Spotlight: Econ Op-eds in Summary

Week ended 25th September '19

In Summary

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

1. Will reduction of policy interest rates spur economic growth?
By: Nimal Sanderatne

- The Central Bank of Sri Lanka has reduced policy interest rates with the aim of stimulating the economy amidst low inflation levels. This decision was further supported by global interest rate reductions. While these low interest rates, supported by rupee appreciation, is beneficial for businesses, it alone will not promote investments.

- Political and economic uncertainty have further deteriorated with the current election climate. This could lead to fiscal slippages and inflationary pressures which reduced the positive impact of lower rates. Additionally, a change of government could negatively impact trade with Western nations which are the main markets for Sri Lankan exports.

- On the plus side, lower trade deficits, sooner than expected recovery in tourist arrivals, stability in remittance flows, and mixed foreign financial flows have led to a rupee appreciation this year. Recent depreciation pressures are expected to be short lived. Therefore, the available policy spaces should be utilised to support productive economic activities.

The Central Bank's (CBSL) policy interest rate reduction is intended to give an impetus to investment and economic growth.

The CBSL's Monetary Board decided to reduce the Standing Deposit Facility Rate (SDFR) and the Standing Lending Facility Rate (SLFR) by 50 bps to 7% and 8%, respectively. It arrived at this decision after a "careful analysis of current and expected developments in the domestic economy and the financial market as well as the global economy, with the aim of further supporting the revival of economic activity in the context of low inflation prevailing at present and the medium term inflation outlook, which is well anchored in the desired 4-6% range."

Global conditions

In making the decision, the Monetary Board was also influenced by global financial and market conditions due to uncertainties arising from trade tensions and geopolitical developments Many Central Banks in advanced and emerging market economies have reduced policy interest rates to support domestic economic growth, and have signalled that their stances will remain accommodative in the near term. Muted inflation and inflation outlook in these economies have acted in favour of such decisions. The lowering of interest rates in Sri Lanka is, therefore, part of a global wave of interest rate reduction.

Response

No doubt most business houses would welcome this reduction in interest rates. This is especially so as the depreciation of the rupee in the past months has increased production costs. The recent appreciation of the rupee and the lower costs of borrowing would no doubt benefit many enterprises.

Cost of money

The cost of money matters. The supply availability and cost of credit are important determinants of investment. The interest rate reduction would assist business, but whether it alone would be adequate to boost investment is questionable. Investors are likely to be circumspect in investing in the current climate of political and economic uncertainty.

There has to be an environment of policy certainty and confidence in the business environment. These factors have been woefully lacking for some time and have deteriorated in the run up to the presidential election. Furthermore, there would be no certainty after this election as the country prepares for the parliamentary elections in 2020.

Too little

Another reason to doubt a positive impact of the lowering of the interest rate to increase investment is that it is too small. Marginal changes in interest rates do not make a large impact on investment decisions. Furthermore, although the rate of inflation has been kept at middle single digit level, the expenditure overruns that are occurring would lead to a fiscal slippage and inflationary pressures.

Trade prospects

A huge uncertainty is whether trade relations with Western countries which are the main markets for manufactured goods and sea food exports would be jeopardised by a change of government. This is worrisome in the current context of the noteworthy growth in exports since 2017.

Economic growth

The CBSL implicitly recognises the limitations of the monetary policy, and specifically the interest rate policy, to stimulate economic growth.

The CBSL announcement observes: "Prevailing economic conditions and the developments observed in leading indicators point to modest economic growth during 2019 as well. Although economic growth is expected to recover gradually towards its potential in the medium term, domestic and global headwinds are likely to delay this recovery." In this context the CBSL has reduced policy interest rates to ease the prevailing constraints. "Therefore, it is essential that the available policy spaces are utilised to support productive economic activity without disrupting the improvements achieved in relation to macroeconomic stability."

External finances

The silver lining in this inhospitable environment is the improvement in the trade balance and external finances. Exports have increased, imports have declined and the trade deficit has contracted significantly in the first half of the year. There have also been improvements in tourist arrivals and workers' remittances have stabilised.

Foreign financial flows, have been mixed with a net outflow from the Government securities market and a net inflow to the stock market, including primary inflows, thus far during the year. The Sri Lankan rupee appreciated against the US dollar by 2.4% so far during the year, although some depreciation pressure was experienced during the past few days. The depreciation pressure, mainly driven by foreign withdrawals from the

Government securities market by a few investors, is expected to be short-lived. Meanwhile, gross official reserves are estimated at US dollars 8.3 bn at end July 2019, providing an import cover of 5.0 months.

Conclusion

All things considered, the marginal decrease in interest rates is not likely to boost investment. On the other hand, the further lowering of interest rates for savings and fixed deposits could be a disincentive for savings mobilisation. It would certainly decrease incomes of retirees and pensioners.

For the full article – Refer The Sunday Times

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2. Small is not that beautiful
By: Dr. Sirimal Abeyratne

- The stock market is a barometer of the economy at the macro level and of companies at the micro level. Such a measurement of the economy is based on the performance of investments by investors who are motivated by long-term economic and company performance. This, however, reflects only a part of the buyers and sellers in the market.

- The remaining buyers and sellers are speculators who want to buy at a low price to sell at a higher price as soon as possible. This segment becomes an issue when the market is too small where someone who has a sizable amount of money in hand has the ability to buy low and drive the prices up, then sell high, and get out.

- The issue becomes more significant when the government is one of those big players. While the government could make a positive impact using a public fund like the EPF, it could also allow speculators to sell at higher prices and leave the market. This is a major issue given that Sri Lanka is the "smallest" among the Asian stock markets, an issue which should be solved at a policy level.

Stock market volatility

Colombo stock market; sometimes, it became even one of the "best performing" stock markets in the world, but not for long. Similar to the way it went up, it went down too.

The stock market is where company stocks of the listed companies are traded. The buyers and sellers range from individual smaller investors to larger investors, who can be based anywhere in the world.

The larger investors may also include individuals with sizable investment funds in hand as well as institutions such as banks and companies, and various funds which pool individual contributions. On the top of all that, there can be even government-managed funds too.

Stock exchange traders execute the buying and selling orders on behalf of all these investors. Stock exchange markets can exist physically in a particular location as well as virtually as a network of computers, either way facilitating stock trading

Barometer of the economy

The stock market is a barometer of the economy at macro level and of companies at micro level. If we like to sense a "real time" economic performance of a country, the stock market is one of the best places to look at, but with caution.

The buyers and sellers in the stock market are two types:

- Investors - who are motivated by long-term economic and company performance so that their investments are also long-term. If such investments are growing it is a healthy sign of the economy.

- Speculators - who look for "quick bucks" and get out. Speculators want to buy at a low price with speculation to sell at a higher price as soon as possible. But there could be repercussions here.

More importantly, some have got the "upper hand" in the stock market to exercise control over stock prices resulting in undue gains for themselves at the expense of genuine investors; this is where the problem is. Why? One important issue is that the market is too small to accommodate too big fellows.

Small is dangerous

The biggest problem of the Sri Lankan stock market is its "small" size. "Small" is not always beautiful, as it can sometimes be "dangerous" too. The small size can make the market vulnerable to manipulations.

According to reported data, the Sri Lankan stock market has only 297 domestic companies listed; the value of all the company shares traded, which is called the market capitalisation, amounts to $16 bn only. A smaller country – Singapore has 482 companies with $ 687 bn market capitalisation. A poorer country – Bangladesh has 593 listed domestic companies with $ 77 bn market capitalisation.

These figures make the Sri Lankan stock market the "smallest" among the Asian stock markets!

The problem is that someone who has a sizable amount of money in hand has the ability to buy low and drive the prices up, then sell high, and get out! This act may put all other investors in trouble, and even the economy in trouble.

On top of that came the biggest fellow who has absolute powers to shake the market – the government, with a big public fund such as the EPF! Someone may argue that the government can boost a sluggish market by entering into it benefiting the economy. True; but at the same time, it is also true that it has the ability to help someone to sell at a higher price get away.

After all, why the domestic companies are fewer in number and smaller in size is not an issue that can be sorted out within the boundaries of the stock market. It is a policy and political issue that has to be dealt with separately.

For the full article – Refer The Sunday Times