Econsult Investments and Advisory Services (Pvt) Ltd

“Market Watch ^ Perspectives”

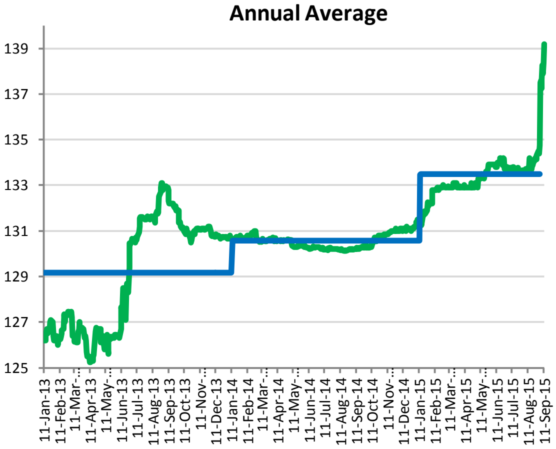
14th September 2015-Vol-2

PRIVATE CICULATION ONLY

Market Watch

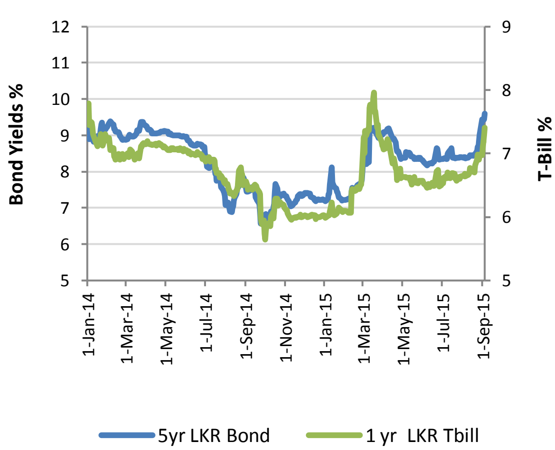
USD/LKR Free Float and Cost of Finance?

USD/LKR Interbank Daily Trading Levels and Annual Average



Source: Thomsonreuters

Figure-2-LKR Bills & Bonds Secondary Market Trading Activity



Source: Thomsonreuters

- For the second time in recent history the Central Bank of Sri Lanka decided to free float the rupee against the US Dollar. The first such instance was in 23rd January 2001 and once again last Friday, the 7th September 2015.
- The rationale for this decision was clearly based on the significant loss of external liquidity as a result of a) wider than expected trade deficit b) out flow of bonds and c) Central Bank intervention in the rupee in forex markets. Such external liquidity leakages prompted considerable deterioration in the country's balance of payments. The overall BOP is estimated to have recorded a deficit of US dollars 791.7 million during the first six months of 2015 in comparison to a surplus of US dollars 1,954 million recorded during the corresponding period of 2014. Data also indicates that external reserves dropped by more than USD 2.0 billion in the past 8 months.
- In the short term *Econsult Research* expects market volatility to be further exacerbated by the burgeoning trade gap (primarily driven by slower exports), slowing down of private transfers/remittances. Additionally the volatile financial markets would serve to deter foreign funds to re-enter bonds and bills. The rupee against the dollar continues to lose ground, trading at 139.25/139.35 (see Figure-1) with Interbank market makers quoting wide bid/offer prices, indicative of the fact that the market remains cautious of further rupee weakness.
- Secondary market yields have moved up as much by 1.0% to 1.25% in the last 4 months. Due to foreign funds selling off of their bond/bill holdings (see Figure-2) together with increased government borrowing. Foreign sales of bills/bonds have amounted to USD 400 million so far. The exit of foreigners in the LKR Bills and Bond markets opens up unpredictable for rupee interest rates. The sell off has affected Sri Lanka three fold, a) loss of external liquidity, b) sharp rise in interest rates across all tenures and c) downward pressure of the rupee .
- Liberal thinkers have argued that high interest rates is the cure to a weak rupee. This argument is based on the *'cost of carry of currencies'*. For higher cost of holding Dollars would force exporters and other investors to liquidate the lower yielding assets. On the other hand empirical evidence indicates that such actions are futile and does not bring desired tangible results. However, it does help stem the external liquidity situation briefly. Sri Lanka needs to watch out for the *vicious cycle of depreciations,* unless such action is supported by strong neo-industrialization.

.

“Perspectives”

Dr. Howard Nicholas , Senior Lecturer of ISS, Erasmus University, Rotterdam Netherlands, talks about “Comparative Advantage”, “Sate Owned Enterprises” and “Debt to GDP”!

- ***<u>Part-1-Conpartive Advantage</u>***

- **Q: Welcome to ‘Perspectives’ Dr Nicholas, talking about Competitive advantage, give us an explanation of what this concept/model is , in simple laymen terms?**

- The theory is very old. It was started with David Ricardo about 300 years ago. The basic idea is that each country should specialize in production of what they are good at producing and export them. So the emphasis is on specialization and advantage in terms of cost. And now its modern incarnation cost is being elaborated on and the argument is cost depends on natural resources or natural endowments people live in. The resources can be labor, can be raw materials, it can be land and it can be capital. And the argument is that each country should actually specialize according to those natural resources. The developing countries by implication should specializing in agricultural products based on land and labor or raw material which are their natural resources. And the advanced countries should specialize in products that requires lot of capital and technology and when they trade both will gain. that’s the essence of it

- **Q: As a developing country how suited is ‘competitive advantage’ to Sri Lanka?**

- Its not at all. It is just pure ideology. It always has been. And is designed to stop other countries competing with the advance countries. So its always promoted by the advanced country and the name of the game is to try and convince the developing countries not to produce the commodities/products that the advanced country is producing.

"Perspectives"

- **Q: So, is it basically a model that is being introduced for growth suppression?**

- Yes. Its just an attempt to get developing countries to do what is actually beneficial for the advanced countries and not necessarily beneficial to themselves.

- Now Just to give you an illustration when this model (i.e. comparative advantage) was first introduced by British economist David Ricardo At the very same time Britain was imposing huge tariffs. Now if they truly believed the modeled they were espousing they would have accepted the cheaper Indian garments and textiles and produce something else, but they didn't. They imposed Massive tariffs and when those tariffs didn't work they actually prohibited Indian garments and textile manufactures. so there is a lot of Hypocrisy with that. And what they Tried to do is to get the Americans to, (the United States), then to produce just agricultural goods and not get into engineering products . And tried to get Germany to produce just Coal and not get into engineering products. Of course those two counties were not going to listen to the British and they pursued their own strategies which was industrialization .In more recent trade negotiations they have actually prevented any discussions of agricultural products and garments and textiles for the last 50 years. If they truly believed in this doctrine of comparative advantage they would have liberalized , especially but they didn't Because it didn't suit their interest so you see, I mean history is replete with this and No doubt if Sri Lanka ever became an advanced country Sri Lankans would be espousing the same views to the developing countries. That is just the natural order of things. And the question is what Sri Lanka should do. And the simple answer is Sri Lanka should export and should produce for exports. Because no developing country can avoid that

- But the question is what should you produce for exports and the answer is quite simply. Certainly This doesn't mean that Sri Lanka gives up key production or the other primary agricultural products . But rather Sri Lanka looks at a diversified set of products. Which are quite competitive and can be made competitive and that's the pressure point. The government has a big role to play in that. And that's the history of all the successful Asian countries, is the government creates the competitive advantage the sectors they prosper in. so big role for government. And that's of course where Sri Lanka has been somewhat backward in recent times

Analyst Certification & Disclaimer

The analyst(s), who is(are) primarily responsible for this research document, certifies(y) that the opinion(s), views or forecasts expressed herein accurately reflect their personal view(s) and that no part of their compensation was, is or will be directly or indirectly related to the specific recommendation(s) or views contained or expressed in this research report.

This market research document has been prepared and is being distributed by the Research Team of ECONSULT INVESTMENTS AND ADVISORY SERVICES PVT LTD and is intended solely for the purpose of clients of ECONSULT INVESTMENTS AND ADVISORY SERVICES PVT LTD and is not for publication to other persons or reproduction purposes. This document should not be published or reproduced without prior consent from ECONSULT INVESTMENTS AND ADVISORY SERVICES PVT LTD, whether through the press or by other means. This document does not provide individually tailored investment advice and should not be construed as an offer or the solicitation of an offer to buy or sell any securities or to participate in any trading, investment strategy. The information contained within this document is believed to be reliable but we do not guarantee its completeness or accuracy. Any opinion(s) expressed herein are subject to change without notice.

“Alternative Economic and Investment Analysis”

Contact us : econsultadvisoryservices@gmail.com

or on

research@eia.com.lk