Spotlight: Econ Op-eds in Summary

Week ended 01st April '20

In Summary

The underneath contains summaries of the articles given above, including key extracts from these articles.

1. A brewing storm: Economic impact of COVID-19 on Sri Lanka
By: Kithmina Hewage

- The COVID-19 pandemic has placed both advanced and developing economies at risk. Yet, there is no coordinated global effort to minimise the economic fallout. With a global recession inevitable, a key issue faced is restarting the economy without creating the likelihood of the virus spreading again.

- The Sri Lankan economy has a significant number of export revenue dependent MSMEs. The slowdown in key trading partners like China, the US and EU will lead to severe impacts on export and tourism sectors. Domestically, curfew measures have caused retail and manufacturing to come to a standstill, with MSMEs and informal-sector workers being disproportionately impacted.

- While stimulus measures including rate cuts and moratoriums for vulnerable industries have been introduced, these may not create swift cashflow to affected MSMEs, but could help avoid a domestic financial crisis. The key challenge for the government is designing an effective fiscal response that allows businesses to sustain themselves, while managing a constrained fiscal landscape given the previous tax relief measures and inevitable delays in collecting revenue.

The big picture: Impending global recession

Economies are much more interlinked with each other through supply chains, migration, and vast volumes of international trade. As a result, countries are much more vulnerable to external shocks now than ever before.

The economic implications of COVID-19 on Sri Lanka hinge not only on the situation within the country, but also on critical markets such as the United States, Europe, and China.

Most recessions are caused by a (i) demand shock (e.g. post 9/11 downturn), (ii) supply shock (e.g. OPEC oil embargo in 1973), or (iii) financial shock (e.g. Great Recession in 2008). Covid-19 promises to cause all of them in one blow. As entire populations move into lockdown, and consumer demand falls drastically, the demand shock is clear. Some initial data suggests that global GDP may have fallen by as much as 5% during the first quarter of 2020.

Supply chains around the world have been severely disrupted, creating supply shocks. Even as China restarts its economic activities, the situation in Europe and US will likely cause continued disruptions in the supply chain.

Amidst a push by governments to pass stimulus packages, MSMEs that work on small margins and very little reserve cash are likely to face a liquidity crunch, leading to foreclosures and bankruptcy. The US Federal Reserve has already injected USD 500 Bn into the repo market, which suggests that there are concerns regarding an impending financial shock. As such, an imminent global recession is inevitable.

High risk of unemployment in the Sri Lankan export sector

A global recession is likely to significantly reduce the demand for Sri Lanka's exports, and lead to considerable job losses. During the Great Recession from 2008 to 2010, an estimated 90,000 Sri Lankans lost their jobs due to downsizing amongst manufacturing firms, especially in the apparel sector. Sri Lanka is also susceptible to delays in accessing raw materials for manufacturing from China.

China's economic slowdown could severely inhibit a major source of foreign direct investment (FDI) to the economy. In a recent research paper by the Overseas Development Institute (ODI), Sri Lanka was identified as one of the most vulnerable middle-income countries due to the impacts of COVID-19 and a resulting Chinese economic slowdown.

The current crisis will gravely affect the tourism sector. In January and February alone, tourist arrivals to Sri Lanka fell by 6.5% and 17.7% respectively, compared to 2019. The closing of the Sri Lankan border for foreign passenger arrivals in mid-March, combined with global travel restrictions, will undoubtedly lead to further losses.

Combined with the loss of revenue last year following the Easter Sunday attacks, the drop in global travel will lead to further job losses both in the formal tourism sector as well as ancillary informal services.

Unlike the Great Recession and other recent external shocks, both developing and developed countries are likely to face significant economic downturns during the pandemic. Therefore, given the scale and cross-sectoral nature of the crisis, its economic impact is assumed to be greater than during the 2008 financial crisis.

Worryingly, unlike in 2009, there does not appear to be a coordinated global response to minimise the effects of a global recession.

Social distancing, curfews, and the domestic economy

Enforcing the necessary social distancing measures, and curfews have stalled the local economy. Whilst some economic activities that can be carried out remotely continue, particularly in the services sector, manufacturing and retail services have effectively come to a standstill.

Even though the Government has allowed agricultural production to continue unhindered, uncertainties surrounding temporary lifting of curfew hours and means of distributing essential goods to households result in wastage and a slowdown in the supply and storage of perishable agricultural goods.

The exact short-term economic impact is difficult to estimate just yet. Daily wage earners and MSMEs, including those in the informal sector, are going to be disproportionately affected during the current crisis. MSMEs account for 52% of total GDP and 45% of national employment.

Nearly half the population is employed in the non-agricultural informal sector. The absence of any meaningful economic activity for an entire month, and possibly longer, will severely affect their wellbeing.

Since many MSMEs operate on thin margins and low levels of reserve savings, a prolonged lockdown without adequate support would lead to unemployment and foreclosures, with few surviving until the resumption of economic activities.

Policy solutions unlike any other

Thus far, the Government has taken several measures to ease the burden on the public with an emphasis on low-income households. During the past week alone, the Central Bank has announced additional liquidity measures and downward adjustments to policy interest rates, the Government has issued debt moratoriums for SMEs in identified vulnerable sectors such as tourism and construction, debt moratoriums to the self-employed, relief on personal loans and credit card payments, and reduced the prices of some essential goods. Further measures may be introduced.

The Government has also requested debt-relief, in the form of suspending debt repayments for a time period, in an effort to gain greater flexibility to address the current crisis. These measures have created some breathing space by easing financial constraints for firms and workers, crucially injecting a measure of liquidity into the economy.

These measures do not necessarily create a swift cash flow into the hands of vulnerable groups such as daily wage earners and most MSMEs. A mechanism to provide cash flows will be needed, in addition to policies such as price reductions, since the continuation of curfew or a lockdown would severely constrain disposable income amongst these groups and heighten difficulties in accessing basic essentials.

The broader challenge for the Government, however, will be to design an effective fiscal response that allows businesses to sustain themselves through this period and minimise job losses, whilst simultaneously managing a constrained fiscal landscape.

The high level of Government expenditure required for such stimulus packages, alongside an approximately LKR 650 Bn revenue loss due to tax cuts introduced following the Presidential Election last year, as well as delays in revenue collection during this crisis will all create a significant fiscal burden. An economic relief package may not help all small businesses, but will at least reduce the potential for a cascade of small business defaults, high rates of unemployment, and a resulting domestic financial crisis.

This situation has to be managed as a public health crisis. Countries should be careful not to move too fast in trying to ease restrictions on social distancing measures to restart the economy without realistically containing the likelihood of the virus spreading again.

China is currently attempting to approach this delicate balance, but Sri Lanka is not close to that point yet.

Uncertainty regarding the pandemic as well as global and domestic economic effects will pervade all policies made at least during the next six months.

For the full article – Refer the Daily FT

2. A COVID-19 Recession and Debt Shock in Asia and Sri Lanka scenario analysis
By: Ganeshan Wignaraja

- The severity of the Covid outbreak has led to a discussion around how the recovery would be for Asia. Research suggests if the outbreak is contained within a few months, Asia could likely recover by 2021, after a short recession. Else, a lengthy recessionary period is possible where growth bottoms out to levels worse than the 1997 Asian financial crisis.

- The second scenario seems more likely as the virus continues to spread across the world, leading many Asian central banks and governments to undertake various stimulus measures. These measures are adding on to already high public debt levels which have exceeded IMF benchmarks. In South Asia, Pakistan and Sri Lanka are considered as outliers with very high public debt ratios.

- South Asian economies are facing a triple whammy of rising borrowing costs, falling commodity prices and declining tourism receipts. This leads to pressure on limited foreign exchange reserves, increasing the risk of debt distress. Policy makers should factor the risk of a debt shock when loosening monetary and fiscal policy to mitigate the expected deep recession.

Developing Asia is famous for engineering V-shaped recoveries following the 1997 Asian financial crisis and the 2008 global financial crisis as well as emerging as a key engine of global growth. The severity of the COVID-19 pandemic has sparked concerns about whether global growth will be V, U, L or I shaped and what it means for Asia.

China, the initial epicentre of COVID-19, accounts for 17.3% of global cases while lagging South Asia has 0.5% (26 March 2020). The rapid transmission of the infection is linked to globalization of the world economy and the advent of global travel. It has triggered a public health emergency and an unexpected economic shock. Stock markets across Asia have tumbled and China-centred global supply chains are collapsing. Travel bans and lockdown shave disrupted daily life. Unemployment and income inequality are rising.

Asia grew at 5.6% in 2019 and in January 2020 the IMF projected that this figure would uptick to 5.8% in 2020. It is premature to assess the full economic impact of COVID-19 on Asia as economic data is lacking and forecasting models are not adequately specified to analyse the disruption from the pandemic. The IMF will update its forecasts during the virtually held Spring Meetings in mid-April 2020.

Projections made in a study on the medium-term outlook on Asia's growth and the prospects for middle income countries are being updated using leading indicators (e.g. the manufacturing purchasing managers index) in an attempt to predict significant changes in economic activity. Preliminary research suggests two economic scenarios for Asia and world with the depth of downturn depending on the effectiveness in containing the pandemic.

Scenario 1: a short outbreak and a limited economic impact on Asia. The spread of COVID-19 in Asia is checked within a few months through lockdowns, social distancing, virus testing, quarantine and medical treatment. A vaccine is available ahead of schedule. Asia's growth could be in the range of 4.0-4.5% in 2020. This is above expected global growth of 2.3-2.5%. An upturn in Asia could be likely in 2021. Nonetheless, Asia would fall into recession.

Scenario 2: A long outbreak and a prolonged economic impact on Asia. COVID-19 continues to spread rapidly in Asia, the interventions are partially successful in containing the infection, another virus season could start with new mutations and vaccine development takes longer than expected. The decline in Asia's growth may be in the range of 2.0-2.5% in 2020 and remain sluggish in 2021. This is worse than the bottoming of Asian growth to 2.8% in 1997 during the global financial crisis. Meanwhile, global growth could slip to 1.0-1.5% in 2020.This would constitute a lengthy recession.

As the pandemic is fast moving with the epicentre spreading from China to Europe, an L-shaped Scenario 2 seems more likely than V-shaped Scenario 1. Amid such a bleak outlook, central banks in Asia have cut interest rates and are buying assets to support financial markets. Governments are also undertaking fiscal stimulus and welfare measures.

Looking at Asian debt dynamics helps to grasp why they are intervening. IMF suggested prudential benchmarks on public debt of a debt to GDP ratio of 60% for developed economies and a debt to GDP ratio of 40% for developing economies.

With a government debt to GDP ratio of 58.8% in 2019, Asia has exceeded the benchmark for developing countries and is approaching that for developed economies. China's government debt to GDP ratio of 60.9% in 2019 is argued to significantly understate the total debt to GDP ratio of 303% when corporate and household debt are included.

The pandemic has led to concerns about high debt in state-owned enterprises and corporates held in a fragile shadow banking system. South Asia's government debt to GDP ratio of 66.5% in 2019 also exceeded IMF benchmarks with outliers Pakistan and Sri Lanka at about 80%.

Interestingly, there is little evidence of a Chinese 'debt trap' due to commercial borrowing for infrastructure projects at least in the case of Sri Lanka. Graduation from concessional aid has left Sri Lanka more dependent on commercial borrowing from international capital markets. The pandemic has left indebted South Asian economies facing a triple whammy of rising borrowing costs, falling commodity prices and declining tourism receipts. This has put pressure on limited foreign exchange reserves and increased the risk of debt distress in South Asia.

The current COVID-19 trajectory points to a scenario of a long outbreak and a prolonged economic impact on Asia. Policy makers should upscale health interventions as well as loosen monetary and fiscal policy to save lives and mitigate a deep recession. In doing so, the risk of a debt shock needs to be factored into the policy calculus.

For the full article – Refer EconomyNext