Spotlight: Econ Op-eds in Summary

Week ended 15th December '21

In Summary

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

Falling forex reserves and policy errors when will our policy leaders come to their senses
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- Sri Lanka reserves has fallen to US$ 1.6 bn by end of November with liquid reserves being only US$ 1.1 bn. With a massive debt obligation to be met within the next 12 months, economists have urged the government to go for an IMF bailout package. The Government however had strongly denied the assistance of the IMF and expect to rely on a more home-grown solution.

- Under these circumstances, similar to 2008, India has issued a statement showing its willingness to help Sri Lanka, which include various credit facilities for essential foods, medicine and refined oil as well as SWAPs and FDIs in Sri Lanka. However, these have not materialized so far.

- The expected inflows in governments' road map have also been unsuccessful due to overestimation and focusing on gross flows instead of net flows. The government is already late in reaching the IMF as it may take months to finalize the bailout package.

Falling forex reserves

Sri Lanka's foreign exchange reserves are falling dramatically month after month. According to the data released by the Central Bank last week, foreign exchange reserves have declined from US$ 2.3 bn at end-October to US$ 1.6 bn at end-November.

When one deducts the gold reserve and the position with the IMF, the immediately available liquid reserves are marked at low US$ 1.1 bn, just sufficient for paying for a little more than two weeks of future imports. Along with this, the Central Bank's net foreign asset position has been estimated to have risen to an all-time high negative position of US$ 1.9 bn, up from US$ 1.3 bn a month ago. This is an extremely critical situation about which the independent writers had repeatedly warned the Central Bank's management. But the response had been a mood of complacence driven by a feel-good sense reinforced by the expectation of a rescue package from friendly countries.

As the declining data have shown, these expectations have so far not materialized. Apart from the high import bill, the country should meet foreign debt obligations amounting to about US$ 7.3 bn in the next 12-month period. The available reserves are only a fraction of this total commitment. Unless Sri Lanka could attract a new mega size inflow in December, the situation will deteriorate to a level beyond redemption. That includes a possible default of the country's loan repayments for the first time since independence.

Six-Month Road Map is claimed to be a dynamic one

Prognosticating this oncoming catastrophe, several leading independent economists had repeatedly requested the country's economic policy leaders that Sri Lanka should seek a bailout package from the International Monetary Fund or IMF. Dismissing this request blankly, the top policy leaders claimed that 'IMF was not the option' and they have a more effective 'homegrown solution'. This homegrown solution was presented by Central Bank Chief, Ajith Nivard Cabraal, in a Six-Month Road Map on 1 October 2021.

He assured the markets that the Central Bank has the necessary expertise to design a solution to the country's grave foreign exchange crisis sans IMF and that solution is already in use. The main component of the solution was to attract new foreign exchange flows to the country immediately. The total gross inflows expected during October-December 2021 amounted to a staggering US$ 10.85 bn. When these gross inflows are netted against the expected imports of US$ 5 bn and other forex payments of US$ 1 bn, the net inflows will amount to US$ 4.9 bn. This is a comfortable net inflow that should increase the country's gross foreign reserves to a minimum of US$ 7 bn by now.

Instead, the actual reserves have fallen to US$ 1.6 bn completely foiling the goals of the Six-Month Road Map. It is therefore time for the Central Bank to go into a diagnostic study as to how its goals have not been attained despite the superior in-house expertise used in putting the homegrown solution to practice. In the concluding slide of the presentation by Governor Cabraal, this has been promised when he said, "This is a dynamic plan, we will tweak it, fine-tune it, or even change some parts, as we move on!"

Requesting for Indian support

In this background, a consolation is the recent visit to India by Finance Minister Basil Rajapaksa to negotiate for a relief package from that neighbor to the north. India as a good neighbor had come to Sri Lanka's rescue in the past. In 2008, on the initiative of present Governor Ajith Nivard Cabraal who was the Governor at that time too, when IMF was sitting on an application for a loan facility of US$ 2.6 bn amidst a similar foreign exchange crisis, India's then Finance Minister Pranab Mukherjee who later became India's President boldly announced that if IMF did not approve of the facility, India would provide these funds to the country.

It did the trick and IMF hastily approved of the facility. India did not stop at that. It arranged a SWAP facility of US$ 1.5 bn in two stages through its central bank, Reserve Bank of India, for Sri Lanka's Central Bank.

Press release by Sri Lanka High Commission in India

After Basil's two-day visit to India, Sri Lanka's High Commission in New Delhi had issued a press statement outlining the broad agreement received by the two parties. It had four elements of support to Sri Lanka.

- India will provide a credit facility to enable Sri Lanka to import essential foods, medicines, and other items.
- India will extend a further credit facility for the importation of refined oil from India, while taking action to modernize the unused oil tank farm in Trincomalee early.
- Reserve Bank of India will extend a currency SWAP facility to the Central Bank.
- Indian Foreign direct Investments or FDIs will be facilitated to flow into Sri Lanka.

The press release has further elaborated that "modalities to realize these objectives will be finalized early, within mutually agreed timeframe". It seems that what has been agreed is only a broad framework without deciding on the numbers in the rescue package. Hence, it is too early to assess the adequacy of the package against the forex commitments which Sri Lanka faces in the next six-to-twelve-month time period.

It is Sri Lanka which is suffering from the festering wound. If it goes untreated, the development of a fatal gangrene cannot be avoided. Hence, the Central Bank is required to act in double-quick time to get India to deliver the promised rescue package in adequate amounts. Any delay in the delivery even by one week will be fatal to the ailing Sri Lanka's economy.

Unrealistic goals of Six-Month Road Map

How have the goals of the Six-Month Road Map gone astray? Two reasons.

- That it talks about only the gross flows and not net flows.
- The overestimation of these gross flows.

In the first place the Government was expected to generate an inflow of US$ 2.85 bn by way of mainly government to government loans and sale of unused assets of the Government. This has been an overestimate and only a fraction has been received during this period. The sale of unused assets had expected to generate US$ 500 mn, but nothing has so far been sold.

Foreigners were expected to invest anew in Government securities some US$ 250 mn. Instead, they have declined from US$ 9 mn to US$ 8 mn. The expected syndicated loan of US$ 300 mn has so far not been contracted out. Sri Lanka Development Bonds held by offshore banking units were expected to be rolled over to the extent of US$ 200 mn. With a grave foreign exchange shortage in the market, only a fraction could be rolled over.

The Central Bank had expected to go into new SWAPs of US$ 1 bn, domestic SWAPs of US$ 0.5 bn and purchase of forex from remittances and export proceeds amounting to US$ 150 mn. Again, on a net basis, the Central Bank has sold and not purchased foreign exchange from the market during October. As promised in the presentation by Governor Cabraal, it is time now to revisit these goals and reset them based on the ground realities.

Threat with a stick while offering carrots

Exports also have been overestimated by about US$ 100 mn per month thereby creating a gap of about US$ 300 mn during this period. What has been mostly overestimated has been the remittances by Sri Lankan migrant workers. The Road Map had expected to receive at the rate of US$ 600 mn per month during this period. However, the actual receipt has been only a half that goal. Then, through a draconian rule under which these remittances have been listed as services sector earnings, those workers have been asked to convert such remittances received after October into Sri Lanka rupees before the seventh day of the following month.

This is a violation of the agreement which the banks had entered with those private foreign currency account holders. That agreement was to keep them in foreign currency form so that account holders could withdraw them in foreign currency as they wished. When the remittances flow fell nearly by half during October and November compared with what the country had got in previous years, the desperate Central Bank had introduced an incentive payment of Rs. 10 per US dollar for the remittances to be received during December.

The objective has been to attract them into the formal banking sector which are presently sent via informal sources at black market prices of about Rs. 240-250 per dollar when the official central bank rate happens to be at around Rs. 199 per dollar. It is a carrot, but the bank has used a stick too to frighten the remitters and those who help them. Under this stick clause, four money changers have been taken to task by the Bank under the Foreign Exchange Act. Given the high black-market margin over the Central Bank's controlled exchange rate of Rs. 199 per dollar, it seems that both the carrot and the stick have been too short.

No impact of conversion on improving forex flows

Despite what the Central Bank believes, the forced conversion has no impact on increasing the forex flows to the country. Instead, it has created innumerable inconveniences to those who work abroad and genuinely remit their savings to private foreign currency accounts in Sri Lanka. This seems to be due to wrong defining of service incomes as 'any service provided abroad' that includes working under an employer too.

Frightening the migrant workers

Let's look at the first factor. These remittances have already been received by Sri Lanka's banks in foreign currency and therefore included in such forex flows. For instance, when a dollar is received into such a private foreign currency account, the bank which credits it to the private foreign currency account assumes a liability but acquires a dollar as a foreign exchange asset. This asset is already in the country's forex flows. But the conversion requires the account holder to transfer it to a rupee account at the rates fixed by the Central Bank. Thus, what happens is that a forex liability held by the commercial bank is now converted to a rupee liability. This is not only a violation of the original mandate, but also a tax on the account holders.

When the banking practices are changed in such a haphazard manner, the country's banking sector loses its reputation. Therefore, it affects the future remittances flows. In addition, these account holders operate their private foreign currency accounts by using debit cards from abroad. They make their day-to-day payments through this mechanism. However, when the debit card does not authorize the payment due to the forex shortage with banks, these account holders face innumerable difficulties there. It is likely that they will choose to shift their accounts to countries where there are no such restrictions. On this ground also, the country will lose its future remittances.

Allow the rupee to fall to eliminate the black market

The Central Bank, instead of eliminating the black market by allowing the rupee to fall in the market, has stuck to its gun by stubbornly fixing the exchange rate at Rs. 199-Rs. 203 per dollar. Since dollars are not available in the market at these rates, the unsatisfied demand has given birth to a lucrative black market where the rates range between Rs. 240 and Rs. 250.

Therefore, the Central Bank's incentive payment is not an incentive at all, but a tax on the remitters. It has prevented them from getting this higher rate which is prevalent in the unofficial market. In general, when an exchange rate is fixed by governments arbitrarily below its realistic rate, it serves as a tax on exporters and a subsidy paid to importers. This is what has happened to migrant workers who have been remitting money to Sri Lanka regularly.

IMF is the option, but it is too late now

The long-term viable solution for Sri Lanka to come out of the present grave forex crisis is not following this unviable homegrown solution but seeking a credit facility from IMF, of which Sri Lanka has been a member since August 1950. Given the fact that Sri Lanka has now been driven to the wall which it cannot scale, it is already too late to go to IMF today. If the Government makes its forward move today, the facility will be delivered to Sri Lanka by mid-2022. The country now has the problem of how to survive during the intervening period. In that context, a sizable rescue package from India will be a bonus for the country.

For full article – Refer Daily FT

2. Will Indian assistance resolve Lanka's balance of payments crisis?

- The outcomes of the finance ministers recent visit to India are still unclear. Despite the government indicating a possible currency swap and several credit lines, these may require Sri Lanka to seek the assistance of the IMF as well as to agree to conditions such as investments by India in strategic local industry and services.

- These conditions could be the reason for the currency swap not materializing. The Indian aid remains a shorter-term anesthetic for the weak external finance situation and resolving of current shortages. Sri Lanka needs to look for medium or longer-term solutions.

- According to many economists the IMF programme would be the least painful solution which would also result in support from organizations such as the World Bank, IDB, ADB and bilateral donors, as it makes Sri Lanka more creditworthy.

The requested aid from India does not appear to have been finalised yet. The requested aid from India is of crucial importance in the current critical bind in external finances of the country and inability to import essential commodities. However, it is not a solution to the medium term balance of payments disequilibrium

Uncertain

At the time of writing this column, it is not clear whether the assistance sought by the Finance Minister on his visit to New Delhi has been granted or whether further negotiations are afoot to secure them. The fact that there has not been any official communiqué from either government implies that the aid package has not been finalised.

Accountability

Financial accountability and prudence of the Indian government may require Sri Lanka to seek IMF assistance as a condition to provide the aid package. This is especially so with respect to the currency swap. There may also be conditions regarding Indian investments in Sri Lanka that have not been agreed upon.

Imperative

Sri Lanka must obtain adequate financial assistance from India to tide over the perilously low external finances of the country, India's assistance could end the current shortages of food, drugs, petroleum, gas and other essentials.

Request

Sri Lanka has asked India for a currency swap of US$ 500 Mn and credit lines for food, fuel and medical imports. These would be essential to rescue the country from her current perilous state of external finances and to resolve the severe shortages of funds to import essential food, drugs and fuel.

Currency swap

The request for a currency swap of US$ 500 Mn was requested from India some time ago, but has not been forthcoming. India might insist on Sri Lanka agreeing to an IMF bailout package to be certain of our ability to repay Indian loans.

Conditions

We would also have to agree to any conditions that India insists on at this critical juncture in our external finances. We may have to agree to Indian investments in strategic industries and services.

Helpful but inadequate

The Indian aid is a short term palliative that will not resolve the country's fundamental weaknesses in external finances. The country must look towards a more substantial resolution of the weak external finances to be able to meet her debt repayment obligations of more than US$ 4 Bn in the next 12 months.

As the former Central Bank Governor Indrajit Coomaraswamy pointed out at the Economic Summit in Colombo, it is not only the current balance of payments deficit that must be bridged by sufficient external financing, but also the onerous debt service payments of US$ 4 Bn plus over the next four or five years.

Solution

Dr Coomaraswamy emphasised that we need to have a medium-term solution that addresses this external financing challenge. He underscored the fact that there are no painless options. "We need to work out the path, which gives us the least pain," he elaborated.

International Monetary Fund (IMF)

Dr. Coomaraswamy pointed out that: "An IMF programme will provide balance of payment (BoP) support. It will also provide direct budgetary support from the World Bank, IDB, ADB and one or two bilateral donors. In addition, the IMF certification makes us more creditworthy; both the public and private sector would be able to tap into international markets easily."

Economists' advice

Nearly all economists have advised the Government to seek the assistance of the IMF to overcome the country's balance of payments crisis and to follow a programme of economic recovery. The Government's advisors think otherwise.

No painless solution

The former Central Bank Governor, addressing the Economic Summit in Colombo said IMF assistance would be the least painful and most advantageous. He said Sri Lanka should consider an IMF programme along with debt restructuring to get over current external stress.

Summing up

The balance of payments crisis has reached such serious proportions that even if we obtain the expected Indian assistance of a currency swap of US$ 500 Mn and trade credit to import essentials from India these are essential palliatives to overcome the immediate difficulties and not a solution to our balance of payments problem.

Only an IMF programme to restructure our debt and reform our economy could ensure economic stability and growth. In fact, the Indian assistance package is likely on condition that Sri Lanka obtains an IMF facility and agrees to an economic reform programme.

Concluding reflection

It is only a matter of time for the country to seek IMF assistance. The proud boast that we will not go to the IMF on bent knees is unlikely.

IMF assistance is the least costly and most advantageous. The IMF's conditions would be painful but a necessary condition for economic recovery.

For the full article – Refer The Sunday Times