctuations, and external pressures such as UNHRC. Greater the volatility, higher the vulnerability and uncertainty. When volatility exists in an economy, anxiety, unpredictability and complexity become the order of the day.

The dominant reason for volatility which protrudes and precedes all others is exchange rate fluctuations. Greater the exchange rates fluctuation greater the volatility. Larger gaps between buying and selling rates reflect and validate the magnitude of the volatility and vice versa. The following chart amply demonstrates a comparison between 'buying & selling' gap in Sri Lanka and Australia. The rationalization for selecting Australia is due to their sound economic policies and the emergence as a "super power' in the Pacific Region.

Country	Buying	Selling
Sri Lanka (xxx Bank)	129.30	135.55
Australia (Commonwealth Bank)	1.0431	1.0459

(Source; www.google.lk; viewed on 18/06/12)

Some conjectures regarding the exchange rates are delineated below.

- Systematic association does exist between the fundamentals of economics and the exchange rates.

- Flexible exchange rates are excessively volatile as the exchange rate would be determined by the market forces, factors such as Balance of Payment (BOP) and interest rates.

- Volatile exchange rates are harmful to international trade.

- Depreciating exchange rates trigger a vicious inflationary cycle. High cost of imports cause price hikes due to the lack of proportionate increase in exports. This leads to a deficit in a country's current account.

- Due to destabilizing speculation, flexible rates become unstable especially when the demand is artificially created.

- Generally foreign exchange market is efficient. But Sri Lanka being a Less Developed Country (LDC) and in the absence of a developed financial market and an effective mechanism to arrest money laundering, one cannot expect the market to be efficient. Hence the projected estimates become inaccurate and the volatility is amplified in exponential terms.

Additional Reasons for Volatility

The additional reasons expounded below contribute directly or indirectly to volatility. Hence it is expedient to discuss these reasons briefly.

Ad-hoc Economic Policies

National politics and economic policies are inseparable and go hand-in-hand. Any country with a visionary leadership will experience sound economic policies and vice versa. For instance one can no doubt agree that the Philippines, from the time of former President and Dictator Mr. Ferdinand Marcos, (thereafter Corozon Aquino, Fidel Ramos, Joseph Estrada, Gloria Macapagal Arroyo) to the present President Benigno Aquino has been in dire economic straits and many other woes with unemployment over 30%. A similar situation can be observed in Indonesia too, from the time of former dictator Gen. Suhartho to the present President Mr. Susilo Bambang Yudhoyono. However contrary to these two Asian countries India having endured some political instability in early nineties after Rajiv Ghandhi's assassination, under the futuristic political leadership of then Premier Mr. Narasimha Rao, India embarked on a multi dimensional strategy and laid the foundation for present India. In this endeavour, Prime Minister, Mr. Rao appointed a 03 member committee to take India towards the new millennium. Dr. Abdul Kalam was assigned the task of transforming India to a nuclear power; Oxford educated Economist Dr. Manmohan Singh to liberalize the economy and Narayana Moorthy (now Dr. Moorthy) to transform India as the world's "Information Technology Hub". They all accomplished the assigned tasks under the able leadership of Mr. Rao. Today India is one of the emerging economies and a 'BRICS' (Brazil, Russia, India, China and South Africa) and a G-20 nation.

Hence professionally, ethically, logically and meticulously formulated economic strategies should be in place, under proper political guidance to reduce volatility.

Indecorous Management of International Trade

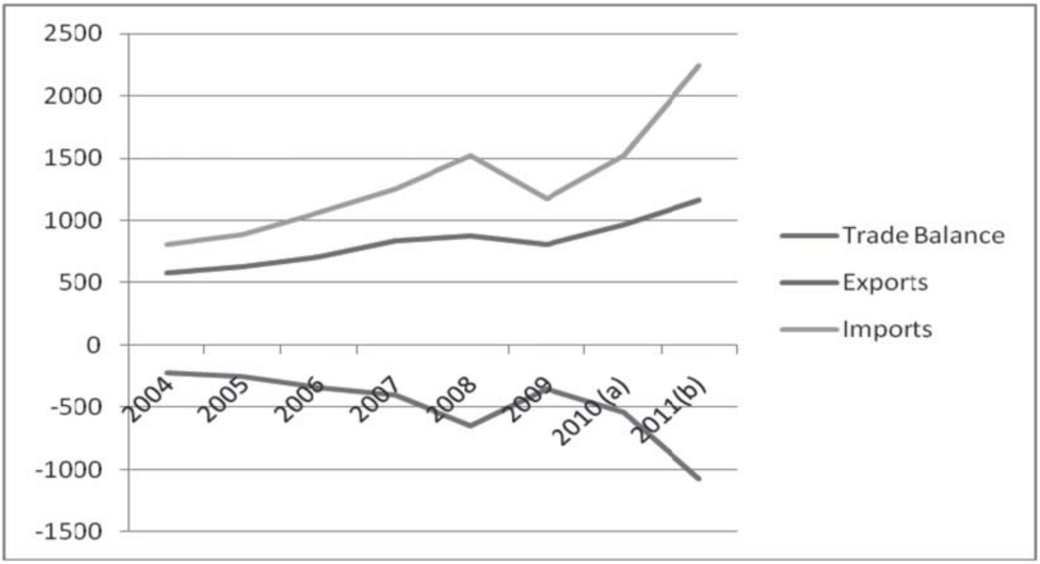
The prime objective of any country should be to enhance exports and to reduce imports to its fullest extent to enjoy a surplus in the current account. Sri Lanka has to utilize all resources and avenues to boost exports. In this endeavour, strengthening backward integration for exports, exploring new markets and congruenting with the evolving world, are a few crucial mechanisms. For instance; Middle Eastern countries import water from the Scandinavian countries. Goods such as water, fish, ornamental fish, dry fish, flora and fauna, salt and many more can be easily exported from Sri Lanka. Japan also being an island supplies 14% of the world's fish requirements. Unfortunately, at the time of writing this article, Sri Lanka is losing her 'top position' with regards to Tea in the world market. Government encouragement to the cottage industry, the SME sector, Ambassadors and High Commissioners acting as "Trade Ambassadors", and "Brand Ambassadors" to garner trade to the country will boost exports immensely and Mother Lanka's foreign exchange inflow would be multiplied in many folds and the volatility would be mitigated accordingly.

The following table and the line chart signify the widening gap in trade balance due to ever increasing imports and the stagnant exports. During the year 2011 (provisional) imports have increased by 47.4% compared to 29.6% in 2010 whereas the exports did not record any significant growth during the year 2011 compared to 2010. The unprecedented deficit of 96.7% in the trade balance compared to 52% in 2010, is one of the causes for this level of volatility in the economic sector.

Trade Balance, Exports and Imports

	2004	2005	2006	2007	2008	2009	2010(a)	2011(b)
Trade Balance	-227.2	-253.1	-350	-404.7	-647.2	-358.7	**-545.4**	**-1073.9**
Exports	584	638.3	716.6	845.7	878.5	813.9	974.4	1167.6
Imports	811.1	891.4	1066.6	1250.4	1525.7	1172.6	**1519.7**	**2241.5**

(a) Revised
(b) Provisional
(Source; Economic & Social Statistics of SL; CBSL, 2012 P. 03)



From the antithetical dimension, imports have to be curtailed to the lowest possible level through implementation of protectionism policies using tariff and non-tariff barriers prudently. Effectiveness of protectionism policies can be measured not only from the reduction of imports and the improvement of current account, but also judging the number of local companies sprouting and embarking as start-up projects and becoming MNCs within a short span of time. When South Korean companies such as Samsung, Hyundai, Kumagai, and LG were struggling to come up as start up concerns, the Korean government not only introduced the protectionism policies effectively in mid eighties to curtail imports of similar products through tariff barriers in to Korea, but also embraced such companies with the required technical guidance and financial assistance to compete in the global market. The rest is history. Today Samsung has overtaken Nokia in the global market for mobile phones, Hyundai latest car is virtually similar to Benz E class model and all other Korean products such as LG are outperforming most of the globally reputed brands as well. Mechanisms such as "Local Content Requirement" (LCR), Administrative Policies and Anti-dumping Regulations, must be implemented in addition to the trade barriers to curtail imports.

This is known as the strategic intervention of the government in International Trade. Proper management of International Trade is a must to reduce volatility.

Lack of Foreign Direct Investments (FDI)

Upon 03 years of ending the civil war, still as a nation we struggle to allure FDIs. Creating a conducive atmosphere to attract FDIs applying absolute, comparative and acquired advantages effectively is vital. FDIs provide adequate inflow of foreign exchange to the country. Striving to attract FDIs under volatile and unfavourable atmosphere can be compared to a collapsing bank with diminishing public image making a futile effort to mobilize deposits for survival. Customers with an iota of common sense will not place deposits in that bank. Similarly, MNCs and wealthy investors too critically analyse and evaluate the political and the economic atmosphere in the country before they invest. They look in from out. Dr. Mahathir Mohamed developed Malaysia mainly through FDIs'. 'London Eye' in England, Disneyland in Hong Kong, are also FDIs. When the FDIs are growing, not only the volatility is reduced substantially due to inflow of foreign exchange but also employment generation, improvement of standard of living along with several other advantages can be experienced. All these reduce volatility.

Global Pressures

Present level of volatility did not happen overnight and is the consequences of a series of blunders made over a period of time. Global pressures the country has been facing have created a negative impact and tarnished the image of Sri Lanka in the investors' mind. The Oil Hedging Deal, Removal of GSP^+ Resolution at the United Nations Commission for Human Rights (UNCHR) to name a few. These fracases have unfortunately made Sri Lanka small in the eyes of the global community.

As professional bankers, it is worthy to understand that "interdependency and integration" are pivotal elements under globalization. Interdependency and integration do not mean antagonizing one part of the world and being friendly with the other part of the world. This has to be clearly understood. All these contretemps without any doubt have painted a negative picture globally and as a result, International Trade, FDIs and Tourism are hampered and hindered significantly. These negative alluviums need to be immediately removed.

Consequences of Volatility

Banks Perspective

High volatility results banks adopting a "wait and see policy" instead of embarking on business ventures. Skyrocketing cost of living, reduction of money value will erode hard earned savings while declining FDIs and exports would increase volatility. The economy would ultimately be engulfed in a quagmire. In this scenario, a liquidity crunch becomes inevitable and as a result, interest rates increase, costs escalate, non performing advances increase. This threatens the very existence of the banking industry thus jeopardizing sustainability.

Due to low profitability and questionable sustainability, Banks naturally become hesitant to embark on CSR and environment conservation projects as survival becomes the only objective. Hence volatility to a great extent undoubtedly hinders sustainability.

Investment perspective

By nature, no investor or entrepreneur prefers losses over profits. High volatility pushes investors and entrepreneurs to explore other avenues and locations to invest their surplus funds. For instance, MNCs search for other countries with better comparative advantages to make FDIs and Corporates postpone launching their "business plans" indefinitely. As a result, banks lose lending opportunities that hinder their profitability; a country loses FDIs; employment generation is hampered and the Gross Domestic Product (GDP) growth is slowed down.

Consumers' perspective

Depreciation of domestic currency adversely affects cost of living, cost of imports and results in money value erosion. This leads to low purchasing power of consumers even for day to day expenses. Savings will then be eroded, resulting in a drop in banks' savings deposit base. Cost of funds will also increase as the banks would be compelled to offer higher rates not only to garner deposits but also to retain the existing deposits. Hence when profitability is in jeopardy, sustainability will become a distant dream to accomplish.

Challenges to the Banks

Some guidelines for the bankers to enhance sustainability under volatile conditions are detailed below.

Reduction of costs

Critical analysis of the entire value chain of the bank and attempt to reduce cost of each activity at least by 0.1%. Carlos Ghosn who resurrected 'Nissan' when Nissan was commercially and financially dying, through Nissan-Renault Strategic Alliance was known as a "cost killer" as he was not attempting to reduce costs but to kill it. This is the degree of accentuation CEOs need under volatile economic conditions. Lowering cost does not mean redundancy as it's against the "People" factor and also not an astute move from the Sri Lankan perspective. Hence cost reduction should be a continuous process.

Develop the Skills to 'Read the Future'

The ability to read and predict the future accurately provides the edge over other banks. To this end, evaluation of both positive and negative risks, close monitoring of micro and macro economic risks should be analysed to be proactive. This is the simple reason why Multinational Banks have employed top Economists not only to read the future and to reduce volatility within the bank, but also to convert future threats into opportunities to maximize the wealth. For instance, during the Hedging Deal saga, Ceylon Petroleum Corporation (CPC) did not consider the fact that oil prices would reduce to below US$ 50/ per barrel, in the world market as they evaluated only the risks of an upward increase. But foreign banks acted proactively and the rest is history.

Focus on "Booming Industries"

Under any economic conditions, growing or otherwise, there are visibly evident booming industries. These occur, with the shift of the Product Life Cycle (PLC), behaviour of the Long Run Average Cost Curve (LRACC), macro economic pressures and evolving consumer habits. Banks have to identify such booming industries in order to enhance their profitability. At present, as per reliable sources, there are only five booming industries in Sri Lanka namely the essential food items (edibles), telecommunication/ mobile industry, private healthcare industry, pharmaceutical industry and the private tertiary education. Financing businesses dealing with luxury items, automobiles may be risky as they are elastic goods.

Avoid Speculative Trading

Speculative trading carried out with the intention of increasing profits for instance forex dealings must be avoided since this further exacerbates volatility. A few banks had bitter experience and faced dire consequences having pursued on speculative trading about 02 years back in Sri Lanka.

Go-Global

When the domestic market is volatile and saturated, it may be advisable to approach overseas markets and emerging markets to expand the horizon. This would, if appropriately assessed and ventured, enhance the profitability, reduce the risk of volatility to a great extent. Most Sri Lankan banks are myopic in entering the overseas markets. To reap the benefits of globalization, banks should see the entire world as one seamless and borderless market.

How to Reduce Volatility from a Macroeconomic Perspective?

- **Formulate** and execute sound economic policies to the country based on fundamentals. ***"Failing to plan is planning to fail".*** Haphazardly decided policies which are detrimental to the economy and the banking industry, increase the volatility further. High volatility in the country is the reflection of poor economic governance.

- **Devaluation –** Rupee devaluation is not the answer. Devaluation aggravates volatility in many folds for a country like Sri Lanka. As per Marshall Lerner theorem, a country should export and import elastic goods to reap the anticipated objectives of devaluation. Since most of our exports and imports are inelastic, except for a few imports such as cosmetics, automobiles and home appliances, anticipated benefits through devaluation cannot be achieved.

- **Avoid** International Monetary Fund (IMF) and the World Bank (WB) regulations as much as possible (The World Bank was initially constituted after the 2nd world war only to reconstruct the already destroyed Europe under George Marshall's plan). Economists with a sound background can counter argue and rationalize their suggestions / conditions to avoid detrimental conditions imposed by them. Critics say the IMF and the WB have *"one size fits all"* policies and they are not accountable for their action (Hill, 2007, p. 391-392).

- **Enhance** exports as much as possible. Strategic and Economic intervention of the government is a must to boost exports in any country. Exports provide the much needed foreign exchange to the country which will in turn reduce volatility substantially. Any country's prime objective must be to maximize exports, minimize imports and to have a surplus in the current account. Forming Export Management Companies (EMC), exploring new markets, territories, products for exports, utilize the diplomatic community as "Trade Agents" and "Brand Ambassadors", strengthening the backward integration for exports, reducing the production cost (ie; electricity) in order to compete in the global market are some ways in which exports can be increased. Germany which is the richest in Europe is economically strong being the third largest exporter in value terms in the world. China has become the "world's factory" and the Yuan is becoming stronger due to exports. Obtaining foreign loans, and issuing 'Bonds' one after the other without generating adequate export opportunities and pay back mechanisms will further enhance the volatility in the country.

- **Curtail imports**- Implementing effective protectionism policies through tariff and non-tariff barriers and curtailing the imports of luxury items with the prevailing volatile situation would help the economy as well as implementing "Local Content Requirements" (LCR), Administrative policies and Anti Dumping legislature will curtail imports substantially.

- **Garner Foreign Direct Investments (FDIs) –** This is a must. Use absolute, comparative and the acquired advantages to the maximum. Carefully analyse the pros and cons of the other countries in the region and design an effective and pragmatic plan to allure FDIs to the country. Offering incentives alone is futile to attract FDIs in the contemporary world.

When the volatility is high, banks playing an intermediary role, naturally become hesitant to take risks due to the vulnerability in the market. Banking system depends on "trust'. When volatility exists, profitability of the banks is reduced substantially. Irrespective of the volatility and the global fracases, shareholders also demand a higher portion as dividends for their investments. All these pressures cause a threat to sustainability. As a result, Banks are reluctantly compelled to ignore the two Ps namely the 'People' and the 'Planet' or the Social and the Ecological dimensions. Ignoring these two Ps itself will create volatility not in monetary terms but in terms of sustainability in the long term.

Hence it is the prime duty of the Authorities to reduce volatility in the country in order to create a conducive atmosphere. Reducing volatility leads to sustainability. Aggravating volatility not only hinders sustainability in the banking industry, but also jeopardizes growth in the entire country.

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