Arjuna Mahendran: The latest financial crisis and Sri Lanka

Speech by Mr Arjuna Mahendran, Governor of the Central Bank of Sri Lanka, at the International Research Conference, Colombo, 7 December 2015.

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Professor Yi Fu Lin, Dr. Harsha De Silva, distinguished delegates, ladies and gentlemen. Welcome to this 8th research conference by the Central Bank of Sri Lanka. I must congratulate Dr. Nandalal Weerasinghe and his colleagues who have developed this tradition which in no small way has established the Central Bank of Sri Lanka on the international research map as a meeting place for the profound minds of several leading academic and banking institutions. This conference itself is no small feat to have organized given that we have participants from several parts of the world in Europe and Asia including several areas that we have very strong relationship with as a country, and I think this is a great testimony to the continuing tradition that we have evolved in the Central Bank in terms of creating another center of excellence in Sri Lanka.

In my opening remarks I thought I would perhaps take a leaf from Professor Lin's commentary just now, and perhaps adapt Sri Lanka's situation in terms of the structuralism or the lack of it that Professor Lin discussed. Now when you look at the total economy, we have in the last five years gone through a fairly challenging period. As Professor Lin said we had the great recession of 2008 and its immediate aftermath what you found was that three strands of relatively new economic activism manifested themselves. In the first instance you saw a huge pump-priming effort by the People's Republic of China, which in its wake created perhaps the strongest commodity price boom that we have seen in recent history. That I think was a key take away from that period and China to some extent prevented the world from falling into a depression by stimulating its economy, and as Professor Lin has now elaborated to us, it falls in line with his perception that in times of recession developing countries are well-advised to go ahead and really stimulate domestic infrastructure construction etc. to take on the slack caused by international events.

Secondly we saw the major central banks of the world, that includes the United States, the Europe, the United Kingdom, Japan and Switzerland, creating money on an unparallel basis which for my calculations to date add up to about 8 trillion dollars worth of new money created in the last 5 to 6 years. That is significant. That's the second strand that emanated from this crisis period. And thirdly what we have seen is that the so called developing economies in a curious twist of their economy fate, actually became the biggest creditors in the world and the so called rich countries, the developed countries, were actually the biggest debtors. So you've turned the world upside down topsy-turvy and today we are seeing India along with other big emerging markets who are effectively lending money to the United States of America by buying their Treasuries and funding their development. So these three stands I think have to be taken into account because they are really new elements of the international financial architecture which have a bearing on how the global economy is going to perform.

So what do we see today in the global economy that is different apart from what I just mentioned. First of all you have a liquidity trap. Keynes's classic liquidity trap is alive and kicking around us. Whatever you do with interest rates it doesn't care at all for production or for consumption because we have too much liquidity, the 8 trillion that I talked about. In that context how do governments stimulate their economies given that monetary policy has done the heavy lifting, it created this excess liquidity but now going forward there is a need for a new element, the Xfactor, which has to then propel the growth forward. You have very influential commentators like Larry Summers of United States who is calling for another round of quantitative easing in the US because he feels that the long term growth path of the United States economy is still not well embedded and the reason for that is partly due to the demographics. You have ageing populations in Japan, Europe and United States, which means that this baby boom generation, the people who were born just after the second world war were now starting to retire are consuming less and saving more and as a consequence you probably don't have that space for a consumption led economic impetus that developing countries such as ourselves dependent on for the last 30 or 40 years to grow our economies through an export-led strategy.

So my first question is; is that export-led strategy relevant any more given these demographic changes that we see in the advanced economies? And secondly given the fact that the advanced economies are in debt – what happened in the great recession was they nationalized private bad debts in their housing sectors, nationalized it, bought it into the government's balance sheet and as a consequence that the western economies are effectively net borrowers in the system – do they then have all the gear to stimulate consumption and create another repeat cycle of that export-led boom that really lifted countries like China and other big Asian exporting economies out of the low income status that they had enjoyed for several decades. That to me is a very relevant question that we have to ask ourselves at this conference.

Have we got to then look at a different model and that's where I think one key element of the international economics situation is very important to understand and that has to do with the emergence of information and communication technology as a principal driver of growth, specifically in the services sector of our economies and what have we used in that space to stimulate the growth impetus that previously resided in manufacturing. Now we have to also understand that the manufacturing space has largely converged in China. The Chinese have built an international value chain over the last 30 to 40 years which is unparalleled in terms of its complexity and its far reaching nature and unless small countries like Sri Lanka participate in that value chain we in a sense are losing out on a tremendous opportunity. I put it to you that Sri Lanka still has not integrated itself adequately in that international value chain which the Chinese has built up in the last 30 to 40 years effectively, and that is why we have effectively not fulfilled our growth potential in the last 5 years since the cessation of the internal civil conflict in this country.

The second point I like to make is that we rely a lot on foreign savings for the growth of our economy. This a peculiarity of Sri Lanka that we resemble countries like Phillipines and Mexico, in a sense that we have large diasporas living overseas who are fairly high income earners relative to our levels of income in this country and I just asked Dr. Weerasinghe, our national savings rate is about 25 percent, and of that perhaps 6 to 7 percent is accounted for by international savings component of our diaspora. That is a significant number; it means that we can afford investment rates of 26 to 28 percent perhaps even 30 percent in the medium term if we marshal these resources effectively and then create our own growth impetus which will engender a sustainable growth path and at the same time integrate ourselves with this global value chain that the Chinese have constructed very effectively over the last few decades.

But there are several challenges that face us in the near term. First of all we have to watch what the American monetary policy makers will do in the next few weeks.

That could potentially create some turmoil for international markets including ours and in the process we could see some potential for dislocation which is why Sri Lanka has decided to reach out to multilateral agencies like the IMF and the World Bank to assist us in terms of sheltering or protecting the economy against any adverse developments that may occur in the near future as a consequence of any turmoil in international capital markets if and when US policy makers decide to raise interest rates.

That is one hurdle we have to look at. The second hurdle I would say is the lack of a structural change the way international, particularly developed countries of the world, are managing their economic affairs. A lot of the changes that we have seen in the last 5 years has had to do with monetary policy and the aggressive easing of the monetary policy. But on the fiscal side, you haven't seen any structural changes in countries like the United States and most European countries that took the world into the great recession in 2008 as a consequence of their housing bubbles. That structural change in terms of improving productivity, reducing the size of social security programs and retooling their economies to become more productive has still not started and until that happens we don't have a sustainable basis for global growth to grow apace.

So the question is, will this very complex Chinese driven global value chain face difficulties in terms of engendering growth, going forward in the absence of those structural reforms that we seek countries as diverse as Greece and Italy and even Ireland starting to implement as a means to fostering stronger growth going forward. That's going to be a big challenge for us in the next few years and I think this conference would do well to try and give us a perspective on that examining in detail on how these structural changes in global economies impact small economies like Sri Lanka and perhaps give us a guidepost in terms of how we can integrate our economy further into the global value chain, which to me is essential for ensuring the future economic prosperity and stability of this country is well-bedded.

Thank you very much for your time here this morning and I thank all the participants for your contributions and we look forward for a very stimulating couple of days in this hall.